

# The Costs and Benefits of Industrial Support

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# 'Picking winners'

- ▶ Market failures appear to be pervasive
  - ▶ Externalities *spillovers*
  - ▶ Agglomeration economies *clusters*
  - ▶ Internal economies of scale *intangibles*
  - ▶ Coordination failure
  - ▶ Credit and equity market failures
- ▶ Apparent case for intervention?
- ▶ But many are sceptical of governments' competence in selective intervention
  - ▶ There's "*a well-established consensus that government cannot pick winners*" (OECD)

*View based on?*

- ▶ The industrial policy record
- ▶ Information problems
- ▶ Rent-seeking behaviour

# The selective intervention puzzle

- ▶ This conclusion on selective intervention is puzzling, and dangerous
- ▶ Let's assume government's industrial goal is to deliver the highest path of per-capita GDP, constrained by a distributional equity objective
- ▶ This means building and retaining high value-added activity
- ▶ Given this goal, any government *must* have preferences across technologies, sectors, companies
- ▶ And will use all the tools it has that are effective
- ▶ Key insight is that the public industrial policy problem is a very close relation of the private industrial investment problem
- ▶ The private sector uses the language of sustainable competitive advantage and of 'intangibles' to analyse the conditions for this

# The private industrial investment problem

- ▶ Companies
  - ▶ Search for high value-added investment opportunities
  - ▶ ‘Value’ is NPV, discounted at the opportunity cost of capital, of incremental costs and benefits within the frontier of company
  - ▶ Value creation associated with
    - possession of intangibles
    - duration, sustainability of competitive advantage
    - fierce competition
    - creation of strategic options
  - ▶ Uncertain payoffs; key costs and benefits nonquantifiable
- ▶ Extreme uncertainty and competition → high failure rate
- ▶ But do we think all economic outcomes are random, and all economic success is luck? Probably not
- ▶ So question is *how* companies go about picking winners in an increasingly competitive world

# The GBI scheme in England

- ▶ Long-running scheme
- ▶ Fairly limited funding; scope limited by U.K.'s non-interventionist culture, and by EU rules, inter alia
- ▶ Cases now typically FDI, green, technology, intangibles-rich
  
- ▶ GBI used here as a model of how, *if you do it*, you may do selective assistance intelligently and successfully
- ▶ Approach characterised by
  - ▶ Rigorous quantification of externalities and shadow prices
  - ▶ Research led
  - ▶ Officials with deep subject-area expertise, industry dialogue
  - ▶ Oversight and review provided by a board of unpaid senior professionals
- ▶ Combines best practice from private and public sectors
- ▶ Resolves the information and rent-seeking issues

# Economic analysis

- ▶ Discounted cash flow analysis → **Private NPV**
- ▶ Adjust for transfer payments, taxes
- ▶ *By default*, private NPV measures public net economic benefit
- ▶ Adjust, line by line, when private NPV doesn't measure public shadow price of the resources, externalities, for example
  - ▶ *Labour market imperfections*
    - Quality of employment
    - Profile expected unemployment, shadow price of labour
    - Social cost of unemployment has social costs
  - ▶ *Supply chain effects*
  - ▶ *Skills*
    - NPV reflects company's net benefit of investing in skills.
    - Adjust if these skills will be valuable later, outside
  - ▶ *Research spillovers* as above
  - ▶ Other
- ▶ → **Public NPV**
- ▶ Risk – meaningful scenario analysis, **expected NPV**

# The value narrative

- ▶ The value narrative counters the tyranny of the spreadsheet.
- ▶ Quality of the business
  - ▶ the quality of management
  - ▶ financial strength
  - ▶ strategic and market review, Porter's 5 forces...
- ▶ Private value logic?
  - ▶ why is the NPV +ve? Sustainable competitive advantage?
  - ▶ strategic options
  - ▶ meaningful scenario analysis
- ▶ Public value logic?
  - ▶ justify the inclusions and exclusions in shadow pricing
- ▶ Unquantified effects
  - ▶ creation of intangible assets
  - ▶ strategic options, that may pay off later.
- ▶ Where is the capital market failure?
- ▶ Identify areas that offer highest return to public intervention

# Review and governance mechanisms

- ▶ Proposals subject to external due diligence
- ▶ Extensive use of sophisticated financial structuring to limit downside risk to public purse, recover funds
- ▶ Industrial Development Advisory Board
  - ▶ 12 members - senior industrialists, entrepreneurs, investment bankers, accounting and real estate professionals
  - ▶ Unpaid
  - ▶ Statutory responsibility, 1982 Industrial Development Act
- ▶ Parliamentary accountability by ministers
- ▶ Public access to process through FOI



# Challenges

- ▶ **Applicants** tend to be either unsophisticated or over-sophisticated
  - ▶ Many corporate applicants have no grasp of the logic of a business case
  - ▶ Some large applicants are expert at grant shopping. Goldilocks presentation - not too profitable, not too unprofitable
  - ▶ Both are costly to process and audit
- ▶ **Additionality**
  - ▶ The biggest challenge is the counterfactual. It is invariably claimed that without government support investments either will not happen or will go overseas.
  - ▶ Increasing mobility of international capital and sophistication of MNEs means governments pay a full price for FDI
  - ▶ The economic NPV defines a *reservation price*, beyond which it is not worth government going. We step out of the race to the bottom at this point.

# Challenges

- ▶ **Research dependence**
  - ▶ Heavy use of empirical evidence to quantify externalities, shadow prices
  - ▶ Research base varies in depth
    - FDI, MNE impacts
    - R&D spillovers
  
    - Labour reuptake after economic shocks
    - Skills spillover
- ▶ Ex post evaluation of industrial interventions is key to learning

# Finally

“Industrial policy has often been criticised as “picking winners”; it is argued that the government is particularly ill-suited to that task. In fact, the government has had a remarkable history of success, from the support of agricultural research (the core industry in the 19th century) which led to huge increases in productivity in that sector, to the first telegraph line (between Baltimore and Washington, in 1842) to the development of the Internet....

The objective of the government is not to pick winners, but to identify externality-generating innovations. While critics of industrial policy recognise the necessity of government support for basic research, they fail to note that there is no bright line between basic and applied research; many applied research projects generate large externalities. The objective of government policy is to identify winning projects with large externalities. In this, they have had a history of notable successes.”

Joe Stiglitz, 1999