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INDUSTRIAL POLICY AND THE WTO

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I. THE ISSUE

The general objective of promoting exports and achieving rapid structural change and economic growth has been an integral part of development economics and policy-making for many decades. There has been a succession of different approaches and thinking with regard to how this objective can best be met, ranging from inward-looking or import substitution industrialization behind high protection, to outward-oriented or export orientation and promotion strategies considered to be part of the success story of East Asia. The range of instruments used for conducting industrial policy has also changed with the evolution of multilateral trading rules, as well as unilateral liberalization, the latter occurring within a framework of structural adjustment that is required in order to stay competitive and in some cases to access international finance. The combination of strategy and instruments used has been the subject of numerous studies, with mixed results on the value of interventions and their outcomes. There has also been a plethora of studies which show that industrialization behind protective walls has often extended beyond reasonable periods of "infancy" and has led to inefficiency and welfare losses, and entrenched vested interests.

Despite the strong theoretical case against activist industrial policy, it is still widely pursued in a number of countries.[1] In the 1990s, however, the context in which it is pursued is different. Rapid technological change, shorter product cycles and developments in information technology have combined with privatization, and trade and foreign investment liberalization to produce a global economy that is distinctly different. In this context, developing countries are striving to ensure that their industries are competitive by using industrial policy to promote particular sectors.

It should be pointed out at the outset that the term "industrial policy" is not a well-defined one. It is ill-defined in relation to the objectives, the industries that are covered and the instruments that are used. The World Bank (1992) has provided a working definition of industrial policy as "government efforts to alter industrial structure to promote productivity based growth".[2] This definition is useful since it focuses on the objective of economy-wide factor productivity growth rather than on merely changing the structure of industrial outputs.

With regard to objectives, many developing countries have in mind the potential for long-run productivity improvements. However, in most cases industrial policy is pursued with multiple objectives, including short-term employment, increased output, better

[1] A number of countries have pursued interventionist industrial policies with some degree of success. In East Asia, the Republic of Korea, Taiwan Province of China and Japan are three examples of where government intervention in the form of activist policies was important for the pace and direction of development (Lall, 1994; Singh, 1996; Asian Development Bank, 1999: 208-210). This intervention, however, was broad-based and not confined to protection. It included aspects of targeted technological promotion, financing and skill development. In an effort to replicate this success many developing countries have taken the position that they too should be allowed to pursue such policies and not be restricted by multilateral rules.

[2] A recent paper by Martin and Mitra (forthcoming) shows that the productivity growth rate in agriculture is higher both on average and for groups of countries at different stages of development.

income distribution and enhancing technological capacity. There are often also, rightly or wrongly, non-economic objectives of national pride and prestige, as well as the perceived need to promote “strategic” domestic industries.

These objectives are further confused to the extent that many developing countries have taken the view that ownership of assets matters. There is a concern that foreign ownership may not always fit in well with broader development objectives, including enhancing domestic capabilities.[3] In some cases, foreign ownership could crowd out domestic firms. Thus, even if the World Bank definition is adopted and productivity-based growth materializes, the fact remains that developing countries have raised concerns about the source of growth. Growth in per capita GDP based on domestic assets seems to be preferred to growth based on foreign assets. The latter would not constitute “development” per se. Some countries may be prepared to trade off a lower rate of growth in per capita GDP combined with lower foreign ownership against a higher rate of growth with more foreign ownership.[4]

The focus of “industries” almost invariably seems to be on the manufacturing sector. This leaves out agriculture, services and mining, although these sectors raise much the same issues. Processing of agricultural and mining products occurs in the manufacturing sector, and the line between unprocessed and semi-processed products on the one hand and processed products on the other is arbitrary. Similarly, many services sector industries add value to manufactures, and they raise issues that parallel those of industrial development in manufacturing industries. Restriction of the discussion to manufacturing industries alone discriminates against non-manufacturing industries and leads to inefficiencies in the production allocation of the economy. Although the growth of industry output and exports in some developing countries in Asia and elsewhere is concentrated in manufactures, in others primary and services sector development is an important part of growth. In this paper, industrial policy is not restricted by sector.

With regard to instruments, the traditional focus has been on tariffs or output-based subsidies or export subsidies to industries as a way of rectifying alleged market failures due to externalities, missing markets or other failures (Lall, 1994). These have also been used to direct resources into certain sectors that may be considered more conducive to development such as those with high growth potential. Recently, however, more attention has been devoted to factor markets, especially foreign direct investment (FDI). Here the belief is that FDI is a bundle of assets that can contribute to economic development. At the same time, however, the use of these assets by affiliates of transnational corporations (TNCs) can also hinder a country’s development efforts. Government intervention is then required in order to alter the operations of foreign affiliates so as to minimize their negative effects (UNCTAD, 1999b).

In reality, developing countries have used a mix of import protection, export promotion, foreign investment restrictions and performance requirements, tax incentives and other measures to promote industrialization. The types of instruments used by developing economies have changed, especially since the 1980s,

[3] For a discussion of how foreign ownership matters in the context of development see UNCTAD (1999a).

[4] One possible reason for this could be the perception that openness would increase the vulnerability of the country to external shocks.

owing to increased restrictions on their use through multilateral and regional agreements, as well as domestic regulatory reforms initiated through structural adjustment loans or domestic efforts to restructure their economies. The major changes faced by countries resulting from multilateral rules are the various GATT Codes that emerged prior to the Uruguay Round, particularly the GATT Code on Subsidies and Countervailing Duties of 1979, which restricted signatories' use of export subsidies. The multilateral trade agreements, agreed upon by WTO members as part of the Uruguay Round negotiations, have created new disciplines on the use of such policies. Meanwhile commitments under the Uruguay Round and regional agreements, and unilateral efforts to liberalize, have led to a decline in the use of tariff and non-tariff measures.

The aim of this paper is to review the objectives and instruments of industrial policy in a changing global context and multilateral rules and discipline. The remainder of this paper is divided into four sections. In the next section an analytical review is undertaken of the objective of, and justification for, industrial policy pursued by countries. The importance of having an analytical framework is that it becomes the benchmark against which objectives, instruments and outcomes can be measured. In the third section the use of different instruments for industrial policy is reviewed. An attempt is made to assess whether changes have been due to compliance with multilateral and/or regional commitments, or due to unilateral reform efforts. This section also discusses whether new non-traditional instruments to pursue protection were needed once the use of traditional instruments became restricted. The fourth section focuses on the role of industrial policy in the post-Uruguay Round era with a view to the next round of WTO negotiations. It examines both the theoretical and the applied aspects of industrial policy before surveying the extent to which existing WTO rules affect a member's ability to pursue industrial policy objectives. The possibilities and implications of revising rules that affect the use of industrial policy instruments are discussed in the fifth section. The last section sets out a number of conclusions.

II. THEORY OF INDUSTRIAL POLICY

This section begins with a brief review of the traditional argument against infant industry protection. This argument still lurks behind most advocacy of government assistance for industrial development in developing (and developed) countries. Moreover, an examination of it highlights pitfalls in policy development which apply equally to other modern arguments since they are essentially variants of the old infant industry argument.

The traditional infant industry argument justified a tariff, or a subsidy based on the output of firms which have an equivalent effect on output, on the basis of some dynamic externality. Kemp (1964) provides probably the first careful statement of the argument. He identified learning processes such as worker learning by doing or on-the-job training as the source of cost saving and distinguished between learning processes which are internal to the firm and those that are external. The former are appropriable by the firm. Only those that are external to the firm warrant assistance, and then only if the reductions in cost over time compensate for the higher costs during the period of assistance,[5] with all flows appropriately discounted. The tax subsidy is temporary.

Baldwin (1969) raised a second difficulty. He pointed out that a tariff (or subsidy) provides no incentive per se for a firm to acquire more knowledge, because it is an output-based intervention. A firm will increase output by the least costly method, not necessarily by acquiring more technology. The correct policy implied by the argument, supposing that it is demonstrated, calls for a subsidy related to knowledge creation, for example a subsidy on the particular workers who learn by doing. Most knowledge or skill acquisition is process-, job- or product-specific. In these cases the corrective subsidy will be confined to the process, job or product, or whatever, and based on the variable with which the externality is associated. Thus, there are substantial qualifications to the infant industry argument.

This line of argument is in fact an example of a much more general theme in the literature of government intervention. Each externality or market failure calls for a tax subsidy whose base is the variable which generates the externality or failure, and the tax-subsidy rate will be the rate that has the optimal effect. Bhagwati (1971) gives an early statement of the rule. Any tax subsidy other than the optimal tax subsidy causes what Corden (1974) called by-product effects that impose costs on the