The sources of an industrial renewal

By Jean-Luc Gaffard

French companies in many sectors have had to deal with a relative increase in unit labour costs, a relative decline in the price of value added, and lower margin rates, meaning that many of them are facing strong competition and are relatively uncompetitive on price due to not having innovated and invested enough in the past. The result over the last decade has been a significant loss of substance in France’s industrial network and a worsening foreign trade deficit. The challenge of carrying out an industrial renewal is clearly posed. This is not limited simply to manufacturing but encompasses any activity that is likely to deal with demand on a relatively large scale and is organized on an industrial basis[1].

It is common sense to assume that the solution lies in the renewed capacity of these companies to innovate, to export and quite simply to expand, or in a word, in the ability to regain or acquire the non-price or structural competitiveness that they are currently lacking. The difficulty they face is that their lack of price competitiveness is leading them to seek immediate reductions in cost to the detriment of investment in innovation. Faced with this difficulty, economic policy makers must resolve a real dilemma: either to take measures to compete on taxation, social contributions, or even wages in an effort to restore companies’ price competitiveness at the risk of further weakening aggregate demand and ultimately negatively impacting their turnover, or to keep the existing system of taxation at the risk of depriving these companies of the means to invest and innovate.

The consensus of the day naturally denies the existence of such a dilemma. The presumed neutrality of money and the budget, coupled with the flexibility of the markets for goods and labour, is supposed to help the economy back on the path of steady, stable growth. Businesses, now reassured by the restoration of balanced public accounts and freed of excessive regulatory constraint, are again free to invest.

This consensus embodies a reductive vision of the functioning of market economies. The model of perfect competition, which is the standard in this instance, pictures a world where companies respond simply to price signals sent by the markets for goods and by factors whose operation is immunized against any power exercised by one or another protagonist in these markets. Somehow or other, this is what is meant by the assumption of efficient financial markets whose function is to discipline firms and States. The reality is very different. Markets are naturally and necessarily imperfect. Companies develop strategies on pricing, production and investment that deal with this market environment at the same time that they help to shape it. It is important to recognize this reality before trying to define economic policies suited to it.

The sources of business competitiveness

In an industrial market economy, business growth comes from *innovation*, in other words from companies' ability to develop non-price or structural competitiveness that is more robust and more lasting than just price competitiveness. Technological or organizational innovation aimed at the creation of new products or services or at the exploration of new markets entails however a *detour away from production*. Time is needed to develop a new production capacity before using it and benefiting from it.

Generally, this new capacity has a higher construction cost than the cost of simply replacing existing capacity. Additional costs must be borne before the corresponding additional income can be collected. A loss of competitiveness, in principle temporary, is apparent. This could be reflected in increases in current prices (of old products) if the hike in costs is to be passed on immediately or, more likely, by a reduction in margins. The performance of the production of existing goods or services is thus negatively affected by the decision to innovate [2].

In this context, it is still necessary for the company to remain competitive on prices in the short term in order not to lose significant market share to its competitors. It is in regard to this immediate requirement that the issue of *labour costs* comes up. This is a particular issue in the euro zone where in the absence of possible adjustments via exchange rates, legal and regulatory differences on social and fiscal matters create real distortions in competition – and when, furthermore, the international fragmentation of production (in reality the relocation of segments of production to countries where wages are lower but qualifications identical) is providing businesses that have the ability or opportunity to exploit this an advantage in terms of the costs passed on in product prices, margins and investment volumes.

Maintaining or regaining immediate price competitiveness will not, however, suffice. It is still necessary to encourage companies to innovate. But when investments, including intangible investments, are irreversible and when information on the future configuration of the market is not immediately available, it is difficult for companies to do this. They cannot base their decisions on price signals alone. They must be able to secure their investments by acquiring sufficient knowledge about the future market, that is to say, not only the size of demand, but also about competing and complementary offers. The point is to ensure that competing investments do not exceed a certain threshold and that complementary investments attain a certain threshold. This is possible only thanks to practices that have to be considered monopolistic, which are related to different forms of connections between the companies concerned[3]. This kind of *organizational strategy* foregrounds, not a particular company, but a *network of companies*, a sort of ecosystem that often brings together a local dimension and capacity to project outwards. The characteristic of these networks is to balance competition and cooperation. Practices that can be characterized as market imperfections here become incentives to innovate. They help to define the *boundaries* of the firm best suited to the decision to innovate.

What is true of investment in physical capital is equally important for investment in human capital. This investment has a gestation period that essentially amounts to the learning time. This is an essential element in developing new productive capacities. Its products must be secured. The labour relationships specific to a company and to the networks of firms between companies contribute to this. The *stability* of the employment relationship, which binds the employee to the company, is a decisive factor in the learning and retention of professional experience. The *mobility* of employees between companies is another factor. This mobility enables each company to draw on what an employee has learned in another company developing the same sort of skills. It is also a source of increases in wages, but it becomes possible only if companies are in a situation of monopolistic competition.

The difficulty of innovating even when investments are irreversible and market information is incomplete requires having access to financing in order not only to bridge the gap between the profile of costs and the profile of revenue, but especially to have a lengthy financial commitment, that is to say, stable financial relations or control of the capital. The problem most innovative firms encounter is that the assets created are not easily re-deployable (including intangible assets). This constraint, which justifies developing the organizational means to acquire credible information about the market, requires at the same time being able to enjoy continuing financial support.

Goals and means of an industrial renewal policy

Identifying in this way the stimulants of business growth should guide the policies to be implemented, which are reducible neither to competition policy nor to industrial policy. These policies concern the operation of various markets (goods markets, labour markets, credit markets and financial markets). They make use of a variety of instruments and are situated at different geographical levels.

Industrial policy should set itself the goal of stimulating *cooperation* between companies, including competing firms, and, more broadly, of contributing to the formation of ecosystems involving companies, banks and research institutions. The point here is not at all to designate products or technologies or even territories to promote *a priori*, but instead to help foster market conditions that encourage companies to invest in the ways that seem most promising. The criteria adopted for subsidies or tax relief should meet this objective, which is obviously more complex than that recently put forward of targeting sectors where competition is strong [4]. This should be the specific objective of funding for France's "competitiveness clusters", as well as of other forms of public assistance.

Industrial policy has a *regional dimension*, since companies have a tendency to group together to benefit from external effects, in particular learning synergies not only with regard to technological knowledge but also to knowledge of the market. This phenomenon is in line with the willingness of local authorities to assist in the creation of clusters. However, there is no evidence that these local authorities have the information they need or that they can avoid being captured by lobbies. Competition between them can be expensive when it involves tax competition, which can probably improve the situation of some but only at the expense of others, and which negatively affects overall performance. This inevitably raises the issue of the competence, number and size of the local authorities.

Competition policy is not a substitute for industrial policy. It must pursue the same objective, *i.e.* to *distinguish between competition and cooperation*. From this perspective, the role that competition policy should play is to punish imperfections and distortions that are harmful to innovation and validate those that foster it. The handling of cooperation agreements in R&D is indicative of this requirement. It cannot be exclusive. Other types of agreement must be able to escape the common law on competition.

Labour market policy must set itself the goal of strengthening the ways and means of *enhancing skills*. First and foremost, this means creating the conditions for stabilizing the employment relationship, which is a source of learning for employees and of making sure that companies retain the skills acquired. These conditions are undoubtedly covered by the employment contract itself, but they are also inseparable from the constitution of the communities or clusters making up innovative business networks. These networks are "local" labour markets in which labour mobility between firms is potentially beneficial to all the partners with respect to mastering new skills. Moreover, an end needs to be put to incentives that contribute to perpetuating the privileging of low-skilled or unskilled jobs. Finally, legal and regulatory conditions that permit businesses to hold onto jobs in the event of temporary difficulties (*i.e.* the use of short-time working) should be strengthened.

Banking policy should set itself the goal of creating *stable relationships between companies and financial institutions*. So-called relationship banks, which collect information on borrowers, have higher costs than traditional banks, but they also have the advantage of providing resources to businesses facing liquidity problems linked to the characteristics of the innovation cycle. In fact traditional intermediation increases the growth rate of the economy and reduces its long-term volatility, as opposed to market-based funding[5]. It is also important to refocus the financial system on traditional intermediation, especially on business credit, and to return to a form of separation between the two types of activity, so that lending to business avoids the consequences of the inevitable vagaries of market activity[6].

Fiscal policy must set itself a dual objective. The short-term goal is to *reduce labour costs* by reducing the rate of employers' social contributions and increasing the tax on value added. The medium-term objective is to *penalize unproductive activities*, those whose contribution to growth is dubious. From this perspective, it is undoubtedly necessary to tax financial services and to make greater use of taxes on wealth and the transmission of wealth, as is recommended by the International Monetary Fund. Without prejudging the possible ways tax reform could be implemented, there is a two-fold importance to reform: first, to promote the production of industrial-type goods and services that are suited to international trade, and second, to carry out a redistribution of income and wealth in order to increase the potential demand for these goods and services.[7]

Industrial renewal poses a major challenge for the French economy, which is now caught between the German economy and the Spanish economy. It requires a reorientation of all the policies that affect and guide corporate behaviour, going beyond just manufacturing firms – policies that are not reducible to either the search for lower costs or to the promotion of new technologies or to compliance with the rules of free competition.

[1] On the nature of industrial organization, see Chapter 4 of the work by N. Georgescu-Roegen, 1971, *The Entropy Law and the Economic Process*, Cambridge Mass., Harvard University Press.

[2] See C. M. Christensen, 1997, *The Innovator's Dilemma*, Harvard, Harvard Business School Press.

[3] G. B. Richardson, 1990, *Information and Investment*, Oxford, Clarendon Press. G. B Richardson, 1998, *The Economics of Imperfect Knowledge*, Cheltenham, Edward Elgar.

[4] P. Aghion, M. Dewatripont, L. Du, A. Harrison and P. Legros, 2012), "Industrial Policy and Competition", *NBER Working Paper* 18048.

[5] Bolton P., X. Freixas, L. Gambacorta, and P. E. Mistrulli, 2013, Relationship and Transaction Lending in a Crisis, *BIS Working Paper*, no. 17.

[6] T. Beck, 2013, Finance and Growth: Too Much of a Good Thing, *Vox eu*.

J.-P. Pollin and J.-L. Gaffard, 2013, "Pourquoi faut-il séparer les activités bancaires?" [Why it is necessary to separate banking activities], Note de l'OFCE, n° 36.

[7] Keen M., 2013, Tax Policy in (and for) Hard Times, Vox eu http://www.voxeu.org/article/tax-policy-hard-times#.Um7TETxwZzA.gmail

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