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The state's role in the economy after a crisis – the rationale behind it and recommendations*

Introduction

The (post)crisis challenges faced by European economies involve also a change of the role to be played by the state and its administration. There is an ongoing debate on the limits of state intervention and the effectiveness of market mechanisms. The economic slowdown and financial turbulences have boosted the role of governments in the economy, “[...] who have become more active in economic policies [...] and are moving away from a hands-off approach to economic growth and development that had prevailed previously” (IIA Issues Note, 2013, p. 3–4). This trend reflects building-up comprehension about the costs of unregulated market forces. Active yet clearly defined state role in economy seems desired for ailing European economies to stop their demise (Nowak, Ryć, 2013). New economic policy should subtly nudge the economy (Aleksy-Szucsich, 2012). Scientific and public discourse seeing national states are simply one of many economic actors in international relations seems losing its validity (Halizak, 2012). Financial crisis has verified these theses, however, no triumphant return of state shall be claimed. Despite dominating impressions, “crisis has not induced any structural effects with respect to state interventions in national economies” (Szalavetz, 2015). There has been no radical departure from prevailing neo-liberal ideology and practice, only the approaches to industrial policy were reinforced. “State activism has never receded: rather, it has taken different forms while continuously adapting to changing environment and new challenges” (Weiss, 2012). Already before the 2008 state interventions has been favoured due to peculiarities of international production networks and existence of fragmented Global Value Chains (GVC), blurred borders between national and foreign, growing role of intangible assets or the threat of middle-income trap faced by some economies (Szalavetz, 2015). Since the 2008 crisis we can observe in the global political economy the “post-neoliberal transformation” (Schmalz, Ebenau, 2012). Majority of economists still believe in free market competition, but hardly consider government neutrality as the best solution (Chwieroth, 2007). Public intervention is a prerequisite for the recovery of European economy (Cohen-Setton, 2014). Existing stagnation makes a very strong case for increasing public investments. This is justified by multipliers implying significant correlation between public spending and output as well as by the hysteresis assuming that after a shock given economic category might not recover at

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all to its pre-shock levels. One may argue, that given the stimulus packages launched shortly after the crisis eruption many governments adopted a neo-Keynesian approach (Pontusson, Raess, 2012; Vail, 2014). However, since tax cuts were more popular than rising public spending, scholars labelled such approach as a form of “liberal Keynesianism” (Naczyk, 2014). The renaissance of state interventionism after the crisis can be traced back to two major developments: diverging EU p.c. incomes and dwindling willingness among policymakers to agree to uniform competition standards (Huether, 2015; Picketty, 2014). Whereas the need for intervention given social exclusion and inequalities is undisputable the question of its scope and degree remains.

This paper takes stock of recent debate on (post)crisis role of state in economy. First, as the background for further discussion contextual framework is outlined. It offers basic premises warranting state involvement in market processes. Next section reviews some of the initiatives adopted in Europe in the aftermath of 2008. Special attention is paid to industrial policy. Given the controversies surrounding the state role in economy important recommendations and guidelines as suggested in the literature are reviewed. Final section concludes and presents the main findings.

Conceptual context

The market and the state are both coordination mechanisms which are imperfect and prone to failure (Wolf, 1988). While in principle, the market should be responsible for allocating goods, its imperfect functioning makes the state improve things by deploying regulatory measures. Its limited role envisages providing certain framework for market operation. As it seems the least controversial thing that has justified state interference with the economy has been the need to eliminate free market inefficiencies and to account for social aspects.

Recent financial crisis has demonstrated that governments still seek to steer their economies rather than surrender to market forces (Clift, Woll, 2012). Political interventions in open economies exemplifies “paradox of neo-liberal democracy”. They result from tensions between international market integration and spatially limited political mandates and it depicts the “need to reconcile both objectives: facilitate the integration of markets and protect the interest of stakeholders within a particular territory” (Clift, Woll, 2012).

When analysing the relation between state and financial market one can distinguish an extreme with state’s domination called “financial repression” or opposite situation labelled “regulatory capture”. Government and its agencies can be seen as “captured”, i.e. at the mercy of the financial sector and favouring their private interests over the public good. On the other hand, governments are portrayed as abusing the financial system to their benefit, simply “repressing” the free functioning of financial markets (Monnet, Pagliari, Vallée, 2014). This simple dichotomy is blurred and does not take into account the dynamic nature of European ecosystem. Governments, central banks, and financial institutions are bound by mutually reinforcing relations. Ties between interest groups and state can be also defined by the reference to lobbying (private sector influencing regulators) and “grabbing hand” theory (*negative* power of governments contrary to *helping* hand approach) (Shleifer, Vishny, 1998). There are two perspectives

on the role of the government in the market: “the public interest world based on the premise that markets can fail so that intervention by a benevolent government is justified (“helping hand”); and the private interest theory, portrayed by the “grabbing hand” recognizing that governments are likely to pursue goals that are different from social welfare” (Buck, 2013). Financial sector which grew over-proportionally and dominates economy can capture the regulator often in very subtle form, due to heightened complexity, which forces regulators to rely on industry expertise. Thus, the official attempts to regulate and stabilise financial market might have detrimental impact on economy due to the government’s “grabbing hand”, which results from the capture by private sector lobbying. Hence, instead of serving the whole society as predicted by “helping” hand approach, state acts on behalf of few (lobbyists) and to their benefit.

Geo-economics – a relatively new paradigm of international relations – see economic policy as integral part of national security and country’s place on international scene as defined by economic strength (Halizak, 2012). “[...] efficiency in economic management is beginning to override choices of foreign or defence policy as the primary influences on how resources are allocated” (Stopford, et. al., 1991). Hence, countries pursue economic diplomacy, support own firms’ internationalisation and try to influence their involvement in global value chains (Wróbel, 2012). Geo-economics shouldn’t be make equal to mercantilism, which aims at achieving political goals with economic activity. In geo-economics the highest priority and end goal are economic issues themselves. It is also unjustified to identify geo-economics with nationalism, which can be categorised rather as autarky and protectionism (Halizak, 2012). Geo-economics is the function of relations between state and business, a “mutual manipulation” (Jarczewska, 2012).

Special role for state is foreseen in what Scepanovic (2013) calls *hyperintegrationist model*. It builds on A. Amden’s (2001) distinction, between *independentist* model and *integrationist* one. In the earlier, “states maintain a guarded stance towards foreign investment and continue to shield domestic capital” (Scepanovic, 2013, p. 170). The latter assumes that “state, foreign capital and domestic firms form a triple alliance in which the state does not set the performance targets directly, but uses industrial policy selectively.” In *hyperintegrationist* development model crucial role plays foreign capital. This implies the necessity to rearrange the relations among key players and sees the state role not just in facilitating transfer of technology and skills to local firms but rather in attracting foreign capital towards the most promising activities. Yet, state’s position in *hyperintegrationist* model is more constrained by the international regulatory environment and while, still “manipulating local conditions to direct foreign investors towards domestic development goals, state plays a more auxiliary role” (Scepanovic, 2013, p. 53).

State intervention through a proactive industrial policy and assistance for national champions can be supported by three arguments (Sauvant, 2008). These are: increased security resulting from reduced dependence on foreign supplies, protection of industries of strategic economic importance such as those, which create jobs and high added value, as well as intervention in sectors characterized by high entry barriers and externalities. Neo-protectionism arguments comprise a number of ideas, the most important of which appear to be strategic trade policies and dynamic comparative advantages achieved through industrial policy (Puślecki, 2001; Budnikowski, 2003). The strategic

trade policy, i.e. the use of various tools intended to assist domestic companies (subsidies) are generally legitimized by the lack of perfect competition i.e. the existence of monopolies, economies of scale and mutual international dependencies (Brander, Spencer, 1985; Rodrik, 2004). Meanwhile, the development of comparative advantages by means of industrial policy is conceived as a departure from passively accepting the existing production structure and attempts to influence such structure and modify industrial activities to ensure it best protects state interests (Grossman, Helpman, 1990). An actual monopoly-based competition, entry barriers and economies of scale make free market conditions purely fictitious. In such an environment, businesses form clusters, enterprises are internationally dependent, and industrial policy supports the development of sectors believed to be valuable for the national economy. Economic patriotism – specific form of state intervention – is understood as selective discrimination in favour of domestic companies or against “territorially defined outsiders” (Callaghan, Lagneau-Ymonet, 2014). However, “it goes beyond economic nationalism and can include territorial allegiances at the supranational or local level” (Clift, Woll, 2012). Brenner et al. (2010) argued that in times of decentralized policymaking, with decision-making authority and funding distributed among various levels of government, the nation state does not seem to be the adequate unit of analysis of institutional systems.

Market failures and coordination failures imply central role of indigenous efforts to build capabilities. Traditional economic rationales for state intervention have been over time enriched by broadly defined systemic or network failures (O’Sullivan, et al., 2013). This can be explained by new understanding of innovation dynamics: “infrastructural and institutional problems; technological lock-in, path dependency, and transition failures; the quality of linkages and network configuration failures; learning dynamics at the firm, local network, and system levels” all justifying state intervention (O’Sullivan, et al., 2013, p. 436).

Crisis has seemingly shifted the “market failure – state failure” balance to the advantage of state. It does not mean that government mistakes have been forgotten. State failures still happen because of “unrealistic goals, distorted information, systemic irrationality, rigidity and lack of credibility, a mediocre bureaucracy, or inherent limits of law” (Schuck, 2014). Neither free market nor pure etatism work well, but only hybrid models can pass the test as they assure some rebalancing and reduce asymmetries (Wolska, 2013). Contemporary economic theories are embedded in certain circumstances and process various doctrines, what only confirms the evolutionary nature of economic phenomena (Wolska, 2013). The observed difficulty in coming up with new paradigm, which would better reflects recent changes and take into account the complexity of contemporary world, can be explained by the wrong approach whereby new problems are being solved with old, inadequate instruments (Mączyńska, 2011).

(Post)crisis state interventions – industrial policy

In general crisis call for more state presence in market processes. This involvement shall address the market failures – moral hazard with excessive risk taking by financial institutions expecting to be bail-out in distress, externalities, lack of prudential over-

sight etc. Thus the regulatory and supervisory role assigned to public authorities. Besides, the growing presence of state materialize via rescue operations – bail-outs for failing banks and stabilizing measures preventing full-blown economic fallout, stimulating growth, and minimizing damages on labour market. Yet, at the same time the state role has been curbed significantly at least indirectly by massive austerity programmes launched almost all over the Europe (Götz, 2012). Spending cuts can be seen in this respect as certain reduction of government impact on economy.

Obviously each European country responded to crisis using own distinctive methods. Whereas France, favours active state intervention and public investment, German “corporate liberalism”, emphasizes the powers and responsibilities of social and economic groups (Vail, 2014). Economic patriotism is an endemic phenomenon and recent crisis only revive it in the form of “German politicians treating foreign investors as locusts; economically liberal British prime ministers proclaiming British jobs for British workers; and America, the archetypal liberal market economy, returning to buy American or French president Nicolas Sarkozy urging French automakers to locate their factories at home rather than the Czech Republic” (Clift, Woll, 2012).

Idea of neo-Colbertism, has been recalled in association with recent M&A attempts in Europe. Alstom acquisition by GE/Siemens or AstraZeneca by Pfizer invoked issues of nationality of capital and national interest (Doering, 2014; Veron, 2014). Government interventions directed against the foreign takeovers might have become more frequent recently, but they do not seem to be linked to the financial and economic crisis but are rather a general phenomenon (Heinemann, 2015).

“Governments frequently turn inwards in times of economic crisis [...] and this time is no exception” (Baldwin, Evenett, 2012, p. 232). By erecting some trade barriers, politicians seek to cushion the blow to disposable incomes, fall of investment and loss of jobs. Fragmentation of markets along national lines has been reintroduced in Europe, however, classic narrow metrics of protectionism does not suffice now (Evenett, 2012). Such approach would miss various innovative measures against foreign commercial interests introduced recently. The highly complex environment of multi-level governance in European Union renders classic intervention obsolete (Clift, Woll, 2012). Weiss (2012) argues that the current science, technology and innovation (STI) policy pursued in advanced economies resembles classic industrial policy directed towards infant industries. Now these industries lie in the knowledge-intensive sectors, and they do not need old-style tariff protection or export subsidies, but “support in the form of R&D infrastructure and subsidies, intellectual property licensing, innovation-led procurement targeting new technologies, and public sponsorship of venture capital funds” (Weiss, 2012, p. 30–31). Hence, as claimed by Kee et al. (2013), in the aftermath of the global crisis, it is not the overall trade restrictiveness as diagnosed by traditional indicators that has risen, but rather a murky protectionism. Although, “hidden” it is gaining attention of the European authorities who seem determined to address it properly (European Commission, 2011). Crisis made governments to reconsider the philosophy of state intervention and some reconfiguration of strategies applied in this respect. Certain repackaging took place. SIT opens up wide opportunities for the entrepreneurial states (Szalavetz, 2015).

Particularly from the crisis outbreak there has been a clear trend of expecting more from state. Now this, however, requires going beyond old-fashioned instruments aimed

at picking winners. This means that governments must come up with innovative yet legitimate ways of intervention in the economy while complying with strict rules of the game. Attention is directed to industrial policy. It can be defined as steps aiming at altering the structure of economic activity. This includes policies toward sectors, technologies or tasks with good prospects for national economic growth, improving local actors' competitiveness and enhancing national economic performance and societal welfare" (Warwick, 2013). Industrial policy can take many forms: from import substitution to export promotion, from infant industry protection to state ownership of enterprises in strategic sectors or national champions' development (Cimoli, et al., 2009). One of current approaches towards industrial policy stresses its international aspect (O'Sullivan et al., 2103). Measures addressing the international interactions matters much because the capacity to interact with global markets and production networks is a success factor in itself. Despite cross-country variations, some convergence of opinion regarding modern industrial policies can be spotted: "the importance of manufacturing R&D, increased emphasis on engineering skills and vocational education, and resource-efficient sustainable manufacturing, and – following the 2008 financial crisis – access to finance for manufacturing-based firms. Highlighted is also strategic role for government in supporting the coordination and alignment of systems with increasing emphasis on 'partnership' with industry, often in cooperation with industrial associations" (O'Sullivan et al., 2013, p. 434).

Crisis uncovered with all brutality the risks associated with overreliance on the service and financial sector and made the case for more balanced sources of growth including renaissance of traditional industry. Central element of various initiatives implemented across Europe has been the restoration of industrial base with the aim of raising industry share in GDP to 20% (COM 2014, 14/2). EU authorities started actively advocating the need for more industry (COM 2014, 614; COM 2012, 582). Over recent years Europe has lost much of its potential in favour of Asian fast growing economies who were able to attract foreign investors. This has led to significant depletion of European industrial base as main companies ventured abroad quitting operations in Europe. With respect to industrial policy European governments have been running different, often contradictory, strategies. Some have been focusing on safeguarding a competitive, business conducive framework enabling domestic firms to thrive, others seek creating and nurturing national champions (Huether, 2015).

Whereas as traditionally assumed state intervention is supposed to address market failures, new public action needs to remedy also coordination failures by pursuing cluster policies and public financing of innovative projects (Fontagné et al., 2014, p. 3–4). The need for more balanced attitude derives also from changing nature of the industry as such since "industry and services are becoming one single entity and boundaries of companies are changing with the splitting of the value chains" (Fontagné et al., 2014, p. 1). We have industry services, service industry and witness trade in tasks. Industrial policy as known so far, as horizontal steps improving business conditions or vertical measures targeting selected sectors complemented by addressing market failure in R&D is being replaced by approach promoting restructuring and technological dynamism, aiming at correcting market and coordination failures (World Bank, 2015). Interventions however entail certain risks such as lack of information by public agency, or

difficulty to discontinue the help. It also imply the problem of political economy of public intervention. Given the diversity of business models in EU MS it seems doubtful, whether it makes sense for all countries to aim at increasing the industry share at all costs at the same speed, the same way (Heymann, 2013). Although, the ambitious goal laid out by the Commission with regard to industry might be not achievable, it sends the clear message that industry will remain highly important for Europe (Heymann, 2013).

Recommendations

New industrial policy must be carefully designed (Fontagné et al., 2014). Instead of infamous picking winners new approach shall account for proper dealing with innovation assuring intellectual property protection and the need to disseminate know-how for the benefit of whole economy. It should safeguard right governance enabling if necessary terminating unviable projects, seek private-public partnerships for investments, focus on most competitive innovative clusters and promote training of human capital and its mobility (Fontagné et al., 2014, p. 12). Mindful of various risks involved experts stress that industrial policy should be about “setting the right framework conditions for growth, innovation and jobs” (Dale, Porcaro, 2014). “The credo ‘Europe needs industry’ should be replaced by ‘Europe needs innovative firms that operate in activities with a high value-added and participate in European and global value chains’” (Sapir, Veugelers, 2013).

R. Hausmann (2014) sees governments’ role in economy via well designed procurement procedures. He claims, procurement is figuratively speaking the “goldmine”. Most countries possess it, but few can and do exploit fully. By imposing concrete quality standards government can by its purchases (high-quality products that address major national challenge) have a tremendous impact on its country’s comparative advantage. In many cases, the benefits of those solutions will stay for long and positive spill-over effects can be set in motion.

“As advanced European economies are caught in trap of meagre growth, low inflation or deflation, persistently high unemployment, debt burden and often lack of competitiveness, governments have to accept responsibility for measures that favour investment and increase demand, foster R&D and technological innovation, improve education levels and implement active labour market reforms and policies” (Constâncio, 2014). Such voices stressing the need for more active engagement of governments come from EBC officials even more often. Particularly, the problem of reallocation of production factors should be address by state assistance. “There is substantial potential to boost productivity by reallocating resources both across sectors and within sectors towards the most productive firms” (Praet, 2014).

Bloated budgets in many European countries and looming problem of public finance solvency have made many governments to adopt often severe measures of austerity policy. Certain state withdrawal or retreat in form of budget cuts has been accompanied by additional actions such as selling assets or recourse to other alternative financing like leasing. Many governments still have piles of assets – banks, utilities, buildings, land and resources. “Selling some of these holdings could work wonders: re-

duce debt, finance infrastructure, boost economic efficiency. But governments often barely grasp the value locked up in them” (“The Economist”, 11.01.2014). Privatisation has also been *in vogue* recently for many reasons such as: the resumption of sell-offs of telecoms, in transport and utilities; catching up processes in CEE, where many large firms, including manufacturers, remain still in state hands or reprivatisation of financial institutions rescued during crisis. Governments facing the twin challenges of reducing public debt and rekindling economic growth, can no longer afford to ignore asset optimization (Audier et al., 2014). In advanced countries, nonfinancial assets owned by the government account for at least 35% to sometimes 90% GDP. Better management of these assets can lead to lower costs, help extract the most value from public possessions and add new revenue streams. The significant pressure under which are most governments in Europe since the financial crisis of 2008, make them to reengineer themselves (Pisani-Ferry, 2015). This would imply better designing of spending, prioritising, focusing on strategic areas with long term growth perspectives and also more empowering of citizens.

Bearing in mind the failure inclination of both market and state the more adequate question is “how to develop innovative and efficient government programmes to provide public goods and services that marketplace cannot deliver on its own” (Tyson, 2014). One of the approach may be to design government to the model role of venture capitalist. Then its task would be less to plan and implement top-down solutions than to invite, asses, endorse, and scale up innovative strategies developed by other entities – local governments, businesses, and non-profit institutions.

Financial turmoil of 2008 and subsequent economic bust suggest the need to move beyond simple “correcting market failures” towards actively shaping economic systems. State’s role in the economy should be complemented by alternative views of what governments could and need to do in order to stimulate economic development. M. Mazzucato (2013) underlines the seemingly neglected truth about the state role in fostering the breakthrough innovations for smart, sustainable and inclusive growth. She debunks “the myth of a lumbering, bureaucratic state versus a dynamic, innovative private sector,” and stresses that “private sector only finds the courage to invest after an entrepreneurial state has made the high-risk investments” (Mazzucato, 2013). The new task for state consist in “bold and offensive shaping the markets”. In the entrepreneurial state government is leading the way (<http://marianamazucato.com/projects/rethinking-the-state>).

Conclusions

In the aftermath of 2008 crisis we have witnessed various innovative forms of state interventions. Under the aegis of economic patriotism some of them have been hampering foreign firms the other facilitating domestic business. In many occasions it has been simply political rhetoric reduced to declarations. Traditional measures cushioning the economic blow have been undertaken as well. The havoc wrought resulted in perception’s change as to the role the state needs to play in economy. It has forced scholars and policy-makers to rethink their approach towards public administration involvement in

market processes. Keynes became popular again and more government intervention desirable as counterbalance for excessive markets (Giles et al., 2009). State aid in the (post)crisis reality still invokes controversies. Documented state failures risks such as “grabbing hand” and financial repression on the one hand, and market failures rationale such as information asymmetry, multiplier effect and hysteresis on the other are weighted against each other. Whereas some approaches tend to argue that state role in globalized world is dwindling and governments can play rather auxiliary role, the other see crucial (post)crisis revival of more state interventionism as justified by market failures.

Success in international competition results usually from state-market symbiosis (Ząbkowicz, 2013). Today, it “is increasingly over the rules, norms, and tools of state involvement in capitalism itself” (Rediker, 2015). As it seems emerging and controversial, yet apparently also desired model of market capitalism assumes that “the state plays a central role in directing outcomes to advance national interests.” This means that the term “state capitalism” loaded so far with negative emotions, “crowding-out” effects or suspicious sovereign wealth funds does not seem to be valid anymore. New “state capitalism” includes more sophisticated state involvement and can be called “State Capitalism 2.0”, where governments intervene in markets through subtler tools.

The closer inspection of the relation “state-market” illuminated the need to abandon the widespread dichotomy of these two extremes. As a matter of fact there are cases when the market dominates and situations where state has an upper hand. Recent crisis-induced developments call for more nuanced approach (Monnet et al., 2014). Currently the state epitomises not only just government but also various agencies, regulatory bodies, supervisory authorities. It is even more than ever supposed to stimulate certain activities (innovations), prevent some developments by better supervision (banking sector abuses), while at the same time stabilising economy (rescue packages, bail-out) and reducing its burden for the society by debt slashing. Tough combination. With regard to the state role on the market, no breakthrough, radical change or emergence of new paradigm can be diagnosed. Global economic crisis has not yet led to a paradigm shift in economic thinking or growth models in most industrial economies (Hay, 2011). There has been, however, visible tilt of attitude towards more state involvement in the economy.

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Summary

This paper showcases a review of recent approaches towards the state role in the post-crisis economy. The background for the analysis is the support and austerity paradox. A state is supposed to stabilise the economy, stimulate growth and prevent abuses by better supervision, and at the same time to reduce the burden on society by slashing debt. A survey of the selected literature shows that the financial turbulence and recent economic downturn call for more state presence in

market processes. There is a rationale behind such interventions, although, given the risks involved, a balanced and prudent approach is required. Recommendations in this respect have been formulated.

Key words: crisis, EU, state intervention, market failures, industrial policy

Rola państwa po kryzysie – przesłanki i rekomendacje

Streszczenie

Niniejszy artykuł proponuje przegląd najnowszych podejść związanych z rolą państwa od momentu kryzys, który wybuchł w 2008 roku. Tłem do rozważań jest paradoks oszczędności i stymulowania, w jakim znalazły się kraje europejskie. Od rządów oczekuje się bowiem zarówno stabilizowania gospodarki, stymulowania wzrostu, zapobiegania nadużyciom poprzez regulacje i monitoring, jak i konsolidacji fiskalnej odciążającej społeczeństwo. Analiza wybranej najnowszej literatury w tym zakresie wskazuje, że kryzys finansowo-ekonomiczny odnowił zainteresowanie większym uczestnictwem państwa w gospodarce. Choć nie brakuje przesłanek dla takiego zaangażowania, związane z nimi ryzyka sugerują potrzebę rozważnego podejścia. Omówiono proponowane w tym względzie rekomendacje.

Słowa kluczowe: kryzys, Unia Europejska, ingerencja państwa w gospodarkę, zawodność rynku, polityka przemysłowa

