

TWO VARIETIES OF INDUSTRIAL POLICY: A CRITIQUE

Don Lavoie

Introduction

Should a special agency be established and invested with the responsibility of explicitly guiding our nation's industrial development? Clearly the growth rate of our economy is not what it used to be. Can we afford to let international economic changes continue to disrupt our economy without entrusting a national agency with the task of easing whatever transformations seem necessary? Must we stand idly by and permit the burdens of such changes to be borne haphazardly and unequally, or should we not consciously decide such matters? Must we not deliberately take on the task of "reindustrializing" the American economy, of getting our economy moving again?

With such questions, contemporary advocates of "industrial policy" are raising issues which have a rich tradition of scholarly debate in the field of comparative economic systems. My aim is not to elaborate on those academic debates but to apply what I take to be their chief "lessons" to the proposals of two of the most prominent advocates of industrial policy, Felix G. Rohatyn, Wall Street financier and head of New York's Municipal Assistance Corporation ("Big MAC"), and Robert B. Reich of Harvard's John F. Kennedy School of Government. I will try to show that the apparent reasonableness of the questions posed in the opening paragraph disguises a serious misunderstanding by industrial policy advocates of the way in which a modern economy works. In particular, I will contend that both the differences between these two advocates of industrial policy and

Cato Journal, Vol. 4, No. 2 (Fall 1984). Copyright © Cato Institute. All rights reserved.
The author is Assistant Professor of Economics at the Center for the Study of Market Processes, George Mason University. This paper is based on a chapter from the author's book-length manuscript, "National Economic Planning: What Is Left?" which was originally commissioned by the Cato Institute.

their underlying similarities reveal basic flaws in the whole idea of industrial policy.

The classic debates I have in mind were over the political and economic difficulties of centralized economic planning. Advocates of industrial policy are quick to point out that their aims are much less ambitious. To avoid—or at least delay—offending my opponents, I will refrain from labeling their policies “national economic planning,” even though I see little substantive difference between industrial policy and the policies that more forthright advocates like Wasily Leontief call planning.

As used today the term “industrial policy” usually implies the idea of establishing a new Reconstruction Finance Corporation (RFC); that is, a special agency of the national government with the responsibility for guiding investment in directions different from those they otherwise would take. This investment-guiding agency might be modeled on America’s earlier RFC—an idea favored by Rohatyn—or on Japan’s Ministry of International Trade and Industry (MITI)—an idea supported by Reich. For theoretical as well as historical reasons, I will argue that we should adamantly oppose the establishment of any such agency in the American economy. A new RFC, whether of the Rohatyn or the Reich variety, would be politically dangerous and economically burdensome for the same reasons centralized planning was shown to be inefficient during the classic debates over planning.

There are two difficulties identified by the earlier debates over central planning which apply to industrial policy. First, there is *the political problem*: The danger that this new RFC could become a powerful dictatorial weapon. Can the proposed agency be expected even to try to do the bidding of the wisest and most benevolent advisors?¹ Second, there is *the knowledge problem*: Those who direct the new RFC will necessarily lack the knowledge to carry out their own goal of reindustrializing our economy. The question here is whether an investment-guiding agency that is (somehow) controlled even by the most benevolent and wise directors would be wise enough to be able to accomplish more good for the economy than damage.²

¹The classic statement of the political problem is F. A. Hayek’s *The Road to Serfdom* (1944).

²The knowledge problem was called the “calculation problem” in the economists’ debates of the 1920s and 1930s, and its chief propounders were Ludwig von Mises (1935) and F. A. Hayek (1948). I have tried to elaborate on the meaning and significance of this controversy in my forthcoming book (1985). See also Vaughn (1990), Hoff (1991), and Lavote (1981).

Reich and Rohatyn readily admit the potential danger of the political problem but offer precisely opposite "solutions," neither of which is terribly convincing. The two authors, however, seem unaware of the knowledge problem, or even the possibility of such a problem, and therefore offer no clues for its solution.

The knowledge problem alerts us to the fact that the competitive market process achieves a higher degree of "intelligence" in spontaneously directing industrial change than is possible for any single agency within the economic system. In effect, decentralized competitive processes, although they possess no single "director," exhibit a sort of "social intelligence" which exceeds the "individual intelligence" that is attainable by any single agency.

The competitive process is able to achieve this by means of the price system. It is the continuously changing configuration of relative prices that provides signals to the disparate decision makers, who calculate profit and loss in terms of these prices. Individuals who discover more efficient ways of using society's resources are rewarded with profits. In this manner a high degree of precision is possible when choosing among an array of complex production plans. The knowledge generated by the various competitive "tugs" exerted by market participants on relative prices is revealed only in profit/loss accounting. Given the manner in which the market uses knowledge, the best any individual intelligence can ever do to enhance the flow of new investment is to *participate in* the social process, to try to tug prices in the desired directions and see whether profit or loss is forthcoming.

The term "social intelligence" is of course only a metaphor. All real intelligence lies within individual human minds. Nevertheless, the only way human intelligence has ever been exercised is in *social* processes of interaction with other minds, whether in the process of communicating in a language, debating in a scholarly scientific journal, or competing for profit in an economy. For our purpose the issue of "social intelligence" involves the extent to which individual knowledge can be imparted to the price system.

The extent to which any particular market participant can affect prices derives from his superior knowledge of localized economic circumstances. He contributes his knowledge to that contained in the price system as a whole and is rewarded for this contribution by earning a profit. On the other hand, if his "tug" is misinformed, its influence will be eroded by incurring a loss. But when the strength of a market participant's effect on prices derives merely from the fact that he receives special attention from an RFC-type agency

attempting to "make industrial policy," the whole knowledge dispersal process is undermined.

The knowledge problem constitutes a challenge to advocates of industrial policy which could be put in the form of a question: "If you are so knowledgeable about investing, why not just go out and make a profit?" This question may sound rude and irrelevant, but it strikes at the heart of the difficulty. Both Reich and Rohatyn rest their case on their own expertise. They are touted by their supporters as "financial wizards" who *know* how to guide investment. But society can more readily benefit from the superior knowledge of any individual when he uses it in the competitive process. If Reich and Rohatyn are the financial wizards they claim, then society will benefit if they gain market power—not by forcibly channeling market forces in the desired directions, but by profiting from their own superior investment decisions.

Reich and Rohatyn have very different ideas about which industries ought to be helped and how; thus they cannot *both* know the best way to guide investment. The only proven testing ground for their competing views of industrial policy is a free and open competition for profit. In short, the competitive market implicitly compels the "smart" investor to put his money where his mouth is, but Rohatyn and Reich want these battles to be fought *explicitly* within the federal government. It is the main conclusion of the knowledge problem argument, however, that there are no rational grounds upon which Reich could convince Rohatyn or vice versa. There is no way an individual can know what specific industrial policy the government ought to follow. The task of guiding industrial development in the modern economy is too complex to be made explicitly; that is, by individual intelligence. Instead, it must be accomplished tacitly by the interplay of rivalrous competition in the price system; that is, by "social intelligence." As a result the battles over specific industrial policies are sure to be fought with weapons other than those of reasoned debate.

The knowledge problem and the political problem are therefore intertwined. The knowledge problem says that neither Reich nor Rohatyn (nor other proponents of industrial policy) can possibly know which industries will ultimately enhance industrial growth. The political problem says that with so much power concentrated in a single agency and since the case for any particular use of this power lies beyond the capacity of human reason to fully establish, battles are likely to be won by brute force rather than by careful debate.

The next section of this paper examines Rohatyn's and Reich's proposals for reindustrializing America in light of the knowledge

problem and the political problem. I then consider their historical arguments, including Rohatyn's own success story in New York City and the one he tells about the old RFC of the 1930s, as well as Reich's attribution of Japan's postwar success to MITI.

Reindustrialization and the "Structure" Metaphor

The word "reindustrialization" has become the political slogan of the season precisely because it is vague enough to include everyone's program and innocuous enough to be negotiable as ideological currency. Everybody favors revitalizing and modernizing American industry. Reindustrialization refers to a fairly uncontroversial *goal* of national policy, achieving a second industrial revolution, while leaving the more contentious *means* unspecified. As a result confusion reigns about what reindustrialization implies in terms of any concrete measures for stimulating the economy. The term spans the spectrum, from radical leftists to establishment liberals and even populist conservatives. In fact one leftist writer (Lens 1980, p. 44) attributes its origin to right-wing congressman Jack Kemp, and condemns it as fascism, while others on the extreme left have tried to appropriate the slogan for themselves (Bluestone and Harrison 1982).³

Despite the wide range of political thinkers associated with reindustrialization, an important subset seems to be emerging, distinguishable from both welfare-state liberals and conservatives. The emerging perspective has been singled out by one enthusiastic writer as a "new economics" that is "at the frontiers of economic thinking" in much the same way Keynes became in the 1930s. It has even been christened with another, almost equally ambiguous, name: "structuralism."⁴

While the common grounds discernable among this diverse group are much too nebulous to earn it designation as an economic school of thought, the term "structuralism" captures a key attitude typical

³Lens and Bluestone and Harrison all consider Rohatyn a politically dangerous corporatist or fascist (understandably in my view) and yet Bluestone and Harrison refer to their own program as "reindustrialization with a human face," a throwback to the phrase popular a decade ago among Eurocommunists and Eastern European dissidents who hoped to create a "socialism with a human face." One may legitimately wonder, however, whether putting a "human face" on what are essentially socialist or fascist policies can somehow transform them from reactionary into progressive ones or whether it succeeds only in disguising their true nature.

⁴Besides Rohatyn and Reich, Karen W. Arenson (1982, section 3, pp. 1, 24) includes rather broadly under this term both Paul Samuelson, an old-time establishment Keynesian, and Barry Bluestone and Bennett Harrison (1982) on the radical left. Among the writers associated with this perspective should be included Bowles, Gordon, and Weisskopf (1983), and Muller (1980).

of most advocates of reindustrialization. The extended use of a civil engineering metaphor typifies this view: The economy is like a great structure, a building in which certain stories (industries or regions) are the foundations which must remain firm to support the whole edifice of the relatively superficial upper stories. Industrial policy is advocated to shore up the weakening beams and supports upon which the survival of the rest of the structure depends. A new RFC is promoted as a sort of crack team of specialists, responsible for identifying any structural weaknesses in the economy and for patching them up with federally guaranteed loans, grants, and other forms of aid.

As long as we remain on this vague and metaphorical level, there is complete agreement between Reich and Rohatyn; but the RFC agencies envisaged by these two advocates of industrial policy are starkly different in two respects. Rohatyn prefers an "insulated" agency funneling aid to sunset industries, while Reich advocates an "open" agency directing aid to sunrise industries.

Rohatyn proposes protecting government experts from the fray of political battles by isolating them from democratic pressures. He complains there are already too many democratic checks on the discretion of our leaders, and he favors constitutional change "so that a president with a real vision of the future will be able to put his program through." Rohatyn admits this change would be "obviously a risk for democracy," but apparently it is one he is willing to take (1980b, p. 24). His new RFC would be "publicly accountable, but sheltered from political pressures" (1982b, p. 80), and Rohatyn believes that in this way "fair" agreements can be negotiated.

In contrast, Reich would pursue consensus by further opening up the process by establishing a "national bargaining arena" where proposals can be "debated in full view [of those] groups on whom their costs would fall" (1983, p. 276). Reich's argument that Rohatyn's closed RFC would represent a dangerous concentration of power is convincing. But so is Rohatyn's claim that Reich's open RFC would become a politicized chaos of special interest dealings. Neither offers any compelling reasons why closing or opening the new RFC to direct political scrutiny would reduce the likelihood of the new agency's exploitation by special interests.

Rohatyn's emphasis on salvaging the declining older industries is also in direct contrast to Reich's emphasis on promoting newer, high tech, or as he prefers to call them, "flexible-system" enterprises (1983, pp. 13, 127-39). Rohatyn wants to channel investment funds toward steel plants, highways, and subway systems, while Reich wants to promote those industries which are, according to his own

expectations, destined to be the technologies of the future. As Reich (1983, p. 13) puts it:

The industries in which the United States can retain a competitive edge will be based not on huge volume and standardization, but on producing relatively smaller batches of more specialized, higher-valued products—goods that are precision-engineered, that are custom-tailored to serve individual markets, or that embody rapidly evolving technologies. Such products will be found in high-value segments of more traditional industries (specialty steel and chemicals, computer-controlled machine tools, advanced automobile components) as well as in new high-technology industries (semiconductors, fiber optics, lasers, biotechnology, and robotics).⁵

But these proponents of reindustrialization fully concur that the economy is dangerously “out of control” and therefore in need of concerted government action. Rohatyn (1980a) begins one of his articles with these words: “It has been apparent for some time that our economy was out of control . . .” (p. 13). Reich (1983) begins his latest book by declaring that “since the late 1960s America’s economy has been slowly unraveling” (p. 3); he later warns ominously that “the U.S. economy is grinding to a slow, painful halt” (p. 134). To meet the challenge of international competitors such as Japan and West Germany, says Reich, “requires far-reaching economic and social changes”; but we are “not organized for changes of this magnitude” (p. 14). Hence an institution for “orchestrating adjustment” is needed as well as “more strategic policies to shift citizens to higher-valued production”; that is, we need to gain control over the “unraveling” American economy (p. 267).⁶

Common to advocates of industrial policy is their use of the structure metaphor to promote the salvaging of certain industries designated as basic. Rohatyn remarks that services are a “weak basis for the economy” and are somehow “debilitating, both in . . . substance and in . . . symbolism” (in Alpern 1981, p. 29). The kinds of industries that Rohatyn views as more appropriate to our country’s symbolic self-image and which constitute the necessary foundation of the industrial structure are the manufacturing sectors, especially the heavy

⁵Reich’s numerous discussions of the kinds of industries he sees dominating the future have the ring of an advertisement for a Wall Street investment house. We must keep in mind, however, that his intention is not to *persuade* people to invest in these industries.

⁶See also Magaziner and Reich (1983, p. 258), who contend that America’s economic problems are attributable to “the absence of any single agency or office with overall responsibility for monitoring changes in world markets or in the competitiveness of American industry, or for easing the adjustment of the domestic economy to these changes.”

industries such as steel and cars. Rohatyn views it as a national crisis that "McDonald's hamburger chain employs more people than U. S. Steel" and concludes that a massive effort is needed to rescue his favored industries (Rohatyn 1981a, p. 16).⁷

Reich (1983) agrees that "the nation cannot rely on services" because these "depend on the vigor of its future manufacturing base" (p. 132). The fact that the "nations of Western Europe and Japan have been selling America more manufactured goods than it has been selling back to them" is taken as evidence of the decline of this country's economy. The crisis is the fact that "America's basic steel, textile, automobile, consumer electronics, rubber, and petrochemical industries are becoming uncompetitive in the world" (p. 126).⁸

Despite frequent insinuations that the proper image of a proud nation should depend on tough and physical things such as steel plate and truck chassis rather than soft and gushy things such as soybeans and hamburgers, there is nothing substantive to suggest what is so shameful about this state of affairs. For over 200 years economists have argued that the wisest course for any nation is to permit free trade. Each country then can produce those goods for which it has a comparative advantage and exchange them for the goods that are more efficiently produced by others. Only in this way can we generate the maximum quantity of all the goods we would like to consume. While it might damage some people's sense of patriotism to face the fact that America exports agricultural products to Japan in exchange for manufacturing goods, surely this is a development with which mature adults can learn to cope. It seems that our primary concern should be whether we *have* jobs and what quality of life these jobs allow us to afford, not whether the goods we happen to be most efficient at producing promote the symbolic image we have of ourselves.

⁷On Rohatyn's propensity to see "serious repercussions" and national crises everywhere, see the insightful review of Rohatyn's *The Twenty-Year Century* (1984) by Michael Kinsley (1984, p. 27).

⁸Similar symbolic preferences for certain "basic" (one could almost say "macho") industries are to be found among most other proponents of industrial policy as well. Bluestone and Harrison (1982, p. 5) find it "shocking" that

in terms of dollar value, the number one Japanese product sold to America was passenger motor vehicles, followed by iron and steel plates, truck and tractor chassis, radios, motorbikes, and audio and video tape recorders. In contrast, America's top seven exports to Japan, in order of dollar value, were soybeans, corn, fir logs, hcmlock logs, coal, wheat and cotton. The . . . United States has been reduced to an agricultural nation trying desperately to compete with the manufacturer of the world's most sophisticated capital and consumer goods.

Rohatyn and Reich do suggest that there are substantive as well as symbolic reasons to resist the decline of the basic industries, but offer only occasional clues as to what these reasons are.⁹ They each try to argue that we should salvage some industries because they constitute the main source of demand for other industries.¹⁰ Such connections between sectors can be multiplied at will and both authors, of course, differ with respect to which industries should be helped. For example much of the steel the United States does produce competitively is the type needed for high-tech industries, such as microprocessors. Hence Reich argues that granting cheap credit to the latter will help the former, while Rohatyn claims that aiding the former will help promote the latter. But the relationships between the health of different sectors in a modern economy are so intricate and complex that it is highly implausible that any single agency could take them all into account.

Reich agrees with Rohatyn that the uncontrolled decline of "basic" industries constitutes the main problem which industrial policy is supposed to solve, but he disagrees about how to respond to this decline. While Rohatyn wants to retard structural change, Reich wants to hasten it. Rohatyn is for shoring up the old structures, Reich for "restructuring" them to adjust to new realities. Reich believes the national bargaining arena should "negotiate a package of public adjustment assistance designed explicitly to buttress their most competitive operations, retrain their work force, and shift other resources to more profitable uses" (1983, p. 276), but he is quick to assure us, "This does not mean that industrialized countries must abandon their older industries, like steel, chemicals, textiles, and automobiles," which are "the gateways through which new products and processes emerge" (p. 130). Nor, he says, should these industries be supported as they are now through government subsidies. Rather we should

⁹Rohatyn occasionally suggests that the real reason for the priority of structural industries is national defense, but this argument carries little weight. It is not only things like steel and truck parts that foreign governments could withhold to hurt our military production. In a world that is increasingly interdependent it is difficult to think of any products, other than nonessential consumer items, the withholding of which could not somehow, directly or indirectly, harm the interests of national security. To defend itself from such potential blackmail the United States would have to become virtually autarkic. But to even approach that condition would reduce our productivity so drastically as to genuinely endanger our national defense.

¹⁰Rohatyn (1982b, p. 80) points out that "the auto industry is one of the largest customers of microprocessors as well as of industrial robots and many other high-technology products." Hence he argues that if we are to promote high-tech industries, we must first save the so-called basic industries. Reich (1983, p. 132) similarly argues that since so much of the service sector is "directly linked to the manufacturing base of the country," it "surely will diminish as merchandise trade declines."

“restructure them toward higher valued and technologically more sophisticated businesses.”¹¹

All of this propping up and restructuring, of course, is going to cost a lot of money. Both Rohatyn and Reich acknowledge this and favor increased taxes on consumption to defray the costs of reindustrializing. They take pride in the fact that, unlike the welfare-state liberalism of the 1960s which made glowing promises of benefits without regard to costs, in the 1980s they *stress* the costs. Rohatyn and Reich remind us, time and time again, that to reawaken our sluggish industrial system real sacrifices will be necessary. The recognition of scarcity, of the fact that every course of action entails the foregoing of other potential courses of action, is, indeed among the most important principles of economics. But, after all, welfare liberals used to talk about sacrifice too. It is hardly a fundamental departure from the old policies if Reich and Rohatyn merely have projections that are less optimistic or if their theme tends to be one of equalizing burdens rather than of spreading unlimited wealth.¹²

The structuralists present their program as if it represented a sharp departure from the kinds of Keynesian/welfare-state policies that have been practiced over the past few decades. Rohatyn, for example, declares that what the economy needs is not the “continued application of Band-Aids” but rather a dose of “strong medicine.” Reich agrees with Rohatyn that the traditional tools of Keynesian macroeconomic policy are “too broad and too blunt” and that we are therefore “beyond economic ‘fine tuning.’”¹³

Upon closer examination, however, the structuralists offer nothing but old fine-tuning policies after all. Their proposals sound like the same old band-aids: increased taxes, runaway money supply and inflation, skyrocketing government expenditure and indebtedness, and more government domination of the economy.

The proponents of reindustrialization are no more sensitive to the genuinely democratic tax revolt than were the welfare-state liberals; they just favor increasing *different* taxes. Reindustrialization proponents often advocate opening up and creating new tax loopholes and using tax incentives as one of the main instruments of industrial

¹¹Reich (1983, pp. 130, 178-79) seems to believe there is a fundamental distinction between the sort of restructuring he has in mind and the kind of government subsidies we now have.

¹²Rohatyn wants the new RFC to ensure “evenly distributed burdens” (1980b, p. 24) while Reich calls for the agency to arrive at “a fair sharing of the burdens and benefits of industrial change” (1983, p. 256).

¹³Rohatyn (1980a, p. 6) and Reich (1983, p. 202). See also Muller (1980, pp. 28-29).

policy.¹⁴ The tax revenues lost to these loopholes are to be more than made up for by imposing heavy taxes on consumption. Both the corporate taxes preferred by welfare-state liberals and the consumption taxes to which the structuralists are partial are likely, however, to be most heavily borne by some of the poorest and most overtaxed segments of society. Having discovered the damage government has caused the economy by stifling investment with taxes on capital gains and profits, most structuralists want to impose excise taxes and stifle consumption instead.¹⁵

While paying lip service to the need to bring government spending under control, the structuralists, like their welfare-state precursors, promise massive spending projects that are guaranteed to increase total government expenditures dramatically.¹⁶ Reich says, "We need a political revitalization," and envies West Germany, France, and Japan, where "traditions of legitimate government involvement in orchestrating economic change were firmly established" and where there are "more government-sponsored training and retraining, more generous unemployment assistance, and health benefits that are distributed more widely." Rohatyn talks casually about spending a trillion dollars on rejuvenating the country's physical plant.¹⁷ And despite their "age of limits" rhetoric, both are as prone to ambitious, visionary government-spending agendas as the welfare-state liberals, as is revealed in the grandiose titles of their latest books: *The Twenty-Year Century: Essays on Economics and Public Policy* and *The Next American Frontier*.

¹⁴Amitai Etzioni (1983, pp. 317-41) relies primarily on tax incentives as the mechanism for his "semi-targeted" planning. Rohatyn (1981a, p. 14) is particularly fond of federal "programs for incentives for local tax reductions as a way to give stimulus to areas suffering the greatest economic hardship." While I agree with the general policy direction of reducing taxes, the basic knowledge problem arguments apply just as much to governmental attempts to steer the economy through *differential* taxation as they do to the use of other policy tools.

¹⁵See Etzioni (1983, p. 317), Reich (1983, p. 242), and Rohatyn (1982b, p. 74).

¹⁶Rohatyn (1982b, p. 80), for example, admits that "slowdowns in the growth of Social Security and healthcare costs are absolutely essential" if they are not to end up completely bankrupting the federal government. He criticizes Reagan's modest attempts to cut back on welfare programs not because he finds their operation actually to be fair, but on the grounds that "a democracy, to survive, must at the very least appear to be fair" and that "this is no longer the case in America" (1982b, p. 90). Presumably were Rohatyn in charge he would keep up appearances of this kind.

¹⁷Reich (1983, p. 275; pp. 14-15), Rohatyn (1982b, p. 72). Under the Carter administration Rohatyn (1980b, p. 23) was saying that part of his gas tax "should finance tax cuts that will lead to increased investment and an increase in military spending." Now that Reagan has promised us this program Rohatyn is saying things like "our defense program cannot be immune from . . . retrenchment" (1982b, p. 74).

Rohatyn likes to joke that Reaganomics is "Keynes in drag," a program dressed up as fiscally responsible but underneath a prescription for deficits caused by tax cuts instead of by spending.¹⁸ But in Rohatyn's own policies it is hard to see how Keynesianism has been transcended. Unwilling to challenge either defense or nondefense spending in any fundamental way, and prepared to add the immense cost of a new RFC to the already bloated budget, the structuralists cannot be expected to do much to reduce the federal deficit (Reich 1983, p. 120).¹⁹ Rohatyn's solution to budgets that do not balance is to move expenses off budget; that is, pretend the deficit is not there, and then get somebody else to pick up the tab.

In addition Reich seems to believe that merely adding the adjective "explicit" to the intellectual arsenal of establishment liberalism is enough to turn old, unworkable policies into promising new ones: "An explicit regulatory policy would let Americans deal sensibly with the hard choices about the social costs of a given path of economic development—the concrete sacrifices of health, safety, and the environment that it would entail and upon whom the burdens would fall." Similarly Reich expects an "explicit training and retraining policy" to work where implicit training programs have failed. His repeated calls for replacing the implicit decision making of the market with explicit political decision making ignore the possibility of a limitation on the capacity of the individual human mind to

¹⁸Rohatyn frequently mistakes Reaganomics the rhetoric for Reaganomics the actual policies of the current administration when he describes the latter as "massive tax cuts and huge increases in defense spending combined with tight money" or as "a huge budget cut coupled with a huge tax cut and restrictive monetary policy" (1981a, p. 14). In fact, federal spending is setting a 10-year record under Reagan, increasing in real terms by 8.7 percent from October 1981 to May 1982, while revenues from taxation rose in real terms in 1982 by 6.2 percent, the fastest increase since 1977. The "tight" money supply (M2) grew at an annual rate of 9.7 percent during the third quarter of 1982. The deficit under Reagan will be large indeed, but its cause is not tax cuts but the more familiar problem of runaway spending. What we have here is not "Keynes in drag" at all. We still have Keynes.

¹⁹The *Business Week* (1980, p. 27) issue on reindustrialization suggests that the federal budget be divided into two parts, a current accounts budget, which "should show a substantial surplus," and a reindustrialization budget, which "would have to run a large deficit for some time." Thus other governmental projects will have to tighten their belts, while the part that is needed "to help rebuild the eroded capital base" should not be "distorted by efforts to create the illusion that income will match outgo immediately." Rohatyn (1981b) insists that running his new RFC with "lending capacity of \$25 billion to \$30 billion, mostly provided by government-guaranteed bonds" would have only "limited impact on the federal budget," but if its operation is anything like that of its namesake we can expect this to directly cost something on the order of \$10 billion for every \$30 billion it lends out, not counting its crowding-out effects on the capital markets.

articulate all the information that is used by the competitive discovery process. Reich simply assumes that anything the market does implicitly can be done as well by explicit government policy. Yet the central argument of the knowledge problem is precisely that the market system's ability to generate as much wealth as it does is primarily due to the fact that it can make use of tacit knowledge in a way that Reich's explicit politics cannot. Reich asserts that questions such as where the burdens of any given regulation will fall are unknown only because Americans are too secretive or are unwilling to face up to the "hard choices" we confront. That such issues might *have to be decided implicitly*—because the remote effects of policies are not ascertainable in advance—is a possibility he does not seem to have entertained.

In short, the advocates of reindustrialization seem to be as certain to increase the burdens of deficits and inflation as were the welfare-state liberals. Reich's only contribution to the failed incomes policies of the past is that he would make them "explicit" so that the government can make "aboveboard choices about how the burden of fighting inflation should be allocated" (Reich 1983, p. 274).²⁰ And Rohatyn repeatedly calls for a renewed bout of credit expansion by the Fed to reduce unemployment (at least temporarily) and to rejuvenate the housing and construction industries with lower interest rates.²¹ Like

²⁰Apparently it has not occurred to Reich that the way inflation works makes its redistributive effects far too complicated to be sorted out. Those who get the newly created money relatively sooner benefit at the expense of those who face higher costs before they receive inflated incomes. The only way to allocate these burdens fairly would be to trace the detailed flow of money expenditures throughout the whole economy. But if that were possible we could dispense with the market altogether and adopt comprehensive central planning.

²¹Rohatyn (1982a, p. 7) advocates the creation of "sizable new credits from the banking system" in addition to debt extensions and moratoriums in order to shore up our weakening financial structures. He says that "we can have no real growth until our interest rate structure is lowered" (1980b, p. 23) and thus considers it "our most urgent national objective" to achieve "the reduction of unemployment through high economic growth rates and low interest rates." This, he realizes, requires "a commitment on the part of the Federal Reserve to accelerate its downward pressure on interest rates" (1982b, p. 74), or in other words vigorous monetary expansion to artificially lower the price of credit.

It has been precisely this policy of credit expansion which Hayek's work in monetary theory (for example, 1931; 1933; 1939) has shown leads to both inflation and unemployment. Although the immediate effect of lowering interest rates is stimulative, the extra investments this policy encourages are not coordinated with genuine consumer demand, but rather are dependent on further injections of money. When the credit expansion is reduced in order to fight the inflation this policy created in the first place, the investments that had been artificially stimulated are suddenly revealed to be unprofitable and a recession results.

proponents of the welfare state, Rohatyn (1982b, p. 90) admits his ambitious spending programs run the risk of inflation, and so halfheartedly suggests that (discredited) wage and price controls could be resorted to as an inflation-fighting policy.

The advocates of reindustrialization still suffer from the crucial economic error of welfare-state liberalism. They both incorrectly presume the institution of government can possess the intellectual resources necessary to *effectively* redirect investment decisions away from the direction indicated by spontaneous market forces. That is, their attempts to "guide" production toward some industries (whether sunrise or sunset) and away from others (specified or not) will result not in a simple *transfer* of socially valuable resources but in a substantial *reduction* of them.

In a competitive capital market, entrepreneurs have to compete with one another to discover profitable projects in order to secure future command over more funds. To the extent that government agencies disperse favors in the form of cheap credits, the competitive discovery process is subverted and politically favored projects succeed at the expense of others which may be more economically efficient. The microprocessor and steel industries, as well as the economy as a whole, would be far healthier if we permitted them to compete fairly for investible funds rather than "rig the game" of the competitive process by providing cheap credit to some competitors at the (hidden) expense of others.

The only way we can know on which lines of production to concentrate and to what extent is by observing the outcome of market rivalry. Whether we are squandering resources by over- or under-investing in microprocessors or steel can be revealed only by the message contained in the relative profitability of rival firms in these industries. But this is precisely the information we garble when we channel money toward one or another of the contenders. Deprived of its elimination process, the market could no longer serve as a method for discovering better and eliminating worse production techniques. Without the necessity of responding to consumers' wants or needs, businesses would not withdraw from unprofitable avenues of production. One need not be a crude Social Darwinist to understand that we could no more expect the market process to function as the economy's coordination mechanism while simultaneously bailing out unresponsive firms than we could expect biological evolution to function without any species becoming extinct.

The only support industrial policy advocates offer for the claim that the particular industries called "basic" are necessary for the survival of other industries seems to be an excessively literal

interpretation of their own metaphors. The term "industrial base" connotes some sort of foundation supporting the economy's structure (appropriately made of solid things like steel) without which the whole building will collapse. Thus we are told that we need to shore up our industrial base before we find it "coming apart at the seams," leading to a collapse of the whole structure.²²

But articulating an analogy between an economy and a building does not constitute an explanation. There is no reason why the steel industry constitutes a more crucial linchpin of our economic structure than any other industry, whether its product is as tough as nails or as soft as software. There is no reason a country cannot find itself most prosperous by specializing in selling intangible services to other nations, in which case its industrial base would be invisible. To sustain an argument that an expensive rescue operation is needed to salvage certain selected industries, it is necessary to go beyond architectural analogies and specify why the overall economy can expect to benefit from such an operation.

The older structural industries are not all that Rohatyn wants to shore up through federal assistance. He also urges that large doses of money be offered to America's "older cities." Once again he uses a structure metaphor to carry most of the weight of his argument, but this time it is in terms of the so-called infrastructure which includes the nation's cities, harbors, and transportation systems. Rohatyn claims that we cannot afford to allow our cities to deteriorate; but he never explains why the rest of the country would benefit from accepting the burdens of the bad management of various mayors, just as he never explains why taxpayers should bear the losses that have resulted from the incorrect decisions of the managers of steel plants (Rohatyn 1980b, p. 23; 1982b, p. 80). If New York City's government cannot pay its bills, why should Idaho taxpayers be compelled to come to the rescue? As in the case of bailing out basic industries, would this not amount to a program for rewarding bankruptcy? Would this not be a policy virtually guaranteed to call forth a rash of defaults in order to win federal loans? If, as Rohatyn admits, the precarious financial situation of so many major metropolitan governments is a direct result

²²Bluestone and Harrison (1982, p. 16) use the latter phrase. The phrase "shoring up the system" recurs throughout this literature. David L. Barnett (1980, p. 60) closes his article on the reindustrialization debate with the prediction that out of it "will come action that will shore up America's economic might." Etzioni (1983, pp. 190 and 313) talks about "steps needed to shore up the economy" and asserts that "all agree that the foundations of the American economy have weakened and need shoring up." Rohatyn (1982a, p. 3) refers to "a coordinated process that would shore up the system and avoid a crisis."

of their irresponsibility, how can government-sponsored salvage operations be expected to make the recipients more responsible?

Rohatyn's response to such charges of rewarding failure is that his RFC would impose onerous austerity conditions on anyone who receives federal assistance, whether in city government or in basic industries (1982b, p. 82). Nobody will see these bailouts as coveted prizes because the conditions on the loans will be stringent enough to discourage further fiscal irresponsibility. This response requires the rather strong assumption that the financial experts within the RFC would be considerably more clever than those whom they are bailing out. We would have to assume that these experts could devise schemes which the managers of the recipient institutions could not devise, so cities or businesses could be saved without providing rewards which would attract others into the now lucrative business of going broke.

But perhaps the real reason Rohatyn wants to bail out older industries and cities is much more straightforward. He openly admits, "I like big cities. . . . Civilization grows there. Religion develops in open air, I suspect. But civilization—that is in the cities."²³ Such an argument takes us out of the realm of social science, however, and into the streets of political struggle. How would Rohatyn respond to a religious rural dweller who cares little about the so-called civilization of big cities and wants an RFC to bail out small farmers and bankrupt churches at the expense of steel companies and city dwellers? As long as we can find no plausible case for the special status of the older industries and cities—a case which can show that the health of other sectors and regions would unambiguously benefit from financing a massively expensive rescue operation—there is no reason why those who do not share Rohatyn's tastes should be expected to endorse his policy prescriptions.

There is no better illustration of the political problem—of the warfare that industrial policy will invariably ignite—than the divergence between its two leading proponents about which sectors ought to be supported. Although we have little assurance that there is any expenditure of which either Reich or Rohatyn would disapprove, it is evident that Reich cares little for Rohatyn's older cities, and that Rohatyn is relatively unimpressed by Reich's new-fangled technologies.

While Reich and others who clamor for reindustrialization largely agree with Rohatyn that basic manufacturing industries are among the structural supports of the economy, fewer would concur about

²³Quoted by Alpern (1981, p. 26).

the older cities. Rohatyn's third major category of potential recipients of RFC funding, the banks, is still less popular. But Rohatyn's logic in this case is no different than in the other two. Banks are described as "weakening financial structures" and pictured in the by-now-familiar metaphor as necessary supports for the rest of the economy. Needless to say, Rohatyn concludes that we must take "steps that would shore up the domestic banking system" because "the private banks, alone, cannot carry the burden." He proposes that "both the taxpayers and the bank's stockholders will have to assume a part" of the burden resulting from overextended credits to Third World countries "if the banking system is to be protected." Rohatyn proposes a sort of bankers' welfare system which would involve supplying "a safety net for our American banks" and "doubling the IMF's capacity to lend money" to help support "our" banks' shaky investments overseas. And, like his argument for saving the cities, Rohatyn apparently seeks to reward the banks for their financial irresponsibility simply because he likes them: "Our banking system is one of the most precious assets of our economy and of the free society itself."²⁴

The real issue in all of these crises of weakening "structures" is the same. Whatever the underlying causes of the deterioration of basic industries, older cities, or overextended banks, their long-term salvation does not lie in propping them up with federal monies. Bail-outs can only reward and perpetuate inefficient uses of scarce resources at the expense of more efficient ones. They can only obstruct the competitive discovery process on which the genuine health of our economy ultimately rests.

The idea of an economy's capital as a structure—in the sense of an interconnected, interdependent network of relationships among sectors—is an invaluable metaphor for understanding how productive processes are coordinated with one another. But unlike a physical structure such as a building, the economy's capital structure is continually changing. Its parts are forever readjusting on the basis of the profit signals without which producers of capital goods would be

²⁴Rohatyn (1982b, p. 72; 1982a, pp. 7, 6, and 8). I am not minimizing the dangers involved in the U.S. banking system's shaky international commitments. The default of a couple of Third World countries could bring down several major banks and cause immense financial difficulties in this country if significant reforms to the banking system are not undertaken first. The issue is not how bad these banking problems are, but whether propping up the very institutions which brought about the problems and rewarding the very decision makers who got us into this danger is the best way to resolve them. The banking system is the oldest cartel in the United States and the most in need of fundamental reform in the direction of more competition, not, as Rohatyn would like, more government involvement. See Weber (1983).

unable to guide their use in such a way as to best contribute to the future production of consumption goods. Thus a call for governmental restructuring or shoring up of this self-ordering system amounts to interference with the very mechanism that tends to keep the sectors of the capital structure integrated with one another.²⁵

The fact that Reich wants to accelerate many of the very changes that Rohatyn wants to slow down does not make his policies any more compatible with the market mechanism. To favor "flexible-system production" is to desire an outcome, not to specify any means for its attainment. To propose that the new RFC *guide* market forces (whether this guidance is called accelerating or decelerating) is to presume that this agency can anticipate future developments better than the market can; it is to assume that the agency's individual intelligence exceeds the social intelligence of the competitive process. How will the agency know exactly which up-and-coming firms to direct funding toward? Whether resisting or promoting the market's structural changes, the advocates of reindustrialization must assume that the directors of the new RFC know enough to intelligently intervene in the market process.

The structuralists often seem unaware that progress requires abandoning less-effective modes of production precisely to release resources for more-effective ones. Rejuvenating the American economy cannot be accomplished without relying on the knowledge, supplied by competition, about which lines of production to discard as well as which to pursue. By taking their own metaphor too seriously, the structuralists presume that shoring up the economy is a task like that undertaken by a civil engineer who repairs the structural supports of a building; they treat a dynamic spontaneous order, which is sustained by the social intelligence generated by competitive processes, as if it were a single static project under the supervision of an individual intelligence.

²⁵In their book on *The Deindustrialization of America* (1982, p. 206), Bluestone and Harrison reveal the essence of the structuralist position by obligingly taking it to its ridiculous extreme. They identify as one of the main causes of our economic malaise "the increase in the velocity of capital mobility." The problem, then, is alleged to be the mobility of investment *per se*, not just its withdrawal from basic industries or beloved cities and banks. Since capitalists are compelled by the profit motive to constantly look for ways to cut costs, they invariably can be found pulling out of less cost effective investments. They are therefore deindustrializing older facilities. The proposed solution to this "problem" is to pass plant-closing legislation to make it difficult for capital to move. This, of course, will mean that less and less of our nation's productive plant will operate cost effectively as time goes on and as economic circumstances continue to change. Taken to its logical conclusion, reindustrialization is a pathologically reactionary call for economic rigidity, for preventing rational adjustments to changing circumstances.

The Expert Coordinators: Some Historical Lessons

The articles and books by Reich and Rohatyn would serve well as formal job applications for the position as head of a new RFC. Their works are filled with general statements about the need for "expert and courageous leaders," but it is not difficult to read "like me" between the lines. While the call for strong leadership plays a crucial role in their arguments for industrial policy, this emphasis contributes nothing to answering the knowledge problem and does little to dispel fears about the political problem. The responsibility of the "strong leader" will be to *coordinate* the actions of the rest of us. Significantly, while Reich and Rohatyn repeatedly use the verb "coordinate," it is always in its transitive form. Coordination, in their view, cannot occur spontaneously among interacting individuals but must be imposed by a coordinator on the coordinated.

Of course both these writers would deny they could become economic dictators. The new RFC would have a decision-making board which will "hammer out" compromises. Rohatyn wants closed hard-headed "bargaining" sessions to be staged among representatives of business, labor, and government and describes himself as an active negotiator by temperament. Reich points out that "much will depend on the quality of America's future political leadership" and that "we will need leaders who are not afraid to recognize frankly the political choices that are entailed in major economic change and who are willing to choreograph openly the bargaining about them." Despite Reich's democratic-sounding discussions of open arenas for bargaining and debate or Rohatyn's promises of fair negotiations, it is a peculiar bargain indeed that has to be choreographed by a courageous leader. And given the nature of the participants in these bargaining sessions (political representatives of special interests) and the sorts of issues being debated (who gets special benefits and who gets penalized), it is inevitable that any consensus reached must either stack the forces on one side among the contenders or leave the real victims out of the "arena" altogether.²⁶

²⁶Rohatyn (1982b, p. 82, p. 74), Reich (1983, pp. 14, 273, 275 and 276). It is worth noting that the original, idealistic aspirations for fascism in Italy were to set up the very same kind of bargaining arena for settling conflicts that Rohatyn and Reich now promote, and that there too we were promised a kind of choreographed bargaining process. See for example Luigi Villari's "The Economics of Fascism" (1932, pp. 98-9): "The National Council was created to coordinate all the productive forces of the nation. . . . The Council is further entrusted with the duty of coordinating the interests of the various branches of trade; this is a particularly important provision, and implies the settling of such conflicts as may arise, as for instance between agriculture and industry, or between two or more rival industries."

Rohatyn places much of the burden of his argument for industrial policy on the issue of courageous leadership; for it was his own trumpeted "success" as chairman of the Municipal Assistance Corporation (MAC) in salvaging New York City that convinced him to attempt to "go national" and set up a bigger MAC for the whole country.²⁷ Rohatyn continuously reminds us how New York was saved through his expert guidance and that, since the nation's problems are similar, the answer must lie in putting a financial expert (like him) in charge of the nation's finances. Each of his several popular articles makes at least passing reference to his extensive financial experience both in business and in rescuing New York.²⁸ Hence it seems fair to ask just what did happen in New York. Do Rohatyn's efforts there inspire any confidence in his financial expertise and in the kinds of policies he wants to extrapolate for the nation?

The bankruptcy of the New York City government was preceded by a 10-year increase in borrowing for current expenses: from \$26 million in 1965 to \$724 million in 1975. During the same period the overall short-term debt rose from \$250 million to over \$4.5 billion. One of the biggest factors in this debt debacle was the mushrooming of off-budget enterprises (OBEs), quasi-private agencies whose borrowing could escape the constitutional limits placed on official government borrowing. The "courageous" (Rohatyn's word) solution that Governor Hugh Carey devised to solve this problem was the creation of even more OBEs. In particular, a state-level Municipal Assistance Corporation (led by Rohatyn) was authorized to issue an additional \$10 billion in new bonds. These bonds, however, were sold only when the federal government agreed to offer over a billion dollars in loan guarantees and other forms of support. Rohatyn admits that "there is a real question whether the market can absorb the billions in New York-related securities," but says that this makes the argument for a new RFC more compelling. But he cannot have his cake and eat it too. Rohatyn cannot plead that the dire financial circumstances of New York City make an RFC necessary and then

²⁷Rohatyn describes New York City's salvation as having "required the courageous political leadership of the governor" (1980b, p. 20), while the nation's problems will also "require inspired political leadership" (1980b, p. 22).

²⁸See for example Rohatyn (1980b, p. 20), where the austerity measures he imposed on New York are declared to be "what saved the city," or Rohatyn (1981a, p. 16), where "cooperation among business, labor, and government coupled with a wage freeze, cost control, and sales tax revenues driven up by inflation," most of which were engineered by MAC, are credited with having "saved New York City."

rest his case for the prospects of a successful RFC on the shining example of his rescue of New York City from its threat of bankruptcy.²⁹

In other words Rohatyn was able to save New York City by spreading its burdens to state and national taxpayers. He advocates similar bailouts for other localities that try to live beyond their means. It was not some mysterious financial wizardry that worked its magic on New York City, or the much-vaunted austerity Rohatyn repeatedly insists he imposed on the unions, banks, and political institutions there.³⁰ It was, on the contrary, the rather pedestrian idea of letting someone else pay the bills. But there are no higher levels of government to pick up the tab for our national problems, though Rohatyn, if given the chance, would love to "go international" and ply his trade at the IMF.

If Rohatyn's success in New York City is less than inspiring as an example for the new RFC, what of the original RFC itself? The Reconstruction Finance Corporation is discussed in a favorable light by Rohatyn almost as often as his New York City story. The agency was established by Herbert Hoover in 1932, and over a period of 13 years it dispersed more than \$35 billion.³¹ As Rohatyn says, the RFC thereby "saved thousands of banks, railroads and businesses, financed public works and ultimately defense plants in World War II." Indeed, Rohatyn declares that, on top of bestowing these blessings on the economy, the original RFC even "returned a profit of \$500 million to the taxpayers."³²

This profit figure, however, was determined through an imaginative arithmetic manipulation (performed by none other than the head

²⁹See Rohatyn (1981b). This account is taken from a more extensive examination of OBEs by Bennett and DiLorenzo (1982), especially chapter 5.

³⁰McClelland and Magdovitz (1981) report that a private auditing firm found a deficit of over \$700 million in 1978, two years after MAC's supposedly tough austerity measures were firmly in place. In spite of Rohatyn's frequent appeals to the need for honest accounting procedures, the city reported a *surplus* of \$32 million in that year.

³¹This is the total amount Jesse H. Jones (1951, p. 3) says the RFC "loaned and spent, invested and gave away."

³²Rohatyn (1982b, p. 80) must have gotten this bogus profit figure by reading Jones's book (1951, p. 4) in which the statement that all of the \$10.5 billion used "in the struggle against the depression" (which was less than a third of the total money dispersed) was "returned to the Federal Treasury with approximately \$500,000,000 profits, after paying the Corporation's operating expenses and a fair rate of interest on the money which it borrowed to finance this phase of its operations." On the same page, however, Jones refers to cancelled debts that turn this half a billion dollar profit into an \$11.5 billion loss. Randall Rothenberg (1983, p. 44) makes a different but equally misleading statement in his article on reindustrialization when he remarks that the old RFC paid for itself because "when Congress closed its doors, the RFC returned \$6 billion to the Treasury."

of the RFC in his self-aggrandizing book about it) which manages to omit some \$12 billion of RFC notes that Congress generously cancelled. If any private credit agency were to take this kind of beating on its loans, it would become the laughing stock of the financial world. The RFC, of course, was established to make what other credit institutions would consider high-risk investments; that is, to aid businesses that might well fail without its subsidized aid. The idea that it could turn a profit by adhering to a loan policy of propping up firms unable to get loans from the private credit market is simply ludicrous. The new RFC would necessitate, as the old one did, considerably increased taxes and a hefty dose of government borrowing to foot the bill.

If the consequences of paying these hidden costs are acknowledged, it is hard to credit the old RFC with having saved any businesses on net. How many firms were taxed out of operation or squeezed out of credit markets because of the generous loans of this agency? Investment funds simply cannot be created by government fiat; they can only be rearranged. Since the proposed RFC, like any single organization, is necessarily limited by the capacity of an individual intelligence and has no crystal ball to reveal where the best future investment possibilities lie, its activities are likely to divert capital from the politically inept but economically efficient (to whom the social intelligence of market processes would have channeled funds) to the politically adept and economically inefficient.

Thus the knowledge problem indicates that the task Rohatyn would like a new RFC to take on—rejuvenating America's industry as a whole—is beyond the powers of any such agency, and indeed that it would almost certainly reduce the nation's real wealth. The political problem, meanwhile, suggests that the RFC, in practice, is likely to permit the securing of special privileges by the politically powerful at the expense of society as a whole. Whereas the old RFC was a dismal failure at rejuvenating American industry, it was a stunning success as a dispenser of privileges to those with high political connections at the expense of those without. Houston millionaire Jesse Jones boasts that during his tenure at the RFC "there was not a single instance of fraud in the entire organization," but his book is one long list of favors, many of them, coincidentally, to friends and relatives of the heads of the RFC.³³ In other words the RFC's only success

³³Jones (1951, p. 11). On the early history of the RFC see Rothbard (1975, pp. 261–65) and Zaid (1973). See also Grindler and Fairgate (1975).

was in its role as what humorist Will Rogers called "the caviar of big business" (see Jones 1951, p. 5).

Reich's favorite model for emulation is Japan's MITI rather than America's earlier RFC, but he recognizes the close family resemblance among all such institutions and sees the RFC as an important experience. Through this experience, he says, government, business, and labor "learned to communicate and bargain smoothly, orchestrating decisions through their hierarchical control over vast reservoirs of complementary resources (Reich 1983, pp. 52-53).³⁴ Reich's "national bargaining arena" would differ from Rohatyn's RFC only on the particular industries he would like to support and the openness with which the agency would undertake its decisions. But Reich offers no more justification than Rohatyn for the belief that this investment-guiding agency will know how to repair the weakening industrial structures of our economy.

The Japanese miracle of rapid economic growth since World War II is attributed by Reich to the farsighted industrial policy of MITI. Unlike the story of the "rescue" of New York, there is no question that Japan's success is genuine. The nation's real GNP has grown from 21 trillion yen in FY 1951 to 191 trillion yen in FY 1980.³⁵ The only question concerns the extent to which we are justified in attributing this success to the positive actions of MITI.³⁶

Reich paints MITI as an elite of experts who have consistently supported Japan's most successful industries. There have been so many winners like Sony and Honda, we are told, because MITI had the foresight to *pick* them. Having spent a lifetime studying the Japanese economy, however, G. C. Allen points out that MITI's record in selecting "sunrise" industries has been anything but awe inspiring. MITI bureaucrats were so unimpressed with the technological possibilities of the transistor in the 1950s that they tried for two years to prevent Sony from buying manufacturing rights from Western Electric. They tried to dissuade Japan's auto manufacturers from getting into the export market, then tried to force Japan's 10 auto firms to merge into two, Nissan and Toyota. Fortunately for the

³⁴Reich (1983, p. 98) explicitly credits Hoover with having anticipated "the kind of government role in industrial development that Japan's MITI would undertake forty years later."

³⁵These figures were computed in terms of market prices in calendar year 1975, as reported in the Comptroller General's report to the Joint Economic Committee of the U.S. Congress (1982, p. 2).

³⁶Chalmers Johnson (1982) supplies an excellent historical survey of MITI and its antecedent institutions but he merely assumes that the Japanese miracle of the past three decades is due primarily to MITI's policies.

Japanese economy all of this advice was ultimately ignored.³⁷ If MITI has made fewer of these sorts of errors than most other bureaucracies, it is only because they exert less power.

Thus if Japanese industrial policy is to be credited with an economic miracle, it would have to be on the grounds of how *little* it interfered with entrepreneurs' decisions relative to other industrialized countries. Reich credits the remarkable success of Japan's semiconductor industry to its government's industrial policy, but, in fact, the United States government has been spending 10 times as much as Japan on semiconductor research and development. The Japanese economy employs more people in R&D than Britain, France, and West Germany combined.³⁸ Government channeling of investment funds, the central policy goal of the reindustrializers, involves a relatively small proportion of Japan's capital formation.³⁹

When the old bureaucratic class, the zaibatsu, was removed from power after the war, the productive forces of entrepreneurial competition were unleashed. Japanese government expenditure is still only about 25 percent of the GNP, compared to 35 percent in the United States and 44.5 percent in Britain (see Macrae 1980, p. 7). From 1951 to 1970 Japan's taxes fell slightly but steadily from over 22 percent of national income to under 19 percent, while taxes in most industrialized nations were rising.

Probably the single most significant factor in Japan's economic success has been its consistently high rate of savings. In 1980, for example, savings were over 19 percent of personal income. Here again it is the *lack* of government involvement which appears to be largely responsible. Depending on the kind of savings program, the first \$13,600 or \$22,600 of an individual's savings are tax exempt (Henderson 1983, p. 114). As a result, the reserves of capital available to Japanese entrepreneurs are estimated to be at least twice that available to American businesses (Gilder 1982, p. 15).

In short, while Reich is right that we can learn an important lesson from Japan, he has learned the wrong lesson. As Richard Casement (1982, p. 21) points out, by and large, "the market is king in Japan and companies respond rapidly to its changing fashions." What is

³⁷See Allen (1981), Henderson (1983, p. 113), Gilder (1982, pp. 12-13), and Sunwall (1984).

³⁸See Beckner (1983, p. 51) and Casement (1982, pp. 5 and 14).

³⁹David Henderson (1983, p. 114) cites a study by Philip Trezise at The Brookings Institution which shows that the Japan Development Bank provides only about 1 percent of private, nonhousing capital formation.

admirable about MITI is not what it has done or can do, but what it has not and cannot do.⁴⁰

There is no substantive argument for industrial policy among the structuralists other than their belief in the expertise of people, presumably like Reich or Rohatyn. But their arguments and history, in fact, provide little to support a claim that the new RFC would be able to “orchestrate” clever solutions to the financial difficulties we face on the national level. Instead, we should expect solutions which offer generous rewards to those who run their businesses or governments into debt—policies which, in themselves, would require the federal government to increase taxes, inflation, or its own debt. Reich’s policy of rewarding winners does not stem from any better conceptual foundation than does Rohatyn’s of rewarding losers, and it is as sure to encourage a gross waste of scarce resources and to make a bad economic situation worse.

Notwithstanding the insistence by industrial policy advocates that one of the main purposes in establishing a new RFC is to explicitly resolve conflicts among special interests, they are actually holding out a new and very tempting prize over which divergent interests can struggle. The political problem indicates that the worst will likely arrive on top in these struggles. Reich and Rohatyn at least *try* to address this problem, however unsatisfactory their solutions may be. But they have nothing at all to say about the knowledge problem. Nowhere are we shown why we should expect any single agency’s individual intelligence to exceed the social intelligence that results from the rivalrous nonpolitical competition among capitalists, entrepreneurs, and workers that takes place in the market. Yet without such a demonstration, the call for industrial policy amounts to nothing more than a plea for more of the same kinds of blind government intervention in the market that has brought us our current difficulties.

Conclusion

The noble-sounding aspiration of reindustrialization, implicit in the rhetorical questions of my opening paragraph, is to achieve control over the process of investment through a government agency rather than allowing the shape of capital investment to be determined by the turbulent, undesigned, and anonymous forces of supply and demand in competitive capital markets. The likely result of the plea for a new RFC is that the turbulence will remain—as indeed the current battles between various factions of industrial policy

⁴⁰For an interesting discussion of the Japanese experience with “industrial policy” and the role of MITI, see Sakoh (1984).

advocates already show—but that the rivalry will be fought with political weapons in addition to financial ones. The upshot will not be more control over investment by society at all. Indeed, the wastes involved in these political battles for government privilege will ensure that society as a whole will suffer. The only way for society as a whole to be served by the investment process is to relinquish all ambitions for “industrial policy”; that is, to abandon all current efforts to control these decisions by governmental agencies, and not to enhance and concentrate such efforts into one immensely powerful bureau.

References

- Allen, G. C. *The Japanese Economy*. New York: St. Martin's Press, 1981.
- Alpern, David M. with Fuller, Tony; Agrest, Susan; and Buckley, Jerry. “Mr. Fixit for the Cities.” *Newsweek*, 4 May 1981.
- Arenson, Karen W. “On the Frontier of a New Economics.” *New York Times*, 31 October 1982.
- Barnett, David L. “Rebuilding America, It Will Cost Trillions.” *U.S. News and World Report*, 22 September 1980.
- Beckner, Steven K. “Panel told Japan's gains not due to MITI policy.” *Washington Times*, 14 July 1983.
- Bennett, James T., and DiLorenzo, Thomas J. *Underground Government: The Off-budget Public Sector*. Washington, D.C.: Cato Institute, 1982.
- Bluestone, Barry, and Harrison, Bennett. *The Deindustrialization of America*. New York: Basic Books, 1982.
- Blustein, Paul. “‘Reindustrialization,’ a Vague Idea, Means a Very Clear Profit for Some.” *Wall Street Journal*, 27 August 1980.
- Bowles, Samuel; Gordon, David M.; and Weisskopf, Thomas E. *Beyond the Waste Land: A Democratic Alternative to Economic Decline*. New York: Anchor Press, 1983.
- Business Week*. “The Reindustrialization of America.” Special Issue reprint from *Business Week*, 30 June 1980.
- Casement, Richard. “The Innovative Japanese.” *The Economist*, 19 June 1982.
- Comptroller General, U.S. “Industrial Policy: Japan's Flexible Approach.” ID-82-32. Washington, D.C.: U.S. General Accounting Office, 1982.
- Counts, George S.; Villari, Luigi; Rorty, Malcolm C.; and Baker, Newton D. *Bolshevism, Fascism and Capitalism*. New Haven, Conn.: Yale University Press, 1932.
- Etzioni, Amitai. *An Immodest Agenda: Rebuilding America Before the Twenty-First Century*. New York: McGraw-Hill, 1983.
- Gilder, George. “The Entrepreneur.” *Manhattan Report*, October 1982.
- Grinder, Walter E., and Fairgate, Alan. “The Reconstruction Finance Corporation Rides Again.” *Reason* 7 (July 1975): 23–29.
- Hayek, Friedrich A. *Prices and Production*. London: Routledge & Sons, 1931.
- Hayek, Friedrich A. *Monetary Theory and the Trade Cycle*. London: Jonathan Cape, 1933.

- Hayek, Friedrich A. *Collectivist Economic Planning: Critical Studies on the Possibilities of Socialism*. London: George Routledge & Sons, 1935.
- Hayek, Friedrich A. *Profits, Interest and Investment*. London: Routledge & Kegan Paul, 1939.
- Hayek, Friedrich A. *The Road to Serfdom*. Chicago: University of Chicago Press, 1944.
- Hayek, Friedrich A. *Individualism and Economic Order*. Chicago: Henry Regnery, 1948.
- Henderson, David R. "The Myth of MITI." *Fortune*, 8 August 1983.
- Hoff, Trygve J. B. *Economic Calculation in the Socialist Society*. Indianapolis, Ind.: Liberty Press, 1981.
- Johnson, Chalmers. *MITI and the Japanese Miracle*. Stanford, Calif.: Stanford University Press, 1982.
- Jones, Jesse H. *Fifty Billion Dollars: My Thirteen Years with the RFC 1932-1945*. New York: Macmillan, 1951.
- Kinsley, Michael. "The Double Felix," review of Rohatyn, *The Twenty-Year Century* (1984). *The New Republic*, 26 March 1984.
- Lavoie, Don. "A Critique of the Standard Account of the Socialist Calculation Debate." *Journal of Libertarian Studies* 5 (Winter 1981): 41-87.
- Lavoie, Don. *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered*. New York: Cambridge University Press, forthcoming 1985.
- Lens, Sidney. "'Reindustrialization': Panacea or Threat?" *The Progressive*, November 1980.
- Macrae, Norman. "Must Japan Slow?" *The Economist*, 23 February 1980.
- Magaziner, Ira C., and Reich, Robert B. *Minding America's Business*. New York: Random House, 1983.
- McClelland, P., and Magdovitz, A. *Crisis in the Making*. Cambridge: Cambridge University Press, 1981.
- Mises, Ludwig von. "Economic Calculation in the Socialist Commonwealth." Trans. by S. Adler, in Hayek (1935).
- Muller, Ronald E. *Revitalizing America: Politics for Prosperity*. New York: Simon and Schuster, 1980.
- Reich, Robert B. *The Next American Frontier*. New York: Time Books, 1983.
- Rohatyn, Felix G. "Strong Medicine." *Across the Board*, May 1980a.
- Rohatyn, Felix G. "The Coming Emergency and What Can Be Done About It." *The New York Review of Books*, 4 December 1980b.
- Rohatyn, Felix G. "A Matter of Psychology." *The New York Review of Books*, 16 April 1981a.
- Rohatyn, Felix G. "An RFC Could Help New York Transit." *New York Times*, 29 June 1981b.
- Rohatyn, Felix G. "The State of the Banks." *The New York Review of Books*, 4 November 1982a.
- Rohatyn, Felix G. "Alternatives to Reaganomics." *New York Times Magazine*, 5 December 1982b.
- Rohatyn, Felix G. *The Twenty-Year Century: Essays on Economics and Public Policy*. New York: Random House, 1984.
- Rothbard, Murray N. *America's Great Depression*. Kansas City, Kans.: Sheed and Ward, 1975.

CATO JOURNAL

- Rothenberg, Randall. "An RFC for Today: A Capital Idea." *Inc.*, January 1983.
- Sakoh, Katsuro. "Japanese Economic Success: Industrial Policy or Free Market?" *Cato Journal* 4 (Fall 1984): 521-43.
- Serrin, William. "Rohatyn, 'Going National,' Doubts Free-Market Future." *New York Times*, 21 April 1981.
- Sunwall, Mark. "Is MITI Responsible for Japan's Industrial Success?" Unpublished paper, 1984.
- Vaughn, Karen. "Economic Calculation under Socialism: the Austrian Contribution." *Economic Inquiry* 18 (Summer 1980): 535-54.
- Villari, Luigi. "The Economics of Fascism." In Counts et al. (1932).
- Weber, Christopher. *Bailing Out a Bankrupt World*. San Francisco: Investment Insights Publishing, 1983.
- Zaid, Charles (compiler). *Preliminary Inventory of the Records of the Reconstruction Finance Corporation, 1932-1964*. Washington, D.C.: National Archives and Records Service, 1973.