INDUSTRIAL ADJUSTMENT POLICIES

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I. Introduction

1. Protectionism is on the increase. The persistent recession and rising unemployment are the main reasons for the political pressures in industrialised countries which have encouraged protectionist policies. It is still widely accepted in official circles in these countries that the current problems facing the industrialised countries cannot be solved by protectionist 'beggar my neighbour' policies and that a resumption of reasonable levels of growth would depend on the continuation of the underlying post-war trend towards more liberal trading policies and a more open international trading system. However, governments have had to bow to protectionist pressures from sectors that have been particularly affected by contraction and labour displacement.

2. There is no doubt that social costs are involved in the situation where labour displaced by industrial change is not readily reemployed. Social costs are also involved in the depopulation and underutilised infrastructure which result from the deindustrialisation of particular regions. But such social costs, even in the short-term, are usually outweighed by the benefits from industrial change and movement to higher productivity and more capital- and skill- and technology-intensive industries. In such situations the benefits must be used to compensate and reduce social costs, if they will be allowed to arise. What are called for are positive adjustment assistance policies to facilitate change, rather than defensive policies to preserve 'lame duck' industries.

3. Unless such positive policies are adopted, the affected sectors will have to bear the full brunt of the disruption and this leads to the demand for protection. Positive policies are therefore vital to facilitate change and provide flexibility in the industrial structure. Even in a recession, when it would seem economically justified to prevent industries with long-term competitiveness from going to the wall, care is needed in the adoption of defensive policies which could prevent a shake-out of uneconomic industries, and a release of scarce resources e.g. of particular skills, both of which would help to sustain the recovery when it comes.

II. Defensive Government Intervention

4. OECD governments have attempted to ease the impact of structural pressures with industry incentives and subsidies to encourage new investment and upgrading of technology in declining sectors in the hope of regaining comparative advantage and avoiding labour redundancies. For most OECD countries, production subsidies as a proportion of GDP have shown a pronounced rise during the 1970's and are highly concentrated in sectors with least apparent growth potential, namely labour-intensive industries and mass production industries with standardised technology.

5. Evidence available suggests that this systematic bias towards protecting labour-intensive industries has been counter-productive to employment maintenance even in the short-run and has added to unemployment problems in the medium-term. Labour-saving investment in protected industries has led, despite increased production, to continued labour-shedding, often at average rates above those experienced in growth industries. Across all OECD countries for which studies have been undertaken, the proportion of structural unemployment which can be traced to import competition from developing countries is minor and has not justified defensive intervention aimed specifically at labour-intensive products from these countries. Indeed, these studies consistently suggest that the major sources of structural pressure originate from intra-OECD trade and technological change.

6. The outstanding common feature of defensive adjustment policy is the provision of 'temporary' assistance or 'breathing space' to slow or control the rate of adjustment. Yet costs are associated with slowdowns in the form of postponement of benefits and the costs of non-adjustment tend to increase over time. Nor is there any evidence to suggest that provision of a breathing space reduces costs to displaced workers. Wage subsidies embody disincentives to labour mobility, encourage inadequate emphasis on retraining and, to the extent that specific labour skills are scarce, contribute to labour hoarding and bottlenecks. Finally, protection raises the private rate of return on capital and, especially if subsidised finance is available, encourages new investment in relatively less productive industry and reduces incentives to scrap excess capacity. Attempts to improve efficiency by labour-saving innovations are likely to fail because if comparative advantage is based on labour and management skills, no amount of increased physical capital in production of standardised goods will improve competitive ability. Assistance to declining industries distorts factor and product markets for more dynamic companies, contributing to irrational investment allocation.

7. The need for a shift away from defensive policies to assist weak sectors and firms increases steadily with the passage of time, even under conditions of slow growth The output and prices of one firm are the input and costs of another: or the subsidies of one firm are the taxes of another, so that a proliferation of defensive measures leads to a progressive debilitation of industries and regions, and to a growing loss of international competitiveness.

8. There are other ways in which the pursuit of defensive policies will adversely affect employment by inhibiting investment. For example, increased profits in an industry which depends on government assistance for its survival are much less likely to stimulate productive investment than greater profits resulting from rising demand, and reflecting long-run competitive strength. Assistance to declining activities also tends to encourage inefficiency both at managerial and shop-floor levels. There is thus a vicious circle of slow growth generating behaviour and policies that impair productivity and accentuate inflation: this prompts governments to adopt more cautious demand management policies and hence leads, directly and indirectly, to even slower growth.

9. Defensive measures to assist weak sectors and companies create strong vested interests in their continuation. Thus 'controlled adjustment' very often turns out to be insufficient adjustment. Naturally, however, there is concern about phasing out defensive policies under conditions of high unemployment, and a shift to more positive adjustment policies, contributing to a revival of non-inflationary growth, thus has several important requirements for success. First, since adjustment is more difficult and painful under conditions of low growth and rapid inflation, governments must seek to achieve an overall economic climate conducive to growth and adjustment. Second, acceptance of adjustment presupposes the existence of effective arrangements for sharing the burden on those directly affected: redundancy payments, unemployment insurance, training programmes, assistance for moving etc. Third, acceptance of adjustment presupposes the existence of effective policies to deal with market imperfections and externalities - in particular, strong competition policies and strong regional policies.

10. This last pinpoints the major difficulty. In view of the degree of economic, financial and industrial interpenetration among developed countries, strong regional policies (for example in Western Europe) need to be international in scope, and strong enough to override national, defensive policies. Purposeful policies for regional development can be fully justified by the social costs of excessive industrial concentration, by the high cost of labour mobility from one region to another and by the desire to promote equality of opportunity and maintain regional, cultural and linguistic traditions. Since 1973, however, such policies have often been diluted by the increased emphasis given to short-term job maintenance programmes. There is also growing concern that under conditions of slow growth, the 'regional' label is being misused to justify policies which simply try to shift the employment problem from one place to another, at high cost. This underlines the need to pursue positive regional policies, based on: regionally differentiated fiscal and financial incentives and disincentives; public investment to provide economic and social infrastructure; manpower policies to increase the supply of skilled labour; and effective arrangements to prevent self-defeating competition between regions, both domestically and internationally.

11. Although competition from developing countries is a relatively minor factor among those creating a need for adjustment, exports to OECD countries are very important to them, and are often particularly vulnerable to defensive measures taken by the industrialized countries. Moreover, the impact of adjustment measures can vary significantly between the industrialized and the developing countries, due to differences in the scale and structure of their economies: smaller and less diversified economies are often more vulnerable to defensive measures taken by other countries than the more advanced economies. Many developing countries advocate a more direct and positive role for governments in planning and controlling industrial investment and production. They are making structural change and adjustment a central focus of the North/South dialogue, and are proposing a greater role for international surveillance and negotiations in this field. Further work on the trade aspects of such policies should, therefore, give appropriate attention to the interests of the developing countries.

III. Need for Positive Adjustment

12. The case for positive adjustment policies has been made out by the OECD[1]. Positive adjustment involves moving resources from the production of goods and services for which demand is declining to production of goods and services for which demand is increasing; from less efficient to more efficient production; away from production in which other countries are gaining a comparative advantage. Policies can be regarded as positive if they facilitate such shifts or, where they are directed to achieving other governmental objectives (such as improving the social and physical environment, the distribution of income, or the fair sharing of the burdens of adjustment), if they do so in ways which minimize adverse effects on economic efficiency.

13. One of the major recommendations made to member countries by the OECD was that they undertake what are called 'positive adjustment policies'. Big changes in relative prices, cost structures and patterns of demand since the early 1970s had made the need for adjustment in the structure of the OECD economies more urgent. At the same time, because of slow growth, high unemployment and a rise in structural rigidities, such adjustment had become more difficult, though by the middle of 1978 the OECD Council at Ministerial level had adopted some 'orientations' for a shift to more positive adjustment policies. Earlier, discussion of adjustment assistance had tended to be linked to problems arising from trade liberalization; but it was only a small step to a broader conception of the matter, focusing on the acceptance or promotion of developing country exports in general.

14. Yet another small step led to an even more general view, that structural problems in industrial economies were not primarily due to import competition: for the most part they arose from internal pressures which might or might not affect comparative advantage. Technical progress, new products, urbanization, and sectoral shifts were sources of structural strain which had in recent decades stimulated a growing list of regional and industrial policies. In such circumstance it would be difficult or meaningless to identify some industrial aids, manpower policies, or other measures as being specifically oriented to trade adjustment. The characteristic of industrial economies is incessant adaptation and adjustment to new conditions. This adaptation had not seemed to present any very great problem in the period of full employment and rapid expansion in the period following the second world war.

15. What above all prompted new thinking about a more active role and a more positive orientation for government in stimulating needful adjustment was the growth of unemployment. Year by year, starting from 1966 (in some countries a year or two earlier or later), the measured rate of unemployment in developed countries was rising. At each peak of economic activity there was a higher level of unemployment than existed at the peak of the previous business cycles. Also, when unemployment was high there were unfilled job vacancies, which were sometimes growing in the face of rising unemployment levels, and on each of the last three occasions when industrial economies had started moving out of recession, their rate of inflation had been higher than in the previous comparable period.

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1. The Case for Positive Adjustment Policies, A Compendium of OECD Documents, 1978/79. OECD, Paris, June 1979.

16. It appears that structural rigidities are a significant cause of the current inadequate growth performance of OECD countries and there is urgent need for a more positive government approach. Despite explicit recognition of this need by governments, positive adjustment policies have been considered difficult to implement in the recent context of slow growth and high unemployment. Implicit in this argument is an assumption that structural adjustment is likely to add to unemployment at a time when countercyclical policy is tuned to inflation targets and appears incompetent in correcting an already rising trend in unemployment. The orthodoxy continues that adjustment should be managed at non-disruptive rates and is excessively costly at times of slow growth. The view therefore has prevailed that governments must first seek to achieve an overall climate conducive to growth. It is clear however that the private costs of adjustment are lowest in periods of rapid growth and adjustment is more likely then to take place in the absence of government intervention. The converse implies that government intervention is most necessary in periods of lower growth when private and social costs diverge.

17. A vicious circle operates whereby government inaction, let alone defensive intervention, perpetuates structural rigidities which themselves impact unfavourably on countercyclical policy so that the growth recovery, and the awaited signal for the introduction of more positive policies, is only further postponed. The removal of negative measures, to the extent that downward pressures are exerted on the price level, may permit adoption of more expansionary policies by making it easier to reconcile growth and output expansion with price stability. The argument that governments should give contemporaneous attention to structural problems in order to 'restructure out of recession' is now gaining acceptance.

18. Policy should aim to minimise social costs of adjustment and redistribute the burden of private costs from displaced domestic factors. A positive approach to adjustment entails phasing out obsolete capacity and reducing or rationalising investment plans in structurally weak industries, encouraging investment in alternative directions likely to be consistent with future trends in international supply and demand and replacing existing measures which encourage retention of redundant labour in uncompetitive activities with action to improve labour mobility and productivity.

19. It is difficult to define _ex ante_ a country's comparative advantage at detailed firm or subsector level. It is also difficult to label specific policy instruments as indisputably positive or negative as both the political feasibility and the likely impact of any particular instrument may vary significantly between individual countries. The recent experience of adjustment policies in OECD countries is reviewed briefly below.

IV. Manpower Policies

20. Current levels of unemployment have acted as major constraints on manpower policy, which generally has been directed to preservation of existing employment levels. Several governments require advance notice of intended retrenchments and make extensive use of employment subsidies, contributing as much as 75% and 70% in Sweden and the Netherlands, respectively, of the wage costs of firms employing surplus labour. Bankrupt firms are entitled under the Swedish scheme to grants up to half of total wage costs for as long as 12 months and government orders are placed with affected firms to postpone or extend the period of closure.

21. The Japanese government provides employment grants to firms with lifetime employment commitments involved in shifting permanent employees from low to high workload areas and to subsidiaries and associated firms. In the UK, employee representatives are vested with special rights in the management of redundancies and in France efforts are made to avoid redundancies via work sharing arrangements. Several countries including Australia provide subsidies for job creation for young people. Employment subsidies inflate wages in subsidised industries. Narrowing of wage differentials implies loss of signals to labour mobility, penalising growth and employment in alternative higher productivity sectors.

22. Further efforts are required to improve labour mobility via resettlement grants, rent subsidies, assistance with and protection against capital losses associated with sale of owner-occupied homes and travel allowances including for job search. Such schemes also reduce the cost to firms of hiring new labour. Minimum wage, payroll tax and equal pay legislation, economy-wide wage negotiation and job security provisions contribute to increased marginal labour costs, reinforcing the tendency, in the context of hesitant growth recovery, to forgo expansion rather than carry additional labour and thus helping to concentrate unemployment among transitory workers and new entrants to the labour force. Subsidies to employment in declining industries could be replaced by general schemes providing tax credits for specially disadvantaged categories of labour across all industry branches, thereby reducing hiring costs of employers in a non-discriminatory fashion. The tax rebate for full time apprentice training in Australia is an example of such a scheme, complemented by financial support to pre-apprenticeship training on-the-job available for all school-leavers unable to obtain apprentice employment. Training and re-training especially on-the-job could be advantageous. Nevertheless, training is inefficient if provided on-the-wrong job. In the UK, on-the-job training is financed by a levy on firms with exemptions provided for small businesses and firms which themselves make adequate training provisions. In Europe the trend is towards grants or tax deductions in favour of joint-firm and group training arrangements.

23. Lump sum compensation payments seem preferable to income maintenance benefits as a means of reducing the private costs of adjustment to redundant workers. Compensation payments which are not wage-related and not conditional on non-re-employment may have added advantages in that they do not delay exit or affect work decisions after redundancy, are available with minimum administrative procedure and assist immediately in reducing costs involved in job search. In the UK, lump sum compensation payments may be 50% refunded from a Redundancy Fund to which employees themselves contribute.

Obstacles to mobility continue to arise from non-transferability of seniority rights and pension entitlements and further consideration could be given to measures both to promote full vesting of pension rights and to reverse taxation biases favouring superannuation over private savings programmes.

V. Industry Policies

24. All direct instruments of industry policy - tariffs, quotas, subsidies, assistance to small business, trade practices legislation, pricing scrutiny, R & D and regional development funding - can be made more or less specific to particular industries. The general tendency has been, with the exceptions of the Netherlands and until more recently of Japan which pursued comprehensive forward planning, to intervene via selective or discriminatory measures assumed to be cheaper and more efficient since targeted to particular industries. The USA, Japan and West Germany have resisted excessive increases in subsidies to specific industries; France, Italy and the UK have not.

25. Adjustment assistance is also commonly provided for industries specifically affected by changes and developments in government policy, such as the Kennedy Round in 1968, the adoption of a Common External Tariff by the EEC, the Canadian-American Automobile Agreement of 1965 and the 25% across-the-board tariff cut in Australia in 1973. A major draw-back inherent in trade-related programmes is that unless industries are precertified eligible for assistance, time-consuming analysis is required to determine, for each applicant, the cause of structural displacement, resulting in delays and uncertainties in assistance. Inequities also arise as benefits discriminate in favour of factors affected only during a pre-determined period by a particular source of structural pressure. In the Australian experience, tariff reduction followed by very delayed ex-post compensation was considered to have undermined business confidence and adversely affected investment.

26. Adjustment assistance to industry is typically provided via capital grants, loans and loan guarantees, interest subsidies, tax concessions or, on a last resort basis, special legislation to allow merger or nationalisation. This assistance has rarely been made conditional on diversification, nor have efforts been made to restrict defensive investment aiming at factor intensity reversal. To encourage positive adjustment and scrapping of excess capacity, direct financial incentives are required, conditional on such scrapping, in the form of compensatory cash grants or subsidised long-term loans.

27. The UK, Netherlands and Japan have some experience in underwriting contraction via compensation payments. In Japan, iron and steel, shipbuilding, aluminium refining and synthetic textiles receive tax credits for reductions in total capacity and scrapping of least-efficient units. In the Netherlands, all selective subsidies have been replaced with a general investment account; tax credits are allowed up to 30 per cent in the case of special investments meeting employment, regional energy and pollution control objectives. In Sweden, firms may appropriate profits, untaxed, to an internal fund for nationally desirable investments, at times suited to overall economic management. The new Canadian Enterprise Development Programme provides a general framework for government anticipation of trade-related change. It provides loans, loan assurances and equity participation in restructuring or rationalisation activities when viable future prospects are identified. Compensation or abandonment assistance is not provided nor is temporary support for declining industries.

28. Trade-related assistance could also be undertaken in conjunction with certain forms of industry-specific intervention.[1] Assistance triggered both by liberalisation or injury on application would cover both precertified industries and individual firms, ensuring that no affected factors 'miss out', that treatment is consistent across industries, and that individual applications provide an early warning system for further structural pressure. Cumbersome identification of the precise source of change in declining industries would also be avoided. As such programmes could prove expensive for small open economies, assistance could be restricted to small firms, worst-affected factors and developing country import competition only. The Netherlands provides subsidies specifically to assist adjustment to developing country imports; the eligibility criteria are very restrictive however; at the end of 1978 total commitments were well below the sums appropriated due to lack of applications, and the scheme is under reconsideration.

29. There is some evidence that it is small businesses which are first and hardest hit by structural changes and, given distortions in capital markets and heavy reliance on retained earnings and shareholders funds, the least able to finance innovative adjustment. Adjustment policies should therefore be designed to meet the needs of small businesses. In Canada and the US advisory services are offered to small business at nominal cost under retired business executive programmes. In Germany contributions to management consultant fees are available and in Canada, Sweden, Germany and the US R & D programmes are specially designed for small business. Much of the import competition faced by small business in Japan derives from offshore subsidiaries of larger Japanese firms. Small businesses are provided with low-interest loans and tax relief in depressed areas when co-operating with government directives in scrapping plant and equipment or shifting to new lines of production. In practice however, it is the relatively larger of the small firms which profit under these arrangements.

30. In Canada, Australia and Japan, government financial institutions have special responsibilities to lend to small businesses. In Australia, trading banks have been advised to review their lending criteria to ensure adequate provision of small business finance and regulations regarding taxation of retained earnings of private companies have been relaxed. In the UK and the US specialist organisations provide small business development finance, risk capital, funds and facilities for leasing and plant purchase, and financial advice on mergers, take-over bids and the stock exchange. Major fiscal incentives are provided in the US for venture capital and small business investment; Canada has initiated public sponsorship of privately operating venture capital institutions and the largely government-owned Canada Development Corporation has taken up minority equity positions in several such corporations. In view of the share of small business in industrial employment, its role in innovation and competition and the particular obstacles it faces in undertaking adjustment in times of inflation, further encouragement of venture capital activity would seem desirable. Similarly trade practices legislation should not impede mergers and takeovers which are likely to improve efficiency. In Japan and West Germany, adversely affected firms are able to form 'rationalisation' or 'structural crisis' cartels for specified periods of time which have, in most instances, been extended.

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1. See "Adjustment Policies and Problems in Developed Countries," World Bank Staff Working Paper No. 349, August, 1979.

VI. Positive and Anticipatory Policies

31. OECD governments have generally avoided forward industrial planning to induce structural changes on the basis that governments are unlikely to be more competent than the market in picking winners and therefore the allocative role of the latter should be supplemented only for long-term, high-risk ventures involving production of non-market goods or requiring high-technology. Some countries give assistance on an adhoc basis targeted to industries or companies thought either to have a particularly promising future or considered to be "at the margin" of economic viability. By engaging in selective intervention of this kind, governments are implicity making judgements about future production structures and it would seem useful to improve medium-range forecasting of industry prospects with a view to developing early warning signals of structural weakness and potentially disruptive structural pressure. In Germany, several independent Economic Research Institutes report directly to the government on trends in structural change. France, Italy and Japan construct detailed indicative plans to guide public sector investment; government banks or credit institutions also play an important role in these countries as well as in Germany in directing private investment.

32. Japan and the Netherlands apply strategies aiming explicity at transformation of domestic supply structures in line with shifts in comparative advantage. Japanese policy is to concentrate on developing industries with relative human capital intensities, abandoning or relocating offshore those with labour and physical capital intensities. Every year since 1975 the Ministry of Industry and Trade (MITI) has prepared a five-year rolling plan roughly projecting the structure of production, demand, investment and employment, along with government measures to achieve projected annual "targets". Administrative guidance rather than government funding is used to smooth the changes envisaged under forward planning. A major instrument is informal persuasion of commercial banks to provide loans to certain sectors and even certain firms and to curb lending for investment in industries listed by MITI for phase-out. Incentives to scrap unprofitable equipment include low-interest conditional loans and guarantees, numerous fiscal incentives for investment contributing to quality of life, accelerated depreciation allowances for priority industries, direct subsidies and installation of special loss reserves for overseas exploration of mineral resources, and a package of tax and financial assistance for development of energy and resource-saving technologies. Protection and subsidy techniques are applied sparingly to high-technology, high value-added or high income-elastic products where large new markets are foreseen.

33. There is considerable scope for improving the "transparency" of policy objectives and consequences, since aspects of government activity, including stabilisation and regional development policy, have an impact on business confidence and labour unrest. The need for government intervention to induce balanced regional growth, for example, is itself indicative of structural rigidities in the labour market. If differences in the inter-regional demand for labour are not reflected in regional wage differentials, then in order to maintain employment, explicit subsidization of labour is required to offset consequences of labour immobility. Meanwhile the impact of structural

pressures and the political resistance to change frequently have a strongly regional dimension. The rapid decline of regionally concentrated industry may have a dramatic effect upon a particular region, especially if that region already has below-average employment and income levels. There is a clear need for proper co-ordination between policies legitimately aiming to achieve balanced regional development and selective industrial policies designed to meet other objectives in specific regions.

34. Special incentives are typically provided, usually to investment, but increasingly to employment, for firms locating in depressed areas. These include provision of infrastructure, reductions in local taxes, removal grants, transport and freight assistance and land-use planning to prevent development in alternative regions. These measures may attract weak firms seeking to lower costs under pressure of import competition; regional incentives should be applied with discretion to prevent further concentration of vulnerable industry in the depressed region.

35. None of these measures compensate for regional inequalities in endowments of the skilled human capital factors on which the comparative advantage of industralised countries is based. It is futile to subsidise the location of physical capital alone as viable long-run employment for unskilled labour in these regions can only be created by encouraging combination with skilled labour resources. Industry policies aimed at improving regional balance should be complemented by policies to improve geographic mobility of highly skilled labour.

36. It is imperative that governments recognise the indirect impact of regional and other policies on production and employment structures, and consider more integrated long-run approaches to industry policy formulation providing unambiguous guidance to investment. The extent to which tariff reductions need to be accompanied by adjustment assistance is clearly less, the slower the rate of tariff reduction and the greater the flexibility of other policies in assisting affected individuals and firms. The availability of general retraining and relocation facilities which operate in an anticipatory manner reduces the need for income maintenance payments, just as assistance requirements of firms are reduced to the extent that the capital market and tax system operate effectively to facilitate structural change.

37. As long as adequate rational assistance remains unavailable for firms adjusting to trade-related shifts in competition, the inequities in private costs and benefits associated with restructuring will promote resistance to adjustment and encourage lobbying for protection. Adjustment assistance programmes need not be expensive, as the successful and very budget-conscious Japanese approach exemplifies. Nor are these programmes likely to be expensive relative to current levels of subsidy to declining industries; various analyses of UK practice indicate that compensation may frequently have been considerably cheaper in terms of absolute commitments. Finally, the opportunity costs of continued protection and defensive industry policy are enormous, undermining the dynamic processes generating rising productivity and hindering achievement of non-inflationary growth.