ACG Insights: Answering Questions on Industrial Policy

Executive Summary

- **Industrial Policy is an economic strategy often used by developing countries and, as the global diplomatic environment shifts, its use by developed nations has increased as well**
- **Tariffs are a tool that can be used to shape the overall structure of a nation's economy, but are also a form of tax, most akin to a sales tax**
- **There is a trade-off between the efficiency of external supply chains with the stability of internal supply chains, which includes considerations of ally networks and defensible regions**

Who Practices Industrial Policy? What is it? Why practice it?

Industrial policy is the implementation of various government policies to incentivize and manage the development of select industries. Historically this was associated with mercantilism, contrasted with capitalist theory which attacked the various subsidies, protections, and privileges granted to favored industries. Industrial policy is inherently inefficient from the perspective of aggregate economic productivity; it is an intentional step to distort the organic state of economic affairs to achieve specific goals. Secondly, implementation of industrial policy typically has additional costs related to corruption and rent-seeking—increasing one's own wealth without contributing to the wealth or benefit of society.

Exhibit 1: Early American Railroads[1]

The early United States, not without internal dissent, implemented tariffs and subsidies extensively, which were largely favored by the Federalist, then Whig, and later Republican parties. In addition, infrastructure projects, such as roads and railroads were subsidized in regions to favor developing northern industry. As in most cases of government economic intervention, issues of corruption abounded, and the benefits and costs of the policies fell upon the country unevenly. The South experienced higher goods prices, while the North benefited from a captive domestic market. The upside for

[1] Civil War Research Engine at Dickinson College

the country was the development of a domestic industrial base, freeing the US from its dependency on a European-based manufacturing industry to consume American raw material exports and, in turn, deliver manufactured goods.

One of the major goals of industrial policy by the old European empires was to secure their supply chains, from the sourcing of raw materials through to the distribution of finished products. To this end, they established colonies, formed alliances and protectorates with local realms, built powerful armies and navies, and granted extraordinary powers to entities such as the British East India Company. To prevent disruptions to manufacturing and agriculture during wartime, these empires erected various trade barriers against hostile neighbors. In more modern times, we can see shades of this in China's Belt and Road Initiative—building infrastructure and, in some cases, entire cities in key locations for their international supply chain. After the World Wars, most of these structures collapsed and the global security of international trade began to be underwritten by the United States, which ironically is among the less trade dependent countries globally[2]. Here we should note that the cost of providing security is not directly borne by consumers or producers of a given product, and so an ordinary free market environment will generate a supply chain with what is effectively subsidized protection. In the past, taxation on trade tended to be linked to protecting it, with the British Royal Navy being formed for this purpose.

Exhibit 2: Imports/Exports as a % of GDP[2]

	Country/Territory/Region/Group	Exports (% of GDP)	Imports (% of GDP)
	WORLD	**29.27%**	**28.67%**
1	Sudan	1.16%	1.04%
2	Turkmenistan	22.23%	12.95%
3	Ethiopia	6.59%	13.99%
4	Argentina	12.92%	14.05%
5	United States	11.63%	15.41%
6	Brazil	18.11%	15.74%
7	Nigeria	9.24%	16.92%
8	Gabon	56.70%	17.44%
9	China	19.74%	17.57%
10	Pakistan	10.39%	17.72%

In recent years we have more frequently seen the cost of disruptions in supply chains. The Russian invasion of Ukraine led to a substantial increase in European energy prices, which has been a drag on their economies. Energy projects take significant time to get up and running. If Russian natural gas returns to their markets, bringing an immediate boost to European economies, such energy projects will most likely not be economically viable. So, Europe must choose between higher cost protectionism and possible supply disruption in the future.

Europe is also grappling with a similar challenge regarding various Chinese products such as electric vehicles. China has developed the means to produce EVs very competitively. This poses a substantial threat to the German economy, which relies heavily on auto manufacturing. In addition to their standard car import duty of 10%, the EU has levied substantial additional tariffs on products from Chinese automakers.

Another consideration for industrial policy is which sectors will have the most potential for technological advancement. Advances and subsequent economic gains for say, potato farming, are less likely to occur in Egypt than Idaho. Idaho is a major center of potato farming, and so it is the one that devotes resources to R&D and competition in the field. Similarly, the US was able to ride major advances in manufacturing and then software technologies to become premier country in those sectors as they made their largest strides. Silicon Valley's existence is in many ways attributable to Cold War defense spending. It bears remembering that, while some developments within industries favored by government protection or spending have turned out well, many also

[2] World Bank, Trade (sorted by imports % of GDP)

fail. In recent years, many green energy and related projects have performed poorly or in a lackluster fashion in both the US and Europe, with the notable exception of Tesla.

The last, and perhaps thorniest, issue relating to industrial policy is that of employment. The human cost of an enduring change to a large segment of an economy is substantial. Labor is not very liquid relative to capital, and communities affected by deindustrialization are generally not beneficiaries of new developments in the economy. On the other hand, the artificial maintenance of an industry can be quite costly. Today, China faces this issue with their steel industry. Their steelworkers are an influential political bloc, and China has been unable to implement cuts to the industry. Meanwhile, the industry runs up considerable losses for their government while simultaneously antagonizing other countries due to their steel dumping.

How is the US implementing Industrial Policy today? How will tariffs and subsidies be used?

There is a certain historical irony in the rise of China, in that it resembles another time that the United States opened trade with and facilitated the development of a major Asian power, Imperial Japan, which the US had forcibly opened and then aided in westernizing. Presently, it seems a broad consensus has emerged around China as both a military and economic threat. This indicates that tariff policy will likely be more enduring against China. US negotiations with other trade partners to reinforce country of origin rules, preventing China from using transshipment to disguise their products, strengthens this possibility. Negotiations with China during the first Trump administration as well as the current weak state of the Chinese economy suggests that China may look to make quick concessions to avoid a prolonged conflict. However, the terms of the first deal weren't fulfilled, likely making the Trump administration hesitant to take any offer at face value. Freedom of navigation in Asian waters as well as market access and intellectual property right protections are likely to remain key issues. Export bans of key technologies issued under the Biden administration may continue under Trump. Efforts to internalize key elements of the supply chain that are at risk in a war with China, such as the semiconductor industry in Taiwan, are likely to continue, though Trump generally appears to favor tariffs over subsidies as an incentive.

Exhibit 3: Perry opens up Japan[3]

In the aftermath of WW2, the US generally held its markets open to the rest of the world while accepting trade barriers against it to facilitate development of damaged or developing countries. South Korea and India are notable examples of fairly protectionist countries that have developed or are developing with tight ties between government policies and their economies. The Trump administration has decried this model as disadvantageous to the US and no longer justified, launching a wave of tariffs on April 2nd in a bid to re-order global trade. While most countries were hit by a 10% tariff, the negotiability of which remains uncertain, several large trading partners were hit by more individualized tariffs. Interestingly, the EU (hit with a 20% rate) was treated as a collective, which runs against Trump's general preference for bilateral negotiations that are more advantageous to the US. Other major trading partners hit with country-specific tariffs were Japan, South Korea, India, Taiwan, Vietnam, and of course, China. Initial responses varied, with some countries seeking conciliation

[3] Bill of Rights Institute: Commodore Perry and the Opening of Japan

and others retaliation. Notably, there were waivers on some classes of goods, such as semiconductors. One might connect that waiver to Taiwan Semiconductor's promise earlier in the year to make massive investments into US production facilities. If so, that could foreshadow the sort of concessions that the Trump administration would seek to reduce tariffs to zero. Otherwise, to reach that 10% baseline, it is likely more modest concessions such as lowering trade barriers towards the US would be sufficient.

It is not trivial to determine which sectors are viewed as most important by the Trump administration, but areas of focus appear to be steelmaking, auto manufacturing, AI and related businesses, semiconductors, rare earths, aluminum, and shipbuilding[4]. Here, again, potential conflict with China is a major focus. Chinese dockyard count is nearing 10 times that of the US. They are the dominant player in steelmaking and rare earths, and have proximity to Taiwan, which produces most of the world's semiconductors. Some combination of more permanent tariffs, subsidies, and governmental support for export or development is likely to be seen to drive the US onshoring of these key industries. Advocacy for these industries and particular concessions are likely to be sought in negotiations.

As to the costs of globalization to the American working class, it must be observed that many of them have already been borne and some are still ongoing. Manufacturing employment fell slowly from 1980 to 2000, roughly 10% overall representing some 2 million jobs. From 2000 to 2010 however, it fell a dramatic 40%, representing some 6 million jobs, which is greater than the employment of three Silicon Valleys. When we consider that these industries tend to be relatively concentrated in geography and often the anchor of local economies, it is apparent that the disruption to people's lives is even greater. In cases where the members of a community have moved on, typically physically relocated, restoration of manufacturing is not particularly important. In communities where people have fallen to drug addiction and despair, the return of manufacturing employment is insufficient for recovery. The return of some manufacturing employment would be most impactful to those communities that are on the margins, not quite collapsed but not doing well either. Based on this analysis, we can conclude that it is not necessary to restore 6 million manufacturing jobs, but a more modest 1 or 2 million may achieve Trump's political aims.

For a tariff to raise meaningful revenue, much like a sales tax, it must be set at a level where transaction volume is still substantial. Taxation set at a prohibitive level raises very little revenue, so the two objectives of encouraging domestic production and raising additional revenue have inherent tension between them. Tariffs in the 5-10% range should be understood as raising revenue and implementing a very modest tilt towards domestic production, whereas those set at 20% and higher indicate a strong preference for domestic production. To the degree that additional tax burden is imposed by tariffs, it is likely that the Trump administration will seek to use the revenues generated to justify tax cuts in other areas, in keeping with Republican preference for lower taxes.

Conclusion

It is clear that the post-Cold War economic policies of western countries are in the process of significant change. The areas that will come under the most scrutiny are those seen as relating to national security, with a drive to move supply chains to areas that are more secure or domestic. Concerns such as sector-specific employment, diplomatic relations, and tax revenue will likely play a role, but will remain secondary. The tensions between

[4] WhiteHouse.gov

these various goals mean that we should also evaluate the permanence of changes. Enduring trade barriers on certain goods are far more likely than others.

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