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Is Industrial Policy Making a Comeback?

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The COVID-19 pandemic and the rise of China have prompted renewed debate about the government's role in shaping the U.S. economy.

Introduction

As the United States confronts a series of challenges—the COVID-19 pandemic, growing income inequality, climate change, and the rise of China foremost among them—there is renewed debate about the role of industrial policy, or government support for particular industries that are deemed strategically important.

To its supporters, a new U.S. industrial policy is essential to respond to China's state-led development, secure a supply of critical materials and products, and develop technologies that could preserve the planet. They point to the use of industrial policy not only in China, but also in countries such as Germany, Japan, and South Korea, as well as its historical use in the United States. To critics, such a policy inevitably distorts the free market and rewards companies not for the quality of their products and services but for their skill at lobbying lawmakers.

After President Donald J. Trump upended the Republican Party's traditional stance on trade and economic policy, the debate over the need for an American industrial policy intensified. President Joe Biden has made clear his desire to transform an economy upended by the pandemic.

What is industrial policy?

Industrial policy generally refers to efforts to promote specific industries that the government has identified as critical for national security or economic competitiveness. The Roosevelt Institute's Todd Tucker has [defined industrial policy \[PDF\]](#) as: “any government policy that encourages resources to shift from one industry or sector into another, by changing input costs, output prices, or other regulatory treatment.”

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Edward Alden, *CFR Senior Fellow*

Industries often included are those with heavy manufacturing or that have military applications, such as aerospace, steel, and shipbuilding. Policy measures could be protective tariffs or other trade restrictions, direct subsidies, tax credits, public spending on research and development

(R&D), or government procurement (goods and services, such as military equipment, that the government buys). “It’s about the government putting a thumb on the scale, rather than just assuming that market outcomes are going to produce the maximum benefit,” says CFR’s Edward Alden.

Alexander Hamilton is widely considered to be the first major proponent of industrial policy in the United States. In his famous 1791 “[Report on the Subject of Manufactures](#),” the nation’s first treasury secretary advocated supporting the fledgling U.S. manufacturing sector through a combination of tariffs and subsidies.

This Hamiltonian tradition has been expressed in various forms throughout U.S history, such as Henry Clay’s vision of an “American System”—a combination of tariffs, a national bank, and infrastructure development—in the early nineteenth century, [writes Ganesh Sitaraman](#) of Vanderbilt University. Sitaraman ascribes several other traditions of U.S. industrial policy to early American leaders, including a “Franklinian” tradition focused on promoting research and infrastructure, rather than particular industries, and a “Madisonian” tradition centered on creating a competitive market through the use of antitrust and other regulations.

However, among advanced economies, the United States has historically been “the most averse to using industrial policies in any kind of consistent fashion,” says CFR’s Alden. Washington has typically embraced it only in response to a perceived external threat, he says.

Experts cite many of President Franklin D. Roosevelt’s (FDR) New Deal programs of the 1930s as early examples. These include the National Recovery Administration, which sought to regulate wages and prices across a slew of industries. The massive, government-directed World War II mobilization that followed was also an extreme case.

After the war, U.S. industrial policy was largely driven by competition with the Soviet Union, including the [space race](#). The Pentagon’s Defense Advanced Research Projects Agency (DARPA)—conceived in response to the Soviet Union’s launch of Sputnik, the first artificial satellite—has been credited with paving the way for the modern internet and the Global Positioning System (GPS), among other breakthroughs. Massive government purchases of semiconductors spurred the growth of that U.S. industry. But competition with Japan in the semiconductor industry in the 1980s stoked fears of a U.S. decline. This led to the creation of Sematech, a government-backed consortium of fourteen U.S. companies aimed at strengthening the industry by coordinating R&D spending and setting common standards.

More recent examples include ARPA-Energy, the Department of Energy’s own version of DARPA, which focuses on developing new energy technologies. President Barack Obama’s [Manufacturing USA](#) initiative, started in 2016, established more than a dozen public-private research institutes focused on promoting advanced manufacturing.

What about other countries?

Many countries, including Germany, Japan, South Korea, and most Latin American countries, have implemented industrial policies with varying degrees of success.

Europe. Industrial policy has a long tradition in Europe, including in France, Germany, and the United Kingdom. The economist Ha-Joon Chang [has detailed](#), for example, how England fostered the development of wool manufacturing as early as the fourteenth century using tariffs,

export restrictions, and other measures. Germany's nineteenth-century Chancellor Otto von Bismarck, who created a unified German state, introduced tariffs to protect both agriculture and industry, known as the "marriage of iron and rye." Chang explains that state-owned enterprises have played an important role in several European economies. The French government today is still a major shareholder of the automaker Renault, while the aerospace giant Airbus is the result of a collaborative effort by the British, French, Spanish and German governments to challenge American companies such as Boeing.

The 1980s saw a turn against heavy state involvement, with the UK's Margaret Thatcher and other leaders privatizing nationalized industries such as steel and airlines. More recently, however, UK Prime Minister Boris Johnson announced plans for a "green industrial revolution," pledging investments in renewable energies and electric vehicles to help make the country carbon-neutral by 2050. In Germany today, research is supported by a network of public-private institutes, and manufacturing is aided by an apprenticeship program. Berlin has also developed an "Industry 4.0" plan to boost high-tech manufacturing through research subsidies and other initiatives.

The European Union, meanwhile, has recently adopted a climate-focused industrial policy, which includes the European Battery Alliance, a network to coordinate research and subsidize battery manufacturing across the continent. The bloc is also looking to increase its share of the global semiconductor market and lead the way in quantum computing.

Asia. Many experts argue that industrial policy stoked the "East Asian miracle," the rapid post-World War II economic development of countries in the region, including Japan and South Korea. The Japanese government fostered the development of industries such as steel and semiconductors using a combination of trade and investment restrictions, subsidies, and other policies. By the 1980s, Japan had transformed into an economic powerhouse rivaling the United States. Yet, some experts argue that [PDF] the effects of industrial policy on Japan's economic growth are overstated, and that other factors, such as entrepreneurship and the country's high savings rate, played bigger roles. After more than thirty years of rapid growth, Japan suffered what some have called a lost decade in the 1990s, and it has since struggled with low growth and deflation.

South Korea also sought to rapidly modernize its economy [PDF] in the 1960s and 1970s, including by developing its steel, shipbuilding, electronics, and automobile manufacturing sectors. This led to the creation of the chaebol, massive conglomerates such as Samsung and LG that dominate South Korea's economy. Seoul also heavily subsidized its semiconductor industry, helping it become one of the world's largest. In Taiwan, meanwhile, the government played a crucial role in developing its semiconductor industry—also a global leader—by funding research and recruiting U.S.-trained engineers. However, economist Arvind Panagariya has argued that South Korea's and Taiwan's success is the result of their embrace of trade, not industrial policy [PDF].

China, under Communist Party leadership since 1949, has long had a state-directed economy despite some market-oriented reforms beginning in the late 1970s. In recent years, Beijing has embraced an aggressive industrial policy in the form of its Made in China 2025 strategy, which outlines Beijing's ambition to achieve global dominance in ten high-tech industries, including electric vehicles, advanced rail and shipbuilding, and artificial intelligence; the government has poured subsidies into the development of these industries.

Latin America. Many countries in the postwar era, worried that they were too dependent on low-value-added commodities in sectors such as agriculture and mining, experimented with import substitution industrialization (ISI). This approach sought to promote domestic industries by discouraging the importation of manufactured goods through tariffs and other trade restrictions. Experts say the results were mixed: some new industries and successful companies were formed, but it also resulted in corruption, inefficiency, and unsustainable government budgets.

Why is it controversial?

The debate over industrial policy is heated because it gets to the heart of a deeper, long-standing controversy over the role of free markets and the role of the government in the economy.

Proponents argue that the government has both the ability and the duty to structure the economy in the national interest, since the free market may fail to do so. For example, the manufacturing industry provides broad societal benefits, such as stable, well-paid employment, that are not factored into an individual company's decision-making, argues Oren Cass, executive director of the think tank American Compass. Harvard Business School professors Gary Pisano and Willy Shih have long argued that offshoring production hinders the United States' ability to innovate, as manufacturing know-how is lost.

What's more, a country could determine that it needs to domestically produce critical goods, such as medical supplies or military equipment, for national security reasons. Supporters also argue that the government should fund R&D because the societal benefits go far beyond what companies will invest in.

A smart industrial policy should focus on high-value industries that compete internationally, have civilian and military applications, and are difficult to revive once lost, says Robert D. Atkinson of the Information Technology and Innovation Foundation. Atkinson cites semiconductor manufacturing as one example.

Critics counter that the government is worse at identifying successful firms than the free market, and that intervention inevitably leads to crony capitalism, where politically well-connected companies benefit at the expense of their competitors. The Cato Institute's Scott Lincicome has documented what he describes as a series of security-motivated industrial policy failures, including U.S. government efforts to support the semiconductor industry in the 1980s that he argues did little to help, and perhaps even harmed, it. Some experts on the left, such as Matt Stoller of the anti-monopoly American Economic Liberties Project, have warned that industrial policy could lead to an even greater concentration of corporate power that he argues would stifle innovation and harm national security.

What is the current U.S. debate about?

Industrial policy fell out of favor in the 1980s and 1990s with the development of the Washington Consensus, by which mainstream economists saw economic development as the result of free-market policies such as the privatization of state enterprises and promotion of free trade. But there is renewed interest among policymakers on both sides of the aisle due primarily to the rise of China, increasing economic inequality, the threat of climate change, and supply-chain vulnerabilities revealed by the COVID-19 pandemic.

Some Democrats have put forward bold proposals that intentionally hearken back to FDR-era interventionism. During the 2020 presidential campaign, Senator Elizabeth Warren (D-MA) proposed a sweeping “economic patriotism” plan to reorient the federal government to protect American jobs and industries. Progressive lawmakers have also proposed a Green New Deal, which envisions a broad, climate-centered industrial policy focused on clean energy, infrastructure, and manufacturing. Senate Majority Leader Chuck Schumer (D-NY) is pushing legislation, known as the Endless Frontier Act, that would invest \$100 billion in research in many of the same industries in China’s Made in China 2025 plan.

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On the right, President Trump broke with long-standing Republican economic orthodoxy with the stated goal of bringing back American jobs, particularly in manufacturing. He imposed tariffs on imported steel and aluminum products, washing machines, and solar panels; he took aggressive action against China, slapping additional tariffs on hundreds of billions of dollars worth of Chinese goods and blocking several high-profile Chinese acquisitions of U.S. tech firms. But many experts criticized Trump’s tariffs as ineffective, saying they generated few jobs at a huge cost to consumers and other industries.

Some other Republicans have followed suit. “The market will always reach the most efficient economic outcome, but sometimes the most efficient outcome is at odds with the common good,” Senator Marco Rubio (R-FL) said in a December 2019 speech advocating for a new U.S. industrial policy to counter China and bring back “dignified work.” His plan includes increasing federal R&D spending, encouraging investment in “strategically important industries” such as aerospace and rail, and incentivizing businesses to invest more in factories and machinery.

Cato’s Lincicome warns against overstating the success of China’s state capitalism, noting that Chinese semiconductor companies have failed to become global leaders despite billions of dollars in subsidies. Moreover, he says, “the United States should lean in to what makes the United States great:” increasing high-skilled immigration, cutting taxes and regulations, and securing new trade agreements with allies. Lincicome further argues that industrial-policy proponents paint a picture of U.S. decline that is far bleaker than reality. Though employment has declined, the value of manufacturing output has risen over the past two decades, and the sector’s declining share of the economy is consistent with those of other advanced economies as service industries expand.

What could Biden do?

President Biden campaigned on a pledge to “Build Back Better,” a plan that would put hundreds of billions of dollars toward improving U.S. economic competitiveness and promises a foreign policy “for the middle class.” As the full extent of the disruptions wrought by the COVID-19 pandemic become clearer, Biden is reportedly eyeing a broad transformation of the U.S. economy.

One of Biden’s first actions in office was an executive order aimed at strengthening so-called Buy American laws, which require the federal government to purchase goods and services from U.S. companies. In another executive order, he began the process of replacing the federal

government's massive fleet of vehicles with clean-energy models made in the United States, a potential boon to the domestic electric vehicle industry. Amid a global shortage of semiconductors and concerns over insufficient stocks of basic medical supplies during the pandemic, Biden also ordered a review of U.S. supply chain vulnerabilities.

However, CFR's Shannon K. O'Neil warns that the push to return supply chains to the United States could make them less resilient by concentrating production among a few U.S. manufacturers. A better approach, she writes, would be to coordinate with allies such as Canada and Mexico to create joint supply chains and strategic stockpiles to respond to future crises. "An industrial policy that tries to preserve the past through protectionism and isolation will only weigh down the United States," O'Neil writes in *Foreign Affairs*.