

RESEARCH HIGHLIGHTS

The Downside of Industrial Policies

Despite their goals, government industrial policies can hamper innovation and restrict growth

Based on Working Paper No. 2017-21, "Innovation, Reallocation and Growth" by Ufuk Akcigit, assistant professor in economics and the college at University of Chicago, and co-authors Daron Acemoglu, Harun Alp, Nicholas Bloom, William Kerr

KEY TAKEAWAYS

- ✓ Governments often subsidize industries
- ✓ These subsidies typically go to all firms, regardless of performance
- ✓ Focused subsidies are more efficient
- ✓ Such subsidies would also redistribute key resources by letting low-type firms exit

Governments often subsidize industrial firms, either permanently or in times of economic stress. Larger firms, which are more effective at obtaining such subsidies, frequently reap the most benefits from such industrial policies. However, despite their ubiquity—especially in China and Europe—the effects of these policies are poorly understood.

In their working paper, "Innovation, Reallocation and Growth," Ufuk Akcigit, assistant professor in Economics at UChicago, and four co-authors examine the effects of such policies and find that they can have consequences opposite their intention. The authors note that while such policies may encourage productivity gains in certain firms, they may also reduce overall economic growth by hampering reallocation of resources to their most productive use.

The authors build on existing research to develop a model that includes firms that go out of business and integrates the reallocation of those firms' skilled employees. This addition is important because it incorporates a key aspect of successful firms—they tend to maximize the utility of their most skilled employees.

Akcigit and his colleagues make a distinction between high- and low-type firms, with the former characterized by having a higher innovative capacity. Low-type firms, on the other hand, have lost their innovative edge and are close to their exit margin, which means that they may soon go out of business. Identification of low-type firms, which the authors' model allows, is a key contribution of this paper because it could help policymakers more efficiently target subsidies.

Figure 1 • Potential Policy Impact



Low-type firms, which often begin as high-type innovators, can lose their innovative edge over time. Many are close to going out of business; these firms are, on average, the most inefficient at employing resources. Therefore, policies that subsidize all firms, including low-type firms, may reinforce inefficient outcomes and drag down overall growth.

To address this phenomenon, policymakers could devise programs that shift R&D to high-type firms, rather than propping up firms that are near their exit margin. Such policies would let low-type firms exit the economy, freeing up resources for those firms that, on average, could put it to better use. By providing a way to identify low-type firms, this research and its attendant model offer a method to develop more efficient industrial policies.

This isn't the final word on the optimal schemes of industrialization policy; the authors acknowledge a number of important questions for further research. However, this paper extends our understanding of the effects of such policies and sharpens policymakers' analytical tools.

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READ THE WORKING PAPER

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Innovation, Reallocation, and Growth

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