THE DESIGN OF A NEW INDUSTRIAL STRATEGY

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1. INTRODUCTION

The publication of the Telesis Report (1982) occurs at a critical time for the Irish economy. Over the next few years the growth of domestic and foreign markets is likely to be sluggish. A satisfactory growth of manufacturing output can be achieved, therefore, only by increasing market share, particularly in export markets. This in turn implies that progress depends on exploiting more effectively whatever competitive advantages we have and on improving these competitive advantages. Moreover, the aggregate volume of mobile international projects may be reduced and there is likely to be intensified international competition for such projects. Such circumstances suggest the need to concentrate relatively more than in the past on the development of domestic enterprise.

It is important to emphasise, however, that the development of a new industrial strategy must also look beyond the years immediately ahead. For one thing, a major re-orientation of industrial strategy cannot be accomplished overnight, a point that will become clear when we come to look at the difficulties in translating the Tesesis strategy into an operational blueprint. It is well to recall that the major elements of the present strategy had to be worked out over a number of years in the period 1952–58, but once in place it continued for nearly a generation. I believe that it is in the nature of an industrial development strategy that its broad framework must remain in place for a considerable time if it is to be effective. It cannot be chopped and changed every few years if clear signals are to be given to enterprise, and if the development agencies are to market and exploit it to best effect. If that is so, then it would be unwise to rush into a new strategy without careful preparation, or to allow immediate pressures to be decisive. Here I think it should be acknowledged that for all the criticims that can be, and have been, levelled by critics (including myself) against the present strategy, it has nevertheless contributed much to Ireland's economic progress, and in the words of the Telesis Report constitutes "a truly remarkable accomplishment" (p. 225).

The Telesis Report is a long one and in the limited time available to me it is necessary to be selective. Much of the discussion of the Report to date has focused on its detailed criticisms of such matters as the high dependence on foreign industry, the small degree of linkages, the concentration on capital grants and subsidies, the low levels of R. and D. etc. Beyond pointing out that these and many of the other criticisms are not new,[1] I shall only incidentally be concerned with them here. Instead I shall concentrate on the broad thrust of the strategy recommended by Telesis and its implications.

[1]See, for example, Cooper and Whelan (1973), Kennedy (1975), Kennedy and Dowling (1975), Ruane (1978), Steward (1978, a, b), Sweeney (1973) and Teeling (1975). For a comprehensive literature review, see O'Malley (1980).

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2. THE BROAD STRATEGY

The Telesis Report states that its "recommendations are offered as amendments to current Irish industrial policy rather than as a fundamental reshaping of that policy" (p. 225). This claim may be too modest, however, since its proposals contain significant modifications to some existing policies, as well as superimposing on the existing framework a new strategic direction.

The modifications to existing policies relate mainly to capital subsidies. Capital grants and tax-based lending would be largely discontinued in the case of non-traded enterprises, both foreign and indigenous, except in the case of high-skilled sub-supply activities.[2] Furthermore in respect of foreign firms in the traded sector, the average capital grant levels should be cut substantially, except in the case of a limited number of particularly desirable projects meeting well-defined criteria, which might receive an even higher grant than now. In preference to capital grants, greater use generally should be made of loans, loan guarantees and equity participation.

The new strategic dimensions to be superimposed on the modified existing framework, would seek to be (i) more selective, (ii) more directive, and (iii) more integrative.

(i) Selective: Selectivity itself would involve a number of dimensions. *First,* priority would be given to the development of indigenous industry and foreign companies incorporating major characteristics important to the long-term strength of Irish industry. The report claims that "no country has succeeded in developing high levels of industrial income without developing a strong indigenous sector" (p. 231). *Second,* there would be greater selectivity as regards type of industry. The prime focus would be on "complex factor cost businesses" where the key to competitive success lies in skill levels, innovation, marketing rather than in low wages. *Third,* selectivity would apply to firms as well as products. The approach would stress the building of a limited number of large new companies,and the development of some existing firms "now serving only Ireland and the U.K. to serve the whole Common Market and beyond" (p. 132).

(ii) Directive: In developing a suitable corporate shell to undertake a selected activity there would be a more directive approach on the part of the development agencies. Existing companies would be encouraged to rationalise and combine, joint ventures might be arranged, or holding companies formed. There would be a more active dialogue between government policy-makers and large companies about investment plans, and sticks as well as carrots might be used, by, for example, tying Prices Commission rulings to the investment conduct of companies.

(iii) Integrative: The approach would be integrative in that it would explicitly address the full range of obstacles that have to be overcome by each selected enterprise. Development plans would be drawn up with each large indigenous firm and an additional battery of potential grants would be introduced and aimed specifically at whatever cost penalty had to be overcome, whether it related to product or process technology, overseas marketing skill development, working or fixed capital etc. The development agencies would have substantial autonomy and flexibility in deciding which grants should be given, in what amounts and to whom, but with the overriding objective of building up firms' internal capability, so that they would ultimately be viable on their own. The Report also stresses the need for an integrated approach to the

[2]The Report accepts that there are difficulties in establishing a clearcut operational definition of non-traded goods, but recommends that the burden of proof should fall on the applicant firm.

development of resource-based industries so as to secure proper co-ordination with the primary production process.

3. EVALUATION OF THE BROAD STRATEGY

Do these recommendations make sense? The answer to that question depends largely on the response to the following questions, which will be considered in turn:

(1) What are the constraints limiting industrialisation in Ireland, particularly in regard to indigenous industry in traded goods?
(2) In what ways are present policies unsuited to surmounting these constraints? and
(3) Can the Telesis strategy be satisfactorily operationalised?

(1) *Constraints*

The number of constraints inhibiting industrialisation in any country is legion. What is of most interest in the Irish case, however, is why indigenous industry in the traded goods sector has been relatively unsuccessful. It cannot be explained by such factors an excessive wage rates, poor infrastructure, and deficiencies in labour skills, since foreign enterprises have had to cope with these factors also. This is not all to say that these factors are unimportant. Clearly they have a major impact on the competitiveness of *all* kinds of industry, foreign and indigenous; and in the short to medium term, they may be the chief elements that can be varied to improve competiveness. But they cannot explain the substantial *differential* performance of indigenous and foreign enterprise in Ireland.

The literature on development economics emphasises the scale and persuaveness of the barriers to entry that face the indigenous firms of late industrialising countries, like Ireland, in reaching a viable scale of operations in free trade conditions. In an important recent study, O'Malley (1982) lists these barriers under the following five heads, and examines their impact on Irish indigenous industry:

(i) *Economies of Scale in Production:* These have the effect of making production unprofitable until a certain scale is reached.

(ii) *Technology:* To compete with established big firms, large overhead expenditures on research and development may be necessary, while the dynamic learning effect can only be accomplished over time.

(iii) *Finance:* Established firms have access to retained earnings and will be viewed as a more secure risk by lending institutions. There are also economies of scale in raising finance on the stock market and elsewhere.

(iv) *Marketing:* Even where access to the market is not restricted, there may still be substantial economies of scale in marketing. Moreover, the foregoing factors may give rise to oligopolistic concentration, restricting access to distribution networks.

(v) *External Economies:* These are enjoyed by firms in large industrial concentrations in the form of ready access to specialist supplies and services, pools of skilled labour, and large adjacent markets. The competitive importance of this factor appears to be vitally important for the early stage of industries based on new technologies.

These barriers may apply not only to new firms but also to established indigenous firms seeking to penetrate international markets. Clearly they operate with different force in different activities, and much more research on the ground is needed to quantify their differential importance. But O'Malley's conclusion that such barriers constitute a major part of the explanation of the comparatively poor record of development of major Irish indigenous industries in free trade conditions is one that is shared by Telesis, and seems well-founded.

There is, however, a further possible constraint, often spoken of but difficult to pinpoint, namely the question whether there may be a deficiency of native entrepreneurial ability in manufacturing activity. This possibility cannot be eliminated by citing the very considerable numbers of new entrepreneurs that have emerged under the IDA Small Industries Programme, since it remains to be demonstrated that a sufficient proportion of these have the capacity to develop into large traded enterprises. Neither can the hypothesis of insufficiency of indigenous manufacturing enterprise be ruled out by reference to examples of major enterprise inactivities such as banking, construction or distribution. Entrepreneurial talent may be specific tó particular ranges of activity and it would be unwise to assume that it is a general gift that could be adapted with equal facility to quite distinct activities. It is sometimes siad that the fact that Irish emigrants have often established highly successful businesses in their country of adoption demonstrates that in a congenial environment there is no innate lack of enterprise among the Irish; but it does not tell us whether a country's traditions, experience and social attitudes may not also be important, as well as the more objective economic conditions, in determining the emergence of entrepreneurial talent. In the present state of knowledge, these must remain as open questions, on which it would be imprudent to be dogmatic, a point to which I shall return later.

(2) *Suitability of Present Policies.*

A manufacturing development strategy should be geared as directly as possible to overcoming the specific constraints that limit industrial expansion. How well do existing policies address the constraints? In view of space limitations, I can only present summary conclusions without developing the evidence and arguments underlying these conclusions.

The low rate of profits tax on manufacturing enhances the incentive to invest and the resources available for investment, provided the firm is profitable. Thus, while it is a good incentive for attracting foreign enterprise and encouraging expansion is well-established indigenous enterprise, it is of limited value to new indigenous enterprise where there are major barriers to entry and expansion of the kind discussed above.

Capital grants and subsidies, such as tax-based lending, perform a dual function. First they enhance profitability by lowering the cost of capital. But they also perform a second function which has not adequately been recognised by some critics, namely that they help to overcome financial barriers to entry and expansion. New ventures, even if economically viable, may not have the finance themselves and may not be able to borrow the necessary finance due to uncertainty on the part of lenders about their ability to service the loan and repay the capital and the risk that security may be totally in adequate if foreclosure becomes necessary. This difficulty is enhanced by the fact that even though a firm would be able to service capital over the life of an investment, it may not be albe to do so in the early years because of the existence of increasing returns or for other reasons. The financial barrier represents a particularly acute constraint for new enterprises, but it can also inhibit expansion even in well-established enterprises.[3]

An alternative method of overcoming the constraint, which is favoured by Telesis, would be through State loans, loan guarantees and equity participation. The same procedure could be adopted towards overcoming the constraint on working capital, which is not generally grant-aided at present and which can be a serious barrier to entry and expansion. Loans and guarantees, however, unlike the grants and interest subsidies, do not improve the firm's profit prospects. But then the enhancement of profitability by subsidising captial is not necessarily an appropriate measure, since it may have the undesirable side-effect of encouraging an excessively high degree of capital

[3]See Kennedy and Foley (1978).

intensity. Where a subsidy to improve profit prospects is required, there may be more appropriate ways of doing so. Certainly any interest subsidies should be determined by reference to explicit and well-defined objectives. This feature cannot be said to apply to the tax-based lending arrangements.

In comparison with the funds allocated through tax relief and capital grants and subsidies, the amounts devoted directly to overcoming technological and marketing barriers have been relatively small. Yet those often constitute the most formidable barriers to indigenous development, and are among the main factors accounting for the relatively better response from foreign firms to the present incentive package.

In summary, while there are considerable merits in present policies, they do not adequately address the full range of constraints that limit indigenous industrial development. The question then arises as to whether the Telesis recommendations are likely to do better.

(3) *Issues in Applying the Telesis Strategy*

The Telesis recommendations do try to address the full range of factors that constrain indigenous development. The report admits, however, that its recommendations are "necessarily general" since "they are designed to point out stragetic directions rather than to be specific blueprints for change" (p. 242). Much of the comment on the Report to date has failed to advert to this qualification and has assumed that any delay in putting into effect the Telesis recommendations is indicative merely of procrastination. In fact, there are major issues that must be considered in seeking to translate the broad strategic direction into a specific blueprint.

First, there is the question of the relation between cost and benefit. The costs are likely to be high in the short to medium term, while the benefits can only be expected to mature in the longer term. Successful product innovation, for example, involves much more than giving grants for R & D. In a study of new product innovation in Canadian manufacturing, Stead (1976) gave the percentage breakdown of the costs as follows: 7 per cent for initial R and D, 15 per cent for design and engineering of processes, 50 per cent for tooling, 10 per cent for manufacturing start-up and 15 per cent for marketing. This point is well recognised by Telesis which admits that "creating and sustaining jobs in indigenous firms is far more difficult and expensive than doing so in foreign-owned firms" (p. 232). But at a time of straitened financial circumstances, careful attention will have to be devoted to the amount of additional cost involved, and how it is to be financed.

True, the Telesis Report does recommend significant savings in existing incentives, but the *net* saving involved would be less. Loan guarantees could give rise to costs since in the event of failure the security, even with a first charge on assets, might not cover the liabilities. It is difficult to quantify the cost since it would depend on the risk levels which the agencies were prepared to accept, and their success in assessing these risks correctly. The achievement of a reduction in capital grants for foreign enterprise without causing a reduction in the volume of such projects may not be as easy as Telesis suggests. It is all very well to establish *ex post* that some firms would have come even with a lower grant, but it is much less easy to discover *ex ante* which firms fall into that category. Moreover as already stated, competition from other countries for foreign projects is likely to increase and we cannot set our incentives purely by reference to what would suit us best, without taking account both of foreign competition and the preferences of foreign enterprise.[4]

[4]It is only fair to state that, in recognition of these points, the Report states that "the grant cuts should be gradually and quietly introduced over time" and that "if too many projects are lost because of that, they can be rescinded" (p. 26).

A second major issue that arises in translating the Telesis strategy into an operational policy is the problem of public accountability posed for a democracy like Ireland in the selection of a limited number of private firms for development, which would be provided with all the resources necessary to succeed. One is not reassured on this by references to South Korea and other such countries, which have a totally different cultural milieu and which are not in fact democracies in our sense of the term. Given the scale and variety of incentives envisaged for selected firms and the substantial powers of discrumination that would be accorded to the development agencies, there is need for a wide debate on the institutional checks and balances that require to be built into such an approach. Without clear and widely-accepted criteria, the agencies would be put in an impossible position. No one should be under any illusion about the difficulty of establishing such criteria, which in my view can only be developed gradually in the light of experience.Even with such criteria,the development agencies would have to be given a greater measure of discretion than at present, without being expected to publicly justify their judgements. Given the degree of selectivity envisaged in the Telesis strategy, it would be unwise to underestimate the efforts that would have to be made to win and sustain a public consensus for such an approach.

A third major difficulty arises in regard to the selection of the comparatively limited number of products that would form part of the selective strategy. It may very well be, as Telesis suggest, that capital goods industries might be particularly suitable. But which among the myriad of capital goods products are likely to be winners? Every development agency in the world would like to be able to pick winners, but all would concede that it is a task beset with enormous uncertainty.

This leads on to the fourth issue in regard to the application of the Telesis recommendations, namely, how to determine when support for the selected firms should end. In relation to the more successful ventures, the issue is how and when to wean them off state support. Telesis states that "the goal must be to transfer the capabilities of the development agencies to the company itself" (p. 233). The means recommended are that the development agencies reduce the amount of "hand-holding" functions, and give more to firms in the way of grants and less in the form of staff-intensive services. It is difficult, however, to see how the implementation of the strategy would not requre in its initial phase an increase in the range of services provided by at least some of the development agencies; and once a bureaucracy is built up, experience shows how difficult it is to shift it. Moreover, some of the incentive grants recommended are of a kind that could all too easily become self-perpetuating.

An even more difficult issue is to decide when to call a halt in regard to failures. Industrial development is inevitably a risky business and it is unrealistic to expect that there will not be such failures. By the time that becomes evident, large amounts of the time and money of the development agencies will have been sunk and there may be an understandable reluctance to cut their losses and withdraw. Even were this not the case, there would be strong political pressures to continue support. Again, this calls for careful advance consideration of the balance of independence and accountability to be assigned to development agencies and for institutional arrangements to protect them from short-term political pressures in the exercise of their assigned responsibilities.

Finally, there is the question as to whether the approach of devoting substantial extra effort and resources to building a limited number of large indigenous industrial enterprises should be directed solely to private enterprise. As mentioned earlier, it remains an open questionas to whether or not manufacturing enterprise is in scarce supply in Ireland. In that case, it would seem unwise to neglect the possiblity that the public sector might produce some of the enterprise. Such a possibility is by no means ruled out by Telesis, which hints that it might be necessary to secure the co-ordinated

development of Ireland's resource-based industries. It is true that the commercial state enterprise sector has a poor image in Ireland at present, but it is difficult to evaluate the reality underlying the image. There is still very little objective evidence as to whether the apparently poor reward is due to innate deficiencies in public enterprise, or to other possibilities, such as that they are saddled with impossible tasks, are unduly fettered by administrative control, or subject to excessive political interference. What does seem certain is that there has been a failure to establish clear long-term guidelines relating to their objectives, independence and accountability. While this is no easy task, it is not in essence different from the task that will have to be faced if the Telesis strategy is to be applied effectively to private enterprise.

4. CONCLUSIONS

While I believe that in the longer-term industrial development strategy should move in the broad direction outlined by Telesis, I also believe that much work needs to be done before that strategy can be applied. In particular, we need to know much more specifically the precise nature of the constraints on indigenous industry (private and public sector) — constraints which are likely to vary from one type of activity to another. We need to establish well-defined objectives for the development agencies and we need to develop institutional arrangements to secure the desired balance of independence from short-term pressures and public accountability for the agencies. Anyone who doubts the extent of the effort required to achieve a major re-orientation of industrial strategy — and the many hesitations and false starts that are likely to be involved — should read the very interesting book published last week by Bew and Patterson (1982).

Even with careful preparation, there can be no certainty that the strategy will succeed. That being so, I believe that the main elements of the present strategy should remain in place until the new approach has been tested. Some elements of the Telesis strategy can be implemented more quickly than others. A case in point is the replacement of tax-based lending, which rests on the accident of tax loop-holes,by a more purposeful scheme. Other elements of the strategy should sensibly be tested on a pilot basis, carefully monitoring and evaluating the results, before applying the approach on a wide scale. In preparation for such pilot testing,the preparation of company development plans on a joint basis involving the firms themselves and the development agencies, would be the logical starting point.

The fact that it will take time to develop a new operational strategy for manufacturing, however, should not detract from the urgency of initiating the task. If it is not begun now, it will still remain to be begun five years hence. In the meantime, however, we must face the fact that efforts to expand manufacturing output and employment in the next few years will still depend heavily on what existing policies can generate and on the success of general policies (like pay restraint) in improving our competitive position.

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