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Germany’s new industrial policy

By laying out his national industry strategy 2030, German Federal Economy Minister Peter Altmaier has kickstarted an important debate. How is Germany’s future as an industrial location to be secured? Many see technological change, US dominance in digitalization, and China’s ascendency as a threat to traditional industrial countries like Germany. Is a new national industrial policy the right reaction? There are three fundamental problems with industrial policy. First, politicians know no more than private investors about which technologies will win out in the future. Second, they tend to be worse than the private sector at terminating failed projects in good time. And third, there is the danger that long-established, politically well-connected companies will abuse industrial policy in order to secure privileges at the expense of competitors, taxpayers, and consumers.

Does it follow, then, that we should keep our hands off industrial policy and leave industrial development entirely to the market? No. Industrial policy is important, but it needs to take into account the economic context and previous experiences with instruments of industrial policy. In particular, it should set out to tackle areas where market forces are failing—where private markets aren’t delivering efficient outcomes. Knowledge-intensive sectors are particularly prone to market failure in industrial development. While a company’s research and development activities often benefit a given sector overall, the fact that the related costs are not shared can justify subsidies for research and development. This applies not only to basic research, but also to the transfer of research findings into manufacturing. A similar principle applies to path dependency in innovation. A sector that has spent decades concentrating its innovative strength on combustion engines might need an external push to evolve the kind of innovation activities required to develop alternative technologies. But empirical studies have shown that public funding is most effective where competition among companies is fierce. In contrast, declaring certain companies to be national champions and shielding them from competition or takeovers is counterproductive. Studies also show that industrial policy is more effective when the support offered is decentralized rather than centralized. Success depends on the scope of projects supported, on making room for experimentation and diversity, and on the resulting competitive forces. What’s also important is to attract co-financing from private sources. As soon as private investors also have skin in the game, efficiency increases and any projects that aren’t delivering results will be terminated sooner. It follows for competition policy and state aid control in Europe that it is better to offer sector-based grants that are essentially open to all companies in knowledge-intensive sectors than to give grants to selected individual companies. But politicians should also bear in mind other important factors for Germany as a manufacturing location: a powerful communication and transportation infrastructure, a reliable and cost-effective energy supply, swift approval procedures, and attractive tax conditions all play their part in safeguarding the industrial base.

Peter Altmaier will have to fundamentally rethink his industrial strategy if it is to be successful. As it stands, the concept draws too little on the experiences described above. It declares individual companies to be national champions without reason and it confuses size with competitiveness. Germany’s industrial success to date is due in large part to its hidden champions, whose strength lies in their innovative prowess and specialization, not their size. There is nothing to suggest that this is about to change. Germany needs a state owned investment company as little as it needs to maintain closed value chains within Germany.

How, then, should we react to Chinese industrial policy, which assists domestic companies through state backing and by hindering foreign competitors’ access to the Chinese market? Imitating Chinese industrial policy is a bad idea for Germany—not least because it is at a different stage of economic development. While China is still catching up in high quality manufacturing, Germany is a leading industrial nation at the cutting edge of technology. German companies’ access to the Chinese market can be secured through negotiation by threatening to lay similar obstacles in the way of Chinese companies in the European market. But this is where a national industry strategy reaches its limits. This calls for action on the European stage.

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