Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

RETHINKING INDUSTRIAL POLICY

To: The Director of the National Trade Council/Office of Trade and Manufacturing Policy
From: Douglas A. Irwin
October 2020

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Background: Both Republicans and Democrats are openly discussing whether the United States should have an "industrial policy" to promote domestic manufacturing in critical sectors. The COVID-19 pandemic and deteriorating relationship with China have sparked concerns about the security of domestic production and its vulnerability to supply chain disruption, adding important public health and national security dimensions to the ongoing debate. The next administration will have to deal with these issues, but with even greater urgency.

In 2017, President Donald Trump created the National Trade Council—later turned into the Office of Trade and Manufacturing Policy—to advise his administration on policies to ensure a strong domestic manufacturing sector. The office—with its skeleton staff, lack of policy authority, and absence of institutional experience—does not seem to provide any real value in terms of additional information or expertise that help in administration deliberations.

PRIORITY 1: Abolish the Office of Trade and Manufacturing Policy

The new administration should rethink the structure and goals of the Office of Trade and Manufacturing Policy. Its purpose—to assist the White House in creating policies that will promote US-based manufacturing—is too narrow, and it functions ineffectively.

One option is to simply abolish the office. Just because the office was created to deal with important issues does not mean that it is best suited to addressing them. The president oversees many executive branch agencies that play a role in formulating specific industrial policies.

Alternatively, the office could serve as a coordinator of administration policy. But the National Economic Council (NEC) already exists to serve that purpose. To the extent that the functions of the office are deemed important, it could be folded into the NEC. Or, to the extent that the office serves a constructive purpose that does not duplicate what is being done elsewhere, it could be repurposed as a joint task force between the Departments of Commerce, Homeland Security, and Defense.

ACTIONABLE TO-DO LIST:

- Abolish the Office of Trade and Manufacturing Policy.
- Or fold it into the National Economic Council.
- Or make it a joint task force between the Departments of Commerce, Homeland Security, and Defense.

PRIORITY 2: Rethink the idea of industrial policy

Whatever is done with the office, US industrial policy requires a rethink. The Trump administration has the professed goal of reshoring American manufacturing and shrinking global supply chains to reduce dependence on foreign suppliers. Public health concerns arising from the pandemic and national security concerns arising from dependence on China for key materials have made these matters the subject of bipartisan concern.

The new administration should undertake an interagency study of the goals and feasibility of different policies to strengthen particular industries or sectors that are deemed essential to maintaining technological prowess, such as strengthening investment in research and development (R&D), or ensuring economic security, defined broadly to include public health. Such a study should not focus exclusively on the manufacturing sector, as many concerns are not with physical production but with setting regulatory standards (where the United States has yielded the initiative to an increasingly assertive China) and the digital economy. Infrastructure that is critical to the nation's economy, such as the electricity grid, as well as stockpiling of essential goods or medical supplies, might also be relevant to such a report.

The proposed study could identify specific product segments or areas where more domestic production capacity is desirable for carefully delineated public health or national security reasons. The objective should be to single out a few genuinely critical sectors where current government policy could be improved, or even where additional support might be given. The problem with America's existing industrial policies—and the nation certainly has them, belying any debate about whether the country should or should not pursue policies that support particular sectors—is that they are undertaken on an ad hoc basis across different government agencies, often at cross purposes. The proposed interagency study should attempt to provide clarity to government, business, and the public at large about these national goals and how to achieve them.

The challenge for policymakers is to identify such industries without succumbing to the notion that every industry is vital to some public objective. For example, the goal of "economic security" is so broadly defined and open-ended that virtually every domestic producer could claim the need for government support on that basis. The risk is that ill-conceived government programs will encourage corrupt behavior in which industries benefit themselves without contributing to national welfare.

Furthermore, the United States cannot and should not have as its policy goal greater self-sufficiency across a wide range of activities. The nation—and the manufacturing sector in particular—is too deeply engaged in international trade to make that advisable. Furthermore, the efficiency gains from this diversification of supply are substantial. The economic benefits from openness to trade are too great to make retrenchment desirable. Most US foreign trade is with neighboring countries and allies where there is mutual interdependence and with whom the risk of disrupted trade is very low. (North American supply chains in automobiles, for example, are based on economic efficiency and are not a threat to national security.)

ACTIONABLE TO-DO LIST:

- Undertake an interagency study of the goals and feasibility of different policies to strengthen particular industries or sectors that are deemed essential to maintaining technological advantage, promoting national security, and ensuring public health.
- Work with allies for cooperative solutions to problems related to national security and public health, and to avoid every country seeking national self-sufficiency.

PRIORITY 3: Avoid protectionism and bad industrial policy

An interagency study, as suggested above, should also carefully examine the specific policies that might be proposed to achieve the objective of making the US economy safer and more secure. The Trump administration's policy focus has been on protecting certain American industries from foreign competition, through import tariffs, rather than promoting these industries, through incentives for R&D, investment in worker skills through labor market policies, and other forms of encouragement. This approach has been deeply problematic for both economic and diplomatic reasons.

First, protectionist policies limit imports, often without distinguishing between reliable foreign suppliers from countries that are US allies and unreliable suppliers from countries that are potential adversaries. As a result, newly imposed tariffs have harmed US relations with friendly nations whose support and cooperation the United States needs in many related areas, ranging from national security, climate change, and terrorism. Tariffs also lead to foreign retaliation against US exports, often targeting the most efficient US manufacturers and farmers, even US business service providers. Such trade wars create collateral economic damage and subvert the goal of boosting employment and growth at home.

A protectionist approach also raises domestic prices, which may help certain narrowly defined producer interests but harm other domestic industries that require competitively priced inputs. The steel industry is a case in point. The administration protected the domestic steel industry through tariffs imposed on imports under the dubious guise of national security. By raising domestic steel prices and creating spot shortages, however, these tariffs have also harmed many domestic manufacturers whose competitive position depends on cheap and readily available steel inputs. For example, the steel tariffs have hurt the domestic automobile industry, raising Ford's costs by over a billion dollars. They have hurt John Deere and Caterpillar and numerous other manufacturers (from beer kegs to bridge construction) by raising their costs of production. The products of some of these harmed companies are far more important to national security and harder to substitute than products of steel producers.

Considerable damage has been done. One study suggests that steel users will pay an additional $5.6 billion for more expensive domestic steel. In other words, steel users will pay about $650,000 for each job created in the steel industry. Another study calculated employment in the US steel and aluminum industries (mainly steel) might increase by 26,000 jobs over three years, while employment would decline by 433,000 jobs in the rest of the economy, owing to the damage higher steel and aluminum prices have done to downstream industries.

These trade restrictions have led to two related phenomena: lobbying for exemptions and lobbying for cascading protection. When one sector is protected, downstream sectors will pressure the government for an exemption from the tariffs on their inputs. The process of determining which users are eligible for such exemptions is fraught with politics and has the potential to be corrupted by political favoritism. If the downstream industry fails to receive an exemption, it will often lobby for protection for itself to compensate for the higher prices that it has to pay. This cascading protection can lead to further trade restrictions, further corruption, and further retaliation by trading partners.

Another problem with trade restrictions is that the achievement of one objective comes at a cost to other industries. For example, an export ban on semiconductor manufacturing equipment to prevent the leakage of high technology to China can harm the domestic industry and spur additional Chinese efforts to produce those sophisticated products at home.

In other words, protectionist policies and trade wars are not good industrial policy. If important sectors of the economy have been identified as meriting support, temporary direct subsidies or other forms of promotion assistance will not raise prices and harm downstream industries nor raise trade barriers that lead to retaliation and ill will among allies. Furthermore, should such financial support fail to achieve desired objectives, it is often easier to terminate the policy than it is to remove trade restrictions.

Government agencies are supposed to serve the public interest, but there is always a risk that private interests will capture them. Even if the next administration avoids protectionist policies, industrial promotion polices are also fraught with pitfalls. While subsidies avoid the problem of tariffs, such subsidies can be misallocated to undeserving industries for political purposes. The recent ill-advised grants to Kodak for pharmaceutical manufacturing, an initiative that came out of the existing Office of Trade and Manufacturing Policy, illustrates this point.

ACTIONABLE TO-DO LIST:

- Avoid protectionism as a seemingly easy solution to difficult problems.
- Be aware of the harmful impact of protectionism on downstream industries, as well as on consumers.
- Create safeguards to avoid policy capture by private interests.