Firms in declining industries have stronger incentives to lobby for protection than firms in expanding industries

Governments frequently intervene to support domestic industries, but a surprising amount of this support goes to ailing sectors. **Frédéric Robert-Nicoud** and **Richard Baldwin** explain why.

Industrial policy:

why governments pick losers

Governments that try to pick winners and losers usually choose the latter. Some of the clearest examples of this come from trade policy. In the United States and Europe, the most protected sectors – agriculture, textiles, clothing, footwear, steel and shipbuilding – have all been in decline for decades. Likewise, one of the few policies of the Bush administration that President Obama is not breaking with is in keeping the US car industry alive 'a high priority'.

Counter-examples are rare. Even when a growing sector gets protection, as the US semiconductor industry did, the protection tends to be focused on market segments – like memory chips – in which the domestic industry is losing ground.

There are a few reasons for protecting 'losers', two of which may make some economic sense. The first is that the losers of today might be the winners of tomorrow: these 'infant industries' need protection while they mature before they can successfully compete with the world leaders. These are industries like biotechnology or semiconductors, where accumulated learning and experience are important drivers of productivity.

But picking potential winners is difficult in practice. And governments seem much better at protecting 'national champions' – sunset sectors like Detroit's car industry or Italy's flagship airline, Alitalia – than dynamic industries. In contrast, 'the market does a great job of rewarding the very best and cutting the rest down to size' (Harford, 2008).

A second justification for protecting losers is one of 'insurance' – a desire to protect the least well-off. But in developed nations, governments have many policies for redistributing income and protecting the worst-off (such as income taxes, unemployment benefits and retraining schemes). So we should separate industry support from considerations of income distribution. After all, we care about people not corporations.

A third intuitive explanation for protecting losers is the fact that people care more about 'known' individuals than unidentified 'faceless' individuals. Anne Krueger (1990) contrasts the impact of a subsidy to a declining sector with one to an expanding industry: both will alter the allocation of employment, but in the ailing industry the jobs 'saved' can be identified with specific people whereas the jobs created in the expanding sector cannot.

Unlike the first two explanations, this 'identity bias' argument has implications that are much more consistent with observed government behaviour. Witness, for example, the asymmetry in press coverage and government response (especially in continental Western Europe) between a factory that shuts down and lays off a few hundred workers and the thousands of jobs being created daily in dynamic industries that go unnoticed.

But an important criticism of the identity bias argument is that it does not explain why certain sectors are more successful in attracting government support than others. In the 1980s, the real wages of US unskilled workers fell substantially but only a small subset of these, including apparel workers, managed to win government support.

Understanding these facts becomes easier if we take a more cynical view of the way policies are shaped. In our research, we use the proliferation of pressure groups to account for the surprising amount of support that goes to declining industries.

Protectionist packages that place controls on domestic entry or production are likely to attract greater lobbying efforts

Pressure groups are ubiquitous. There are an estimated fifteen to twenty thousand lobbyists in Brussels. In the United States in 1999, 3,835 political action committees were registered and over eleven thousand general interest groups, companies and associations engaged representatives in Washington, DC (www.opensecrets.org; Grossman and Helpman, 2001).

Some of the activities of these groups may be beneficial: they can relay complex information from experts to legislators and senior civil servants. But it is also clear that such groups are equally successful at bringing home what Americans call 'pork'.

Our basic story is simple. Government policy is influenced by pressure groups who engage in expensive lobbying. Special interest groups spend money in return for favours that benefit their bottom line (Grossman and Helpman, 1994). But contracting industries have much more to gain from retaining lobbyists than expanding industries.

In an expanding industry, a given firm cannot successfully retain the benefits from lobbying as new firms will enter the market and compete away any profitable opportunities. This is not true in declining industries. Since there are costs that are 'sunk' when a firm enters the market (such as unrecoverable investments in product development, training and brand name advertising), new entrants will not be able to compete away profitable opportunities as easily.

The result is that losers lobby harder. So it is not government policy that picks losers but rather that losers pick government policies. This may also explain why special interest groups fight harder to avoid losses than they do to win gains.

One key ingredient in our story is that lobbying is costly. Some sectors might overcome these costs and organise more easily than others. In particular, sectors with only few firms should find it easier to prevent one firm from 'free-riding' on the lobbying efforts of others than sectors with a plethora of small firms. Recent US evidence suggests that all things being equal, sectors that have few large firms get more protection than others (Bombardini, 2008).

The other key ingredient in our story is that there are entry costs that are 'sunk' and not recoverable on exit. When these sunk costs are investments in human capital, this also explains why workers with skills specific to ailing industries lobby harder (for example, farmers and car workers).

Our analysis sheds light on the undesirability of packaging protectionist policies with policies discouraging entry from competitors (such as a government monopoly or production quotas). Such packaging is likely to lead to greater levels of protection because it increases the incentives of all industries to lobby for protection.

In addition, when some of the entry costs are created by regulation and red tape, special interest groups that manage to keep such regulations in place need not be losers. Taxi drivers in the big cities of the world are an example. How else to explain how a New York taxi licence hit the record price of US$600,000 in May 2007? If entry were free, the licence would be worthless.

Government policy doesn't pick losers: losers pick government policies

While most OECD countries have laws prohibiting cartels that prevent new production and entry, in certain industries, such as medicine and law, the special interest group itself regulates the flow of new entrants. In many countries, the airline industry regulator and the flagship airline seem to be indistinguishable in practice.

Unions can play a similar role: those that are able to control the wages of new workers benefit from higher tariffs in both contracting and expanding industries. In fact, many countries have sanctioned 'closed shop' rules that have had exactly this effect. France protects its energy market from foreign competitors (in violation of European Union rules). In this case, the unions of its national giant, EDF, managed to secure wages at a much higher level than the national average – that is, to capture a share of the profits being created by limited entry that usually accrue to shareholders.

The recent US 'cash-for-clunkers' policy and the government loans to Chrysler and GM can also be understood as ultimately helping a key constituency of the Democrats: the members of the United Auto Workers union.

So protectionist packages that place controls on domestic entry or production are likely to attract greater lobbying efforts – which is worse for society as a whole. If governments refrain from packaging trade policy with policy that (in effect) regulates entry, protectionism should be reduced.

Image: Anastasia Whittle

This article summarises 'Entry and Asymmetric Lobbying: Why Governments Pick Losers' by Frédéric Robert-Nicoud and Richard Baldwin, CEP Discussion Paper No. 791 (http://cep.lse.ac.uk/pubs/download/dp0791.pdf) and subsequently published in the *Journal of the European Economic Association* 5(5): 1064-93, September 2007.

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Further reading

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Tim Harford (2008) 'Rewarding Mediocrity', Forbes.com, 29 January (http://www.forbes.com/business/2008/01/29/national-champions-economics-biz-champions08-cx_th_0129harford.html).

Anne Krueger (1990) 'Asymmetries in Policy between Exportables and Import-competing Goods', in Ronald Jones and Anne Krueger (eds) *The Political Economy of International Trade*, Basil Blackwell.