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Interaction between Competition and Industrial Policies

Contribution

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Interaction between competition and industrial policies

Q: From the viewpoint of the private sector, how do you think the relationship between competition and industrial policies has changed in the past decade? Any suggestions to better deal with the current economic environment?

In the wake of challenges, the world has been facing such as the COVID-19 aftermath, vaccine nationalism, global supply-chain instability, net zero transitions, and geopolitical competition, industrial policy regime has been in focus. Governments around the world are adopting industrial policies that incentivise domestic manufacturing to create jobs and reshoring of the value chains. The efforts are to improve performance of key manufacturing and business sectors. This trend was accentuated due to the covid pandemic and is a shift towards the real economy comprising jobs, production, and localisation.

The noted Harvard economist Dani Rodrik has termed it as 'productivism'. The earlier emphasis was on finance, consumerism, and globalisation. Industrial policy, shunned in the heydays of globalisation, is now back in fashion in industrialised as well as developing countries. There is renewed debate about the role of industrial policy and government support for firms and industries deemed strategically

important. Therefore, it is important to ensure these efforts do not subvert competition and support special interests.

The objective of an industrial policy, as traditionally understood by some, may conflict with that of a competition policy. Governments in the past have given primacy to industrial policy, often at the expense of fair and free competition in the market. At the same time, it is important to realise that both competition and industrial policies should complement each other for building a successful economic system. The same was noted by Jean Tirole, Nobel Laureate in Economics, as he raised the issue of "participatory" antitrust in the relationship between industrial policy and competition policy.

It should be understood, that focus on industrial policy would be a priority for any developed or developing country. No country has been able to sustain growth or reduce poverty without the manufacturing sector driving that growth. The productivity levels in industry are much higher than in either agriculture or services. Manufacturing is the engine of economic growth, as it offers economies of scale, embodies technological progress, and generates forward and backward linkages that create positive spillover effects in the economy. Moreover, it is employment led growth. Therefore, economic development is complemented by a sound industrial base. Industrial policies are major corner-stones of a country's economic policy.

In the same vein, competition policy aims to ensure that market practices and strategies do not reduce consumer welfare. Competition policy aims to protect and promote competition in the market. Effective competition policy removes market-entry barriers imposed by incumbent players. It provides innovation incentives to new entrants who want to improve their market position and increase their customer

bases. It also incentivises the existing market players to innovate and protect their market share from competitors. Therefore, competition policy fosters innovation which leads to better-quality products and services being offered at a competitive price, thus increasing both consumer and producer welfare.

As per OXERA research[1], before the global financial crisis that began in 2007, there was a general transatlantic consensus that effectively functioning and competitive markets were the best instrument to deliver the goods and services that consumers need and want. At the same time, it was accepted that rules were needed to ensure free and fair competition, so that businesses competed on a level playing field and consumers were not exploited or harmed by a powerful combination of firms acting together. On this basis, competition law was deemed the most appropriate and least intrusive way of regulating markets. Cartels were rightly regarded as undermining competition.

While competition provides increased incentives to firms to innovate, industrial policies can help by improving their capacity to undertake growth-inducing investments. A successful model of industrial development thus needs both, competition as the basis, and carefully designed industrial policies on top of that, without violating competition rules.

The efficacy of industrial policies highly depends on how competitive markets are. Industrial policies are more likely to be successful when they are implemented in markets of some optimal degree of competition. A study conducted based on data from China, found that the more competitive the sector that receives state aid, the more positive the effects of state subsidies to that sector on total factor productivity,

[1] Competition and industrial policy in Europe: how can they work together? - Oxera

its growth and product innovation. By contrast, for sectors with low degree of competition, the effects are negative.

However, even in a competitive environment, there might be market imperfections that impose constraints on investments in innovation and growth. Then, there is a need for industrial policies that can remove these constraints and motivate investments. Such impediments may arise due to capital-market imperfections and credit constraints, administrative burden, or complicated labour or tax rules. Well targeted industrial policies can provide, for example, tax incentives for innovating firms, re-design the rules to reduce the administrative burden for innovators, and relax credit constraints by protecting intangible assets. Constraints may also limit the reallocation of firms towards new, growth-enhancing sectors (e.g., ICT, nanotechnology, biotechnology). If markets are competitive, state intervention can be more effective in providing some assistance to firms to enter and scale up in these sectors.

An important criterion for this complementarity model to be successful is that vertical industrial policies should not provide selective advantages to specific firms. Various countries have promoted specific firms or industries as national champions, such as semiconductors in Taiwan, renewable energy in Germany, and aerospace in France. This approach aims to create globally competitive companies, ensuring economic growth and security. Although the use of industrial policy to establish national champions has been successful in some cases, it remains controversial. Economists worry that picking winners and losers can lead to market distortions and inefficient allocation of resources.

In fact, sector-wide industrial policies that apply to many firms without discrimination expectedly will work better at inducing sustainable growth. Indeed,

picking a specific firm as the champion of the sector, instead of letting the market's competitive process decide which firm will emerge as the leader, can be ineffective. This is because the government cannot assess the chances of commercial success better than the market (it may pick a winner that is not the most efficient). Also, the government's selection process may involve the risk of capture and rent-seeking, especially if the selection process is not transparent and the rules of selection are not clear. Despite the concerns, the revival of industrial policy shows no signs of slowing down.

In the US, industrial policy is a priority of the government. There is bipartisan support for the Creating Helpful Incentives to Produce Semiconductors and Science Act (CHIPS Act), which aims to revitalise the US semiconductor industry. More than 90 percent of advanced chips, crucial for defence and artificial intelligence (AI), come from Taiwan which raises concerns about US industry vulnerability due to China's presence. To address such risks, the US government is allocating $39 billion in funding from the $280 billion CHIPS Act to support the development of advanced semiconductor manufacturing capability. The Biden administration's industrial policy is far-reaching, and at least two semiconductor manufacturing clusters are planned by 2030. Funding recipients also face extensive conditions, such as a 10-year ban on expanding advanced chip capacity in China and a commitment to affordable childcare. These policies are part of the administration's broader approach to industrial policy, which also includes $370 billion in subsidies for clean energy in the Inflation Reduction Act. The use of domestic content regulations on solar panels has also been authorised under Buy America Act.

Meanwhile, Japan is providing subsidies worth more than $500 million to 57 companies to encourage them to invest domestically, as part of its efforts to reduce reliance on China. Similarly, the European Union is scaling up its industrial policy,

including by setting aside €160 billion of its COVID-19 recovery fund for digital innovations such as chips, batteries, and climate adaptation. In response to massive subsidies in the US Inflation Reduction Act, Italy's economy minister recently called for a common EU approach to support competitiveness and protect strategic production.

India as well with its recent manufacturing push with Make-in-India for job creation is a part of the global trend. India's new industrial policy has unfolded with ease-of-doing-business, production-linked incentives (PLIs), tariffs protection, sectoral missions such as the Semiconductor Mission, and Gati Shakti, among many initiatives. India's recent emergence as a net exporter of mobile handsets and toys gives confidence that the industrial policy can work.

India's past was dominated by an inward-oriented strategy for industrial development for almost 40 years after independence. The main reason behind this was to foster industrialisation and save foreign exchange. The developments since then clearly prove that the industrial policy of a country should not be an isolated matter that stands in conflict with other policy strands like trade policy, competition policy, monetary policy, fiscal policy, etc. Absolute clarity on the role of these policies and their ability to achieve convergence will be critical to achieve desired growth and employment in an economy. it would be a mistake to analyse their interaction in isolation and without taking into account other important related policies, especially competition policy and also monetary, fiscal, taxation, and sector-specific policies.

Review of literature including IMF research[2] suggests an industrial policy in the market economy which is not against or outside the markets, especially international

[2] Global Trade Liberalization and the Developing Countries -- An IMF Issues Brief

ones. Industrial policy must necessarily be part of an economy open to international trade. It should not impose constraints that expose companies to additional costs that would downgrade them in the domestic market or in international competition. A highly misunderstood aspect of industrial policy is that it ignores market mechanisms. On the contrary, a good industrial policy intervenes in the domestic economy to kickstart a "virtuous cycle" of industrialisation but then relies on market mechanisms to sustain it.

We also look towards fair-market capitalism which offers a different path to achieving national security goals than the protectionist industrial policy approach. Instead of each country promoting national champions, the approach encourages a diversified global supply chain based on open and fair trade, thus avoiding an economic arms race. This approach can lead to greater efficiency and innovation in the long run while mitigating risks of supply-chain disruptions through diversification and international cooperation.