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Economic Patriotism

New game in industrial policy?

Globalisation triggers protectionist reactions. In the current discussion about economic patriotism industrial policy and protectionist arguments are commingled. Economic patriotism arises also as a reaction to growing economic interdependence. National industrial policy cannot be viewed in isolation any more but has to be seen in a global context.

Theory argues against activistic industrial policy. Theory only justifies government intervention in industry if the market malfunctions. Even strategic trade policy and endogenous growth theory, neither of which assumes perfect markets, only justify intervention in exceptional cases. Information continues to be the key problem for active industrial policy. The state presumes that it can identify and pursue trends better than the market players. Information deficits generally result in the benefits of intervention being smaller than the cost.

Different focuses in industrial policy within Europe. The UK broadly takes a liberal attitude to takeovers by foreign investors and is profiting from this openness. France has stronger interventionist traditions and continues to protect prestigious companies. Networks between the political and business elite play a special role. All the same, on international comparison the country is very open to investment. Germany places priority on free market policy (*Ordnungspolitik*) over industrial policy; the creation of national champions is not pushed, which is also due in part to the structure of German industry in terms of company size.

No empirical evidence that intervention is successful. A direct comparison of different industrial policy strategies is difficult for methodological reasons. However, there is sound evidence of a correlation between competition and growth; therefore protectionist strategies are not promising in the long run.

National champions as a threat to the single European market. Protectionist tendencies interfere with the proper functioning of the single European market. Since national breaches of the rules harm competition within the EU, all member states have to shoulder the costs of economic patriotism. Openness continues to be key to long-term economic success.

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1. Economic patriotism = industrial policy + protectionism?

Globalisation and economic patriotism − does that fit together? Obviously, it doesn't. But what might appear paradoxical at first sight is closely connected. Globalisation creates pressure for adjustment and makes change necessary. This is often painful, with the result that markets are shielded from foreign competition through trade barriers, technical obstacles, subsidies etc. and adjustments are avoided or put off. However, the economic patriotism currently in evidence goes beyond classic protectionism. In the public debate "economic patriotism" is used as a general euphemism for a wide array of protectionist and industrial policy measures. On the one hand, the state's aim is to protect the domestic market against competition from abroad through classic obstructions while, on the other, it presumes for itself the right to shape corporate decisions at home. For instance, by deliberately influencing company size, governments can seek to create national champions in a given industry which then become unlikely takeover candidates themselves because of their size or rules of law. Local content requirements are a prime example of a mix of classic protectionist measures and an industrial policy agenda. Traditionally, rules requiring that at least part of a product's value is created locally were introduced to support domestic employment and income creation. However, there is a tendency to go beyond that, for instance by setting ceilings also for foreign investments in firms. There can also be more or less explicit pressure to enter into joint ventures with local firms since otherwise foreign companies do not have access to public contracts.

Growth in cross-border mergers …

With growing economic interdependence, cross-border mergers are also acquiring greater importance. Companies based in the EU have completed over 20,000 transactions in the past twelve months (at the height of the New Economy boom the figure was not even half that), and cross-border transactions already account for 63% of all European mergers and takeovers. Driven by favourable financing opportunities on the international capital markets, we are witnessing the next stage of globalisation.

… triggers protectionist reactions in many cases

One step forward and two steps back is the conclusion that can often be drawn, for this frequently triggers protectionist reactions. The public reaction and government action often reflect national egoisms. The proposed takeover of the British port operator P&O by an Arabian company sparked huge public protests in the USA as six US ports would also have been operated by the new owner. According to an Internet survey by CNN 64% of the respondents stated that they would rather have the US ports managed by the mafia than by an Arab company. Legislation to tighten the control over foreign investments is currently also in preparation.[1]

That economic patriotism is also finding such a strong echo on the eastern side of the Atlantic should give still more cause for concern. The majority of the takeovers currently under discussion were projects within Europe such as the Italian energy company's plans to take over the French utility Suez, E.ON's bid for Endesa or the case of Poland (banking sector). Ideally, the bidder's nationality should

[1] Legislation is currently pending before the US Senate which extends the rights of Congress to examine foreign direct investments from national security aspects. While at present only security-relevant sectors in the narrower sense are vetted, the new law would also cover "critical structural sectors" which leaves considerable leeway for interpretation.

not play a role any more, at least within the single market. Quite apart from that, given global interdependence and multinational companies it is unrealistic anyway to set store by a company's nationality.

M&A on the rise

Buyer	Targeted Company
2005	
Telefónica (ES)	O2 (GB)
Unicredit (IT)	Hypo Vereinsbank (DE)
Pernod-Ricard (FR)	Allied Domecq (GB)
Santander Central Hisp. (ES)	Abbey International (GB)
Boots (GB)	Alliance Unichem (GB)
Metrovacesa (ES)	Gecina (F)
Saint-Gobain (FR)	BPB (GB)
Deutsche Post (DE)	Exel (GB)
Lufthansa (DE)	Swiss (CH)
2006	
Suez (FR)*	Gaz de France (FR)
E.ON (DE)*	Endesa (ES)
Linde (DE)	BOC (GB)
Mittal (NL)*	Arcelor (FR/LU)

* proposed takeovers

Sources: Spiegel March 6, 2006, DB Research

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Proponents of state intervention in industry field a number of different arguments. At the top of the list is the alleged concern about domestic jobs. With the utilities industries such as gas, water and electricity the question of safeguarding public supply plays an important role. This is often linked with national security and strategic reservations. On top of that, there is a vague feeling of losing sovereignty. This is obviously a problem not only for governments, whose scope of control is crimped by globalisation, but also among the population where there are widespread concerns.

But are these doubts really justified? This study aims to provide an overview of the subject of industrial policy in the context of the current debate about economic patriotism. In many cases it is no longer possible to draw a clear dividing line between national industrial policy in the sense of government influence on companies at home and protectionism in the sense of trade barriers to the outside world. Nonetheless, in the following the focus of the discussion will be on industrial policy, but within the context of a globalised economy.

1.1 Concepts

The debate about industrial policy mirrors the fundamental question as to whether government intervention in industry makes sense or not. "Industrial policy" is understood generally to mean state measures to support certain industries. However, what means are suitable for this purpose is a moot question. Basically, there are two opposing factions. Proponents of a competition and location-oriented policy argue that the state should concentrate on creating good framework conditions for industry but stay out of corporate decision-taking. This is a perception of industrial policy which leans heavily towards a free market policy. Others, in turn, argue in favour of a more active state which furthers deliberately and also focuses on individual companies with a view to creating national champions. This includes deliberate government influence on company size. The dividing line between furthering domestic firms and protecting them against foreign competition is fluid, and protectionist measures are often an established means.

Free market policy or interventionism?

Between these two extremes there are a great many shades of action. In practice, not only the basic orientation is at issue, but also the choice of the goals and means. If you favour government support, the question is then which industries to chose. Should funds be allocated with a view to the future, for instance by investing in solar technology and biotechnology, or should industrial policy also help cushion structural transitions? What appears politically opportune does not always make economic sense. While views on the need for government intervention differ widely in the public discussion, economic theory presents a clear-cut case.

2. Theory sees state activity confined to framework conditions

From a theory point of view, state intervention should take place only on a very limited scale. Although economists do not always agree on how industrial policy should in fact be shaped, there is broad consensus on one point: markets are the most efficient mechanism to allocate resources. This is based on the understanding that markets use information fast and flexibly and investment decisions are adjusted accordingly. This point is the key issue for industrial policy. Governments wishing to actively support individual companies or industries must make a choice. Here, they face considerable uncertainty, especially when this involves furthering research or the development of new products. As a rule, they rely on a more limited information basis than there would be available when knowledge of resources, consumers and production processes can be activated through the market process. Markets serve as a process of discovery, as Hayek once put it.

Market malfunctioning can require government action

Theory argues that state intervention is only required when the market systematically malfunctions. Theoretical models which are used as an argument for active industrial policy and from which a need for government action might be concluded, invariably rule out the assumption that markets function perfectly and are always more efficient than state intervention.

The need for government intervention is mostly justified with arguments drawn from strategic trade policy and new growth theory.

2.1 Strategic trade policy

When a country pursues "strategic trade policies", government deliberately takes action to influence strategic relationships between companies.[2]

Strategic trade policy abandons model assumptions of constant returns to scale and perfect competition, and in so far is more realistic. The theoretical groundwork was laid by Brander and Spencer. Although it was originally developed to explain trade policy decisions, the basic arguments of the model are also used in the

[2] "The government becomes the first player in a multi-stage game and can influence the equilibrium outcome of the game played by private agents by altering the set of credible actions open to them." See Brander, James /Spencer, Barbara (1983). International R&D Rivalry and Industrial Strategy. NBER Working Paper 1192.

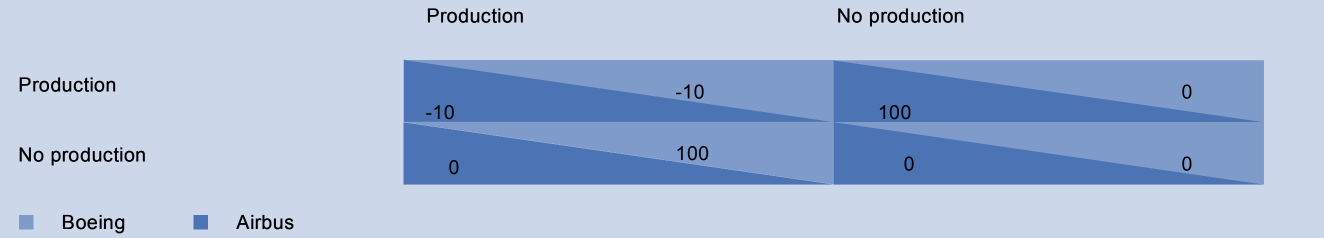
context of industrial policy. Increasing returns to scale (economies of scale and scope) yield size advantages for companies operating within oligopolistic markets. In this situation the state can improve companies' strategic position by distributing subsidies (for instance as grants for research and development projects) selectively to specific firms. Owing to the oligopolistic market structures, government support can skew the competitive situation quite considerably.

Strategic trade policy can be seen as an argument for an industrial policy that selectively furthers individual companies so as to achieve strategic advantages. Although the theoretical logic is consistent, the argument has only limited validity in practice. In reality, governments generally do not have the information or the resolve to pursue strategic trade policy successfully. This is presumably also because other states could take similar measures in response to strategic trade policy so as not to be placed at a disadvantage, with the result that the desired objectives are not achieved.

However, if they counter the government support policy perceived as "unfair" with the same weapons (catchword "retaliation"), there is the threat of a subsidisation race and/or the erection of reciprocal barriers (protectionist spiral). In either case all those involved are worse off than before intervention. Nonetheless, because of the prisoner’s dilemma[3] it is difficult to find a way out of this situation. The decisions are mutually interdependent and nobody is willing to make the first move (and bear the related costs).

A game theory example of strategic trade policy

The aerospace industry is mostly cited as a classic example of strategic trade policy and its application to industrial policy. Let us assume that Boeing and Airbus both decide to produce a new model. Owing to the high development costs production only pays if one manufacturer supplies the whole market. The following payoff matrix summarises the situation for the two companies:



If one of the two companies (say Boeing) has penetrated the market first, it does not make commercial sense for the other to enter the market since it risks making a loss (if both companies produce, the payoff in each case is -10). If either Airbus (A) **or** Boeing produces, the respective supplier receives 100 million $, while the other company has no revenues. If neither produces, the profit for both companies is nil. If the two companies produce simultaneously, both lose 10 million each. At this point there is government intervention. If Airbus receives subsidies of 15 million $, it makes sense for the company to enter the market (payoff for Airbus with subsidies +5 million $, payoff for Boeing -10 million $). Without government support Boeing would withdraw from the market in the long run and Airbus would be the sole producer (payoff +100 million $) and would therefore be profitable also without subsidization. Example cited from Dominick Salvatore: International Economics (5th edition).

[3] In game theory the term "prisoner’s dilemma" refers to a decision-making situation where the outcome depends not only on the one player's decision but also on the other player's decision. The player taking the decision therefore has to consider the other player's reaction to the decision. See Mankiw, Gregory (2004). Grundzüge der Volkswirtschaftslehre.

2.2 Endogenous growth theory

A second possible justification for government intervention is presented by endogenous growth theory.[4] According to neoclassical growth theory technical progress is an exogenous parameter. By contrast, in endogenous growth theory, as first developed by Paul Romer and Robert Lucas,[5] technical progress is viewed as the result of investment in human capital and research & development. However, since these areas are exposed to strong external effects, there are not sufficient investors. As a result, less technical progress is generated via the market than would be optimal in terms of economic welfare. This provides a rationale for governments to support research activity. All the same, this argument cannot be used unreservedly to justify an activistic industrial policy. In practice, the information problem still remains. A conclusive recommendation for state activity can only be derived for the area of basic research since this is where the strongest external effects are assumed to lie. Even proponents of a liberal industrial policy would not deny the state the right to provide support in this area. In fact, it can be argued that basic research is already implied in the call for government to create conducive framework conditions, not least of all since ultimately this also means investment in the education system.

2.3 Information problems are key

Basically, poor information is the key problem for an active industrial policy. There is no evidence that the state has an information lead as far as the success of new products and technologies is concerned. Rather, a number of problems emerge when politics, not the market, decides how funds are allocated. Firstly, there is the danger that efficiency is relegated to second place as a decision criterion, since there is the temptation for politicians to be guided by other factors. This can mean that it is not the most profitable and promising projects that are supported but those where vested interests are best organised. Furthermore, the pressure to achieve visible successes at short intervals (election cycles) can encourage short-term thinking with the result that sustainable long-term strategies are neglected. The prestige thinking of political leaders can distort the process of project selection. In the worst case the quest for high-visibility image-building projects can become the end purpose of industrial policy measures.

Rent-seeking as a negative effect

Secondly, an industrial policy that actively allocates financial support to individual companies encourages rent seeking. In this case companies compete for government support and allocate resources to lobbying in order to influence political decisions in their favour. Even if individual firms might be better off if they receive subsidies, from a macroeconomic viewpoint this process wastes resources. Furthermore, the lobbying process is always biased towards established firms. New, possibly as yet undiscovered technologies have fewer contacts and resources to win government support. This fundamental asymmetry casts doubt especially on government claims to further "tomorrow's technologies".

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[4] See Burda, Michael/Wyplosz, Charles (2001) Makroökonomie. Eine europäische Perspektive.

[5] Lucas, Robert E. (1988). On the Mechanics of Economic Development. Journal of Monetary Economics, 22 (1). Romer, Paul M. (1986). Increasing Returns and Long-run Growth. Journal of Political Economy, 94(5).

Who ends inefficient projects?

Another argument derives not so much from political economics theory but from practical observation. Experience shows that political leaders have difficulty withdrawing support once it is given. This applies not only in cases where financial support has become superfluous (for instance because products have already become firmly established in the market) but also in cases which were a mistake from the start. After all, no decision leader likes to admit publicly that he or she was wrong. In most cases cutting subsidies also involves political costs such as the loss of votes. This is an inducement to shelve necessary decisions for as long as possible. At the same time, long-term support can lead to a kind of subsidisation mentality on the part of the companies. In the worst case the lack of competitive pressure can even lead to less being invested in research and the results not being used effectively to bring commercial products to the market. All in all, it is an illusion to believe that protectionism can help save jobs or even create new ones. Intervention and government protection only delay the necessary adjustment processes. In the long run only competitive firms can create jobs. So competition is important.

Active intervention is therefore at best risky and in the worst case the damage it causes to the economy by far outweighs any benefits created. All the evidence thus indicates that state activity should focus on creating growth-conducive framework conditions in line with free market principles.

Japan: Long-run impact of industrial policy

For a long time Japan was regarded as a model example of active government industrial policy. It was coordinated centrally by the MITI (now METI). When analysing Japan's industrial policy economists point to the dual character of the country's economy. Highly competitive sectors (automobiles) contrast with uncompetitive sectors (chemicals). It is argued that this structure is also reflected in Japan's industrial policy (Busch, Berthold: Renaissance der Industriepolitik), with the majority of the interventions being focused on low-growth sectors where there are still cartels and market entry barriers, while the competitive industries faced up to the competition and were rarely targeted for government support. Following this argument, Japan's industrial policy would be oriented more towards protecting rather than furthering individual companies.

Howard Pack takes a different view and comments that Japan's industrial policy has been a success in the long run because it does not just rely on protectionism but also contains competitive elements (Pack, Howard: Industrial Policy: Growth Elixir or Poison?). For instance, support was also withdrawn if companies did not meet targets. Based on a number of assumptions an estimated roughly 1% of growth in manufacturing industry is attributed to industrial policy. However, since the stagnation in the 1990s Japan's industrial policy has come in for increasing criticism. Although it may have helped the country to catch up in economic terms, it has been seen to be unsuitable for solving structural problems within the economy.

3. Industrial policy in practice – a comparison

In practice, industrial policy looks different in many cases. Even Europe is a mixed bag, with some countries taking a more liberal stance while others favour intervention.

3.1 The UK: "Wimbledonisation"

In Britain's view, a successful industrial policy is one that creates the best possible framework conditions for private industry. On European comparison, the UK has the most liberal attitude towards acquisitions and favours an open approach to the capital markets. In the last ten years more than 300 billion pounds sterling has flowed into the UK in the form of foreign direct investment.[6] Meanwhile, over one-third of the Financial Times Stock Exchange 100 companies are foreign owned. National symbols appear secondary. In the late 1990s even Gieves & Hawkes, the Queen's tailor, was acquired by the Chinese holding company Champion. Electricity and water companies are also being taken over (for instance Powergen and Thames Water by RWE), while EDF of France already supplies one in every four British households with electricity. Even the computer business of one of the biggest suppliers of defence electronics (Racal) was sold off.[7]

London is particularly attractive for foreign investors. Although the number of government interests in industry has been substantially reduced over the past 20 years, the state still has key holdings in many companies. One-fourth of the world's financial services firms have their European headquarters in London. It is estimated that over 3,000 institutional investors operate there, and more than 100 of Europe's top 500 companies are based in London. There is even

[6] See Harrington, Simon (Edt.) (2006): Foreign Direct Investment 2004 Report. National Statistics.

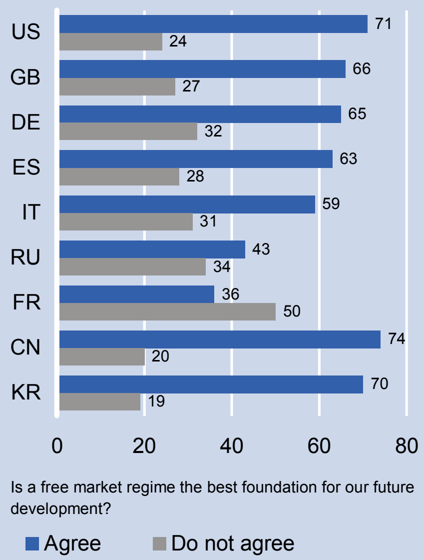
[7] Platinum Equity Holdings Inc (USA) bought the computer and communications division. All the same, in the defence industry the British government reserves the right to scrutiny deals closely and intervene if necessary.

Takeover Directive

The EU has been debating a directive on common takeover rules for fourteen years. The outcome is a compromise which has to be translated into member state law by May 20, 2006. Whether a common practice will be adopted is more than questionable. The directive leaves considerable scope for discretion and options for the member states. Only five EU member states (NL, LT, LV, PT, GR) intend to prohibit obstacles such as multiple voting rights or shareholder contingency resolutions as the original intention had been. The management board's duty of neutrality is inclined to be freely interpreted, and four member states (DE, DK, PL, NL) do not even intend to write this clause into national law. The directive also contains a reciprocity clause and makes the obligations null and void if a foreign bidder is not subject to the same rules as apply in the respective country. Despite the scope for individual adjustments it is still unclear whether the directive can be implemented on time. So far only Denmark and Hungary have done so.

Against the backdrop of the wave of mergers rolling across Europe some member states have seized on the discussion about the implementation of the takeover directive to introduce national safeguards. France, for instance, has enacted a law that allows so-called poison pills to be used as a defence against takeovers (issuance of additional shares on more favourable terms so as to drive up the price). By decree, sectors have also been identified which enjoy special protection against takeovers (e.g. casinos, defence technology, biotechnology and information technology).

Free market economy



Is a free market regime the best foundation for our future development?

Source: World Public Opinion **2**

talk of a certain "Wimbledonisation" of British industry: the UK is hosting the tournament but the majority of the players are from other countries. But this seems hardly to trouble anyone in the home of "fair play". Even interest groups such as the Trade Union Congress have no objections to foreign takeovers since, if anything, the new owners would invest more than the British. It is estimated that last year alone some 40,000 jobs were created in the UK by foreign firms.

3.2 France: Openness despite patriotisme économique?

France is considered the home of "patriotisme économique" and it would seem that Colbert's heritage is still much in evidence. The French government deliberately pursues a strategy aimed at creating national champions, in other words specific companies receive financial assistance and especially political support. This involves direct intervention by the state in corporate decisions. Last February it was the Premier, Dominique de Villepin, for instance, who announced the merger of Suez and Gaz de France even though he is not head of either company. The orchestrated merger of Suez and Gaz de France is not the only case where the government has actively favoured a "French solution". The merger of Aventis with Sanofi-Synthélabo was also pushed, and in the case of the ailing rolling stock, ship and turbine manufacturer Alstom the government itself took a 20% stake in the company rather than accept it being taken over partly by Siemens.[8]

The French government not only intervenes in specific cases but also seeks to secure its influence over industry generally, for instance by a bill currently before parliament that would block takeovers in a number of sectors. The definition of important strategic areas is likely to be fairly broad. It is reported that the companies classified as meriting protection also include an important strategic food manufacturer. With a number of big, high-profile companies there is considerable public and political interest in seeing that they remain French in the future.[9]

Informal networks between politics and industry play a very important role, especially between alumni of France's Grandes Ecoles. In this respect patriotisme économique also has strong support from the public which takes a more critical view of the globalisation process.

However, firms are not protected across the board. Rather, there are differentiated rules: while government protects the big, high-profile French brands as national champions, it tends not to intervene in the small and mid-size business sector.

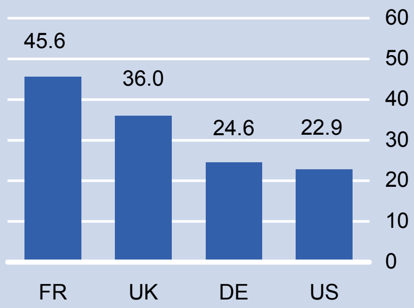
The criticism of protectionism is frequently refuted by pointing to France's openness to foreign investment. Indeed, according to statistics published by the International Monetary Fund, foreign direct investments account for 45.6% of France's GDP, which puts it at the top of the world league.

Nonetheless, economists argue that the larger the economy the lower the ratio of direct investment to GDP. It is therefore difficult to make a direct comparison with other European neighbours such as

8 See Die ZEIT (15.09.2005). Die Wirtschaftspatrioten.

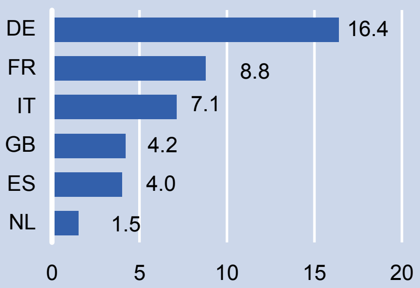
9 This includes companies such as Arcelor, Suez, Danone, Société Générale, Casino, Saint-Gobain, Thomson, Carrefour, Vivendi Universal and about ten other smaller companies. According to unofficial sources they have been placed on a "red list" and are to enjoy special government protection from takeovers. See La Tribune (3.3.2006): La Liste des Entreprises du CAC40 surveillées par Matignon.

Foreign direct investment
as % of GDP



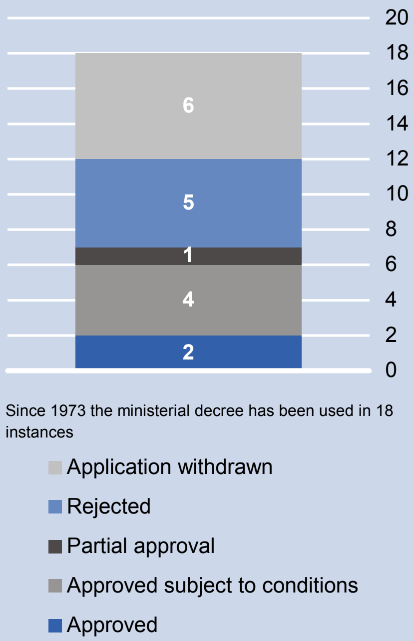
Sources: IWF, Eurostat 3

Total government subsidies by country
Figures for 2003 in EUR bn



Source: EU-Nachrichten 2005 4

Use of the ministerial decree



Source: BMWI 5

Germany (24.6%) since their economies are larger in absolute terms. All the same, a number of indicators suggest that France is indeed far less protectionist than might often appear. France's national statistics institute Insee found that the number of foreign-owned firms and branches more than tripled between 1993 and 2003 (to almost 18,000). Meanwhile, one in every seven persons in employment works for a firm which is not French owned.[10]

On closer sight France's industrial policy therefore presents an ambivalent picture: while there is relative openness in many areas, prestigious companies still receive preferential treatment.

3.3 Germany: Free market policy with small blemishes

Essentially, German policy has a socially tempered market economy approach and is oriented more towards creating framework conditions (*Ordnungspolitik)*. Nonetheless, here, too, the need for government intervention has been an issue again and again, for instance at the time of the merger of the French pharmaceutical company Aventis with Hoechst-AG and the French chemicals group Rhone-Poulenc. In Germany, too, a number of examples of government influence on company structures can be found. Take the case of Holzmann for instance. However, they are not so much a reflection of interventionist conviction but more a proverbial (and mostly unsuccessful) last-minute rescue bid on the grounds of saving jobs. In Germany, there is no active promotion of national champions, at least publicly. Subsidies tend to be allocated across the board, but at the same time quite liberally; Germany is top of the league on European comparison (although the subsidies are partly due to reunification).

In Germany, there is no elite network à la francaise based on long-term personal links between politics and industry. The cosy relationship - dubbed "Germany Incorporated" - which had existed for a long time between domestic financiers, banks and industrial companies has been markedly reduced under the adjustment pressures set in motion by globalisation. Competition and the effects of internationalisation as well as changes in tax law have been contributing factors inducing many big companies to sell off holdings, thus reducing the level of interlocking corporate interests.[11]

Nonetheless, there are also possibilities here in Germany for pursuing an active industrial policy. The appropriate instruments are now even anchored in law. Take "ministerial consent" for instance. By ministerial decree it is possible in specific cases to allow a merger even though it is prohibited on antitrust grounds. However, the merger must be in the public interest or have overwhelming welfare benefits. Decisions by ministerial decree have repeatedly sparked controversy in the past.

Furthermore, it is not only active intervention in the form of financial assistance or political support that has a competition-distorting effect. Government holdings in companies such as the German Post Office (Deutsche Post) or in network industries have been reduced

[10] This excludes the financial sector and (public) administration. See Le Figaro (7.3.2006). Le piège du patriotisme économique.

[11] The average size of the capital market holdings of more than 400 listed companies fell for instance from 31.8% in 1997 to 28.9% in 2001. See Wójcik, Dariusz (2001). Change in the German Model of Corporate Governance: Evidence from Blockholdings 1997-2001. This trend has gathered pace since 2001.

but still provide a certain protection against takeovers.[12] Volkswagen is an example. The classic problem of shielding the home market from foreign competition is still very much in evidence in the utility industries. Insufficient competition leads to losses in macroeconomic efficiency.

To sum up, German industrial policy is oriented more to framework conditions, and the creation of national champions is not pushed. A strategy on French lines would not make much sense either given German industry's strong bias towards small and mid-size firms and the many successful hidden champions. Indeed, it would skew competition especially at the expense of small and mid-size firms. All the same, generally the structures are not as liberal as in the UK for instance. Competitive distortions caused for instance by subsidies are not insignificant, but are often less obvious than in France. German industrial policy is less visible, and appears opaque and even contradictory at times. This is due not least to the country's federal structure, which has led to the existence, alongside each other, of federal and state government policies, especially on subsidies.[13]

4. Intervention or (concentration on) framework conditions?

What possibilities are there for measuring the success of different industrial policy strategies? Macroeconomic indicators such as growth, inflation, per capita income or unemployment give an idea of a country's economic performance but are not very useful for assessing industrial policy. Although industrial policy – whether in the form of active support for specific firms or of creating framework conditions – is a factor which influences an economy's overall performance, it is just one of many. Moreover, measures to improve the framework conditions (for instance investment in research and development or in major infrastructure projects) take a long time to feed through. It is therefore only possible in the rarest of cases to attribute economic performance to the failure or success of industrial policy.

No success discernible at the macroeconomic level

What result active support measures have is also difficult to assess. This would require a comparison with investment alternatives. This is not possible at the point in time when the investment decision is taken since earnings cannot be reliably predicted. It is also difficult to make comparisons ex post facto, since it can never be said with any certainty how the alternatives would have developed ceteris paribus. Multicollinearity, in other words the linear inter-correlation among independent variables, and uncertainty make it difficult to find conclusive empirical evidence for the effectiveness or ineffectiveness of industrial policy. There is little data and no established instruments with which to measure and establish solid empirical correlations. Nonetheless, there are a number of indicators (Fraser, World Bank, Freedom House) which underline the

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[12] The Federal government no longer holds any shares in the German Post Office since 2005 but it transferred a large block to the state-owned KfW (which currently owns 44.7% of the Deutsche Post shares). The Federal government has a 15.4% stake in Deutsche Telekom (source: BMF). KfW's interest has fallen to 17.3% following the acquisition of the block of shares by financial investor Blackstone (source: KfW)

[13] State support for small and mid-sized enterprises for instance falls under the laws of the regional states. Competition between the states can have a beneficial effect in terms of vying for the best political concepts. But at the same time there is the danger of inefficiencies and duplication due to a lack of coordination or competitive subsidisation. See Hepperle, Guntram (2004). Zukunftsorientierte Industriepolitik.

fundamental importance of a liberal economic framework. There is also evidence that openness and competition have a beneficial impact on an economy's growth.[14]

Positive correlation between competition and growth

This correlation is confirmed by experience with the European single market. The European Commission estimates that, as economic integration has advanced, this has led to gains in economic welfare, in terms of additional gross domestic product, of 877 billion euros between 1992 and 2002. Furthermore, some 2.5 million jobs have resulted Europe-wide from the creation of a single market. Obviously, these are just rough figures. But there are everyday examples which provide concrete evidence of the benefits of the single market. Telephone charges and air fares within Europe for instance have fallen sharply over the last ten years because the Commission has been a major force in liberalising these markets. Transaction costs within the EU have also declined since border controls were largely dismantled under the Schengen Accord.

Can the success of industrial policy be assessed better below the macroeconomic level, for instance at the company level? After all, industrial policy strategies which aim to create national champions set out to strengthen specific firms.

It only appears possible to draw more clear-cut conclusions about industrial policy measures in individual cases. Companies such as Fiat, Alcatel or Alstom which presumably only (continue to) exist in their present form thanks to (temporary) government aid. However, survival alone is a dubious measure of success. Views are even divided on the oft-cited positive example of government support, the European aerospace group Airbus. While it is largely agreed that the company owes its existence to active subsidisation, whether it can be regarded therefore as a success is a more contentious issue.[15]

No conclusive successes at the company level either

If we ignore individual examples and try to compare the corporate landscapes in the respective countries, the picture remains blurred. Company rankings do not suggest any conclusive industrial policy success model either, at least when comparing Germany, the UK and France. At the global level, six of the world's Top 50 companies in terms of market capitalisation are British, two French and one German. On the other hand, in terms of sales eight of the world's Top 50 companies are German, four French and two British. Within Europe, 17 of the 50 biggest companies are based in Germany, eleven in France and seven in the UK.

However, we need to be cautious about taking size alone as a measure of success. If a group has not grown from competition but has been forged together as an "artificial" product, there is a great danger that the behemoth may not prove viable or competitive in the long run. If failure then looms, governments are under still stronger pressure to act. If the group is "too big to fail" from a political view, considerable resources are needed to ward off bankruptcy.

[14] See Baldwin, Robert (2003). Openness and Growth: What is the Empirical Relationship? NBER Working Papier 9578; Stefan Bergheim et al., Global growth centres 2020, Deutsche Bank Research, Current Issues, March 23, 2005, pp. 15-16.

[15] See 15th Report of the Monopolies Commission. An added factor is that the aerospace industry is not a functioning market (oligopolies and in some cases state-owned airlines which are ready to buy the aircraft) so government intervention takes place on a different basis.

Germany, France and the UK in comparison

Ranked among the world's TOP 50 industrial companies in terms of sales

Rank	Company	Sector	2004 sales in USD bn
3	BP (UK)	Oil	285
5	Daimler-Chrysler AG (DE)	Automobiles	192
8	Total SA (FR	Oil	166
12	Volkswagen (DE)	Automobiles	126
13	Siemens (DE)	Technology	101
22	Peugot (FR)	Automobiles	73
27	E.ON (DE)	Utilities	69
29	France Telecom (FR)	Communications	63
31	BMW (DE)	Automobiles	60
32	RWE (DE)	Utilities	60
35	Unilever (UK)	Food	54
36	ThyssenKrupp (DE)	Steel	53
40	BASF (DE)	Chemicals	50
41	Renault (FR)	Automobiles	50

Source: FAZ July 5, 2005

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From a company viewpoint, too, political influence can quickly become a drawback, namely if it restricts companies' freedom of manoeuvre. Firstly, there is the danger, especially for big companies, of being permanently under political guardianship. Secondly, it is bad for managers to rely too much on state assistance. If they know that they can count on political support in an emergency, this can encourage them to enter into unreasonable risks (moral hazard issue).

Whether an interventionist industrial policy can help improve the competitiveness of firms is more than questionable. In fact, there are empirical studies which point for instance to a positive correlation between interventionist industrial policy and corruption.[16] This conflicts not only with the aim of generating investment through industrial policy but also harms a country's business environment generally. Proponents of an active industrial policy should also realize that government intervention has its costs. Calls to protect national industry are quick off the ground but it is forgotten that this has to be financed. Active support through subsidies is costly (the losses in economic efficiency not included) and is financed, if anything, through higher taxes or public deficits. Both have an adverse impact on the business perspective.

5. European industrial policy

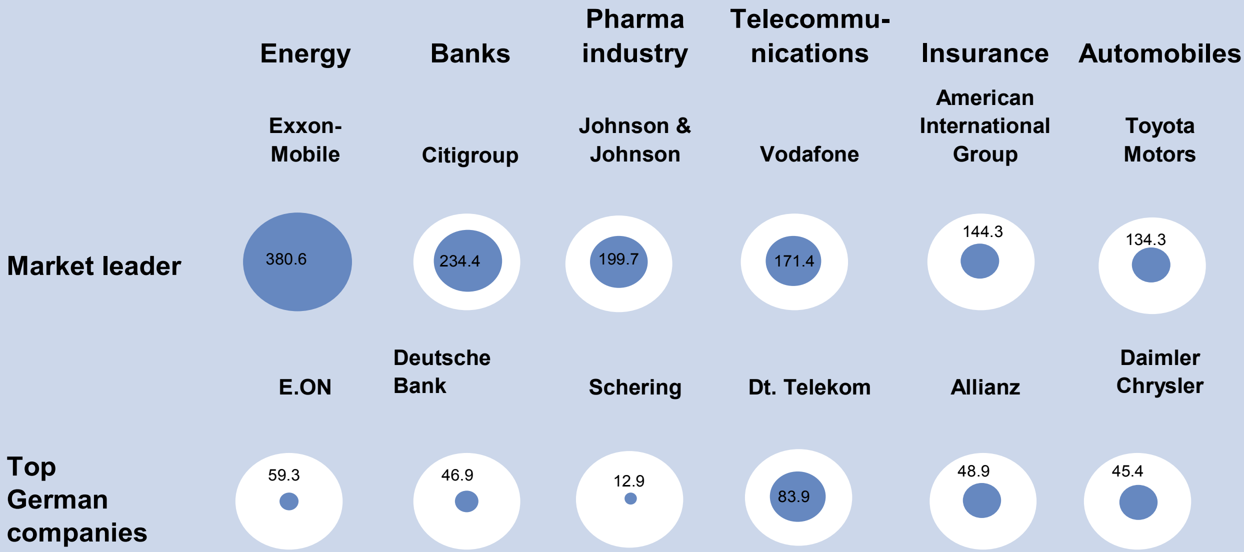
The creation of a single market with common rules is the EU's biggest and most successful liberalisation measure to date, with considerable industrial policy implications. In the early days industrial policy was oriented more towards conserving structures than promoting competition.[17] Since the 1980s the focus has shifted increasingly to the realisation of the single market and a stronger orientation to competition. The aim is to create optimum framework conditions for firms by enforcing internal market freedoms. The Treaty of Maastricht (Art.157 Treaty on European Union) explicitly regulated the Community's industrial policy powers for the first time:

[16] See Ades, Alberto/Di Tella, Rafael (1997). National Champions and Corruption: Some Unpleasant Interventionist Arithmetic.
[17] Much of the aid went to heavy industry (especially steel).

"The Community and the Member States shall ensure that the conditions necessary for the competitiveness of the Community's industry exist".[18] The interpretation of this article has led to frequent discussions in the past. France for instance also cited it when it came to the rescue of ailing groups such as Alstom. Article 157 has an important addendum which is occasionally overlooked: "This title shall not provide a basis for the introduction by the Community of any measure which could lead to a distortion of competition […]". The blocking of cross-border mergers and deliberate government measures to create national champions cannot be justified on this basis.

Top companies in terms of market capitalisation

Selection, market capitalisation in billion dollars (blue circle: Exxon market cap for comparison)



The fact that the market capitalisation of German companies is relatively small on international comparison is also due to considerable differences between national tax and capital-funded pension funds

Source: Fortune Global 500 (2005)

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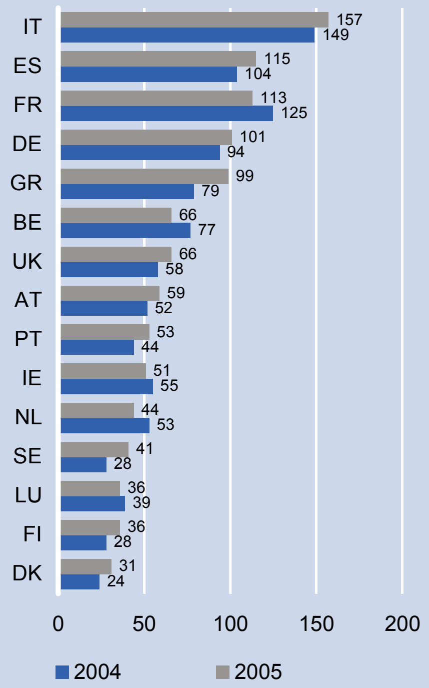
Competition in the EU as an industrial policy measure

In the past the EU has taken important initiatives for more competitiveness, for instance with the white papers on the single market, the liberalization of the network industries or the Lisbon Agenda. Its powers in industrial policy matters, however, go far beyond the role of an initiator and include, among other things, common competition policy, the liberalisation of bidding procedures for public contracts and EU-wide rules for state aid. The Commission has set out again and again to push liberalisation selectively in individual markets – as it is currently doing in the energy sector.

[18] Article 157 of the Treaty on European Union was formulated against the backdrop of the de-industrialisation debate at the time. A few years later, the Commission published a study documenting that there was no significant evidence of de-industrialisation in the EU. Article 157 was left in its original form, however.

Infringements within the EU-15
Number of proceedings



Source: Binnenmarktanzeiger 8

At the same time, it is a benefactor itself, for instance through research support programs. All these measures are aimed at shaping the framework conditions. The concept of "European champions" is confined to a few isolated projects, although their creation is supported in some areas such as aerospace (Airbus/EADS, Gallileo) or high technology (Quaero as a counterpart to Google). In most cases security of supply or national security issues play a role in this context. An example is the development of a satellite-controlled navigation system. But the key role for the EU and for the Commission especially is to defend and where possible to expand on the freedoms that have been achieved and the rules of the single market. It is precisely here that there are often conflicts with national industrial policy aims.

6. Economic patriotism: Threat to the single market

A problem here is that the Commission cannot take fast and effective action against offenders who breach the rules. If a member state infringes EU law, for instance by blocking business combinations, approving anti-competitive mergers or helping national companies to competitive advantages in some other way, the Commission can institute infringement proceedings. They are effective since heavy fines can be imposed by the European Court of Justice, but they take a long time.

The only other possibility the Commission has to penalise offenders is political pressure. However, this, too, can often take quite a long time. Ultimately, the ability to exert pressure effectively on a government depends on support from the other member states. And this is the rub. If one state breaks the rules, others can be tempted to strike back with the same weapons. Who wants to play fair, when others are not keeping to the rules? There is a big risk of being drawn into a protectionist spiral, for if one country resorts to unfair means, political leaders soon come under mounting pressure to "retaliate" and to "return like for like".

Protectionism in the EU does twofold harm

Such a mentality leads nowhere. Instead, there is the danger that in the long run the single market will lose acceptance and reciprocal protectionism will be the result. Protectionism in the EU does twofold harm. First, the country which retreats behind barriers or distorts competition in some other way loses its competitiveness in the long run. National egoisms hurt all other EU member states as the single market is impaired by competitive distortions. Less competition also means less growth. Consequently, it should be in the member states' interest to maintain and expand on the present level of openness, not reverse it. Otherwise, the economic, and possibly the political costs are considerable.

Therefore it is important for the Commission to actively sanction protectionist measures which breach the rules of the single market. But active support from the member states is also vital since only then can the Commission enforce the rules. The Commission's clout will be put to the test not only in the implementation of the takeover directive but also in the upcoming liberalisation of the energy markets.

In theory, any form of cooperation within an international organisation, or in this case within the EU as a supra-national institution, which provides a kind of "public good" (here the single market) faces this dilemma. Rules must apply to all and they must be enforceable. If defection cannot be punished, the number of infringements increases and there is evidence of disintegration.

7. Conclusion

Neither theory nor empirical observations can justify an interventionist industrial policy under the euphemism of economic patriotism, and by no means within the single market. Economic patriotism creates neither employment nor growth in the long run. Barriers and state support which distort competition only lead to necessary adjustments being put off. What is intended as support therefore threatens the competitiveness of companies. State intervention can only be justified in a few isolated cases on grounds of security of supply. However, it must always be closely examined, especially within the framework of the EU, which level can provide public goods most efficiently.

Good framework conditions are key

The best and, at the same time, safest way for growth to be furthered at the political level is to create good framework conditions. Although the proponents of an interventionist industrial policy regard this as a restriction of the scope of state activity, this is only true to a qualified extent. It is right that the state should not interfere in corporate decision-taking. However, this does not mean that governments have no scope of influence. Indeed, creating the framework conditions calls for well-devised concepts, consistency and a high measure of political resolve and the ability to implement them. State activity is required in the area of labour market and tax policy, investment in infrastructure, furthering education and reducing bureaucracy. With effective measures better conditions can be created in the longer term for many business players. And good framework conditions are beneficial in two ways. Firstly, better operating conditions are created for domestic firms. Secondly, good framework conditions make the country more attractive for foreign investors. If there is such a thing as economic patriotism and its true intention is to make the country a more attractive location for business, then openness and competition should be essential ingredients, not protectionism.

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