THE ROLE OF THE STATE IN ECONOMIC GROWTH

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Industrial Policy in Europe

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The global economic crisis of 2008-09 has led to a reconsideration and revaluation of the role of the state in developed market economies. The initial policy responses to the crisis on the part of western governments have consisted in major support programmes of the financial sector in the form of bailing out banks, sometimes involving their nationalizations, together with major stimulus packages to the real sector through expansionary fiscal policies. Following the Eurozone crisis stricter rules have been imposed by the Fiscal Compact, but tough austerity packages have done little to help a more sustained economic recovery. The continuing economic crisis has led to a further loss of confidence in the prescriptions of neo-liberal economic policies and reconsiderations of the role of the state. These changing perceptions are well illustrated by Wade (2012), who reminds us of what used to be the 'near-consensus' for the past two to three decades in the West: 'For the sake of freedom, economic growth and poverty reduction, the state in market economies should limit itself to regulating markets and (sometimes) correcting market failures'. Wade notes that, as of recently, this neoliberal near-consensus has been challenged 'by circumstances with which it cannot contend'. One of the key ideas behind the fading consensus is its rejection of industrial policy. Yet the US government has long practiced a hitherto little noticed type of industrial policy focused neither on the individual firm nor on the geographic region but on networks of firms and a (small) change in the American normative climate has occurred post 2008 in favour of a government steering role in markets. Some middle-income countries, with manufacturing sectors shrinking in the face of East Asian competition, have recently shown renewed interest in industrial policy. Parts of the World Bank have recently begun to operationalize industrial policy, under the banner of 'building competitive industries' (industrial policy by another name), as has not been the case since the mid 1980s (Wade, 2012). Also in Europe, in the search of new policy instruments, the role of industrial policy has been highlighted and heatedly debated, particularly in countries where the crisis has been most pronounced.

Towards a more targeted industrial policy in Europe

Over the past two decades industrial policy in the European Union has increasingly been taken to represent 'horizontal' measures offered to all enterprises without discrimination, replacing the earlier 'vertical' measures in support of 'national champions'. The horizontal policies aim at strengthening enterprise competitiveness through a supportive business environment, incentives for investing in R&D and innovation, support of small and medium sized enterprises, services for the creation

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of enterprise networks and technology parks, incentives for cooperation between research institutions and industry. These 'horizontal' policies have been one of the focal points of the Lisbon Strategy adopted in 2000 and the more recent Europe 2020 Strategy adopted in 2010.

From late 2008 onwards, however, following the strong impact of the global financial and economic crisis, there has been some rethinking of the EU approach to industrial policy. Already in 2010, the Europe 2020 Strategy with its flagship actions on industrial policy stressed a 'targeted approach' based on sector-specific initiatives, identifying sectors for development at the European level such as space industry, clean and energy efficient vehicle technologies, transport equipment, environmental goods, low-carbon production technologies, pharmaceutical and healthcare related industries. There is rising awareness that in order to enhance the global competitive position of the EU, there is a need for a EU-level industrial policy, which would create globally competitive European industries to compete against the rising powers of China, India and other emerging economies (Bartlett, 2014). The EU industrial policy now aims to combine the 'horizontal' approach which remains relevant for national industrial policies as to prevent unfair competition within the EU, with the sector-specific dimension in support of industrial policy cooperation among EU countries in the designated target industries. The new industrial policy draws on the provisions of the Lisbon Treaty, in particular Article 173 of the TFEU on industrial policy (see Bartlett, 2014).

In the meantime, the severity of the economic crisis and bleak prospects of a more permanent recovery in many EU member states have contributed to a further reconsideration of industrial policy as an instrument to re-launch European competitiveness and growth. The economic crisis has underlined the importance of the real economy, particularly manufacturing, for economic growth and recovery in Europe. It is precisely countries that have maintained a large manufacturing base – such as Germany - that have fared better during and after the crisis. Moreover, the recovery has been driven mainly by exports of manufactures. Since the shift away from manufacturing has accelerated during the last decade reaching a critical threshold, there is concern that manufacturing has declined too much. Despite the declining share of manufacturing in EU's GDP and employment, this sector is widely acknowledged as the engine of the modern economy. The importance of industrial activities is much greater than suggested by the share of manufacturing in GDP: nearly one in four private sector jobs is in industry, while each additional job in manufacturing creates 0.5-2 jobs in other sectors. Firms in manufacturing are more inclined to undertake innovation and research, and productivity growth is higher in manufacturing than in the rest of the economy. In fact, the fall in the value-added share of manufacturing is due mainly to falling relative prices of manufacturing in relation to services, which in turn stem from higher productivity growth. Manufactures also account for a very large proportion of tradables (75 per cent of EU exports) and their higher tradability combined with the increasing services intensity of manufactures imply that they have assumed an important carrier function for services (EC, 2013).

These are some of the reasons why the EU Commission considers that a strong industrial base will be of crucial importance for Europe's future economic growth. The European Commission's Strategy for the Reindustrialization of Europe launched in 2012 aims at increasing the share of manufacturing in the EU economy from 15 to 20 per cent of GDP by 2020 (EC, 2012), while the 2013 European Competitiveness Report proposes 'knowledge driven reindustrialization' as a means for strengthening EU competitiveness (EC, 2013). The European Commission's Vice President Antonio Tajani has recently called for an 'Industrial Compact', in addition to the 'Fiscal Compact', and a Competitiveness Council as strong as the Ecofin Council. Further steps in this direction were taken in 2014, with the European Commission's quest 'For a European Industrial Renaissance'. EU member states are invited to recognize the central importance of industry for creating jobs and growth, and of mainstreaming industry-related competitiveness concerns across all policy areas. Rather than considering single sectoral priorities, it is necessary to take into account the whole value chain, from infrastructure and raw materials to after-sales services. Six strategic cross-sector areas in which investment ought to be encouraged are: (1) advanced manufacturing (knowledge and innovation in high value-added manufacturing); (2) potential key enabling technologies; (3) production of bio-based products; (4) clean vehicles and alternative fuels infrastructure; (5) eco sustainable construction and raw materials; and (6) smart grids and digital infrastructure (EC, 2014a).

Renewed academic interest in industrial policy

There has also been a revival of academic interest in industrial policies as evidenced in writings by Rodrik (2008), Chang (2009), Lin and Monga (2010), Lin (2012), Greenwald and Stiglitz (2012), Wade (2012) and Stiglitz and Greenwald (2014), among others. Although each of these contributions highlights different aspects of industrial policy, they all converge in sustaining the importance of a pro-active industrial policy.

Rodrik (2008) presents a number of arguments in favour of industrial policy, which is understood to denote 'policies that stimulate specific economic activities and promote structural change'. Rodrik convincingly argues that horizontal interventions need to be considered as a limiting case and not as a clear-cut alternative to sectoral policies. Two modes of industrial policy should be combined: the traditional mode where the government picks certain sectors and provides incentives to get them off the ground through various policy instruments (tax credits, subsidies, directed credit) and a range of sectoral priorities; and the new mode without a preconceived list of sectors and policy instruments, aimed at constructing an institutional framework that elicits some of the main problems deriving from the implementation of industrial policy mentioned earlier.

Chang (2009) draws our attention to the fact that there is selectivity and targeting involved in virtually every (broadly-defined) industrial policy measure, even those intended for all enterprises, like the typical EU measures in the 2000s – if they favour R&D, innovation, SMEs or other. Moreover, there are a number of examples in history where government officials made investment decisions that went against market signals, sometimes even using state-owned enterprises as vehicles, only to build some of the most successful businesses in history. Chang also makes a strong case in favour of export-promoting policies.

Lin and Monga (2010) stress that government intervention has always played an important role in facilitating structural change – through the provision of information, coordination, of hard and soft infrastructure improvement and compensation for externalities. Government intervention is indispensable for helping economies move from one stage of development to another. If the government pro-actively provides information, coordination and externality compensation in the process of industrial upgrading and diversification, the country can grow much faster and achieve the goal of converging to high-income countries. In defining its industrial policy, a country should follow the patterns of specialization of those countries that are, on average, about 100% higher than their own level of per capita income.

Greenwald and Stiglitz (2012) recall that the major insight of welfare economics of the past fifty years is that markets by themselves in general do not result in (constrained) Pareto efficient outcomes. Industrial policies seek to shape the sectoral structure of the economy, partly because the sectoral structure that emerges from market forces, on their own, may not be that which maximizes social welfare. There is a rich catalogue of market failures in which appropriately designed industrial policies may improve matters. There can be, for instance, important coordination failures, which government action can help resolve. There are two further reasons for the recent interest in industrial policy. Firstly, market forces do not exist in a vacuum: institutions are central to growth - all the rules and regulations, the legal frameworks and how they are enforced, affect the structure of the economy, so unwittingly, government is always engaged in industrial policy. Secondly, when the government makes expenditure decisions - about infrastructure, education, technology, or any other category of spending - it affects the structure of the economy.

Current challenges

Whereas industrial policy is back in fashion, little progress has actually been achieved with its implementation in Europe. Despite the new EU approach to industrial policy and a renewal of academic interest, the revitalization of the EU economy through reindustrialisation has not (yet) happened. Since 2008, 3.5 million jobs have been lost in manufacturing, while the share of manufacturing in GDP in the EU has actually fallen from 18.5 % in 2000 to 15.1 % in 2013 (EC, 2014b). There are significant divergences among EU member states regarding the performance of the manufacturing sector and its weight in the economy. In 2012-13, only eight EU member states – the Czech Republic, Romania, Ireland, Hungary, Slovakia, Germany, Slovenia and Lithuania – had a manufacturing sector accounting for more than 20% of total value added (EC, 2014b, p. 22). Such divergences clearly highlight the important role that public policies may play in some countries. By early 2014, Poland, Slovakia, Romania, Estonia and somewhat less Belgium, Austria and the Czech Republic have surpassed their pre-recession peak levels of manufacturing output, but the majority of EU member states are still producing less manufacturing goods than before the crisis (EC, 2014b, p. 20).

Can we achieve faster growth and greater real convergence among EU member states through a more targeted industrial policy? A more efficient industrial policy may be able to stimulate economic growth and compensate partly for the current imbalances within the EU, but this would require a reconsideration of present rules regarding competition policy and state aid and closer coordination of aid instruments with industrial policy measures of EU member states. The EU State Aid regime provides a framework that directs member states investments towards addressing only clearly identified market failures, leaving room for a number of policy objectives for which State aid can be considered compatible, but these measures can only be implemented after approval by the Commission. Moreover, state aid provided by the EU member states has been falling during the past decades and in 2011 was at a historically low level of 0.5% of GDP (Stollinger and Holzner, 2013). In 2013, the EU Council of Ministers has formally adopted two European Commission proposals for revised regulations on state aid exemptions and procedures, that ought to contribute to a more flexible approach. The new regulation introduces new categories of aid that the Commission may decide to exempt from the obligation of prior notification, such as aid for innovation, culture, natural disasters, sport, certain broadband infrastructure, other infrastructure, social aid for transport to remote regions and aid for certain agriculture, forestry and fisheries issues. Within the financial perspective 2014–2020 some funds have been earmarked specifically for industry and reindustrialization. Whether these new initiatives and additional funding will actually lead to the attainment of the desired objectives of EU industrial policy is yet to be seen. What seems to be missing is a more concerted and coordinated approach to the EU commitment to reindustrialization and modernization of Europe's industrial base, that would take into account both the EU-level objectives and the potentially very different contributions that individual EU member states can make. The challenge for EU member states will be to engage with this new agenda and try to make a contribution to Europe's new leading cross-sector industries, while pursuing national policies for increasing competitiveness and growth.

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