

## Competition and Industrial Policy<sup>1</sup>

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1. I would like to talk about the roles competition and industrial policy play in the process of economic development. My talk is based on economic theory and the Japanese post WW2 experiences.

I am afraid that it is often the case that the roles competition and industrial policy played in the post WW2 economic development in Japan are not understood correctly. This misunderstanding might lead to the wrong policy recommendations. It is important to have a balanced view on the relative importance of these two factors, based on the sound economic theory.

2. The competition in the Japanese industries was very intense during the period of high speed economic growth of the 1950s, 60s and 70s. At this time, there were 11 car manufacturers, 5 main frame computer manufacturers, and 6 aluminum

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<sup>1</sup> The opinion expressed in this paper (and speech) is solely mine, and it does not necessarily represent the position of the Fair Trade Commission.

smelters. These numbers are much larger than the numbers of firms in the corresponding industries in the U.S. where the market sizes were much larger. Each firm tried to obtain technology that enabled it to produce better products at lower costs than rivals.

In the early period, import and inward foreign investment were restricted. However, even in this period, the government decided to end the protection within near, certain date and announced it. The domestic firms were keenly aware that the protection would end soon, and they would face the competition from much larger, advanced foreign firms. This drove domestic firms further to acquire advanced technology.

Secondly, Japanese firms were very much export oriented. In overseas market, Japanese firms had to compete with larger, technologically advanced Western firms, and in order to succeed in the overseas market, they had to have advanced technology.

3. The backgrounds of the intense competition were dissolution of Zaibatsu and large firms after WW2, and the active entry of new firms induced by rapid growth of markets. Competition

policy also played an important role. The Anti-monopoly Act was introduced and the Fair Trade Commission was established in 1947. Japan was among the first countries that introduced competition law. However, in the 1950s and 1960s, the importance of competition was not understood well by politicians, the business community and general public. The Fair Trade Commission's status in the government was not strong within the government compared to powerful ministries such as Ministry of International Trade and Industry (MITI). But the existence of the Anti-monopoly Act and the Fair Trade Commission as the Agency to enforce the law provided the baseline to stop the Japanese economy to return to the pre WW2 economy which was dominated by a few Zaibatsu (corporate group), and to maintain a competitive environment.

4. Ministries, particularly the MITI, employed various policy tools to protect and promote industries they regulate. As mentioned earlier, the number of firms in Japanese industries tended to be large. Industrial policy ministries tried to merge these firms to create a few large firms, citing duplicative

investments and excess competition. Firms resisted this government initiative, and the industrial policy ministries eventually gave up this idea. For instance, the MITI tried to merge car companies into two large companies capable of mass-production of passenger cars, and tried to limit new entry. Mr. Soichiro Honda, the founder of Honda Motor, who used to run a bicycle repair shop, was just trying to start manufacturing passenger cars. New companies such as Honda were alarmed by this plan, and fought against the plan vigorously. Looking back, this was the crucial moment of the Japanese car industry.

Fortunately, the plan to create national champions in the car industry, petro-chemical industry and specialty steel industry was abandoned, and companies competed each other vigorously and this made them strong, competitive companies. Ministries employed other policy tools such as subsidies and tax breaks, but the effectiveness of these policies are not very clear. Richard Beason and David Weinstein of Columbia University did a careful econometric study to examine the

effectiveness of these policies.<sup>2</sup> The result was that these policies did not help to improve productivity of the Japanese industries, and rather they played a role to rescue declining industries.

5. Industrial policy ministries also promoted the formation of recession cartels and rationalization cartels during the economic downturn. They were treated as exemptions of the Anti-Monopoly Act, and there were many such cartels in the 1960s and 70s. In addition, after the first and second oil crisis, a series of “special acts” was introduced to promote consolidation and rationalization of the declining industries. Hayashi and Prescott show that the real problem behind the stagnation of the Japanese economy in the 1990s, “a lost decade”, is not a breakdown of financial system after the burst of the bubble in the early 1990s, but the low productivity growth.<sup>3</sup> They conjecture that these measures taken to rescue

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<sup>2</sup> Richard Beason and David Weinstein, “Growth, Economies of Scale, and Targeting in Japan (1955-1990)”, *Review of Economics and Statistics*, May 1996, 78(2), pp. 286-95.

<sup>3</sup> Fumio Hayashi and Edward Prescott, “The 1990s in Japan: A

inefficient firms, or “zombies” and declining industries resulted in the low productivity. With the current economic crisis, we should keep in mind that the short term relief given during the slump would have enduring consequences. I should mention here that the system of depression cartel and rationalization cartel were already abolished.

6. In order to enhance the competitiveness of firms, one of the most important points is to encourage firms to accumulate the capacity to learn and create new technology. Vigorous competition forces firms to acquire this capacity. Firms enjoying an easy life of monopolists have little incentive to do so. When competition is intense, firms had to invest in R&D to acquire and use this capacity to excel over rivals.

At the same time, they need an assurance that once they succeed in developing new technology, they can appropriate profits from it. This can be given by a patent system and other

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Lost Decade”, *Review of Economic Dynamics* 5, 2002, pp 206-235. See also, Merton Peck, Richard Levin and Akira Goto, “Picking Losers: Public Policy Toward Declining Industries in Japan” *Journal of Japanese Studies*, vol13, No.1 Winter 1987, pp79-123, also included in *Government Policy Towards Industry in the United States and Japan*, (John Shoven Ed.), Cambridge University Press, 1988, pp.165-239.

appropriability mechanisms. Economic theory shows that intense competition prior to innovation and the expectation of the limited length of monopoly period would lead to active innovation. To create such an environment, appropriate combination of competition policy and patent system is the key. In addition, close relationship between companies on the one hand and public research laboratories and universities on the other hand is needed. Stable macroeconomic management is of course the pre condition to induce investments.

7. Thus, protecting and promoting competition at the market place is itself the key element of the policy to promote industry. Out of intense competition grows strong and competitive companies. Excessive intervention by the government under the name of industrial policy often ends up by favoring existing large firms, leading to rent seeking activities, and hindering economic development at the end of the day.

This type of policy is the product of 20<sup>th</sup> century when such industries as steel and automobiles were dominant. It is neither effective for knowledge intensive industries in the 21<sup>st</sup> century nor service industry which is already a dominant

industry today.

8. This does not mean that there is no role for government to promote industry. On the contrary, there are many important roles government should be playing. First of all, enforcement of competition law. This is particularly important to create an environment where companies try to earn profit by introducing better and cheaper products, not by cartels and bid rigging. Competition policy is important to create an environment where firms try to create wealth, not to steal wealth from consumers and tax payers.
9. Other than competition policy, there are important policies for the government to implement to promote industry. They include, education, promotion of R&D, training of scientists and engineers, promotion of financial system that provide funding to entrepreneurs with fresh ideas, removal of various restrictions and regulations that hinders entry, introduction and enforcement of an sensible intellectual property system, and building infrastructure such as roads, telecommunication and electricity network. The role of the government here is more than significant.

10. Now, countries have to plan economic growth strategies in the face of rapid globalization. This gives great opportunities for countries as the market for them is expanding. The role of the government to monitor developments of the market trends and technological development overseas, and feedback those to domestic firms are increasingly important to seize opportunities open to them.