



TOWARDS A RETURN OF INDUSTRIAL POLICY?
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Fragmentation, Comparative Advantage, and Industrial Policy

Alan V. Deardorff
University of Michigan

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Some questions:

- What is industrial policy?
- When is it warranted?
- Does comparative advantage justify it?
- Does fragmentation change this?
- If others do it (and they do!), should we?

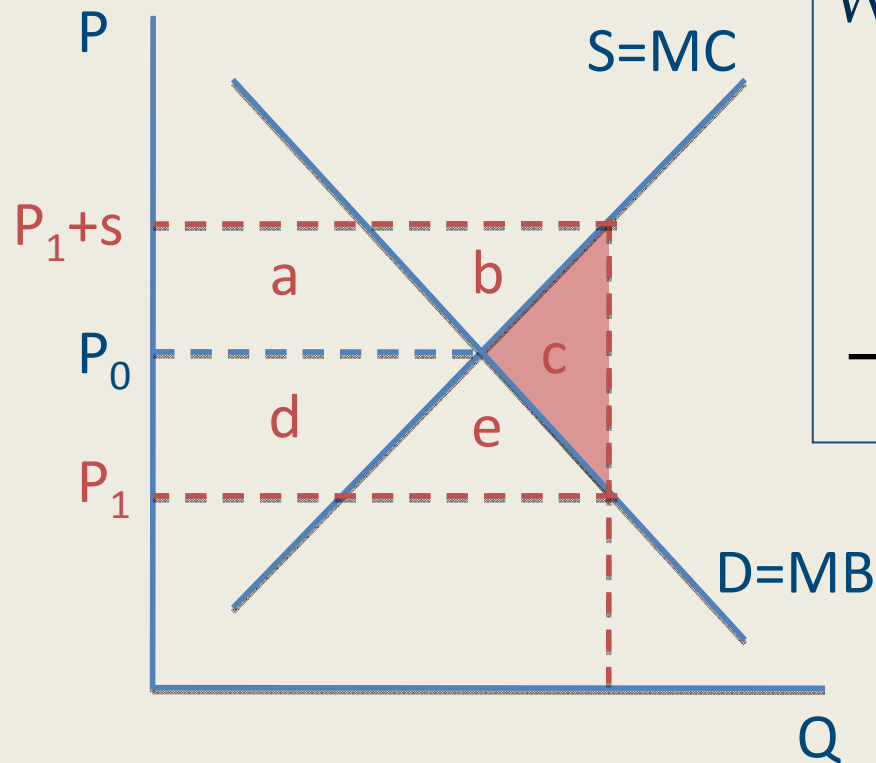
What is industrial policy (IP)?

- Policies to influence presence of size of industries
 - Subsidies
 - Taxes (or tax breaks)
 - Regulations with effect of subsidies/taxes

When is IP warranted?

- When there are market distortions
 - Externalities
 - Static or dynamic
- This is very basic economics...

A subsidy without a distortion lowers welfare



Welfare effects of
subsidy, s :

Suppliers $+(a+b)$

Demanders $+(d+e)$

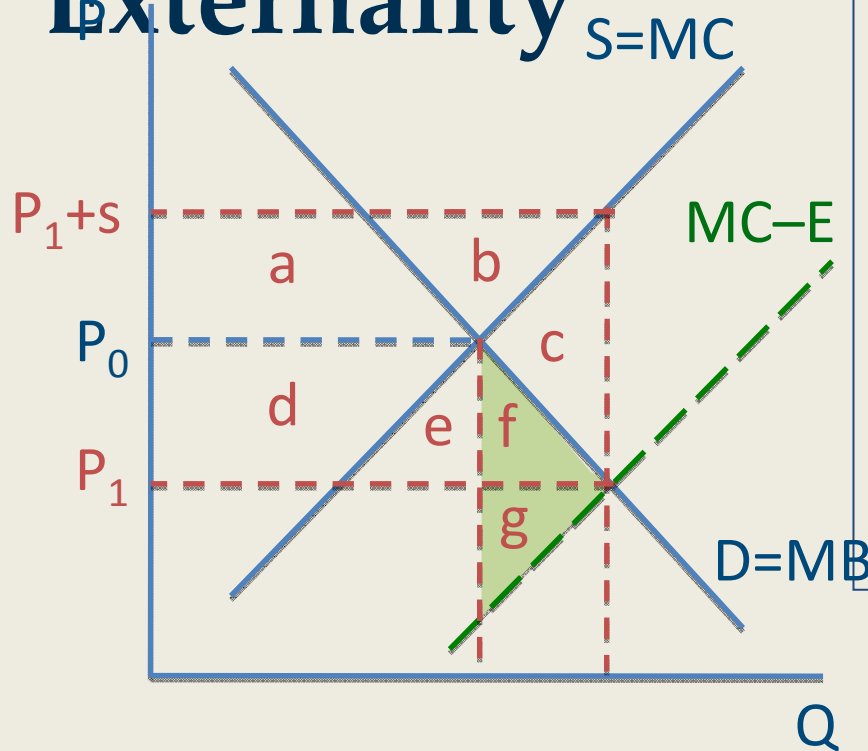
Government $-$

$(a+...+e)$

Net:

$-c$

A subsidy can raise welfare with a distortion: +ive Externality



Welfare effects of
subsidy, s , & ext, E :

Suppliers $+(a+b)$

Demanders $+(d+e+f)$

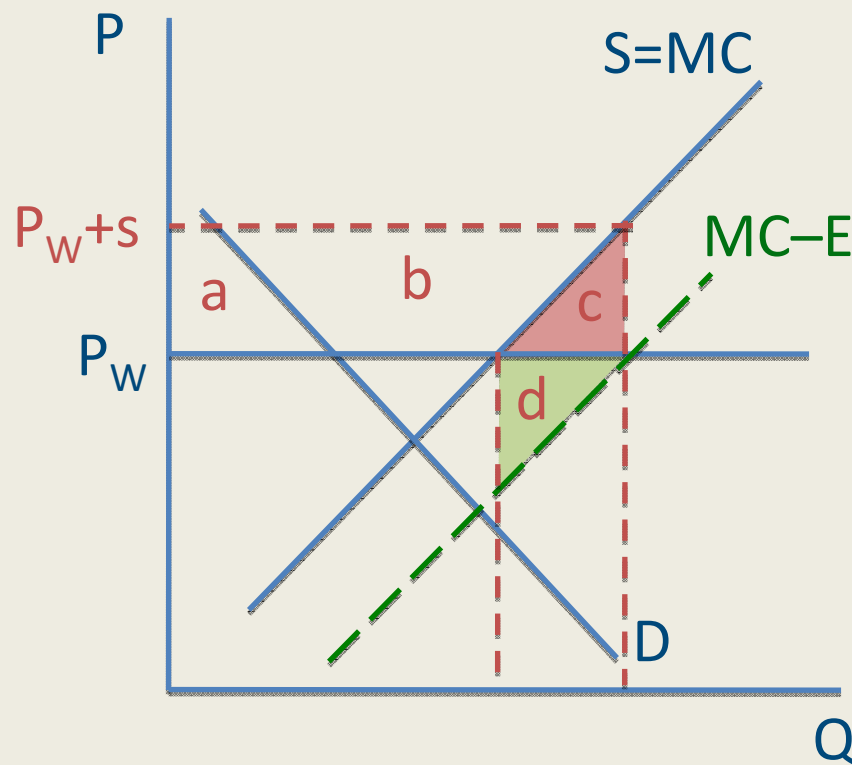
Government $-$

$(a+...+f)$

Externality $+(c+f+g)$

Net: $+(f+g)$

Both true also with trade, export...

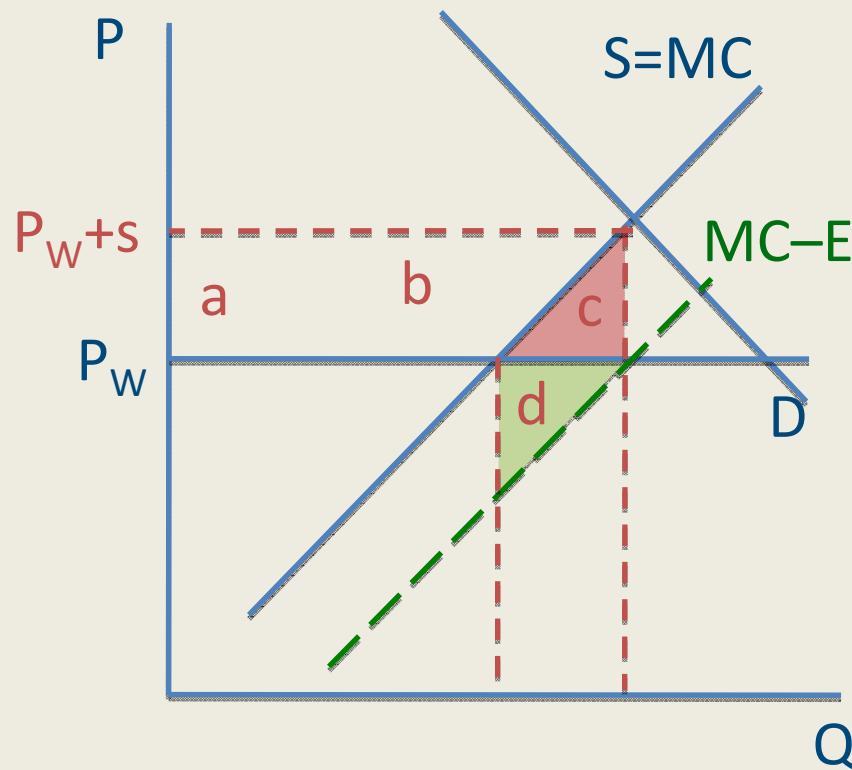


Net welfare effects of
subsidy, s , :

No Ext $-c$

Ext=E $+d$

... or import



Net welfare effects of
subsidy, s , :

No Ext $-c$

Ext=E $+d$

When is IP warranted?

- Other? Yes, with imperfect competition
 - See the 1980's literature on New Trade Theory
 - (Of course, this too is a distortion, but IP isn't exactly correcting it. It's exploiting it.)
 - But the conclusion of that literature was
 - Yes, there exist theoretical cases of gain from subsidies
 - But they are not practical: Way too hard to

Why is IP in New Trade Theory unlikely to succeed?

- See Krugman's (1987) "Is Free Trade Passé?":
 - Empirical difficulties: Hard to know where to intervene
 - Entry: Benefits dissipated by new firms
 - General equilibrium: Help in some sectors hurts others
 - Retaliation: Other countries may react
 - Political economy: Industries lobby for help
- Note: Some of this also holds for correcting distortions in perfect competition

Does comparative advantage justify IP?

- To promote a CA industry?
 - Not necessary, or desirable, unless there are distortions
 - With free markets, CA will be revealed
 - Promoting CA industry will expand it beyond optimal, lowering welfare
 - See diagram above
 - Also easy to show in general equilibrium

Does comparative advantage justify IP?

- To “create” comparative advantage?
 - Same answer, but dynamic
 - But distortions may be more likely in a dynamic context
 - Credit constraints limit investment
 - Intellectual property is intrinsically distorted
 - Internalizing benefit requires monopoly
 - But it’s the distortion, not the CA, that justifies intervention

Does fragmentation change this?

- CA now defined for parts of industries
 - Inputs
 - Outsourcing
 - “Trade in tasks”
- Distortions may exist for fragments
 - If not, CA will still drive trade and be optimal

Does fragmentation change this?

- Identifying comparative advantage is made harder
 - Can't just look at whole industries
- If IP means policy at the industry level, it will more like harm
 - Both CA and distortions will exist for fragments
 - Policy will also promote fragments where not justified

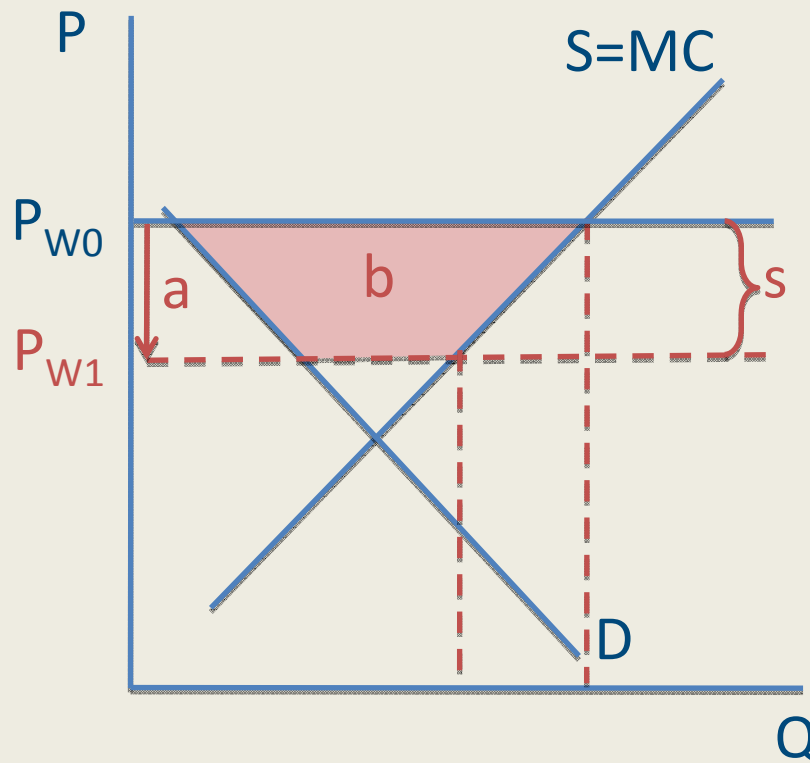
But Industrial Policy is a Fact of Life

- The “best kept secret” in the title of this session
- Recent examples
 - Airlines after 9/11
 - Car companies after financial crisis
 - Banks everywhere
- Long-standing use of subsidies
 - Agriculture
 - Boeing-Airbus

If Others Do It, Should We?

- No: Others' subsidies do not make our subsidies more beneficial
- Again, it's simple market analysis:
 - A foreign subsidy lowers prices
 - This hurts us if we export
 - Helps us if we import
 - But either way, matching the subsidy makes us worse off

Foreign subsidy lowers price. As exporter, we lose...



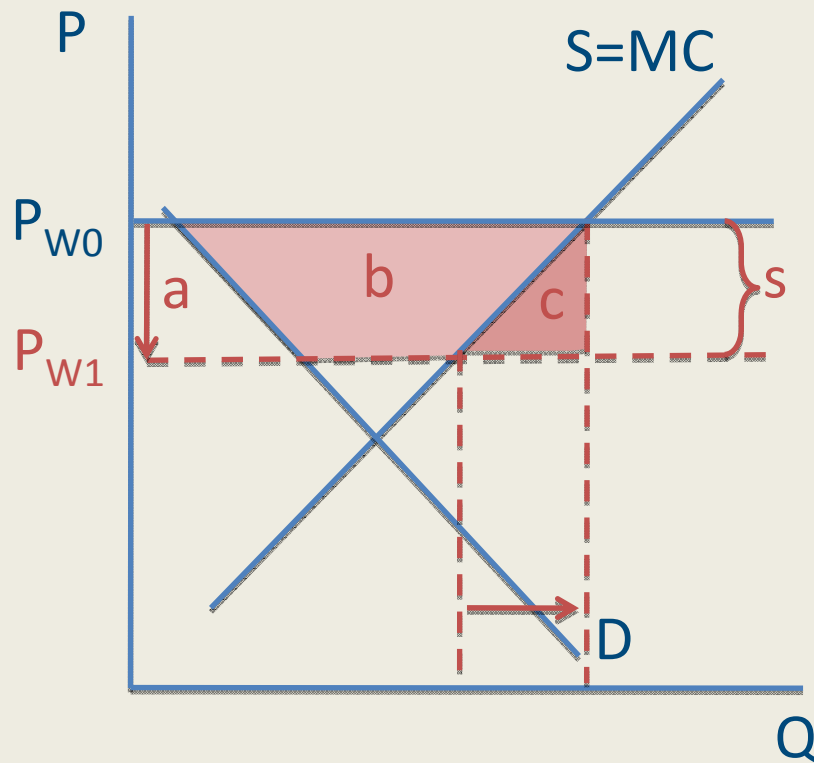
Net welfare effects of
foreign subsidy, s :

Demander: $+a$

Suppliers: $-(a+b)$

Net: $-b$

...but if we also subsidize, we lose more:



Net welfare effects of both foreign & domestic subsidy, s :

Demanders: $+a$

Suppliers: 0

Government: $-$

$(a+b+c)$

Net: $-(b+c)$

Conclusion

- The case for industrial policy
 - Even though often used
 - Is not good.