

# Industrial Policy:

## Recent Trends and Considerations for Inequality and Sustainability

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## INDUSTRIAL POLICY AND INEQUALITY

Industrial policy, broadly cast, can be defined as, “a set of policies that selectively favours the development of certain industries over others” (Schwarzer, 2013). The modern adaptation of that definition goes beyond manufacturing – industrial policy’s traditional subject—and includes measures that target everything from agriculture to services sectors. The objective is to drive economic development in ways that the market alone would fail to do effectively. The linkage to inequality between nations is straightforward: industrial policy is a means of “catching up” – of narrowing the gap between industrialized countries and developing countries by fostering globally competitive firms and sectors, ideally with spin-off benefits to the broader economy.

There are two broad categories of industrial policy: vertical measures, which target support to specific sectors or firms (such as targeted tax breaks), and horizontal measures, which create a more conducive investment climate for innovative ventures across a *range* of sectors (such as science and innovation policies). As a rule, trade and investment law has little to say about horizontal measures, and governments have broad discretion to pursue such policies.

The same cannot be said about vertical industrial policy, which typically manifests in trade- and investment-related policy tools such as:

- Protective import tariffs on final goods;
- Lower tariffs on specific inputs;
- Subsidies to specific sectors or firms: outright grants, land grants, low-interest loans, R&D support, tax holidays, etc., and
- Local content requirements.

In general, such measures are implemented with a view to shielding domestic infant industries from global competition, in the hope that they will eventually “grow up” and become engines of economic development, as opposed to burdens on the treasury.

Given their basic intent—to promote domestic firms at the expense of foreign competitors—it is not surprising that most of these tools are potentially illegal under trade and investment law (Cosbey, 2017). Tariffs set higher than bound limits are prohibited by GATT Article II:1. Any subsidy that is specific to a firm, set of firms in a particular geographic area, or particular sector is actionable under the Agreement on Subsidies and Countervailing Measures (SCM), while subsidies contingent on export performance or the use of domestic over imported inputs are prohibited outright. Local content requirements that are conditions for some advantage will likely mean the measure to which they are attached is illegal under the Agreement on Trade-Related Investment Measures (TRIMS) and the GATT. Most modern international investment agreements have the same provisions, framed as prohibitions on performance requirements. The General Agreement on Trade in Services (GATS) prohibits a number of measures that might shelter domestic infants from the establishment of foreign service providers in country (commercial presence), including: limitations on the number of foreign providers, requirements for an economic needs test as a condition of establishment, joint venture



requirements, and limitations on the percentage of foreign ownership (GATS Article XVI.2). There is a limited exception to GATT rules for the purposes of industrial policy in Article XVIII, Section A, but it is procedurally difficult to access and has never been used. Some recent RTAs go further than the WTO disciplines to also prohibit technology transfer requirements and joint venture requirements.

Is it a problem from the perspective of equality within and between nations that such measures are disallowed under trade and investment law? The answer depends fundamentally on the answer to another question: is it possible for vertical industrial policy to be successful at creating competitive domestic firms and sectors? If it can be, then restrictions on its use will impede policies that could allow developing countries in particular to catch up, “kicking away the ladder” formerly used by now-developed countries (Chang, 2003). If it can’t be, then restrictions are an appropriate way to prevent governments from succumbing to tempting but futile policies that will further immiserate their citizens and thus aggravate inequality between nations.

In their survey Harrison and Rodríguez-Clare (2010) find, unsurprisingly, that some tools are more likely to be successful at fostering competitive domestic firms than others, for example with tariff protection less likely and subsidies designed to encourage export more likely. Pack and Saggi (2006) on the other hand, survey the literature and find no compelling evidence that any sort of vertical industrial policy has been successful. Altenburg (2011), in a survey of industrial policy in seven developing country studies, finds some successes but more failures. Overall the evidence on effectiveness is mixed, and even those that ardently support industrial policy argue that we need to expect many failures for every success (Amsden, 2001). More nuanced judgments find that industrial policy *can* work, provided it’s done properly (Rodrik, 2004), for example applying it broadly in competitive sectors (Aghion et al., 2013) or in skills-intensive sectors (Nunn and Trefler, 2010).

If it is true that industrial policy can be successful at creating globally competitive domestic firms when done properly, where does that leave us on the normative question of whether it should be prohibited in trade and investment law, given its potential for reducing inequality between nations? It’s not clear. Significantly, Altenburg (2011) notes that the preconditions for success are rarely found in the countries that most need economic development. Issues for discussion include:

- If vertical industrial policy is indeed hard to get right, are the existing prohibitions useful restraints against economic foolishness, or are they patronizing obstacles to development?
- There are few precedents for trade and investment law that allow practices only if carried out in ways likely to make them effective, but pre-conditions of other types do exist, such as those found in SCM’s Article 8 as conditions for the use of environmental subsidies. Could such an approach be helpful?
- Is there room in trade and investment regimes for facilitative approaches that would help countries “get it right” when it comes to industrial policy?



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