ERIA-DP-2016-40

ERIA Discussion Paper Series

Competition Policy vs. Industrial Policy as a Growth Strategy

Tatsuo HATTA

Asian Growth Research Institute[*]

March 2017

Abstract: *This paper examines the rationale behind industrial policy and competition policy as growth strategies, and shows that competition policy, rather than industrial policy, generated the rapid economic growth in post-war Japan. It also reveals that Japan's growth rate was lowered from the mid-1970s due to newly introduced industrial policies and paucity of further competition policy. The current Abe government recognises the need for competition policies in Japan to recover from the low-growth period. The paper describes the types of competition policy carried out under Abenomics, especially in strategic special economic zones.*

Keywords: Abenomics, completion policy, industrial policy, growth strategy, trade liberalisation, privatisation

[*] *11-4 Otemachi, Kokura-kita, Kitakyushu, Fukuoka, Japan*

It has often been argued that the source of Japan's rapid post-war growth was the industrial policies of the Ministry of Economy, Trade and Industry (METI).[1] In recent years, competition policies have been widely recognised as essential for the recovery of growth in Japan.[2] In this paper, we compare industrial policy with competition policy as a strategic instrument for promoting economic growth in the context of Japan's post-war economic growth.

Industrial policy promotes targeted industries selected by the government through trade protection, tax breaks, and government loans. *Competition policy*, on the other hand, refers to any policy that promotes competition in the market. It includes deregulation, trade liberalisation, anti-cartel policy, and the privatisation of publicly owned monopolies.

In this paper, we examine the rationale behind industrial policy and competition policy as growth strategies, and we show that competition policy, rather than industrial policy, generated the rapid economic growth in post-war Japan. We will also reveal that Japan's growth rate was lowered from the mid-1970s due to newly introduced industrial policies and paucity of further competition policy. The current Abe government recognises the need for competition policies in Japan to recover from the low-growth period. We describe what types of competition policy have been carried out under Abenomics, especially in strategic special economic zones.

In Part 1, we compare competition policy and industrial policy as a growth strategy. In Part 2, we examine various justifications for industrial policies and conclude that none of the conventional justifications for industrial policies are well founded in practice. Then we cite a number of empirical studies that confirm the industrial policies were not effective in Japan. In Part 3, we demonstrate that the series of competition policies in the early post-war period laid the groundwork for the economic growth of the 1960s. In Part 4, we examine why Japan stopped growing in the mid-1970s. We conclude that this was due to a slowdown in competition policy, which was not politically popular. We also review recent attempts to revitalise competition policy in Japan, especially under the Koizumi reform and the recent Abe

[1] See, for example, Johnson (1982).
[2] See, for example, Botman, Danninger, and Schiff (2015).

reform. We outline the current status of these reforms and difficulties they have faced. In Part 5, we point out the most urgent growth agenda that Japan has faced is reform of employment regulations. The conclusion reiterates why competition policy, which is politically difficult, plays a crucial role as a growth strategy. The appendix outlines the system of national strategic special zones under the Abe government.

1. Growth Strategy

1.1. Two Sources of Economic Growth

In designing a growth strategy, it is useful to distinguish between two sources of economic growth:

The first is, of course, innovation.The second is shifting resources from low-productivity sectors to high-productivity sectors. For example, migration of workers from agricultural to the manufacturing sectors improved nation's productivity during the rapid growth period.

Industrial policy is typically intended to foster innovation in targeted industries. Competition policy is designed to shift resources to high-productivity sectors. To implement competition policy, the government does not select targeted industries. Rather, the market is given the role of selecting the industries that grow.

1.2. Why Competition Policy?

Microeconomics tells us that competitive markets allocate resources efficiently in the absence of market failure. This proposition, which is called the 'basic theorem of welfare economics', is the basis of any competition policy.

In the absence of market failure, market competition ensures that resources flow in the direction of higher productivity in search of higher rewards. Hence, markets allocate resources efficiently.

However, this natural flow of resources often faces obstacles set up by incumbent firms to protect their vested interests. Competition policy is designed to remove these obstacles that hamper the natural flow of resources.

A noteworthy example of competition policy that removes the obstacles to free movement of resources is the tariff-free opening of Japanese ports in 1859, which was forced on Japan by the foreign powers. This wiped out Japan's domestic cotton-growing industry within 10 years. The high growth of the early Meiji period would not have been possible without such a drastic competition policy.

1.3. Why Industrial Policy?

Industrial policy is nothing but a market intervention. In view of the basic theorem of welfare economics, it is justifiable to the extent that market failure exists. Such failure could arise from scale economies, public goods, externalities, and informational asymmetries (Rosen and Gayer, 2014).

2. Industrial Policy

2.1. Justifications for Industrial Policy

Let us now examine whether any of the market failures can justify industrial policies.

Scale Economies

The first example of industrial policy is the 'infant industry argument', which states that an industry subject to scale economies may be protected in its initial stages, through import tariffs, for example.

However, if capital markets are perfect, private investors will find it profitable to invest in such industries anyway. In this case, government intervention is unnecessary (Krugman, Obstfeld, and Melitz, 2015).

In particular, given perfect international capital mobility, foreign companies will be attracted to invest in such an industry. Thus, the traditional justification for industrial policy based on the presence of scale economies is untenable in the contemporary environment of global capital movement.

Externalities

The second justification is based on the existence of externalities. However, if the source of externalities is the spillover effect of technological innovation, the appropriate policy is to establish a system for protecting intellectual property rights. If externalities are caused by agglomeration-type externalities, it is appropriate to provide Pigouvian subsidies for the activities that produce externalities rather than export subsidies, for example (Rosen and Gayer, 2014; Krugman, Obstfeld, and Melitz, 2015).

Strategic Trade Policy

The third justification is based on Krugman's strategic trade policy (1986), which is essentially a 'beggar-thy-neighbour' policy. Krugman (1987) points out that by its nature, this policy may be difficult to sustain in the long run. Thus, strategic trade policy is impractical.

We therefore conclude that none of the conventional justifications of industrial policy are well founded in practice.

2.2. Industrial Policies

Throughout the post-war period, the Government of Japan intervened in the market to promote growth of some industries and to prevent decline of other industries.

We may roughly divide this period into two periods: the rapid growth period until the oil shock of 1973 and the low growth period after that (Komiya, Okuno, and Suzumura, 1988).

In the first period, the Japanese government promoted various heavy industries like steel and the petrochemical industries. The government also allowed 'recession cartels' into industries like steel and shipbuilding by exempting them from the Antimonopoly Act for a certain period.

In the second period, the government shifted the target industries to the computer industry. It also started to subsidise the declining industries such as agriculture, mining, textile, and shipbuilding, under 'structural adjustment', exemplified by the Law on Temporary Measures for the Structural Improvement of Specified Industries (1983).

2.3. Failure of Industrial Policies in Japan

Until around 1980, a common belief was that the source of Japanese economic growth was the industrial policy orchestrated by the Japanese Ministry of International Trade and Industry (MITI), as promulgated by Johnson's book *MITI and the Japanese Miracle* (1982).

However, most of MITI's industrial policies were ineffective in stimulating growth. In a comprehensive study of industrial policy, Beason and Weinstein (1996) examined all industries and, contrary to the conventional wisdom, found no evidence that industrial policy measures enhanced productivity.

Moreover, Ohashi (2005) demonstrated that subsidising steel exports, a major plank of MITI's industrial policy, had an 'insignificant impact on the growth of the steel industry'. Export subsidies were not the source of the emergence of the Japanese steel industry.

2.4. Industrial Policy for Declining Industries

Despite its ineffectiveness, industrial policy has attracted policymakers. For example, Beason and Weinstein (1996) found that Japanese industrial policy disproportionately targeted low-growth sectors and sectors with decreasing returns to scale.

In addition, Noland and Pack (2003) showed that Japanese industrial policy focused mainly on agriculture and mining, which are not exposed to international competition.

2.5. Growth without Government Help

The post-war Japanese experience confirmed the theoretical expectation that industrial policy is ineffective: it is difficult to name any successful industries that received help from the government.[3] In fact, companies such as Sony, Honda, and Panasonic grew in the post-war period despite receiving only little help from the government.

Indeed, Takeuchi (2002) showed that the government played a negligible role in Japan's post-war industrial success. His list of industries that thrived in the absence of government help includes industrial robots, air conditioners, sewing machines, videotape recorders, fax machines, audio equipment, car stereos, typewriters, cameras, carbon textiles, rail tracks, computer games, musical instruments, and forklifts.

[3] Other supporting evidence can be found in Okita (2010) and Miwa and Ramseyer (2006).

By shifting resources to targeted industries, industrial policy reduces output levels in untargeted industries. Japan's industrial policy hampered its economic growth.

The damage was exacerbated by choosing industrial policy targets on political, rather than economic grounds (Okita, 2010).

3. Competition Policy

3.1. Competition Policies in the Early Post-war Period

Competition policy played an important role in stimulating Japan's post-war economic growth. Let us review the history of competition policies implemented during this period.[4]

Dissolution of the Zaibatsu (1945–1950)

Immediately after the Second World War, the General Headquarters of the occupation force, which was then called the GHQ, requested the Japanese government to dissolve the pre-war industrial conglomerates known as the zaibatsu. The dissolution of the zaibatsu took place between 1945 and 1950.

Before the war, a small number of conglomerates, including Mitsui, Mitsubishi, and Sumitomo, dominated the Japanese economy. GHQ felt that these conglomerates had been a driver of the nationalistic, expansionary government policies that led to the war. GHQ wanted these pre-war conglomerates to be dismantled, partly because of this perception and partly because of its well-founded belief that promoting competition would provide an essential environment for a healthy economy in Japan, as it had in the United States. As a result, the zaibatsu companies were broken up into several smaller companies, and the shares of the holding companies owned by the zaibatsu families were effectively confiscated.

Establishment of the Fair Trade Commission (1947)

In 1947, the Japanese government introduced the Antimonopoly Act and established the Fair Trade Commission. Following the breakup of the pre-war conglomerates, the various sibling companies managed to maintain informal associations between themselves. However, they were no longer governed by a single

[4] Ito (1992) gives a good survey of the post-war economic growth of Japan.

holding company, and these informal groupings were strictly regulated by the Fair Trade Commission. The antitrust policy, initially forced upon Japan by GHQ, undoubtedly laid the foundation for the competitive business environment underpinning Japan's post-war economic growth.

A symbolic outcome of this policy was the merger of the former Mitsui Bank and the former Sumitomo Bank into the Mitsui-Sumitomo Bank in 1996. It is particularly interesting to note that this took place while a number of Mitsui and Sumitomo group companies were competing against each other, as exemplified by the competition between their respective real estate companies or chemical companies.

3.2. Competition Policies during the 1960s

Trade Liberalisation (1960s–Present)

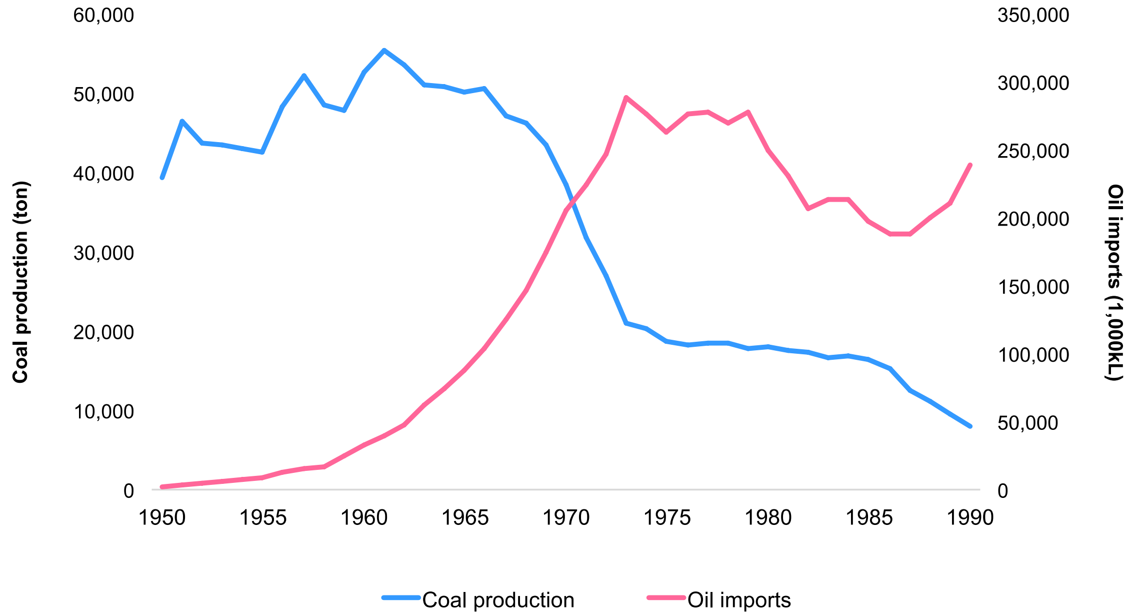
The next major competition policy was the drastic trade liberalisation policy of the 1960s, which forced Japanese firms to face international competition.

A striking example is the liberalisation of oil imports. By 1960, Japan was almost self-sufficient in coal. However, when the late 1950s brought the availability of cheap Middle East oil, the Japanese government relied on oil import barriers to protect its domestic coal industry.

In the early 1960s, the Japanese government's liberalisation of oil imports effectively dismantled the coal industry, compelling some 200,000 workers to lose jobs in this industry (Shimazaki, 2013). However, the rapid economic growth of the 1960s would have been impossible without the liberalisation of oil imports (Figure 1).

Thus, competition policy was essential in bringing about Japan's post-war economic growth.

Figure 1. Coal Production and Oil Imports



Source: Japan Coal Energy Center, Ministry of Economy, Trade and Industry.

4. Political Economy of Competition Policy and Industrial Policy

4.1. Why Did Japan Stop Growing in the Early 1970s?

It is natural to ask why Japan stopped growing in the early 1970s. The answer is that politicians and bureaucrats, who found industrial policy extremely tempting, had been introducing new entry barriers and new industrial policies since the mid-1960s. They strengthened such barriers in the agriculture, medical, and distribution industries. For example, acreage reduction of the rice field was introduced in 1970, new medical schools have not been allowed since 1972, and the Large-Scale Retail Stores Location Law was introduced in 1975. Politicians and bureaucrats also reallocated government budgets from metropolitan areas to rural areas to protect the declining rural areas, thereby artificially reducing migration from the rural to the metropolitan areas.

By the end of the 1960s' period of rapid growth, various industries had accumulated vested interests, which they protected by using their influence on politicians and government officials to block new entrants.

Policymakers have been reluctant to conduct competition policies because they challenge the interests of incumbents whose political power exceeds that of consumers. Thus, Japanese policymakers have been unable to remove entry barriers in agriculture, fisheries, and the health sector. For example, corporations are not allowed to own farmland or to operate independent fisheries along the coast. Also, an import tariff of 778% is imposed on rice. In addition, numbers of hospital beds are strictly controlled in each city to protect the interests of its doctors.

The dramatic decline in Japan's economic growth rate over the last 40 years was brought about by scarcity of new competition policies, and the accumulation of these entry barriers created by new industrial policies.

4.2. Hopeful Signs: Efforts to Rebuild a Competitive Environment

There have been sporadic attempts to strengthen competition.

Privatisation of Public Utilities by Nakasone (1980s)

Influenced by President Reagan and Prime Minister Thatcher, the Nakasone administration privatised the Japan National Railways (1987), Nippon Telegraph and Telephone Corporation (1984), Japan Tobacco and Salt Public Corporation (1985), and Japan Airlines (1987).

Regulatory Reform by Koizumi (early 2000s)

A more recent example is the series of regulatory reforms implemented by the Koizumi government in the early 2000s.

By the end of the 20th century, various industries had accumulated vested interests and started to defend their interests by setting regulations to block new entrants through their influence on politicians and government officials. The purpose of the Koizumi deregulation was to remove such entry barriers.

In particular, revision of the Antimonopoly Act in 2005 introduced amnesty measures that drastically reduced bid-rigging among major construction companies on public projects.

4.3. Abenomics

Prime Minister Abe, who regained power in 2013, introduced regulatory reforms in the form of the third of the Three Arrow of Abenomics: the first being monetary expansion policy, the second fiscal expansion policy, and the third a so-called ‘growth strategy through competition policies’. Commenting on the third arrow in Davos in 2014, Abe said ‘I’m willing to break through the solid rocks of vested interests over the next 2 years’.

In the subsequent 2 years, Abe introduced a number of competition policies, including the following:

(1) Full liberalisation of the electricity market
In the late 1990s, power transmission was opened up to high-voltage users under the third-party access scheme, which imposes penalties on imbalances created by non-utility suppliers. This scheme lasted until March 2016. However, in April 2016, coverage of the liberalised sectors was expanded to include the household sector and an imbalance settlement scheme was introduced, under which imbalances could be bought and sold at the market price.

(2) The removal of special legal status of the Japan Agricultural Cooperative (JA, Noh-kyoh), which functioned as a political machine to coax protection policies from the government

(3) The various accomplishments made in the so-called National Strategic Special Zones, which has been the centrepiece of the Abenomics growth strategy
    - Corporations can now own agricultural land.
    - New medical school has been established.
    - Homestay businesses have been legalised despite opposition from the hotel sector.

5. Agenda for Further Competition Policy

What is the competition policy most needed to spur growth in Japan? Of all its entry barriers, those in the labour market have damaged the Japanese economy the most. Japanese employment regulations effectively oblige companies to keep their ‘regular’ employees until retirement age (Ouchi, 2013, Chapters 1 and 3). This makes it difficult for companies to dismiss ‘regular’ employees.

Under this regulation, it is risky for a company to hire a mid-career person even with useful experience for a particular role as a 'regular' worker because the company would be obliged to keep that worker even after he or she is no longer needed. To cope with unexpected changes in the corporate environment, most companies are compelled to hire young persons with good general aptitude and flexibility. Because of these employment regulations, companies have a strong incentive to hire school leavers, with a seniority-based wage scale, rather than experienced mid-level career employees (Ouchi and Kawaguchi, 2014, Chapter 5).

These regulations make it hard for regular workers to switch employers. First, because dismissals are rare, vacancies for mid-level career positions rarely arise. Second, even when such vacancies do come about, companies typically fill them by promoting internally. Employing someone mid-career implies that the promotion of all the regular workers under the seniority of this outsider has to be postpones.

These regulations prevent 'non-regular' workers from getting regular jobs.[5] These make the Japanese labour market inflexible by hindering workers from switching employers. Moreover, strict employment regulations hinder people from quitting large companies to start new ventures because quitters who fail have nowhere to go back. This may explain why relatively few venture companies emerged in Japan's information technology industry. This contrasts with the case of Taiwan, for example, where there were successful collaborations with Silicon Valley firms in the 1980s.

6. Conclusion: More Competition Policy for Growth

6.1. Choice of Growth Industries

Industries are targeted for growth differently under industrial policies and competition policy. The industries targeted by industrial policies are often selected for political reasons. If the policies fail, no one in government takes financial responsibility. By contrast, the industries that grow under competition policy are selected based on competition in the market. If these industries fail, investors in these growing industries take full responsibility.

[5] Companies can hire non-regular employees as such at most 5 years.

6.2. Political Popularity of Industrial Policy

Despite its ineffectiveness, industrial policy has been favoured by policymakers. This bias has led to their misguided use in Japan.

Why do policymakers favour industrial policy? The answer is that the beneficiaries of industrial policies campaign for them more vigorously than their opponents campaign against them.

Because industrial policy heavily benefits a relatively small number of firms, the beneficiaries of such policies have a strong political incentive to campaign for their implementation. This tempts government officials and politicians to receive either explicit or implicit kickbacks from the assisted industries[6]. In Japan, many high-level government officials retire to take up executive positions with firms that have been targeted by industrial policies. For example, two presidents and six vice presidents of the major steel company in Japan were former vice ministers of METI between 1980 and 1989.

Because the negative effects of industrial policy are thinly spread across consumers in the form of slightly higher prices or tax rates, the victims of industrial policy do not find it worth campaigning against them (Krugman, Obstfeld, and Melitz, 2015).

This is why industrial policies are popular among politicians and bureaucrats despite their ineffectiveness[7].

6.3. More Competition Policy for Growth

Some representative post-war Japanese firms started as venture companies in a competitive environment. For example, Sony was founded in 1946 by two young engineers, Masaru Ibuka and Akio Morita. Honda Motor was founded by Soichiro Honda, who was not a college graduate. Panasonic was founded by Kōnosuke Matsushita, who did not even go to junior high school. These success stories in the early post-war period indicate the importance of the competitive environment symbolised by the zaibatsu dissolution, anti-monopoly policy, and trade liberalisation.

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[6] See Olson (1965) and Stigler (1971)

[7] See Stigler (1975) for a further discussion on this point.

Whether Japan can regain its strength depends on how vigorously it can continue to implement competition policy.

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Appendix: Abenomics and Special Economic Zones

In this appendix, we discuss the vehicle of regulatory reforms made under the Act of National Strategic Special Zones (NSSZ) enacted in December 2013, under which drastic deregulation programs have been experimentally introduced into health, agriculture, and city planning, among others.

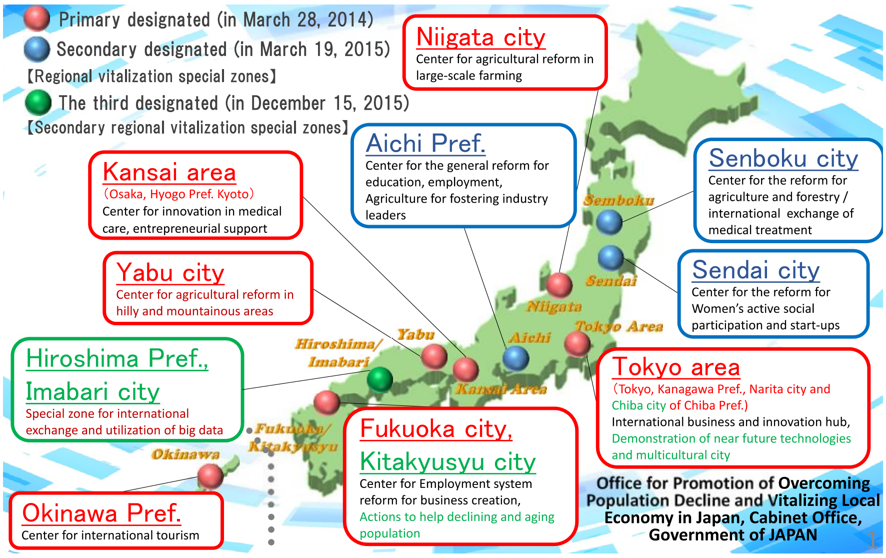
In 2014, the first six special zones were selected, and in succeeding years, additional zones were chosen. As of April 2016, there are 10 special zones, as delineated in Figure A1.

The NSSZ Act stipulates that certain clauses of various laws are exempted, and new measures are introduced in the NSSZs instead. The new measures introduced in the NSSZs are listed as the reform 'menu' of the act. The act is revised each year and new measures are introduced.

Each special zone can take advantage of any reform measures listed in the menus. The Regional Council established by the NSSZ Act for each zone proposes projects allowed by the menu of the act, with the Regional Council for each special zone consisting of the Cabinet Minister in Charge of NSSZ, heads of local governments, and private sector representatives appointed by the Prime Minister.

These projects proposed by the Regional Council are approved by the Council on Strategic Special Zones chaired by the Prime Minister (see Figure A2).

Figure A1. National Strategic Special Zones



Source: Cabinet Office (2016), National Strategic Special Zones. Office for Promotion of Overcoming Population Decline and Vitalizing Local Economy in Japan, Cabinet Office, Government of Japan. Tokyo, Japan. Available at: http://www.kantei.go.jp/jp/singi/tiiki/kokusentoc/pdf/jigyou_all_e.pdf (accessed on April 1, 2016).

Figure A2. Council on Strategic Special Zones

Council on Strategic Special Zones

Members

- Prime Minister
- Ministers
  - Chief Cabinet Secretary
  - Minister of Finance
  - Minister of Economy of Public Finance
  - Minister in Charge of Special Zones
  - Minister in Charge of Regulatory Reform
- Private sector members
  - AKIIKE, Reiko (The Boston Consulting Group, Partner & Managing Director)
  - HATTA, Tatsuo (Osaka University, Professor Emeritus)
  - SAKAMURA, Ken (Tokyo University, Professor)
  - SAKANE, Masahiro (Komatsu Ltd., Councilor)
  - TAKENAKA, Heizo (Keio University, Professor)

Source: Public Policy Planning & Consulting.

Although there have been other types of special zones in the past, the current system of NSSZs marks a clear distinction from its predecessors.

First, pre-Abenomics special zones were chosen from among applicants to promote the respective regions' growth and welfare, and not the whole nation's growth. NSSZs, on the other hand, are approved by the government for a national growth strategy as the engines of major regulatory reforms. Thus, they are the laboratories for reforms of 'bedrock' regulations.

Another key distinction from the pre-Abenomics reforms relates to who negotiates with the regulatory offices of the relevant ministries. In the pre-Abenomics period, officials in charge of regulatory reforms conducted such negotiations. However, it has often been difficult to achieve meaningful reforms through negotiations involving only government officials. In its current reform, the Strategic Special Zones Working Group, comprising private business people and academics, negotiates with the regulatory authorities. The working group members are independent of government and have no vested interest in any government activity. When negotiations between the two groups become deadlocked, the Council on Strategic Special Zones – the supervisory body of this Working Group, of which Prime Minister Abe himself is a member – is responsible for resolving conflicts with the regulatory offices. Thus, it is difficult for a regulatory office to insist upon preserving its regulations under such political pressure.

Such a decision-making process, which differs significantly from that of the pre-Abenomics reforms, makes it possible to achieve significant regulatory reform in a short period.

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