



# TRADE AND DEVELOPMENT SYMPOSIUM

## Perspectives on the Multilateral Trading System

A Collection of Short Essays

## The revival of industrial policy: how should the WTO address it?

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## Introduction

Industrial policy has been considered outdated since the 1980s when the Washington Consensus took the dominance in economic theory and policy. However, industrial policy is recently back in fashion. One important reason is that the rise of China seemingly proves that state-led industrial development might be a workable and even preferable model. Other major emerging economies like Brazil and India which once gave up government-oriented approach now look to China for industrial policy. Another significant phenomenon is that after the global financial crisis, many developed countries strengthened government intervention in economy. The Western governments have not only lavished billions of bailout to the suffered financial sector and other industries, but also pursued active industrial strategy to either reindustrialize or establish new industries.

The global reemergence of industrial policy has serious implications for the WTO. The existing WTO rules were established in the Uruguay Round when the global policy-making community was dominated by the orthodox neoliberal economics. The general aim of these rules was to restrict the use of industrial policy instruments. Therefore, the increasing use of industrial policy has led to many trade disputes between major members and posed challenges to the current WTO system. To maintain a stable and foreseeable trade policy environment, the WTO should promptly and carefully address the issue of industrial policy revival. The desirable response for the WTO might be rethinking the rationality of industrial policy in the new circumstances and accommodating the increasing demand for government intervention in industrial development.

## The global revival of industrial policy and its implications

Industrial policy has been debated for a long time in both theoretical and practical domains. Since the early 1980s, the neo-liberal economic philosophy has assumed the dominance, which does not favor government involvement in economic activities beyond some functional intervention in the form of investment in education, health and security, etc. Meanwhile, a strong wave of trade liberalization and marketization has prevailed all over the world. The most significant examples are China and India. It once seemed shameful for an economist to defend industrial policy, and even guilty for a government to pursue it. But in fact, industrial policy never disappears into history. While no one now would aspire to return to central planning, the role of government is still believed indispensable for industrial development. The reality is that industrial policies have run rampant during the last three decades, although it has been less noticed until two new developments occurred: the rise of China and the burst of global financial crisis.

China's success was considered that of market economy and trade liberalization. Since its reform and opening up in 1979, China has kept moving toward a market-oriented economic system. China's accession to the

WTO in 2001 seemed to indicate its resolution to join the liberal international club. However, after ten-year membership, China's economic model with strong state control is still far from a free market economy. In particular, the government is still conducting widespread selective industrial policy to promote those preferred industries. Interestingly, the emerging economies like India, Brazil, Russia, and Vietnam are following China's model to preserve a large state sector and to undertake interventionist industrial policy. In fact, some countries like Brazil had given up the model of state-led industrial development during 1980s and 1990s. But when Brazil's economy stabilised in the mid-2000s, the government was able and keen to refocus on industrial policy.

Moreover, in the aftermath of the global financial crisis burst in 2008, many developed countries have taken a variety of steps to increase the role of government and to deepen the link between the government and the private sector. U.S. President Barack Obama claimed that the government must make "strategic decisions about strategic industries". His stimulus plan last year earmarked billions for innovation in sectors such as renewable energy, high-speed rail and advanced vehicles. Japan's prime minister, Naoto Kan, said that the government wanted to create a new "Japan Inc", deepening the links between business and the state. The Ministry of Economy, Trade and Industry (METI) announced a strategy to combat the "increasingly aggressive" industrial policies of America, Britain, China, France, Germany and South Korea. The European Commission will unveil a new, active industrial strategy later this year, which will pay more attention to manufacturing and less to services and "knowledge" industries.

The global revival of industrial policy poses a serious challenge to the WTO. The current WTO rules were made in the late 1980s and early 1990s when government interventionism was disregarded and discarded. Therefore, industrial policy is largely illegal or at least undesirable in the WTO. A number of WTO rules have constrained the flexibility of its members in its choice of instruments which may be used to pursue industrial policy objectives. But at the same time, there is no clear discipline about what can be done and what cannot. Now there are some major players including China listing industrial policy as a critical tool to promote industrial and structural upgrading, and the United States embarking billions for innovation in sectors such as renewable energy, high-speed rail and advanced vehicles. However, all these policies are inconsistent with the orthodox neoliberal economic philosophy and questionable under the WTO rules. China has been under attack more often due to its industrial policy. There have been 43 countervailing duty cases against China since 2004, accounting for 50% of all cases during the period. The United States also initiated several cases questioning China's industrial policies under the WTO dispute settlement mechanism.

Nevertheless, China is not the only one actively pursuing industrial policy. The United States itself is not innocent. Hence, while the United States initiated an anti-subsidy action against Chinese solar industry, China also reacted with an investigation on US subsidy

programs for renewable energy. In the context of global competition for industrial policy, such conflicts could be expected to spread and worsen without clear guidance from the WTO. In particular, those countries seeking industrial policy are all major players in the world trade and economy. Their mutual confrontations could be damaging for the whole world. Therefore, the WTO should take prompt and careful actions to address the issue and come up with reasonable solutions to it.

## What should the WTO do with the new wave of industrial policy?

Industrial policy remains controversial in terms of its rationality. There have been successes, but also many expensive failures. Nevertheless, while not all countries pursuing industry policy are successful, almost all successful countries have undertaken some forms of industrial policy in their journey to industrialization. The global revival of industrial policy itself has proven its value and necessity in the current economic circumstances.

In fact, although industrial policy covers a wide range of instruments, such as import protection, export promotion, investment incentives, performance requirements for FDI, and subsidies, the current WTO rules have limited their applicability to a large extent. Some old-fashioned industrial policy tools like high tariffs, quantitative restrictions, export subsidy, are basically prohibited. As a result, the currently used industrial policy instruments are generally less trade-distorting domestic policy rather than trade policy. The most common one is production subsidy in various forms whose economic implications are perplexing and controversial. So it is not a good choice for the WTO to preclude all industrial policies. The WTO should allow more policy space for both developing and developed members to establish their own selective industrial policy. It might be desirable to completely rethink WTO philosophy and redesign WTO system, but it is beyond the intention of the piece, which is just trying to offer some policy choices within the system to accommodate the features of the new wave of industrial policy.

### 1. Revalidate the non-actionable subsidy provision

In the Uruguay Round Agree on Subsidies and Countervailing Measures, subsidies are divided into three kinds, one of which is the non-actionable subsidies. Article 8 of the Agreement allows for subsidies to R&D activities, to disadvantaged regions, and to environment-related investments. These subsidies are considered economically reasonable and have negligible distortion to international trade. However, according to Article 31, the Committee shall review the operation of the provision in five years, with a view to determining whether to extend their application, either as presently drafted or in a modified form, for a further period. On 20 December 1999, the Committee held a special meeting to conclude the review. At that meeting, no consensus was reached by the Committee to extend Article 8, either as drafted or in modified form. Article 8 has therefore lapsed and there is no non-actionable subsidy any more. All production subsidies are actionable now.

A major goal of industrial policy is to promote technological development and to help establishing new industries. R&D subsidy is a very important instrument to achieve this goal and has strong economic reasonability. In the aftermath of the global financial crisis, the world is eager for new economic growth sources to get out of recession as well as for new technology to address global challenges such as climate change. Moreover, income inequality among different groups and regions in many countries are believed a major root source of economic recession. Governments need to balance domestic economy through a variety of policies including subsidies for disadvantaged regions. In all, non-actionable subsidies are desirable and reasonable policy choice for governments to lift their economies out of economic recession. However, the lapse of Article 8 restricts their capabilities in adopting such policies. In response to the new reality of increasing demand for them, the WTO should again review the provision of non-actionable subsidies and legitimize the use of them. Under the current circumstances, members are likely to make different decision than in 1999. The availability of legitimate policy tools would help to reduce the pursuit of other questionable options.

### 2. Due restraint in using countervailing duties

For importing members, there are two optional remedies for subsidized imports, one is to initiate countervailing actions by its own authorities, and another is to file a dispute case to the WTO. In the 21st century, there was a declining trend in the use of countervailing duties, reaching the lowest number with 6 cases in 2005. But since then, the number of cases has risen again largely because that China became a new major target. Cases against China account for half of all from 2004 to 2010.

In fact, imposing countervailing duties on subsidized imports is considered unwise by many economists. And compared with dispute settlement in the WTO, countervailing actions are more self-discretionary and arbitrary. As a result, many countervailing actions were brought to the WTO dispute settlement and found inconsistent with the SCM Agreement. This is actually a waste of resources and creates unnecessary tensions between importing and exporting members. So it would be preferable to make cases under the dispute settlement mechanism than to initiate countervailing actions. It is not possible for the WTO to restrict members' choice. But the Committee can try to reach a consensus on due restraint in using countervailing duties. Especially if those major users of CVDs could make such a commitment, it is still a helpful movement to reduce trade conflicts relating to subsidy policies.

### 3. Allow for more space for green industrial policy

Green technology and industry is somewhat a global public good since climate change and environmental pollution are serious challenges to the whole world. Subsidies for green industrial policy arguably internalize environmental benefits not captured in the market price for green energy: primarily clean air and reduced GHG emissions. It is an empirical question whether



the subsidies in any given case match the external environmental benefits, but at some level they will actually correct market distortions caused by underpricing of environmental benefits. Moreover, the green industry is still a new industry with not so much international competition. The policies in support of green technology and industry are mostly domestically focused and have little spill-over and distortional effects on international trade.

However, some big countries are competing for the leading position in the new industry. Although all of them have conducted some forms of industrial policy, they still complain each other, causing a lot of trade tensions between them. Several disputes have occurred between the United States and China over each other's green industrial policy in solar and wind power industries. There is another dispute case between Japan and Canada on this issue.

Therefore, the WTO should allow for more space for green industrial policy and encourage all competent members to make their contributions to the development of green technology and industry. It might be infeasible to develop new rules on this issue, but the WTO can try to list green industrial policy under the non-actionable subsidy and acclaim such efforts.

#### 4. More concrete S&D treatment to developing members

The less developed countries usually have less developed market system with higher possibility of market failure. Therefore, developing countries are more in need of effective government intervention. The WTO system has taken into account different demands of members in different stages of development. A set of special and differential treatment rules are incorporated in all agreements. In particular, the least developed countries almost do not have to take any responsibilities in many areas. However, for those more advanced and bigger developing countries, the WTO rules have little S&D treatment and its increased intrusiveness into what were previously domains of domestic policy have significantly circumscribed the applicability of their industrial policy. Although they have larger economic scale and trade volume, they are still in the process of industrialization. The government is still expected to play important role in the process. Besides, the approach to S&D treatment in most agreements has typically been in the form of transition arrangements, which has little true value.

Indeed, the issue of what type of market system best suits a country remains a keenly contested territory. The WTO should focus on those trade-related policies and trade distortion domestic policies. A member has their own freedom to choose the kind of market system which it believes is most suitable to it. In the case of industrial policy, as long as it does not distort trade evidently, developing members should be allowed for more policy space to formulate and conduct its own industrial policy to promote its selected industries. No

success is guaranteed. But the WTO should not prevent them trying.

## Conclusion

Industrial policy prevails again in recent years. Not only are the emerging economies like China and Brazil pursuing explicit and larger government intervention in economic development and structural adjustment, but the developed countries like the United States and European Union are actively striving to design government-led industrial strategy.

The revival of industrial policy is a challenge to the WTO system because the current WTO rules are unable to accommodate the increasing demand for industrial policy space. Therefore, trade disputes and tensions have occurred among members with competing interests in developing their industries. It would hurt the stability of the world trade order.

The WTO should address the challenge promptly and carefully. The basic principle to deal with the new wave of industrial policy is to allow for more policy space for both developed and developing members. It should be recognized that in the new circumstances, industrial policy has its rationality and feasibility. The existing WTO rules established two decades ago might not be appropriate to judge what is done at present.

There are four actions that the WTO should and could do with industrial policy. The first is to revalidate the lapsed provision on non-actionable subsidies, permitting members to increase government investments in R&D and social development. The second is to call for due restraint in the use of CVD actions and instead for dispute settlement cases under the WTO. The third is to allow for green industrial policy to address global challenges and to nurture new industries. The fourth is to offer more S&D treatment to especially big developing members as long as their industrial policies are domestically oriented and have little trade distortion.

The role of the WTO is to restrict members from distorting trade rather than to teach members to develop their economy. It is more agreeable for the WTO to leave more policy space to members and to let them choose own approaches to development.

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