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Research Report

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Subsidy wars and modern industrial policy

by

Kenneth A. Reinert*

Nearly sixty years ago, Harry Johnson [discussed](#) the role that economic nationalism plays in economic policymaking, noting the special role of manufacturing. Johnson stated (p. 183) that “emphasis will be placed on manufacturing, and within manufacturing, on certain industries possessing special symbolic value of industrial competence.”

Currently, this old-fashioned manufacturing nationalism is being joined with techno-nationalism in the US, China, India, Republic of Korea, and the EU. “Techno-nationalism” has been [described](#) (p. 553) by Yadong Luo as “a strain of systemic competition thinking that links cross-border technological exchanges directly to a nation’s national security.”

This new trend composes what has been called [modern industrial policy](#) or [new industrial policy](#). This policy is emerging, for example, in calls for both the EU and the US to push back against China in multiple technological realms, including 5G networks, artificial intelligence, quantum computing, robotics, bioscience, and semiconductors. Indeed, the US has reached a rare bipartisan consensus to undercut China in all “foundational technologies.”

Meanwhile, China is pursuing its own modern industrial policy across a broad array of technologies to establish “self-reliance” and, to this end, has funded the [Made in China 2025](#) and [China Standards 2035](#) initiatives; India has its own [Make in India](#) and [Production Linked Incentive](#) campaigns; the EU has its [2020 Industrial Strategy for Europe](#); and the Republic of Korea has its [K-Chips Act](#), all with similar ends.

These efforts are driven by subsidies, and their increased use affect trade and FDI. For example, industrial subsidies lavished by the US reach [as high as an estimated US\\$1 trillion](#), with global

estimates being [even higher](#). Consequently, the world is in the middle of a [subsidy war](#), whose impacts have not been thought through. While there is the [Pigovian theory of appropriate subsidies](#) to address positive externalities, there is little evidence that careful economic thinking is motivating the current subsidy war.

This subsidy war has implications for FDI, potentially distorting FDI flows in response to large-scale government interventions. MNEs are now competing for and (when unable to secure them) against the subsidies of national governments; any successful access to these resources comes with conditions attached, limiting MNEs' ability to respond to market changes and to pursue traditional corporate strategies. Examples of these sorts of conditions include nation-based supplier restrictions and export controls.

One pattern is for subsidies to support selected FDI projects. For example, the Taiwan Semiconductor Manufacturing Company is engaging in new projects in the US in response to US subsidies. It announced plans for an initial US\$40 billion investment on two semiconductor manufacturing plants in Arizona. While one plant quickly ran into [skilled labor shortages](#) and conflict with US labor unions, a recent US\$6.6 billion subsidy was enough to commit the company to a [third plant](#).

India is following the same pattern with subsidies to [Foxconn and Lenovo](#), among others, in its efforts to boost electronics manufacturing as part of its Make in India plan. While the goal here is less to push the technology frontier and more to engage in assembly, it is another example of a trend.

Some of these efforts will backfire. For example, there is the reality that semiconductor chip fabrication in the US costs [up to 50% more](#) than fabrication elsewhere, suggesting that the subsidies supporting this production are inefficient and might even increase costs for households and firms.

Another pattern is to support domestic firms and to allow them to partner with foreign firms. This is the case, for example, with Japan's subsidy of the semiconductor manufacturer [Rapidus](#). Similarly, there are cases where subsidies implicitly restrict FDI based on nationalist investment plans by attaching stringent conditions to attempt to develop systems of "trusted suppliers." This is the case for the [SSN-AUKUS submarine project](#).

The subsidy wars involve a select set of countries, largely confined to the G20. Even smaller high-income countries (e.g., Switzerland, New Zealand) will not be able to play this game. Most low- and middle-income countries will also be left out due to a lack of resources. While there will be benefits to importing cheaper, subsidized goods, these countries are the ones where actual learning-based manufacturing subsidies might make some sense, but they will not be able to pursue this policy path.

What to do? From an economic efficiency perspective, the first-best approach would be to restrict subsidies due to their zero-sum nature and deleterious [fiscal effects](#). They should also undergo

scrutiny under WTO rules regarding both [subsidies](#) and [trade-related investment measures](#). Far from celebrating them, it should be recognized that their growth signals a breakdown of the rules-based multilateral system, and that this breakdown will make life much more complicated for MNEs.

Alternatively, and more productively, major players could turn back to the [open innovation model](#) that was taking hold before the subsidy war began. Open innovation recognizes the technological complementarities among both countries and MNEs and leverages these through collaboration reflected in practices such as cross-licensing, non-equity alliances and strategic supplier agreements. While political realities might restrict the open innovation model to allies, [pragmatic inclusivity](#) is the best path forward.

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