

Maennig, Wolfgang; Wagner, Helmut

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Wolfgang Maennig*, Helmut Wagner**

Unified Structural Adjustment Policy in Europe?

Low growth and high unemployment have induced the European Union (EU) to outline an economic programme in which long-term effective growth and structural policy measures play a central role. Simultaneously, the German government adopted an "action programme aiming at more growth and employment", in which the efforts on the EU level play hardly any role. Is international coordination of growth and structural adjustment policy legitimated from an economic point of view or is competition between national policies more efficient?

High unemployment is the main economic problem in the European Union (EU) at present. The unemployment rate is about 11 per cent with an upward tendency. This unemployment is the result of an unfortunate combination of low economic growth and the low employment-intensity of economic growth. The reasons for these two tendencies are interrelated and can only to a certain extent be analysed separately.

With regard to the slow growth, the declining competitiveness¹ of the EU compared to its main competitors, the USA and Japan, has to be pointed out, a decline that shows itself in decreased world market shares especially in the rapidly growing fields of high technology. There is no unanimity regarding the basic causes of this competitive weakness. On the one hand, a low rate of structural change leading to an "adjustment backlog"² is emphasized. On the other hand, the lower increase in the factor productivities of European countries compared to Japan is stressed, though it remains open whether this is a cause or a consequence of lower growth. Furthermore, R&D expenditure is lower than in Japan, the regulations in certain research segments are more numerous and hence there are far fewer applications for patents.³

Moreover, besides the lower expenditure on "human capital" one also has to consider that the accumulation of real capital (which is usually called "investment") is lower in Europe than in Japan. Additional factors that negatively influence European competitiveness at least temporarily are – on the supply side – the increased volatility of the world

economy, the high tax burden, the partly culturally caused difficulties of entering the Asian growth markets, and – on the demand side – the preliminary end of the post-war reconstruction of Europe and the comparatively high external value of the European currencies.⁴

As to the low employment intensity of European economic growth, labour market efficiency is up for debate. First, the (unit) labour cost level of the European economies in general, and of Germany in particular, is comparatively high. Although this statement is problematic because of exchange-rate distortions and possibly varying labour force qualifications and productivities, it has to be emphasized that in most European countries unit labour costs rose in the 80s and at the beginning of the 90s more than in the USA and, especially, Japan. Second, wage differentials at low wage levels are relatively small and hiring and firing costs are

¹ For the discussion on microeconomic indicators of international competitiveness cf. B. Gahlen et al.: Zur internationalen Wettbewerbsfähigkeit der deutschen Wirtschaft, Discussion paper No. 19, Science Center Berlin, 1985. For indicators which emphasize supply conditions and national institutions cf. G. Fels: Zum Konzept der internationalen Wettbewerbsfähigkeit, in: Jahrbuch für Sozialwissenschaft, Vol. 39 (1988), pp. 135-144.

² Cf. J. Donges, K.-D. Schmidt et al.: Mehr Strukturwandel für Wachstum und Beschäftigung, Kieler Studien No. 282, 1988.

³ Cf. Frankfurter Institut für wirtschaftspolitische Forschung: Zwang zum Strukturwandel. Hilfestellung durch Industriepolitik?, in: Argumente zur Wirtschaftspolitik, No. 46, 1993; and Rheinisch-Westfälisches Institut für Wirtschaftsforschung Essen: Strukturwandel in der Krise. Analyse der strukturellen Entwicklung der deutschen Wirtschaft, RWI-Strukturberichterstattung 1993, Band 1, Gesamtdarstellung, Essen 1993, p. 139ff.

⁴ Cf. H. Klodt, K.-D. Schmidt et al.: Weltwirtschaftlicher Strukturwandel und Standortwettbewerb. Die deutsche Wirtschaft auf dem Prüfstand, Kieler Studien, No. 228, 1989; Bundesministerium für Wirtschaft: Zukunftssicherung des Standortes Deutschland, Bonn 1994; and Bundesministerium für Wirtschaft: Forum Zukunftssicherung des Standortes Deutschland, Bonn 1994.

* University of Hamburg and E.A.P. Berlin, Germany.

** Hochschule für Wirtschaft und Politik, Hamburg, Germany.

comparatively higher. These microeconomic inflexibilities seem to be closely connected with macroeconomic instability.⁵

The EU "White Paper"

In order to achieve higher growth and higher employment-intensity, the European Commission recommends a strategy combining three elements (cf. Table 1):⁶

- the implementation of stable conditions via macroeconomic policy,
- an active labour market policy, and
- a decisive structural adjustment policy in order to strengthen the competitiveness of the EU economy.

In the official language of the White Paper the policy measures of these three areas are equivalent. Nevertheless, it is obvious that in the areas of macroeconomic and labour market policies the origins of the European problems are analysed in detail, but the description of the instruments is much less specific. Although these areas are of essential importance to the solution of the European problems it has to be concluded that the respective recommendations of the Commission only represent a general and not a binding orientation, which makes it worthwhile concentrating on the structural policy measures, on which the White Paper elaborates in more detail.

The recommended structural policy measures can be divided into an "Ordnungspolitik" (infrastructure projects and regulation/deregulation policy) and a sectoral structural adjustment policy (industrial policy and environmental policy).⁷

As to the infrastructure projects, they are composed of the creation of new information and telecommunication networks, the enlargement of the European transportation network, an energy network and "large" environmental projects. The total costs of this infrastructure programme amount to about ECU

864 billion over the next 15 years. ECU 491 billion are to be spent by the end of the century.

As to technology and research promotion, research policy cooperation by the member states and interfirm cooperation are to be supported. "Major priorities" are to be identified, "this being the only guarantee that the market potential is taken into account when defining research priorities".⁸ This new approach should be followed "for a limited number of major projects"⁹ in the three areas of new information

Table 1
The EU White Paper on "Growth, Competitiveness, Employment", 1993

| | |
|-----|---|
| 1 | Macroeconomic Policies |
| 1.1 | Reduction of budget deficits |
| 1.2 | Stability of monetary policy; inflation target 2 to 3% |
| 2 | Labour market policy |
| 2.1 | Improvement of labour market flexibility |
| | - Reform and strengthening of a European education system |
| | - Focus on the broader employment environment and the financial deterrents to employment creation embodied in taxation and related fiscal systems |
| | - Decreasing labour costs and increasing job creation |
| 2.2 | Promotion of the development of new employment opportunities (e.g. services in the sectors of households, leisure, culture, environment) |
| 2.3 | Lowering the relative costs of labour with respect to other factors, especially for low-skill jobs |
| 3 | Growth and Structural Policies |
| 3.1 | Infrastructure policy; establishment of high-quality transeuropean networks |
| | - Transport infrastructure |
| | - Telecommunications network |
| | - Energy transport infrastructure |
| | - "Large" environmental projects |
| 3.2 | Regulation and deregulation policy to make the most of the internal market |
| | - Initiative to ease the adaptation of small and medium-sized enterprises to the new requirements of competitiveness |
| | - Completing the legislative programme in the energy, telecommunications and postal services |
| | - Increasing the efficiency of the management of the Community area |
| 3.3 | R&D policy |
| | - Identification of major priorities |
| | - Major joint projects geared to new information technology, bio- and ecotechnologies |
| 3.4 | Environmental policy according to a model of "sustainable development" |

Source: European Commission: Growth, Competitiveness, Employment. White Paper, Luxembourg 1994.

⁵ Cf. for more detail OECD: Positive Adjustment Policies. Managing Structural Change, Paris 1983, p. 23; and B. Gahlen: Zu den Leitlinien für eine Politik der positiven Strukturanpassung, in: Erfolg und Mißerfolg sektoraler Strukturpolitik, Beihefte der Konjunkturpolitik, Vol. 31 (1985), Berlin, pp. 231ff.

⁶ Cf. European Commission: Growth, Competitiveness, Employment. White Paper, Luxembourg 1994. For a critical description of the White Paper cf. G. Stahl: Gibt es eine europäische Antwort auf die Beschäftigungskrise?, in: Wirtschaftsdienst, Vol. 74 (1994), pp. 146-150.

⁷ As for macroeconomic and labour market policies, the White Paper policy recommendations for regulation, deregulation and environmental policy are hardly specific. Therefore the following analysis does not concentrate on them.

⁸ European Commission, *ibid.*, p. 15.

⁹ *Ibid.*

technologies, biotechnologies and ecotechnologies. It is to increase the growth of R&D expenditure and strengthen the common coordination of R&D activities, which is regarded as inadequate.¹⁰ Concerning the concrete instruments for research promotion, the Commission argues rather vaguely in favour of the "coordination of national efforts (research consortia) and industrial research policies .., and concentration on a limited number of key technologies with a major impact on many branches of industry", but nevertheless unambiguously towards the coordination, centralization and sectoralization of European R&D policy.¹¹

The German Action Programme

In September 1993, the Federal Ministry for Economic Affairs in Germany presented an "action programme for more growth and employment" that included 30 immediate measures (cf. Table 2). As in the White Paper, labour market policy is a key element, although it is much more detailed in the German paper. The measures work towards a higher flexibility of labour market laws and of the wage structure.

In more detail, the German action programme

Table 2

The German Action Programme for More Growth and Employment, 1993

| |
|---|
| I. Consolidation of public budgets |
| Three measures, including the targeting of the state quota to reach the level of the period before German unification. |
| II. Initiative for innovation and for the foundation of new small and medium-sized enterprises. |
| Five measures of public support for the foundation of new firms and for the qualification of labour. |
| III. Improvement and enlargement of labour market instruments. |
| Ten measures including the restriction of wage subsidies, the allowance of private labour agencies, the support of part-time work, and the combating of the shadow economy. |
| IV. Tax incentives for more jobs. |
| Promise to present a new and simpler tax concept soon, including a reform of the taxation of firms and income. |
| V. More growth through more private initiative and deregulation. |
| Nine measures including the privatisation of public enterprises and motorways, the reform of postal services, the construction of "Transrapid Berlin-Hamburg". |
| VI. Additional housing space. |
| Two measures including the reform of public housing programmes and the reduction of standards in housing construction. |

Source: Bundesministerium für Wirtschaft: Aktionsprogramm für mehr Wachstum und Beschäftigung, Bonn 1993.

shows only a few common aspects with the EU White Paper, in emphasizing the necessity of a budget-consolidating macroeconomic policy and a more liberal labour market policy. In the context of growth and structural adjustment policy, only one point, namely the expansion of transport infrastructure with partly private financing, is common to both programmes. All the other measures in the German action programme are deregulative. The expansion of the telecommunication and energy infrastructure, large environmental projects and the sectoral promotion of research, technology and development, propagated in the EU White Paper, are not mentioned.

Since, moreover, the EU White Paper was already in an advanced stage of preparation when the German action programme was published, and the measures included therein were not mentioned at all, one has to conclude that there was obviously very weak coordination, if not in fact complementarity or competition, between the programmes.

The contrast between the two approaches provokes the question whether and to what extent growth and structural adjustment policies should be internationally coordinated.

Legitimation of a Coordinated Approach

The most modern arguments for international coordination are delivered by the "New Growth Theory" (NGT). This theory, which endogenizes technological change, has been developed within two broad model branches called "learning-by-doing" models on the one hand and "invention" models on the other hand. Both branches have recently been more and more integrated.¹² Learning-by-doing models¹³ view technical change as the serendipitous outcome of goods production. Consequently, the recommended economic policy instruments are incentives to produce a high number of different types

¹⁰ The commonly administrated research budget amounts to about 10% of the total expenditure of the EU, *ibid.*, pp. 101f.

¹¹ *Ibid.*, p. 105.

¹² For more details cf. H. Wagner: *Wachstum und Entwicklung. Theorie der Entwicklungspolitik*, Munich and Vienna 1993; and *Journal of Economic Perspectives*, winter 1994.

¹³ Cf. P. M. Romer: *Increasing Returns and Long-run Growth*, in: *Journal of Political Economy*, Vol. 94 (1986), pp. 1002-1037; R. E. Lucas, jr.: *On the Mechanics of Economic Development*, in: *Journal of Monetary Economics*, Vol. 22 (1988), pp. 3-42.

¹⁴ Cf. P. M. Romer: *Endogenous Technological Change*, in: *Journal of Political Economy*, Vol. 98 (1990), pp. S71-S102; or P. S. Segerstrom, T. C. A. Anant and E. Dinopoulos: *A Schumpeterian Model of the Product Life Cycle*, in: *American Economic Review*, Vol. 80 (1990), pp. 1077-1091.

of goods. Invention models,¹⁴ which are increasingly dominant, view technical change as a costly and deliberate process and generally focus on factors which influence the incentive to innovate consciously, such as the institutional framework and market size.

In either approach, technological and knowledge spillovers play a central role. Knowledge is assumed to be something that cannot be fully internalised by its producers. So the public-good character of knowledge production is emphasized. These spillovers allow successive generations of researchers to achieve technological breakthroughs by using fewer resources than their predecessors. The resulting decreases in the real cost of invention counteract any tendency for marginal productivity to fall. The process of knowledge accumulation hence endogenously generates the productivity gains that sustain growth in the long run.

It follows from the endogenous growth literature that because of the prevalence of positive externalities or because of too small a market, a laissez-faire equilibrium will allocate too few resources to growth-generating activities.¹⁵ Secondly, because of static and dynamic returns to scale, international monopolies can arise and reap monopoly rents. In either case, (national) income level and growth rate can be too low. Because of transaction costs or asymmetric information this problem cannot be solved by private agents' coordination efforts.

From these classical arguments referring to market failure, the necessity of public subsidies to growth-enhancing R&D measures is usually deduced. The second central public measure is infrastructure. Spillovers (national or international, technological or knowledge) only lead to learning effects if workers are able to work with these technologies in the sense of imitation or further development. This, however, requires a certain level, or even a steady improvement, of education and training. Because of the public-good character of such infrastructure, government has to supply some intermediate input. Education policy hence plays a central role for an economy's growth.¹⁶ In addition, since market size is decisive for the profitability of R&D investments involving high fixed costs, a growth-oriented economic policy must enable access to hitherto protected markets through trade stimulation (GATT), customs unions and free trade areas (USA-Mexico) or interior market programmes (EU). The efficiency of market enlargement is raised by an increase in "market homogeneity" in the sense of development

adjustment, which depends upon the above-mentioned intermediate institutional input in the form of an improvement in education particularly in the by now underdeveloped regions. Finally, in order to break up a foreign monopoly which actually uses its market power, the products of which hardly can be substituted (key industries) and which is not contestable by the usual market mechanisms because of its lead, a (temporary) protection of home markets and subsidization of the respective products can be adequate.

While international coordination seems to be almost impossible for the latter form of growth and structural policy, it might seem plausible for the other areas. Insofar as the externalities mentioned are effective across countries, national technology and infrastructure policies do have international spillovers which – as in other policy areas – might lead to decentralised economic policies producing sub-optimal results.¹⁷

Differing Efficiencies

From the above arguments it is evident that growth policy to a considerable extent consists of "Ordnungspolitik", international economic policy and, especially, sectoral structural adjustment policies, with a clear overlapping of these fields. The question whether international coordination is efficient must be examined differently in these fields.

□ Concerning international economic policy, international coordination is indispensable for the achievement of central targets such as customs unions and free trade areas, systems of fixed exchange rates and common markets.¹⁸

□ In the area of deregulation policies, specific counter-interests regularly arise which could be more easily overcome with internationally binding commitments.¹⁹ From the point of view of political

¹⁴ It can be shown, however, that there are some cases in which the free market may allocate too many resources to growth-enhancing research activities, because the private firms that conduct research make no deduction for the loss of surplus to the incumbent firm when calculating the expected benefits of research. This loss arises for instance because the foregoing generation of intermediate goods becomes "obsolete" – by virtue of "creative destruction". On this cf. e.g. G. M. Grossman, E. Helpman: *Innovation and Growth in the Global Economy*, Cambridge, Mass. 1991, pp. 339ff.

¹⁵ Cf. G. S. Becker et al.: *Human Capital, Fertility and Economic Growth*, in: *Journal of Political Economy*, Vol. 98 (1990), pp. 212-237; R. J. Barro: *Economic Growth in a Cross-Section of Countries*, in: *Quarterly Journal of Economics*, Vol. 106 (1991), pp. 407-443.

¹⁷ In the case of positive (negative) spillovers non-coordinated structural policies are too small (large).

¹⁸ This is not yet a decision as to whether these targets and their planned dimension are adequate. Cf. the extensive literature on optimum currency areas, free trade areas, and common markets.

economy, international policy coordination makes sense for the deregulative form of structural policy.

□ For the rest of "Ordnungspolitik" international coordination is not necessary in general,²⁰ but it is indispensable for the infrastructure fields mentioned in the EU White Paper.²¹

□ Looking at the sectoral structural adjustment policy (industrial targeting, industrial policy) to which the EU White Paper aspires with the specific promotion of a few R&D-intensive sectors, there are fundamental problems which are broadly discussed within two argumentation lines. Firstly, the (national) efficiency of any incentives-placing structural adjustment policy is questioned. The second argument takes (positive national) effects of structural adjustment policy as given and questions whether international spillover effects of structural adjustment policy exist and whether a demand or necessity for international coordination can be derived from this. Both problem fields will be treated in the following.

Limited National Efficiency

Before using an economic instrument it has to be proven, firstly that the prospective benefits of the application are higher than the expected costs, and secondly, no better alternatives are at one's disposal.

The benefits of a structural adjustment policy are uncertain. Indeed, the benefits of an incentive-providing, sectoral structural adjustment policy in R&D-intensive fields were derived above by pointing

out positive external effects. Nevertheless, it was emphasized that specific model structures are necessary for this. Relatively small changes could, even if external effects exist, lead to contrary results, i.e. to negative benefits of industrial policy, if for example the external effects work globally and not only locally.²²

On the other hand, the costs of a sectoral structural adjustment policy might be high. Firstly, the expected costs of a selective industrial policy consist in a possible reduction in allocative efficiency. The involved protection of domestic industries reduces the benefits from trade, which consist of higher competitive pressure, of stronger cost degression and of a wider variety of goods. The protected industries have a tendency towards lower productivity growth, higher factor immobility and lower international competitiveness.

Furthermore, there is the danger of retaliatory measures which can lead to a destabilization of the world trade order. Finally, the sectoral structural adjustment policies are only theoretically applicable in both directions; later amendments often encounter political resistance so that the policies are largely irreversible, with corresponding economic costs in the form of higher prices, higher taxes, a real appreciation of the domestic currency, and possibly lower growth rates.

In sum, it cannot be shown theoretically that the benefits of sectoral structural adjustment policies exceed the costs. The empirical proof of a positive profit is difficult, too.²³

Also, the second condition may be fulfilled only accidentally. The political selection of the sectors and the tools is subject to high uncertainty about future scarcities on the global goods and factor markets and about the effects of the instruments. Hence it is wise to use the instruments less actively and to pay more attention to stability.

The following stabilizing instruments are available: The "first-best" solution is the building of institutions to remove the causes of the market failure indicated by the New Growth Theory. The problem with the market solution consists in the non-internalisation of externalities, the cause of which lies in the lack of clearly defined property rights. Hence it has to be considered whether the problem could not be eliminated through the definition (in the form of an ameliorated and extended protection by patent) and the constitutional embodiment of these missing property rights. Externalities could also be internalised more easily by creating private

¹⁹ For example, the extent of today's deregulation in the German transport, telecommunications and energy sectors would hardly have been achieved without pressure from the EU.

²⁰ Coordination in the sense of harmonization tends to replace the competition of national economic policies and decreases the possibility of using it as a method of discovery for the dynamically changing optimal "Ordnungspolitik". Cf. S. Sinn: *Economic Models of Policy-Making in Interdependent Economies: An Alternative View on Competition Among Policies*, Institut für Weltwirtschaft Kiel, Working Paper No. 3, 1989.

²¹ Nevertheless the concrete implementation is subject to different points of view. Cf. e.g. for the energy market H. Eiß, R. Lukes, H. Pick, W. Schulz: *Die Ordnung des Elektrizitätsmarktes in der Europäischen Gemeinschaft*, Munich 1990. In the case of the White Paper infrastructure, questions arise respecting the ability of the member states to finance the huge programme; cf. U. Voigt: *Ausbau der transnationalen Verkehrsnetze*, in: *Europartner Information*, June 1994, pp. 35ff.

²² Cf. e.g. G. M. Grossman, E. Helpman: *Quality Ladders in the Theory of Growth*, in: *Review of Economic Studies*, Vol. 58 (1991), pp. 43-61.

²³ For analyses of the computer and airplane industry cf. R. E. Baldwin, P. Krugman: *Market Access and International Competition: a Simulation Study of 16K Random Access Memory*, in: R. C. Feenstra (ed.): *Empirical Methods for International Trade*, Cambridge 1987; R. E. Baldwin, H. Flam: *Strategic Trade Policies in the Market for 30-40 Seat Commuter Aircraft*, Seminar Paper No. 431, Institute for Economic Studies, University of Stockholm 1989.

contractual agreements in the form of industrial associations and company structures (e.g. integration or joint ventures). Private industrial associations and company structures coordinate the behaviour of otherwise independent firms through sets of rules and impede free-rider behaviour. This effect may be strengthened through regional clusters of industries by the advantages of physical proximity. Government should therefore encourage and not hinder such private institutional settings.²⁴

However, even if this "first-best" solution cannot be implemented because of information problems, distribution problems and competition problems, it seems appropriate to look for other alternatives before a policy variant like sectoral structural adjustment policy is used, which, as explained above, is quite uncertain and costly. The second-best solution may be to first accept the market solution with its failure and simultaneously improve the framework for R&D in the form of financial participation in the innovation risk of the enterprises and the reduction of inefficient public regulations. This, however, is a global structural adjustment policy which refrains from a political selection of the relevant sectors.

Problems of International Coordination

As to the international coordination of national structural adjustment policies and the arguments mentioned above in favour of it, four counter-arguments are indicated:

□ Firstly, the New Growth Theory provides the legitimation basis for a structural adjustment policy, but – with its assumptions of steady state processes, rational expectations, and the costless and timeless accessibility of information and knowledge, and its lack of attention to institutions and transactions costs – it describes only parts of the growth and production processes.²⁵

²⁴ Cf. R. Weder, H. G. Grubel: *The New Growth Theory and Coasean Economics: Institutions to Capture Externalities*, in: *Weltwirtschaftliches Archiv*, Vol.129 (1993), pp. 488-513.

²⁵ Cf. for more details P. Aghion, P. Howitt: *The Schumpeterian Approach to Technical Change and Growth*, in: H. Siebert (ed.): *Economic Growth in the World Economy, Symposium 1992*, Tübingen 1993, pp. 55-76; R. Weder, H. G. Grubel, op. cit.

²⁶ Cf. T. Bayoumi et al.: *Structural Reforms and Macroeconomic Adjustment in Industrial Countries*, in: *International Monetary Fund (ed.): Staff Studies for the World Economic Outlook*, Washington D.C., August 1989, pp. 13-64; W. Maennig: *Internationale Wirkungen und internationale Koordinierung der Strukturpolitik*, in: *Konjunkturpolitik*, Vol. 37 (1991), pp. 316-330.

²⁷ Cf. R. Vaubel: *Coordination or Competition Among National Macroeconomic Policies?*, in: W. Machlup et al. (eds.): *Reflections on a Troubled World Economy*, London 1983, pp. 3-28.

□ Secondly, the empirical research described suggests that structural adjustment policy has too few externalities or spillover effects to legitimate its explicit international coordination.²⁶

□ Thirdly, international competition for the best structural adjustment policy will be reduced, if not eliminated. With today's knowledge, the optimal structural adjustment policy cannot be described with certainty; on the contrary, this policy is subject to a permanent process of discovery in Hayek's sense.²⁷ But exactly this process can be hindered by international arrangements about structural adjustment policy.

□ Fourthly, in the case of international coordination the problem of the lack of reversibility is strengthened; for this reason alone a structural adjustment policy which accelerates structural change, and which should be only temporary, does not seem wise in the framework of international cooperation, unless the cooperative arrangements simply bind the partners to renouncing such instruments.

To summarize, it can be said that the international coordination of growth and structural policies is necessary and efficient in large areas of international economics (trade and monetary systems) and of "Ordnungspolitik" (infrastructure policy and regulation/deregulation policy). Within the framework of a structural adjustment policy delaying sectoral changes which clearly burdens other countries, international coordination is also quite acceptable.

As to structural adjustment policy accelerating changes, a weighing of the pro and contra arguments is difficult even on a national basis, and – depending on the national economic situation and principled attitudes towards market mechanisms and competition – results in different conclusions. Anyway, the weak theoretical and empirical knowledge concerning structural adjustment policy and especially its international spillover effects, has to be interpreted as a considerable uncertainty, which conflicts with far-reaching international coordination.

Therefore, the European national and/or regional decision-makers should have a sufficient degree of freedom in the field of structural adjustment policy accelerating change, so that the probability of the "discovery" of an optimal industrial policy, which certainly depends on the period, place and other circumstances, remains large. Probably the necessary degree of freedom is so large that international cooperation should restrict itself to an interchange of information and ideas.