Economic Perspective 3

CLOSURES : SHOULD THE GOVERNMENT SUBSIDISE LOSS-MAKING ENTERPRISES

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The most powerful arguments against the provision of public subsidy to loss-making enterprises seek to establish that it is the public welfare, rather than private interest, which is diminished by the subsidy; that, moreover, the subsidy assists some privileged group at the expense of the great majority of the population, many of whose members have incomes lower than those of the people that they are obliged to subsidise.

The most immediate effect (it is argued) is that money has to be transferred from the taxpayer to the members of the subsidised work-force (which, it should be understood, includes managers and, sometimes, directors, as well as workers). It is naive to suppose that the major part of this burden on taxpayers will be borne by the well-to-do. No matter what the formal system of tax may be, the well-to-do can afford (and are entitled) to obtain the advice of tax specialists, if they lack the knowledge themselves, on the most effective means of tax avoidance. It is possible that the burden of tax on the well-to-do is higher than is socially desirable, but that is a quite separate question.

The second effect would be to raise the costs, or reduce the returns on businesses which would otherwise have achieved some measure of success but which fail because of the addiional burden imposed upon them. The loss of actual or potential employment in these establishments may be greater than the number of jobs saved in the subsidised establishment.

The third effect that might be evident in the fairly short run is encouragement to inertia. Innovation is often uncomfortable, and if it is believed (albeit incorrectly) that establishments which fail to take the steps to achieve an acceptable level of profitability will be protected from what should be the consequences of their behaviour, it is unlikely that either management or workers will display much enthusiasm for proposals which would expose them to uncertainty and inconvenience.

The immediate loss suffered by the general public as a consequence of these considerations may, however, be small compared with those eventually occasioned by failure to take advantage of the inevitably imprecise but relatively effective function of the 'signals' imparted by the market system. Consumers are able to provide real information about their preferences; producers provide (and obtain) information about the real costs of responding to the perceived preferences.

No sensible person supposes that the market provides perfect information, but in a world in which there is inevitably a great deal of ignorance, and in which no more than very crude guesses about future prospects can be hazarded, the market provides more accurate information about what consumers want, and about the most effective ways of providing what they want, than any other source.

The elimination of loss-making concerns is viewed by some as an essential part of what may be called 'creative destruction'. Indeed, it can be argued that the 'fundamental impulse' of a dynamic capitalist economy, which is the one best able (on historical evidence) to achieve rising living standards for all sectors of the population, comes from the continuous introduction of new methods, new markets, and new organisations. Consequently, some establishments which had previously been efficient and profitable no longer produce what is required or fail to produce at a cost that is now acceptable. To shield the failures, it is argued, is not merely to inflict a direct cost upon the rest of the community but to drain the vital fuel from the engine of growth.

This argument (subsequently referred to as 'Pure Market Argument' or PMA) tends in current British political debate to be thought of as 'right wing'. There are, perhaps, some implicit assumptions in the argument which might be of a 'right wing' nature, but there should be nothing in the general nature of the argument which would offend 'left wing' propensities - there is no reason why socialists should insist that workers **in general** are likely to benefit from an arrangement which obliges working people to subsidise inefficient performance.

There are, however, grounds for rather more scepticism about the effectiveness of PMA than is usually displayed by its protagonists (who do, as a matter of fact, tend to be 'right wing'). Proponents of this view are inclined to talk **as if** the clear record of **economic performance** is entirely consistent with their explanation of behaviour.

Evidence about what happens in the 'real world' is far less clear cut. Careful studies of industrial performance in relation to much less complex (and more easily measured) factors provide very few sure guides to the circumstances in which success is achieved. It might, then, seem reasonable to examine the conditions in which high rates of growth and development have really taken place. On doing this, however, it quickly becomes apparent that those economies which have achieved a high rate of growth have engaged in a great many interventionist activities including various forms of protection against foreign goods, and other government assistance to domestic industry. Japan, Germany, France and even the United States provide examples of dynamic growth which has been accompanied by high levels of government intervention in the market economy.

Japan has often been cited as an example of a very successful economy, yet is one which is characterised by a high degree of government intervention. The nature of the intervention may have been overstated by some commentators, and its implications misunderstood, but the monograph by Professor G C Allen, published by the Institute of Economic Affairs (**How Japan Competes**), a body unlikely to express undue enthusiasm for intervention, notes that "in the early years of reconstruction and in the period in which Japanese Shipbuilding attained predominance in the world, government subsidies, mainly in the form of low interest loans, made an important contribution. Without this help the industry would probably have been unable to break into foreign markets, let alone dominate them" (p28).

Some forms of intervention have been less clearly successful. Both Japan and Germany have felt it worth their while to provide (for example) substantial subsidies to their coal-mining industries. This may have been due in part to misjudgement about the potential profitably of coal-mining, or it may have reflected a desire to reduce the costs to members of the declining industry, but it has been part of a 'package' which has, on the whole, been rather successful.

It is argued by the protagonists of PMA that these economies would have been even more successful if they had allowed greater scope to the free play of market forces. This may be so, but it is not self-evident. It may be the case that some degree of protection from the arbitrariness of market forces, which often are beyond the power of the labour force to influence, encourages a more co-operative disposition and greater willingness to accept technological change. Protection is quite clearly **not** enough **by itself**, but it may be the case that the United Kingdom has been wrong, not so much in providing subsidies but in the nature of the 'package' in which they have been presented. Before developing this theme, however, it might be useful to consider some of the circumstances in which subsidies are appropriate.

There are two distinct sets of circumstances in which a subsidy might be considered appropriate. One is where there is reason to believe that those who, directly or indirectly, are likely to bear the costs of the subsidy might be expected to gain in the long run from the arrangement. The other is where those who bear the costs will be worse off, but where the effect on them is considered to be offset in terms of some welfare criteria by the gain to the direct beneficiaries. The second case would, however, involve a highly contentious set of welfare judgements. I intend, therefore, to concentrate on the first case.

The simplest set of circumstances is where the cost of the subsidy would be less than the unemployment (and related) benefits paid to those who lose their jobs. When the loss of income due to redundancies has a significant multiplier effect (e.g. shopkeepers and others going out of business because they have lost their customers) the off-setting costs may be high relative to the subsidy. In normal circumstances, it would be expected that the displaced workforce would find other jobs, possibly in conditions where their productivity would be higher, but with present high levels of unemployment the offsetting costs would be likely to last for a considerable length of time. If redundancy payments are high (as with the **current** terms offered to mineworkers for example), the costs to the rest of the community might well be substantially higher in the near future than the subsidies required to maintain employment. In addition, where relocation of workers means that a large proportion of the local labour force has to move to another area, there will be an additional cost in the form of homes, schools, clinics (for example) that must be replaced. Unless there is spare capacity in the areas to which the workers (eventually) move, there will be additional costs to the community in providing replacements for the homes, schools and clinics which have become derelict.

The adherents of PMA will argue that costs will rise in the areas to which the (sometimes unhappy) migrants will go. So, it will cost more to live in London. That might, eventually, make it more attractive to live in Glasgow. **In fact**, however, a government ostensibly committed to PMA offers its own workers a bonus if they live in London, in order to meet the extra costs that are a consequence of the migration that has taken place. Whether this is due to incompetence or disingenuity is a matter that will not be explored here. In either case the costs will be met by the same people who would have been obliged to pay the cost of the initial subsidy.

In addition to these consequences of the failure of a firm or establishment, account must also be taken of any induced changes in the price of imported goods which replace domestic production. If resources (including labour) cannot be transferred fairly quickly to other (equally or more) productive activities, there will be an increased demand for imports. The consequent rise in the price of imports may impose a greater cost than that which would have been imposed by the cost of the subsidy.

Advocates of the PMA approach are slow to recognise such costs. They are equally slow to recognise that potentially productive establishments may fail to meet costs because of essentially short-run phenomena over which they have no control. During a period in which world trade is depressed, firms which could prosper in better (or even 'average') conditions may be forced out of business. If the slump is of short duration, it may be practicable to 'reassemble' the skilled workforce and set up in business once again. There does, however, seem to be reason to believe that during the past five years a not insubstantial section of British manufacturing has been lost permanently.

Under such circumstances more substantial loss may occur as a consequence of large scale long-term unemployment. A significant part of the prospective labour force may fail to acquire either the skills or the industrial discipline required to enable them to make a useful contribution to the economic life of their communities. If the proportion of local labour force in this condition rises above some critical level, the long term effect may be devastating. Entire communities become depressed areas; their populations embittered and alienated, and if not a permanent charge on the rest of the community, at least unlikely to make a significant contribution to general welfare.

Awareness of the potential costs of the PMA approach should not, however, lead to losing sight of the strong points of its case. It **is** important that the immensely valuable 'signalling' device of the market place should be able to operate, and that its signals be understood; it **is** important that there should be incentives to improve productive performance and that resources should be encouraged to move from less productive to more productive activities; it is important that political considerations (in terms of potential votes in the next election) should be no more than (at most) a minor consideration in the determination of industrial strategy, and it is important that there should be few artificial restraints on occupational and geographical mobility.

The weakness of the more extreme versions of PMA is that they rest on an implicit assumption that rapid adjustment is practicable and do not distinguish adequately between failure to meet short-term difficulties (which may include periods of five to seven years trade depression) and fundamental productive inefficiency. It may, indeed be the case that dynamic establishments are more vulnerable to short-term effects than more conservative counterparts which have paid less attention to improving productivity than to maintaining liquid reserves.

It is undoubtedly true that there are considerable difficulties in deciding which loss-makers are suitable cases for treatment. British experience may, however, have been particularly unhappy in this respect because of a tendency, particularly with nationalised industries, to lump together costs due to quite different, and sometimes conflicting, objectives. As a consequence, it is often difficult to know what the real 'signals' are. There is, for example, a considerable amount of disagreement among experts about the real operating losses of the Coal Board.

At the same time, insufficient attention is paid to positive action which would increase the mobility and adaptability of a labour force. There is not space to develop this argument, and I will confine myself to one comment. Japan has a far higher proportion of its school age population in education to the age of eighteen, and has approximately five times as many engineering graduates per head of the population.

Reference:

G C Allen (1978) "How Japan competes", **Hobart Paper 1981**, Institute of Economic Affairs.