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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Foreign Industrial Targeting-- U.S. Trade Law Remedies

Many U.S. business leaders have been increasingly concerned that foreign industrial targeting, the coordinated government support of specific industries, puts U.S. firms at an unfair disadvantage. However, most nations, including the United States, provide some support. Distinguishing between "fair" and "unfair" targeting practices requires examining the facts of each case. Determining whether U.S. business has been hurt by foreign practices also must be resolved on a case-by-case basis.

As mandated by the Trade and Tariff Act of 1984, this report examines issues surrounding foreign industrial targeting and the applicability of current U.S. trade laws. GAO believes that current law provides the oppportunity to adequately address foreign targeting practices.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report presents information on the effects of foreign industrial targeting practices on U.S. commerce. It also discusses whether such practices should be considered unfair trade practices under U.S. law and whether current law adequately addresses any subsidy element in foreign industrial targeting practices. The report was made in compliance with Section 625 of the Trade and Tariff Act of 1984 (Public Law 98-573).

We are sending copies of this report to the Secretaries of State, Commerce, and Labor and to the U.S. Trade Representative.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

FOREIGN INDUSTRIAL TARGETING--
U.S. TRADE LAW REMEDIES

DIGEST

A number of business and labor leaders contend that foreign government support of specific industries, commonly called foreign industrial targeting, gives foreign firms an unfair advantage over their U.S. competitors and constrains U.S. businesses from being internationally competitive. They believe that the United States should take more vigorous steps to mitigate or counter the effects of such targeting on U.S. industries. Others disagree with this position, believing instead that foreign industrial targeting has little or no overall effect on the U.S. economy and is not a significant cause of the U.S. balance-of-payments deficit. (See pp. 1 and 2.)

Section 625 of the Trade and Tariff Act of 1984 requires the Comptroller General to study the effect of foreign industrial targeting on U.S. commerce, to examine the applicability of current U.S. trade law in dealing with the adverse consequences of foreign targeting, and to recommend changes in the law if deemed appropriate. (See pp. 5 and 6.)

FAIRNESS OF FOREIGN INDUSTRIAL TARGETING DEPENDS ON THE SITUATION

For a variety of reasons, nations, including the United States, provide assistance to specific industries. Many nations have targeted industries in some ways that distort international trade. Such practices may be regarded as "unfair," because firms in the targeted industries are given an artificial competitive advantage over foreign firms. Home market protection and export subsidies are examples of such unfair targeting. With some exceptions, such as a developing nation assisting an infant industry, international trade law and agreements seek to remove these practices.

Targeting, however, frequently corrects flaws or inadequacies in markets. Government aid

for high-cost, high-risk research and development, for instance, enables firms to conduct research that they might not otherwise consider, such as when they could not realize all the benefits of the research. GAO believes that trade law and trade policy generally should not seek to counter such targeting practices.

GAO could not identify a generally applicable rule to distinguish between fair and unfair targeting. Because the facts of each situation will be different, a targeting practice that might be considered fair in one situation might not be in another. Many factors, such as the economic condition of both the industry being targeted and the nation providing the assistance, will help to determine whether or not a particular practice should be considered fair or unfair. (See pp. 7 to 11.)

EFFECTS OF FOREIGN INDUSTRIAL TARGETING OFTEN CANNOT BE MEASURED ACCURATELY

Accurate measurement of the value of the targeting practice to foreign firms or the effect of a targeting practice on U.S. industries is important in finding an appropriate counter policy that remedies the injury caused by the foreign targeting without adding new and unwanted distortions itself. It may be possible to produce generally accepted estimates of the value and harm in some cases, such as when nations subsidize exports or restrict imports to aid their industries. However, the effects of foreign targeting on U.S. businesses cannot be accurately measured in many other situations, such as when foreign firms benefit from home market protection or when foreign governments impose restrictive standards on imports. Empirical studies have not resolved the issue of whether the U.S. economy, on the whole, has lost jobs or profitable markets due to foreign industrial targeting. (See pp. 17 to 20.)

U.S. TRADE LAW CAN ADEQUATELY ADDRESS MANY ASPECTS OF FOREIGN INDUSTRIAL TARGETING

GAO found that current U.S. trade law can address many aspects of targeting. The

countervailing duty laws provide an appropriate way to offset the calculated benefit of subsidies to foreign producers. The anti-dumping laws provide similar protection against products that are dumped on U.S. markets. Section 201 of the Trade Act of 1974, as amended, provides temporary relief to U.S. businesses hurt by increased imports, be they fairly or unfairly traded; relief can be granted when the imports are from targeted firms. These laws, however, may not be able to deal adequately with all types of targeting practices, such as those that provide nonmonetary benefits, including home market protection, and those that occurred in the past and are only now affecting U.S. industries. (See pp. 25 to 31.)

Section 301 of the Trade Act of 1974, as amended, potentially provides the broadest approach to countering the effects of foreign industrial targeting. Section 301 authorizes the President to enter negotiations to remove unfair trade practices or foreign violations of negotiated trade agreements. If the negotiations are unsuccessful, the President may take any appropriate and feasible action to remedy the situation. This could include retaliating against the nation with the unfair practice by raising tariffs on goods from that country, otherwise restricting that country's exports to the United States, or suspending or withdrawing concessions granted that country under international trade agreements. Section 301 seldom has been used to address alleged unfair trade practices, however. (See pp. 32 to 34.)

Because the President has broad discretion in deciding when to use section 301, its use is inevitably based on balancing several policy objectives. In many cases, these policy objectives may unavoidably conflict because of trying to balance worthy goals, such as maintaining good relations with foreign countries and respecting their policy decisions, while maintaining the rights of U.S. businesses to compete fairly. Presidential discretion permits the government to directly confront the different policy objectives and to integrate trade, foreign policy, and national security concerns. (See pp. 36 and 37.)

CONCLUSIONS

GAO believes that current U.S. trade law, particularly section 301, has the capability to address instances when foreign industrial targeting is judged to unfairly affect trade, even though the effects of such targeting cannot be adequately measured in all cases. Certain provisions of law, including section 301, also allow Presidential discretion to defer action to balance competing national goals. Thus, GAO offers no recommendations for changes in the law. (See p. 37.)

AGENCY COMMENTS

GAO requested comments on a draft of this report from the Department of Commerce and the Office of the U.S. Trade Representative. Commerce suggested a number of clarifications regarding issues under its responsibility; GAO has adopted most of the suggested changes. The Office of the U.S. Trade Representative did not wish to comment on the draft report. (See p. 37.)

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ABBREVIATIONS

CVD	Countervailing Duty
EC	European Community
GATT	General Agreement on Tariffs and Trade
MITI	Ministry of International Trade and Industry
NTT	Nippon Telegraph and Telephone Corporation

CHAPTER 1

INTRODUCTION

Many government and private-sector leaders believe that the effort by U.S. industries to retain or regain international competitiveness on their own is futile in the face of "unfair" collaboration between foreign governments and industries. Such collaboration, which is generally called foreign industrial targeting, focuses government aid, market protection, and special regulatory treatment on selected industries, giving them an unfair advantage in competing with U.S. firms. The large U.S. trade deficits in the last several years have given added urgency to this concern, although it is generally conceded that these deficits result from more than simply foreign trade practices. The prescriptions proposed to address these concerns vary, including a "get tough" stance for U.S. trade policy and adoption of an explicit industrial policy that would identify and aid U.S. industries that are or can be world leaders as well as assist the adjustment of declining industries in the United States.

For a variety of reasons, other leaders strongly disagree with the assessment that the United States has suffered from a loss of competitiveness because of foreign industrial targeting. Some argue that, on balance, the U.S. economy has not been seriously hurt by foreign competition and that the highly visible problems of particular industries, such as steel or automobile manufacturing, are caused by factors other than foreign industrial targeting. In many high-technology industries, in fact, the United States is the world leader. Others believe that foreign industrial targeting has a potential influence on U.S. industry but that nothing could be gained by either greater U.S. toughness or more explicit industrial targeting. One reason for this belief is that foreign countries may retaliate against industries, such as agriculture, that are targeted by the U.S. government. A second reason for opposing policy changes, some experts believe, is that government involvement in business is at best unnecessary and at worst counterproductive.

One problem in addressing foreign industrial targeting is that all nations, including the United States, provide some type of assistance to selected industries. In many cases, the assistance is a legitimate response by the government to national needs. The United States, for example, provides substantial assistance to the defense industry in an effort to help ensure national security. When governments aid selected industries for such legitimate reasons, there may well be effects on international competitiveness. In other cases, however, the intent of the government's aid to selected industries is to foster their international competitiveness, even at the expense of

other nations. Distinguishing between the two cases in practice, however, poses a significant dilemma in addressing foreign industrial targeting, since the motivation for policy decisions is rarely clear-cut. The mix of practices may change over time, and the goals of the targeting may differ. An industry may be aided in its infancy by prohibiting imports from entering the domestic market and by government subsidies designed to encourage research and development. Once the domestic industry has become competitive with foreign producers in its home market, the government might end the home-market protection and the subsidies but may encourage the industry to increase investments by providing favorable tax breaks and may provide a ready market by limiting its purchases to that of the domestic industry. Once the domestic industry can compete successfully in the international market, the government may drop these tax breaks and allow foreign producers to bid on contracts. If economies of scale in production exist, the government may also encourage the industry to consolidate itself into one or two firms, further strengthening its place in the international market.

Assistance from the Japanese government to particular industries is frequently singled out for attention. Japan's success as an exporter and the large trade deficits that the United States has had with Japan in recent years are major reasons for the attention paid to Japanese industrial policy and to the government agency most identified with it, the Ministry of International Trade and Industry (MITI). MITI's "visions" are cited by some experts as models that U.S. policy ought to emulate and by others as examples of the policies that the United States ought to oppose. Other analysts, however, see less consistent success in Japanese policy and so are less persuaded that it could serve as a guideline for U.S. policy.[1]

INDUSTRIAL TARGETING AND TRADE POLICY

Attempts by a country to target a domestic industry are frequently considered to be unfair practices designed to gain market share at the expense of similar industries in other

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[1]For an overview of Japan's industrial policy, see GAO: Industrial Policy: Japan's Flexible Approach, (ID-82-32) June 23, 1982 and Industrial Policy: Case Studies in the Japanese Experience, (ID-83-11) Oct. 20, 1982; Magaziner, Ira C. and Hout, Thomas M.: Japanese Industrial Policy (Institute of International Studies, University of California, Berkeley, 1980); Johnson, Chalmers: MITI and the Japanese Miracle (Stanford, CA: Stanford University Press, 1982); and Wheeler, Jimmy; Jonow, Merit; and Pepper, Thomas: Japanese Industrial Development Policies in the 1980s (New York: Hudson Institute, 1982).

nations, either through increased exports by the targeting nation or through reduced imports. Conceptually, government involvement in industry that affects international trade runs contrary to the free-market principles that underlie international agreements, such as the General Agreement on Tariffs and Trade (GATT).[2] In many situations, however, countries accept another nation's industrial targeting as a rational response to its economic environment or unique market conditions. Such situations could include the protection of the home market by a less developed country to allow an infant industry time to develop or the granting of subsidies to a domestic industry that is vital for national defense purposes. GATT rules also sanction import restrictions to ease industry adjustment to trade liberalization, i.e., "escape clause" actions. (Nations have used escape clause actions in other situations as well, including sudden import surges above prior levels.)

Although targeting can be defined in a general sense as coordinated government assistance to specific industries and the policies used to target an industry can be listed, it is impossible to comprehensively define unfair targeting. Policies may be considered fair for a particular industry in a specific country but unfair in a different country and different industry. The distinction between fair and unfair targeting, as viewed by the United States, depends on the facts of the particular case: the harm, if any, caused to U.S. firms in the industry, the characteristics of the nation that is giving the aid, the nature of the aid, and the characteristics of the beneficiary firms.

Targeting practices are industry specific and have different effects in different nations and industries. In addition, the effects may change over time. Any general definition of targeting will not be able to incorporate the distinctive features of an industry that help to determine whether the targeting policy succeeds or fails. The criteria by which a policy's success can be judged, furthermore, may vary according to the industry. In some circumstances, for instance, market share may be a more important criterion for success than profitability.

U.S. government policy may demonstrate the problems inherent in trying to comprehensively define targeting. For example, the United States has long supported a great deal of research and development for its space exploration and national defense programs. In many cases, this research has led to commercial "spinoffs," i.e., marketable applications of products originally designed for the space or defense programs or entirely different

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[2]The GATT is the basic international agreement setting out the rules of fair trade.

products made possible by the original research. Electronics and civilian aircraft are the most visible examples of such spinoffs where the importance of government assistance is undeniable. Whether such assistance should be considered to be industrial targeting is another question, however.

Economic change and targeting

As technologies evolve and economies change over time, most industries must adapt or else decline in importance. Distinguishing between firms and industries that are affected by industrial change and those affected by foreign targeting practices is a difficult and politically divisive process that often cannot yield a definitive answer, particularly when the prospects for an industry and its workers are bleak or when the decline of an industry will mean serious problems for whole regions.

Government responses to depressed industries have to balance competing concerns about the role of government in the economy. Most countries are quite reluctant to allow major industries to decline or fail, particularly if foreign government assistance to competitors is seen as a primary cause. This reluctance is part of the reason why some analysts are concerned that the United States may be "deindustrializing" by losing its basic manufacturing industries and becoming too dependent on lower wage service industries.

Calls for increased government efforts to prevent further declines in the manufacturing sector, however, run contrary to the free-market belief that allowing relatively free markets to operate naturally is the best way to assure that the economy operates efficiently and that, as a result, the government should not interfere with the workings of markets except in the most extraordinary and important cases. Even if markets are not perfect, many analysts believe that government intervention is much more likely to make matters worse than better. The Reagan administration, most notably, has adopted this philosophy, although it has assisted some depressed industries, including the steel and auto industries.

The problems recently experienced by the U.S. automobile and steel industries, which are major employers and have long been highly visible barometers of the nation's economic condition, have highlighted the issue of foreign industrial targeting. Widespread concern that foreign targeting had a major role in generating these industries' problems and the array of actions taken by the government to counter the problems indicate the importance of the debate over the consequences of foreign industrial targeting on U.S. industries and the appropriate U.S. response.

Many nations have targeted their steel industries, and partly because of this, the global steel industry has substantial excess capacity and is operating uneconomically at well below capacity. The U.S. steel industry, itself in deep financial difficulty, contends that foreign targeting has been a major source of its problems. U.S. policy has long sought to aid the domestic steel industry, with Title VIII of the Trade and Tariff Act of 1984 (Public Law 98-573) being the most recent statement of objectives, such as the need for the industry to modernize its plant and equipment and the need for eliminating the adverse effects of unfair trade practices that impose "unusually harsh burdens" on the U.S. steel industry.

The importance of foreign industrial targeting in the automobile industry is less clear. In 1984, the Japanese auto industry provided 77.6 percent of U.S. auto imports, excluding imports from Canadian subsidiaries of U.S. manufacturers, and was restrained from providing more because the Japanese government had agreed to restrict Japanese auto exports to the United States. The Japanese auto industry had received home-market protection in its infancy, for instance, but later resisted government pressure to determine the structure of the industry. (MITI sought to limit the Japanese automobile industry to two firms, Nissan and Toyota, rather than the 10 companies now operating in the industry.) Mitsubishi's joint venture with Chrysler, furthermore, went against MITI's plans for the industry, as did Honda's decision to produce automobiles.

OBJECTIVES, SCOPE, AND METHODOLOGY

This study was made in compliance with Section 625 of the Trade and Tariff Act of 1984, which directed the Comptroller General to submit to Congress, by June 1, 1985:

> "a comprehensive study of the problem of foreign industrial targeting, whereby foreign governments adopt plans or schemes of coordinated activities to foster and benefit specific industries, and of the desirability or need to amend the United States trade laws in order to provide effective remedies for domestic industries against the adverse effects of such targeting."

The section directed that our study include at least:

> "(1) an analysis of- (A) whether foreign industrial targeting should be considered as an unfair trade practice under United States law; (B) whether current law, including remedies under title VII of the Tariff

Act of 1930, adequately address the subsidy element of foreign industrial policy measures; and (C) the extent to which foreign industrial targeting practices are significantly affecting United States commerce; and (2) any recommended legislation considered necessary based on the study results."

We focused on the effects of foreign industrial targeting on particular firms or industries rather than on attempting to measure the macroeconomic consequences of foreign targeting. Doing so provides a better basis to assess the adequacy of U.S. trade laws which seek to redress injury caused to specific industries or firms. The lack of a generally accepted comprehensive inventory of foreign targeting practices, the multitude of practices that might be included in such an inventory, and the inconsistent ways that the effects of these practices are measured also prevented our developing a credible macroeconomic analysis.

Given the limited available time and the extensive available literature on how particular industries fare under targeting and how individual nations conduct targeting policy, we relied primarily on existing analyses of targeting practices in market economies. We reviewed government and private-sector analyses, selected so as to demonstrate the extent of targeting practices and their range of effects rather than to comprehensively inventory the practices or the affected industries. We also discussed the issues in this report with government and private-sector officials. These officials were selected to indicate the range of opinions and options rather than to develop a sample to statistically measure prevailing views of targeting, its effect on business, or U.S. responses. Finally, although the work specific to this study was conducted in Washington, D.C., between December 1984 and March 1985, we have drawn heavily on other published and forthcoming GAO reports that embody work conducted over a much longer period.

We sought comments on a draft of this report from the Department of Commerce and the Office of the U.S. Trade Representative. We received comments from Commerce and incorporated them into the report as appropriate. We did not receive comments from the Office of the U.S. Trade Representative.

The study was conducted in accordance with generally accepted government auditing standards.

CHAPTER 2

INDUSTRIAL TARGETING: OBJECTIVES AND METHODS

Industrial targeting is a general term applied to a coordinated mix of government policies that are designed to help domestic producers in specific industries become more competitive with foreign producers. Targeting is generally used to either protect declining domestic industries from foreign competition or promote emerging industries. A nation may also aid a particular industry in an attempt to counter the targeted assistance given to foreign competitors.

REASONS FOR TARGETING AN INDUSTRY

Governments target industries when market forces fail to allocate productive resources among industries in an economically or politically acceptable manner. Markets are remarkably efficient in determining the appropriate level of investment in an industry, but they are not infallible. In some cases, targeting an industry is a legitimate government response to national needs. In these cases, targeting corrects market failures or inadequacies, such as when the private sector invests more than is optimal for the national well-being in certain industries or less than is optimal in others. Markets can fail for several reasons, such as failing to fully recognize social benefits and costs. The social return from a particular research project may exceed its costs, for example, but the inability of any one firm to fully realize those benefits may render the project unprofitable.

In other cases, however, targeting may distort a market allocation of goods and services that is efficient yet does not achieve other national goals. For example, industries providing a large number of jobs may be targeted for assistance even if economic efficiency dictates that the industry be allowed to decline. In many such cases, another nation unfairly bears the consequences of industrial targeting.

A government can increase the profitability of its industries and possibly its public's welfare at the expense of other countries and their industries by the judicious use of targeting in some cases. A nation may target an industry to exploit potential benefits from learning curve effects (i.e., through "learning by doing," the manufacture of standardized products, such as semiconductors, becomes cheaper over time as manufacturing experience and output increases). Even if the targeting results in an inefficient allocation of productive resources in an economy, it can conceivably improve the position of the domestic industry. For instance, if targeting a domestic industry can deter foreign competitors from investing as much in the

industry as they would have otherwise, the profits of the domestic industry might increase. However, if foreign countries do not decrease their investment in the industry or if they retaliate by targeting the same industry, the expected gains from the targeting may be reduced.

Individual governments, of course, can differ significantly in deciding what is a politically or economically optimal allocation of resources. Developing countries may believe that it is worth sacrificing current consumption to establish an industrial base. Developed countries may target mature industries to protect them from foreign competition to prevent domestic workers from losing their jobs. To a certain degree, Western European and Japanese agricultural industries have been targeted for this reason. A country may also target emerging industries in an attempt to increase the country's overall standard of living.

Research and development and risk spreading

Governments may also target emerging industries because of the inability of firms to realize all the benefits from spending on research and development. Such targeting corrects a situation in which markets inadequately allocate resources. The total benefits of research could exceed the costs; because the benefits are spread throughout the economy, however, the costs to the firm may exceed the benefits it directly receives. As a result, no private firm will be willing to undertake the investment. Government support of research and development expenses in industries that use emerging technology is often an example of this type of targeting; the Japanese semiconductor industry was targeted because of the possible widespread benefits associated with its development. Semiconductors are now being used in numerous applications that were never envisioned when government assistance was proposed. The many commercial "spinoffs" from research sponsored by the U.S. government in its space exploration program indicate the benefits from research that can go beyond the boundary of the original goals.

The risks associated with investing in new products and processes can limit the ability of private firms to raise outside capital. Long time lags between a research project's conception and completion may keep investors away, even though the project will be profitable in the long run. The shortsightedness of investors or the need to share risks might lead the government to provide the needed funds for the research or to otherwise encourage it. Because most foreign countries do not have markets for venture capital that are as developed as that market in the United States, foreign governments may feel that they have to take a more active role in providing such capital to emerging industries than does the U.S. government.

"Linkage" industries

Industries such as semiconductors and steel are often targeted because they are "linkage" industries that provide products used by other industries in their production process. Many countries believe that viable domestic linkage industries increase the competitiveness of domestic industries that provide final goods. For example, they believe that the effects of low-priced semiconductors and steel will increase the competitiveness of the many domestic industries that use these products in the production process. Financial assistance given to such industries is often referred to as "upstream" subsidization to distinguish it from the direct aid given to final producers. It is not clear, however, that targeting an indigenous linkage industry is a better strategy to improve the competitiveness of final producers than using low-cost imports.

National security

Governments may target an industry whose survival is deemed essential for national security but in which private industry may underinvest because of low returns. Steel and agriculture are often targeted for national security reasons to enable a country to maintain some control over its food and steel supply and lessen the threat of supply cutoffs. Recognizing that national defense is an essential government function, GATT rules allow governments to protect such vital domestic industries. The country that provides the protection, however, is expected to compensate the countries that are injured by its actions. Compensation can include reducing other tariffs and duties imposed on imports from the affected countries or other trade concessions. There are no explicit criteria to determine which industries are vital to a nation's defense, so nations that suffer from another's decision to target an industry on national security grounds may object that national security is only a guise to hide unfair assistance to domestic industry. In some cases, research done for national defense projects can have major applications in commercial projects. For example, the research done to help develop the U.S. Air Force played a role in establishing the U.S. aircraft manufacturing industry as the world leader.

"Picking the winners"

Governments also target industries that they believe will become vital industries in the future. The Japanese targeting of the semiconductor industry illustrates a successful example of the "picking the winners" type of targeting. In part due to government assistance, Japanese firms emerged as major suppliers of 16K and 64K semiconductor chips. Anglo-French targeting of the supersonic transport plane, the Concorde, is an example of

unsuccessful targeting. Although the Concorde was a technological success, only 10 of the planes were sold and the venture was never profitable. Japan, likewise, has so far been unsuccessful in its efforts to develop a strong civil aircraft industry producing its own aircraft; the Japanese aircraft industry today primarily produces planes under license from U.S. manufacturers for Japan's defense forces. (The Japanese industry also supplies some components of the Boeing 767 airplanes.) Similarly, aluminum smelting and petrochemicals were favored industries 15 years ago in Japan, but the public and private investments have paid off very poorly and capacity in these industries is now being reduced. Likewise, despite much effort, the countries of Western Europe have had only mixed success in closing the technological gap with the United States and Japan in new technology industries. Despite government assistance, for example, the electronics industries in West European nations generally lag behind their U.S. and Japanese rivals.

Economic development goals

Some developing countries target industries to accelerate economic development through increasing exports and/or reducing imports; these actions also may increase the availability of foreign exchange to repay foreign debt. The Brazilian government, for instance, originally targeted its national steel and aircraft industries for import substitution purposes, but both have since developed into key sources of foreign exchange earnings, aided by both government assistance and protection from imports. Further, Brazilian exporters can be given preference to obtain import licenses and tax advantages on "essential imports" if the manufacturer commits to an equal or greater export goal. Many developing nations, such as Brazil, targeted their durable goods and capital equipment industries in the hope that they would engender greater economic growth for the entire economy by substituting domestic production for imports. How effective these actions have been in spurring economic development has not been conclusively determined.

Governments of developing nations may target infant industries to allow them time to develop sufficiently so they can compete successfully with established foreign firms. Infant industries are commonly given home-market protection, at least until they mature. Brazil, for instance, protects its aircraft industry by reserving its general aviation market for national firms and assessing a 50-percent tariff on competing imports. The government controls the domestic market for both civilian and military aircraft and, although its preeminent manufacturer, Embraer, is a privately run corporation (with some government participation), government support was a component in developing its export capability.

National goals

National prestige is sometimes a reason for targeting an industry. Developing countries may believe that a certain industry would be good for its national image and might target that industry. Smokestack industries, such as steel, used to have this mystique, but the problems such industries have had in recent years, most notably the overcapacity of the steel industry, have reduced this somewhat. Developed countries trying to increase national prestige generally try to develop high-tech industries. National prestige played a role in the British and French decisions to support development of the supersonic Concorde, for example.

A government will sometimes target an industry to reduce the country's reliance on foreign produced goods. The Airbus was developed, in part, to reduce the reliance of European nations on U.S.-built aircraft. Additionally, European nations are concerned about U.S. export control policy for high-technology products, creating an incentive for them to develop domestic substitutes for those products.

Countertargeting

One other reason a government might target an industry is because other countries may be targeting that industry. The government may believe that it must countertarget the industry to prevent domestic firms from suffering a competitive disadvantage. A government may also retaliate against foreign targeting in one industry by targeting a different industry.

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In summary, industries can be targeted for a wide variety of reasons ranging from protection of declining industries to promotion of emerging import industries. For example, in targeting the semiconductor industry, the Japanese government targeted an emerging linkage industry that provided externalities that were beneficial to the economy as a whole. Similarly, Brazil initially targeted its aircraft industry to achieve an independent national defense capability while stimulating economic and technological growth and improving its balance of payments.

INDUSTRIAL TARGETING: DIFFERING APPLICATION OF COMMON TOOLS

Targeting will generally change the way investment funds are distributed throughout the economy, but will not necessarily change the total level of investment. Governments can use a

wide variety of policies to assist a targeted industry, including tax benefits, home-market protection, government procurement practices, financial assistance, and antitrust exemptions. In some cases, governments may waive or relax other regulations for specific industries or may control access to natural resources. Industrial targeting does not include government practices that benefit most sectors of the domestic economy, such as the policy of the Japanese government to keep interest rates low.

Tax benefits

Governments can aid a specific industry by giving it tax benefits that are not available to other industries. Such tax benefits can increase the profitability of domestic firms in the industry, relative to firms in other industries, by giving the favored firms more money to invest in new equipment and research and development. Such investment could reduce production costs or result in new or higher quality products that would increase the competitiveness of the industry. Special depreciation rules and special treatment of export earnings are two specific policies that governments have used. Purchasers of the goods made in the targeted industry can also be given tax incentives, which could create greater demand for the products and thus indirectly aid the targeted industry.

Certain tax policies that are sometimes cited as examples of unfair practices are permissible under international agreements. For example, GATT rules allow indirect taxes[1] paid on exported goods to be rebated to sellers because such rebates are not considered export promotion actions. Thus, the value added tax imposed on producers in the European Community (EC) is rebated to sellers of EC exports. The United States relies on direct taxes at the national level, such as the personal and corporate income taxes, and has no taxes to rebate when goods are exported. Therefore, border tax rebates, such as the value added tax rebates, may appear to be unfair subsidies.

Home-market protection

Governments can increase the sales and profitability of domestic industries by imposing high tariffs on selected imports or by using nontariff measures, such as quotas or arbitrary product standards, to raise the price of imported goods or to reduce their availability. Such practices could give infant domestic industries time to become competitive or could protect already developed industries from lower priced imports. GATT rules sanction efforts by less developed countries to establish infant industries with home-market protection.

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[1]Indirect taxes include those assessed on the value of final products such as sales, excise, or value added taxes.

Governments in most nations set product standards that specify minimally acceptable quality standards for a range of different products. The manner in which these standards are set, however, may give domestic producers a competitive edge. Nippon Telegraph and Telephone Corporation (NTT) has used product standards for equipment purchases so detailed with respect to design (rather than performance) that only Japanese manufacturers could reasonably expect to meet them.[2] The U.S.-Japan Agreement on NTT Procurement, which became effective in 1981 and was renewed in 1984, opened procurement to foreign suppliers, but sales of U.S.-made equipment have not met U.S. government expectations.[3]

Government procurement practices

Governments can increase the sales of a domestic industry by discriminating against foreign goods in government purchases. If economies of scale exist and government purchases constitute a relatively large share of the market, increased sales will result in lower per unit costs and higher profits. In addition, the reduction in competition should allow domestic producers to raise their prices and thus their profits.

The GATT Government Procurement Code, negotiated in the Tokyo Round of Multilateral Trade Negotiations which ended in 1979, attempted to reduce the effect of government procurement practices on trade by granting firms in signatory nations equal status with domestic firms in securing government contracts. The Code thus far has had limited success, primarily because a fairly large number of government departments and agencies were excluded from its provisions.[4]

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[2]NTT's system of design specification entailed a joint effort by NTT and its suppliers during the initial product design and testing stages. Since NTT had traditionally limited its procurement to a "family" of domestic suppliers, dominated by Nippon Electric Corporation (NEC), Oki, Fujitsu, and Hitachi, U.S. firms found it hard to penetrate the market because their existing equipment would not meet specifications even if it performed identically. Many countries use product specifications that set performance standards.

[3]See our report Assessment of Bilateral Telecommunications Agreements with Japan, (NSIAD-84-2) Oct. 7, 1983, for an analysis of the 1981 Agreement. While NTT's conversion to a private company may change its procurement practices, there is no way to predict the effect of any changes.

[4]See our report The International Agreement on Government Procurement: An Assessment of its Commercial Value and U.S. Government Implementation, (NSIAD-84-117) July 16, 1984.

An example of an industry that is excluded from the provisions of the Government Procurement Code is the heavy electrical equipment industry, which includes products such as turbines, generators, power transformers, and power circuit breakers. In West Germany, Great Britain, and France, for instance, government-owned utilities are the major purchasers of these products and buy-national policies require these utilities to purchase heavy electrical equipment from domestic producers.[5]

Financial assistance

Governments can lower the cost of production in an industry by offering financial assistance either directly through grants or low interest-rate loans or indirectly through loan guarantees. This assistance could give the industry a cost advantage over producers in other countries that are not being assisted by their governments. Emerging and declining industries in many nations, including the United States, have been helped by government financial aid.[6]

Government financial assistance could even extend to government ownership of firms in the industry, which obviously could increase the industry's access to investment funds. Government ownership does not guarantee financial success, however.

The Subsidies Code, another agreement reached in the Tokyo Round of Negotiations, went into effect on January 1, 1980, and was implemented in the United States by the Trade Agreements Act of 1979. The Code commits the signatories to eliminate export subsidies on "non-primary" or industrial products, to structure domestic subsidies in a manner to prevent adverse effects on other nations, and to disclose information regarding existing subsidy practices. (Developing nations received some temporary exemptions.) A number of controversies have arisen over interpretation of the Code's language and the responsibilities of signatories so it is not clear whether the Code has substantially influenced the behavior of the signatory nations; i.e., whether it has been instrumental in reducing subsidy levels.[7]

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[5]See our report International Restraints to Competitiveness of the U.S. Heavy Electical Equipment Industry, (NSIAD-83-51) Sept. 14, 1983.

[6]For a discussion of U.S. government aid to declining industries, see our report Guidelines for Rescuing Large Failing Firms and Municipalities, (GGD-84-34) Mar. 29, 1984.

[7]See our report Benefits of International Agreement on Trade - Distorting Subsidies Not Yet Realized, (NSIAD-83-10) Aug. 15, 1983.

Antitrust exemptions

Governments can increase the profitability of a domestic industry by easing antitrust regulations in that industry, enabling firms in the industry to agree to fix prices, allocate market shares, or share research and development expenses. Such policies could lower the costs of production and raise prices, giving the industries more profits to invest. The Davignon Plan, which limited steel shipments within the EC in the late 1970s, and the successor system of production quotas are examples of policies that reduce competition in an industry.

In the United States, the Export Trading Company Act of 1982 authorizes the Department of Commerce, with the concurrence of the Department of Justice, to grant antitrust protection to export trading companies. U.S. firms had been reluctant to enter into joint export ventures for fear of violating antitrust laws. Section 2 of Public Law 65-126 (15 U.S.C. Section 62) allows U.S. firms to pool resources in certain export-promotion activities without being subject to the Sherman Antitrust Act.

Governments could also allow domestic firms to merge to reduce competition among themselves and to achieve economies of scale that could make them more competitive with foreign producers. In some cases, governments may urge domestic firms to merge to form a "national champion" that would have the economic resources necessary to compete successfully with the largest foreign firms. For example, it has been suggested that the British government targeted its heavy electrical equipment industry so that a national champion could compete with the large Japanese and U.S. firms in that industry.

Governments also can encourage research and development by providing antitrust exemptions. Provisions of the National Cooperative Research Act of 1984 (Public Law 98-462) made it possible for U.S. computer manufacturers to collaborate in a research and development project directed toward developing a "fifth-generation computer." (Japan also has research underway for a fifth-generation computer which embodies artificial intelligence advances.)

No other country follows the U.S. approach to antitrust, with its legislative emphasis on due process. Japan and most Western European nations have laws prohibiting certain practices that discourage competition, but their governments have encouraged certain industries to reorganize to increase competitiveness or to improve efficiency. For example, Japan allows firms to form depressed-industry cartels when faced with insufficient demand or excess capacity.

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Targeting does not typically involve the simultaneous use of all the above policy instruments. Rather, targeting policies are generally applied selectively over time. The particular mix of targeting tools varies according to the needs of the targeted industry and the willingness and ability of governments to extend aid. The Brazilian aircraft industry is an example of how a variety of targeting techniques can be successfully combined. In addition to its "market reserve" policy that protected the home market, the Brazilian government developed a fiscal incentive program under which Brazilian firms could take a tax credit of one percent of their tax liability for the purchase of stock in Embraer. Low fixed interest rate financing was available for exports, which were also encouraged through an over-rebate of the industrial products tax applicable to aircraft purchases. Indeed, by the time an industry becomes internationally competitive, it may be getting very little assistance from the government, as is the case of Embraer.

CHAPTER 3

EFFECTS OF FOREIGN TARGETING ON THE UNITED STATES CANNOT BE FULLY MEASURED

Much concern over foreign targeting is based on a stylized picture of its effects on U.S. industries. The picture looks something like this: a foreign government targets an industry whose firms initially are at a technological and cost disadvantage relative to U.S. firms. Through the government's combination of financial assistance and protection of the domestic market, the industry has time to gain expertise through experience until it is ready to face U.S. firms in the world market. With the advantages both of government support and of a protected domestic base where it can charge high prices to offset the costs of selling abroad at low prices, the foreign industry drives the U.S. firms from the field. U.S. workers may be pushed out of high-wage jobs into either unemployment or low-paying jobs. With their competitors gone, the foreign firms are able to raise prices and realize large profits. And the targeted industry, carefully chosen to weaken future U.S. competitive ability, serves as a springboard for the next conquest.[1]

This view of targeting assumes that governments are particularly skillful in being able to pick out winners when they target industries. Yet the evidence suggests that, although governments have sometimes picked apparent winners, such as the Japanese targeting of the semiconductor or machine tool industries, they have sometimes picked apparent losers, such as the Concorde or Japan's civil aircraft industry. In some cases, governments have totally missed apparent winners; for instance, Japan did not target either its consumer electronics or motorcycle industries, yet both have dominated world markets. In other cases, such as the European Airbus, it is too early to tell if the targeting was successful. For still other cases, such as the EC and Japanese targeting of agriculture or the EC steel industry plans, targeting helped to preserve industries. The cost of such success has been high, however, since the economic performance of these industries has been relatively poor.

Because governments do not necessarily have any greater insight into the future than the private sector, they have had a mixed record in picking winners. Such factors as the time needed for research and development, slope of the learning

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[1]See Paul Krugman, "The U.S. Response to Foreign Industrial Targeting," Brookings Papers on Economic Activity, 1984:1, p. 81.

curve, number of potential competitors, and size and growth potential of the market are all unknowns that governments and private investors alike must consider when they are thinking about targeting or investing in an industry.

Regardless of the overall success of foreign targeting, most experts agree that some sectors of the U.S. economy have been affected by foreign industrial targeting. On both an economy-wide and industry-specific basis, however, the effects are extremely difficult to measure. No one feature of a targeting policy or a targeted industry is the key to success, nor is there a fully reliable method to assess the injury that targeting causes U.S. industry. If one method of targeting complements another, augmenting its effectiveness, the problem of measuring the effects of targeting is made more complex. It is thus difficult enough trying to determine the effects that targeting one industry has on a non-targeting country, much less trying to estimate the effects of all foreign targeting practices on another nation and its industrial base.

Empirical studies have not yet resolved the issue of whether the U.S. economy, on the whole, has lost jobs or profitable markets due to foreign industrial targeting. Paul Krugman[2] and Robert Lawrence[3] show that the disappointing performance of the U.S. manufacturing sector during the 1970's was part of a worldwide slowdown in industrial growth and was not unique to the United States. Krugman found little evidence that the degree of overall U.S. specialization in high-tech areas has declined relative to that of other countries. On the other hand, Ira Magaziner and Robert Reich,[4] among others, argue that the United States is suffering from a declining competitiveness in its basic industries and that this erosion of the U.S. industrial base will inevitably lower the U.S. standard of living.

The overall effect of targeting on the United States cannot be reliably predicted, because governments have not and cannot consistently pick winners. The U.S. industry that competes with a successfully targeted foreign industry may indeed suffer a loss in competitiveness, but the inefficient use of foreign resources prompted by unsuccessful targeting should increase the

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[2]See footnote 1 on p. 17.

[3]"Is Trade Deindustrializing America? A Medium-Term Perspective," Brookings Papers on Economic Activity 1983:1 and Can America Compete? (Washington, D.C.: The Brookings Institution, 1984.)

[4]Magaziner, Ira C. and Reich, Robert B.: Minding America's Business (New York: Harcourt Brace Jovanovich, 1982).

relative competitiveness of other U.S. industries. The overall effect on the United States is impossible to determine, but many economists believe it is not likely to be very great one way or another.

In addition, exchange rates may at least partially adjust to give U.S. producers a competitive advantage in non-targeted industries to offset any competitive advantage that foreign producers might have in targeted industries. Although the recent experience with a strong U.S. dollar, particularly in the face of record U.S. current account deficits, shows that floating exchange rates do not necessarily and automatically balance trade flows, nations do have to pay for targeting, and exchange rate movements are likely to demonstrate this. If a nation subsidizes an industry, through grants, preferential loans, or special tax benefits, the subsidy has to be financed through either higher taxes or higher deficits. If a national policy induces inefficient investment in a targeted industry, investment elsewhere in the economy is limited or is more costly. Whether these costs are large enough to be reflected in exchange rates is problematic, particularly given the limited understanding of how exchange rates react to changes in economic conditions.[5] Unless the targeting practice compensates for some failure of normal markets (such as the inability of firms to fully realize benefits from research and development spending), the cost of targeting is paid somewhere in the economy.

If the economy tends to move to a certain level of unemployment, as some economists believe it will, targeting will change the mix of jobs held by U.S. workers but will have no long-term effect on aggregate U.S. employment. Some of these jobs may in fact pay less than those lost, but the extent to which the lower paying jobs will replace higher paying jobs is an open empirical issue. When workers in firms affected by foreign targeting lose their jobs, it is difficult to determine what the consequences will be. For some workers, particularly older blue-collar workers with job skills that are not easily transferred to other industries, the result can be long-term unemployment or underemployment. However, the rapid growth of employment in other sectors of the U.S. economy means that other good jobs are available.

The main microeconomic or industry-specific effect of successful foreign targeting on a U.S. industry is the reduced international competitiveness of U.S. firms in the industry. If the foreign targeting successfully reduces U.S. exports or

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[5]See, for instance, our report, Floating Exchange Rates in an Interdependent World: No Simple Solution to the Problems (NSIAD-84-68) Apr. 20, 1984.

increases U.S. imports, U.S. employment and production in the targeted industry will generally be lower than what they would be in the absence of targeting.

If the targeting takes place in an already developed industry, the effect will generally be rising U.S. unemployment and falling production in that industry. For example, the widespread practice of targeting in the steel industry has helped to increase U.S. steel imports, contributing to plant closings and layoffs in the United States.

If the targeting takes place in an emerging industry, the effect will be to prevent the U.S. industry from becoming as large or as developed as it would otherwise be. The Japanese targeting of the semiconductor industry, for example, helped the Japanese semiconductor industry to be a strong competitor with the U.S. semiconductor industry, once the undisputed leader.

U.S. industries that use the products of the targeted industries in their production process might actually benefit from foreign targeting if it lowers prices and increases availability. For example, U.S. auto producers, despite sharp cutbacks in the amount of steel they use per car, have benefitted from the intense competition in the steel industry, which to some extent has occurred because a number of countries targeted their steel industries. Similarly, U.S. consumers could benefit from targeting if reduced prices were passed on to them.

CHAPTER 4

WHAT ASPECTS OF FOREIGN TARGETING SHOULD U.S. TRADE LAWS ADDRESS?

U.S. policymakers have several possible options for dealing with the damage that foreign targeting causes to U.S. industry. One option would be to provide automatic relief in any case where injury is demonstrated and can be attributed to foreign targeting. This option has the disadvantage of requiring a statutory definition of targeting; any such definition, however, would be inherently limited. Also, this approach does not recognize the interrelationship between trade, foreign policy, and national security or the possibility that lower foreign prices for targeted goods may imply greater social benefits to U.S. consumers and other domestic industries versus the social costs incurred by the injured domestic industries.

Another option would be to provide the government with the flexibility to address targeting issues with broad discretion and a wide range of policy tools, which would include trade negotiations as well as legal remedies for injury. This option, which is essentially the status quo, may not provide relief to an injured industry even if it could demonstrate that unfair foreign targeting contributed to the injury. The overall national interest may be best served by denying a relief request that, if upheld, could damage U.S. economic or diplomatic relations with foreign countries.

Other alternatives include some form of unemployment assistance or retraining aid to workers who lose their jobs because of foreign competition or aid to U.S. industries competing with foreign firms getting unfair benefits. General macroeconomic policies to foster full employment could also aid many workers who lose jobs, fairly or unfairly, to foreign competition.

POTENTIAL RESPONSES TO FOREIGN INDUSTRIAL TARGETING

Many experts believe that the U.S. government should be more aggressive in dealing with foreign industrial targeting and should retaliate or threaten to retaliate if the targeting is not stopped. Retaliation could take the form of assisting injured U.S. industries or imposing a higher tariff on imports from targeting nations. Furthermore, retaliation in one case can be a warning to others. Such an aggressive policy risks creating a dangerous cycle of retaliation that would restrict world trade and leave all countries worse off, such as happened in the 1930's. The ultimate effects of targeting and any ensuing rounds of retaliation are difficult to assess with any certainty

because nations will react differently to U.S. efforts to countertarget. In some cases, the United States will gain more than it loses through countertargeting even if the foreign country retaliates; in other cases, the United States will lose more than it gains through foreign retaliation.

Furthermore, the United States itself is vulnerable to charges of targeting. Foreign governments could interpret the Chrysler loan-guarantee program, the proliferation of programs to help the steel industry, agricultural price support and research programs, and extensive research and development in space technology as examples of U.S. targeting. In addition, foreign governments might complain about the subsidies offered by state and local governments to entice industries to establish plants in their jurisdictions. If the United States establishes a prescribed policy for dealing with foreign targeting, other countries may follow suit and begin to protest U.S. policies that they consider to be examples of targeting.

Many of the effects of foreign targeting do not occur in the United States, but in the targeting country or in a third country. Home-market protection by foreign countries, for example, affects U.S. exports but does not directly affect U.S. imports. A comprehensive U.S. law designed to deal with foreign targeting would have to include ways to deal with targeting practices that do not affect U.S. imports.

The U.S. response to targeting would have to change depending on the facts of the case. If foreign targeting increases U.S. imports, the United States could limit imports or raise tariffs to counteract it. But if the targeting reduces U.S. exports, an effective response will be more difficult to determine. The United States could take unilateral actions, such as assisting U.S. exporters in the affected industries or retaliating against the targeting country by raising tariffs or imposing quotas on other products imported by the United States from the targeting country. Retaliating against other imports from the targeting country, however, does not remedy the injury suffered by the domestic industry unless the U.S. action causes the foreign government to drop its practices or the U.S. government uses the proceeds from higher tariffs to assist the affected U.S. industry. The United States could also threaten to impose high tariffs on any goods that are exported to the United States by the targeted industry, but again such a response would not be of much immediate help to the affected U.S. industry.

Determining the criteria to demonstrate injury is a major problem in devising a comprehensive response to foreign targeting. Demonstrating injury when the targeting results in reduced U.S. exports will be especially difficult because of the problems in obtaining accurate data about an industry in a foreign

country. Proving injury or the threat of injury caused by foreign subsidies or dumping has been a contentious and time-consuming process. In targeting cases, the facts are likely to be even less clear than they are in countervailing duty and antidumping cases.

Legal responses to foreign targeting practices that adversely affect U.S. businesses are hampered by the delay between the time an industry receives the foreign government assistance and when U.S. firms are affected. Laws can more easily deal with current practices than past practices, because it is easier to tie contemporaneous effects to a current practice than to one that has ended. Foreign industries that receive home-market protection or research and development grants in their infancy, however, may not significantly affect U.S. trade until long after the targeting practices have ended. For example, the Korean steel industry, which was targeted fairly extensively in its infancy, currently receives relatively little assistance from the Korean government. (Major assistance to the Korean steel producers, including tax exemptions and financial support, was abolished in early 1983.)

An additional problem caused by the lag between the time assistance is given and when its effects are felt is that a foreign country may argue that any U.S. response to past targeting is unfair if the United States did not complain when the targeting was occurring. The foreign country may argue that it is currently doing nothing wrong and cannot remedy what the United States views as an unfair situation.

Another problem in designing a law to deal with foreign industrial targeting is determining the value of benefits received by the foreign industry. An estimate of the value is required if appropriate remedies (i.e., some type of offsetting duties) are to be applied. If financial support from its government kept the foreign industry in existence, the actual dollar amount provided by that government may not truly indicate the amount of assistance received by the industry. Assurances of government support, furthermore, can be key factors in lining up private investment, but determining that such assistance has in fact occurred and measuring its effect on U.S. industry cannot always be easily done.

In a similar vein, for a U.S. law to deal with targeting, it would have to be determined if the value of assistance dissipates over time, and if so, at what rate the value dissipates. The Japanese government's assistance to the semiconductor industry in the late 1970's may have had a large effect on the current competitiveness of Japanese semiconductors, whereas the market protection that the government gave the Japanese auto industry in the early 1960's probably has had little to do with

the problems of the U.S. auto industry, such as its lost share of the domestic market, most of which have occurred in the last 5 years.

For certain targeting practices, it will be nearly impossible to determine the value of government assistance, regardless of when the assistance is given. The value of subsidies, such as grants, loan guarantees, or low interest-rate loans may be relatively easy to determine in many cases, but not the value of home-market protection or government procurement regulations, thus complicating the U.S. task of coming up with appropriate countermeasures.

If the targeting aid is not publicly announced, the issue is even more clouded. Governments may not publish the details of the aid for reasons quite apart from trade policy. These can include preserving confidentiality (as in the case of IRS data on U.S. tax expenditures) or maintaining the secrecy of national security projects (as in some cases of U.S. computer research). One policy option would be for the government to increase its surveillance of foreign industrial targeting and to use this information either to assist businesses in documenting foreign targeting practices when filing petitions or to take action itself to address unfair targeting practices. In 1982, the Department of Commerce started compiling a foreign targeting data base that could form the foundation for this effort. Commerce also maintains a subsidy library that is available to businesses.

The United States could also attempt to deal with targeting through negotiations to persuade foreign governments to refrain from targeting. The Subsidies Code is one example of an international agreement that established common procedures to deal with a particular targeting practice. The code established two "tracks" of action. Nations can prevent injury to domestic industries through countervailing duties or negotiation agreements to remove or reduce the export subsidy. The second track enables signatory nations to use a multilateral dispute settlement mechanism to enforce their rights. The U.S. effort to negotiate access to the Japanese telecommunications industry is an example of a bilateral trade negotiation designed to remove home-market protection. Successful results, however, may be difficult to achieve without the United States either offering some concession to the other country or threatening to retaliate in some manner.

Targeting of emerging industries poses another problem for any possible trade law. Foreign targeting may result in such a rapid growth in foreign production that a similar U.S. industry never has time to develop. Although U.S. countermeasures may be provided for by the law, U.S. firms may be reluctant to initiate

proceedings for fear that a complaint would be dismissed because of the difficulty in showing injury when U.S. industry itself has not started commercial production. U.S. firms may also fear retaliation by foreign governments for filing unfair trade petitions. Because of this, a more active government role in initiating proceedings against foreign targeting may be needed, especially in emerging industries.[1]

The speed with which industries are developing in today's economic environment produces another problem in dealing with targeting. If the procedures to invoke U.S. targeting laws take too long to produce results, emerging U.S. industries may suffer irreparable damage that would prevent them from being competitive with foreign producers even if relief is granted.

EFFECTIVENESS OF U.S. TRADE LAWS TO DEAL WITH FOREIGN INDUSTRIAL TARGETING

The United States has no trade law that specifically deals with foreign industrial targeting, although some U.S. trade laws contain provisions that can be used to deal with some aspects of targeting. Most current U.S. import trade laws are designed to deal with imports that are injuring or threatening to injure a U.S. industry and they address injury on a case-by-case basis. The immediate goal of most current U.S. import trade laws is to aid the injured industry rather than to move directly to end the foreign assistance to industry. Countervailing and antidumping duties can be removed if the subsidies are eliminated or the price of the foreign goods raised. This takes place after U.S. action, such as setting a preliminary or final duty, that seeks to neutralize the subsidy or dumping margin.

These relief mechanisms are consistent with international agreements and the relief provided by these laws is internationally acceptable. If the United States were to establish new laws to specifically deal with targeting and did so without

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[1]To some extent, the Trade and Tariff Act of 1984 may make it easier for an emerging U.S. industry to get relief from subsidized imports by articulating the criteria the International Trade Commission must use to determine whether an industry faces potential injury by imports. The Commission's affirmative vote in the Motorola cellular phone case illustrates this emphasis on seeking protection before an industry is irreparably damaged. The Commission's preliminary decision (Cellular Mobile Telephones and Subassemblies thereof from Japan, USITC Publication 1692, Dec. 1984) provided relief to the industry after it alleged that it was threatened by imports rather than requiring that actual injury be demonstrated.

international agreement, there is a danger that other countries might retaliate against U.S. goods.

The current U.S. countervailing duty and antidumping laws provide a definite response to unfair foreign practices. The President has limited discretionary powers in these cases. Other U.S. laws, such as section 201 and section 301 of the Trade Act of 1974, as amended, give the President wide discretionary powers. Under section 201, the President can grant temporary assistance to an industry injured by imports (whether or not unfair trade practices are alleged). Under section 301, the President has broad powers to determine the proper U.S. response after deciding that foreign trade practices are unfair and do injure a U.S. industry. Because the President has the discretion to make these decisions, overall U.S. foreign policy is not necessarily tied to protecting injured U.S. industries. These statutes allow the President to weigh the costs and benefits of providing relief on a case-by-case basis. As a result, the overall benefits of unrestricted trade need not be lost because a relatively small number of firms and workers are injured. On the other hand, giving the President the discretionary power to determine the proper remedy increases the political pressures, both domestic and foreign, that will accompany the decision.

Countervailing duty laws[2]

In most cases, a countervailing duty (CVD) is imposed when a foreign industry exporting goods to the United States in sufficient quantity to injure or threaten to injure a U.S. industry receives a subsidy from a foreign government.[3] The amount of the CVD assessed on each imported unit is equal to the amount of the subsidy divided by the number of units being subsidized. Although a CVD case takes almost 7 months to complete, a preliminary decision giving interim aid to the industry is generally made within 85 days after a petition is filed. However, the availability of appeals to the Court of International Trade to contest certain interim determinations made by Commerce or the International Trade Commission (referred to as interlocutory judicial appeals) as well as other administrative processing requirements complicates the entire process, making these estimates of the time required to resolve cases uncertain. As a result of the lengthiness and cost of CVD cases, some domestic industries, particularly small businesses, have been reluctant to file petitions. Title VI of the Trade and Tariff Act of 1984 contains several provisions designed to streamline the process

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[2]Subtitle A, Title VII of the Tariff Act of 1930, as amended.

[3]See our report Judicial Review of Antidumping and Countervailing Decisions (NSIAD-84-129), June 26, 1984.

and make it more accessible to small businesses. Among these are provisions that

1. eliminate the interlocutory judicial appeals;

2. allow the consolidation of International Trade Commission hearings in concurrent CVD and antidumping investigations of the same product;

3. simplify the process for access to proprietary data by participants in CVD and antidumping proceedings under administrative protective orders;

4. establish a small business assistance office in the International Trade Commission to answer questions about the trade laws and potential remedies; and

5. provide for administrative review of CVD and antidumping orders only when one of the parties to the action so requests.

These changes in the Trade and Tariff Act of 1984 also apply to the antidumping provisions that are discussed below.

Although CVD petitions may be filed to counter foreign subsidies that affect an entire industry, the duties imposed apply only to the particular products specified rather than to the industry in general. This limits the effectiveness of the CVD laws in cases where aid is given to an industry producing a wide array of products, because injury must be shown for each product. Although imposing a CVD may encourage a foreign government to reduce or eliminate an unfair subsidy, the CVD laws are primarily aimed at eliminating the benefit of the subsidy in the pricing of the subsidized foreign product.

A major problem with using CVD laws to deal with targeting is that the Commerce Department, which is responsible for determining the value of the subsidy, looks only at monetary benefits, such as grants and loan guarantees, when it calculates the subsidy level. Because of the difficulty in calculating nonmonetary benefits and because of the possible foreign repercussions resulting from such U.S. calculations, the Commerce Department does not look at nonmonetary benefits, such as home-market protection or the relaxation of antitrust regulations. Many benefits conferred by targeting come in the form of nonmonetary assistance.

A second problem is that CVD laws are keyed to effects of ongoing rather than discontinued subsidy practices, even if these discontinued practices continue to have effects which may be disproportionate to the size of the subsidies. Research subsidies may have long-term effects even after the subsidies have ended, for instance. Although Korea heavily supported its steel

industry in the past, such assistance has been relatively limited recently. The Korean steel industry, furthermore, has repaid many of the preferential loans that it received. As a result, many of the antidumping and CVD petitions brought by U.S. steel companies against Korean steel producers in recent years have resulted in either negative findings or de minimis findings. In cases where subsidies or dumping margins were found, the levels ranged between 0.9 and 5.0 percent of the import price. These are small relative to the duties assessed on steel imports from other nations, which go as high as 62 percent.

Another problem with the CVD laws stems from the International Trade Commission looking at the profitability of the industry in determining if a domestic industry has been injured by subsidized imports. If the least profitable firms in the industry have been driven out of business by imports, the Commission may determine that imports are not injuring the domestic industry because the remaining firms in the industry are profitable.

Although the Trade and Tariff Act of 1984 includes a provision that clarified the authority of the Department of Commerce to include upstream subsidies[4] in its calculations, the provision merely codifies an existing Commerce practice and thus should have little effect on Commerce's calculations.

Antidumping laws[5]

In most cases, antidumping duties are imposed when imported goods are being sold at less than fair value and when the goods are being sold in the United States in sufficient quantity to injure or threaten to injure a U.S. industry. The amount of the antidumping duty is equal to the difference between the price of the imported good and the fair market price as determined by the Commerce Department. As with CVDs imposed on subsidized imports, antidumping duties are assessed on a case-by-case basis, and thus cannot address the more general effects of targeting. As with the CVD laws, the immediate objective of the antidumping provisions is to remove any benefit--in terms of lower U.S. price--that a foreign firm seeks in dumping goods on the U.S. market rather than to act directly to remove the dumping practice. The time required for resolving antidumping cases and the complexity of filing such cases has been seen as a limit

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[4]Subsidies given to a product that is used in the production of another product; for example, upstream subsidies in the steel industry would include subsidies given to the coal industry because coal is used in making steel.

[5]Subtitle B, Title VII of the Tariff Act of 1930, as amended.

to the usefulness of the antidumping law. A normal antidumping case takes 287 days to be decided, although a preliminary decision is reached in 160 days. As noted previously, the Trade and Tariff Act of 1984 has amended the process in a number of ways that should streamline and shorten the process, but it is too early to tell what effect this will have.

Sales at less than fair value could occur if a foreign government protected the home market, thus allowing its firms to reap large profits from sales in their home market. These high profits could then allow the foreign firms to price their goods very competitively in other markets in an attempt to gain market share overseas. The antidumping laws can be used to offset this attempt by foreign firms to price discriminate, i.e., to charge different prices in different markets.

The antidumping laws do not seem as readily applicable to foreign targeting as do the CVD laws because antidumping laws deal with pricing behavior. Foreign targeting, however, will not always manifest itself in goods selling below cost or in price discrimination. In such cases, an antidumping petition might not help the domestic industry affected by foreign targeting, whereas a CVD petition could help if the assistance offered by the government is in the form of subsidies.

Section 201 of the Trade Act of 1974, as amended

This statute can be used to provide temporary import relief to any domestic industry that is injured by imports. The imports need not be unfairly traded for section 201 to be applied; section 201 cases generally take between 6 and 8 months to be resolved.

Section 201 is designed to provide temporary relief to an industry to allow it time to adjust to a changed competitive environment. Investigations conducted under section 201 have generally involved depressed industries that need time either to invest in new plant and equipment or to rationalize production so as to regain competitiveness.

Any relief granted under section 201 to a U.S. industry that is injured by foreign targeting would not eliminate the foreign targeting practice; the relief merely grants the industry time to adjust. Once the period of relief is over, the U.S. industry must deal by itself with the foreign targeting practice.

One advantage to industries in using section 201 to deal with targeting practices is that the industry does not have to

document the foreign targeting practices or quantify the benefits of these practices. It merely has to show that it is being injured or threatened with injury because of increasing imports. An additional advantage is that section 201, unlike the CVD and antidumping laws, could be used to grant relief to an industry that has been injured by the ongoing effects of past foreign government practices. The antidumping and CVD laws are inappropriate in these cases because no current subsidy or dumping practice exists.

Although section 201 can be used to deal with foreign industrial targeting, it is far from being an ideal measure to use for this purpose. Section 201 investigations must look at imports from all countries, not just those that are targeting the industry. Thus, even those countries that do not target the industry will be subject to a tariff increase or a quota that might be imposed as a result of the investigation.

In addition, under GATT rules, a foreign country affected by relief granted under section 201 may retaliate against the United States by suspending substantially equivalent trade concessions or GATT obligations, unless the United States and the foreign nation agree on the relief action. This retaliation could include increased tariffs on other goods exported to that country from the United States for instance. An ideal remedy for unfair targeting should not open the prospect of retaliation.

An additional problem with using section 201 to deal with targeting is that section 201 generally requires finding that imports constitute a significant portion of domestic consumption. This makes it very difficult for a U.S. firm in an emerging industry to bring a case when foreign targeting has not yet resulted in substantial U.S. imports. By the time imports reach a level that would permit import relief under section 201, the U.S. industry may have suffered irreparable damage and may never catch up technologically with the foreign firms.

The U.S. International Trade Commission has considerable latitude in addressing section 201 cases, although the President ultimately decides what, if any, relief to provide an industry. The Commission determines if the U.S. industry is being injured or is threatened with substantial injury because of imports. If it finds that no such injury exists, as it did in 1984 in the case of nonrubber footwear, the petition is terminated and the request for relief never reaches the President. If, however, the Commission finds that such injury does exist, it must recommend an increase in tariffs or the imposition of a quota that will provide relief to the industry. The President can uphold the Commission recommendation, as he did in 1983 in the case of heavy-duty motorcycles in response to a complaint brought by the

Harley-Davidson Motor Co.; he can provide relief in another form, as he did in 1983 in the case of specialty steel by imposing a mix of additional tariffs and quantitative restrictions on most specialty steel imports rather than the recommended quantitative restrictions; or he can provide no relief for the domestic industry, as he decided in 1984 in the case of unwrought copper in response to a petition brought by several major U.S. copper producers.

Section 232 of the Trade Expansion Act of 1962, as amended

This statute grants import relief to those U.S. industries that are vital to the national security and that are being injured by imports. The imports need not be unfairly traded. Because few U.S. industries are vital to the national defense, section 232 is limited as a means of dealing with foreign targeting. Furthermore, it is difficult to demonstrate that imports threaten national security. As with section 201 cases, the United States, to avoid retaliation, might have to compensate any affected foreign country by means of other trade concessions for any actions taken under section 232. The President has full discretion as to the type of remedy provided under section 232.

The National Machine Tool Builders' Association petitioned for relief under section 232 in 1983. The petition alleged that foreign machine tool manufacturers, particularly Japanese manufacturers, benefited from government aid. Such practices have been in place for 25 years and have included protection from imports, cartel arrangements, tax breaks, and subsidies to help the industry become internationally competitive. As of April 22, 1985, no decision had been reached on the National Machine Tool Builders' Association petition.

Section 337 of the Tariff Act of 1930, as amended

This statute can be used to counteract unfair methods of competition and unfair acts made in importing goods into the United States. Section 337 cannot be used to deal with subsidized or dumped imports; the CVD and antidumping statutes must be used. Section 337 has generally been used to provide import relief to a domestic firm that is being injured because a foreign firm has infringed upon its patent rights.

The International Trade Commission decides on all section 337 cases. In more complicated cases, the Commission's investigation can take up to 18 months. The President has 60 days to disapprove any cases "for policy reasons."

Section 337 requires the International Trade Commission to investigate allegations of unfair methods of importing and selling products in the United States. If it determines that unfair competitive practices exist, the Commission can issue a "cease and desist" order, mandating that the foreign producer stop its illegal act or else stop exporting to the United States. Since the law has not been used to address foreign targeting practices, however, its potential effectiveness is unknown. Despite the narrow manner in which the statute has been applied, the law itself is much broader, dealing with unfair methods of competition and unfair acts in the importation of articles into the United States.

Section 301 of the Trade Act of 1974, as amended

This statute gives the President broad powers to enforce U.S. rights granted by trade agreements and to attempt to eliminate policies of a foreign government that are unjustifiable, discriminatory, or unreasonable and that restrict U.S. trade or violate international trade agreements. Most cases brought under section 301 involve alleged violations of these agreements. If negotiations to remove the objectionable practices are unsuccessful, the President is authorized to take all appropriate and feasible action, including invoking the dispute resolution procedures in the agreements or retaliating against the foreign government's practice. This retaliation can include suspending or withdrawing concessions entered into under the trade agreements. Section 301 cases generally take between 9 and 14 months to resolve.

The Trade and Tariff Act of 1984 extends the President's powers to use section 301 against foreign barriers to U.S. trade, including practices that could be defined as targeting. The Act also broadened the definitions of the "unreasonable," "unjustifiable," and "discriminatory" trade practices that the law is to remedy.

Because of its commitment to adhere to the international rules governing trade, the United States has been reluctant to take unilateral action against a foreign practice that it considers unreasonable or unfair. This reluctance stems both from respect for the sovereignty of foreign governments and from the difficulty inherent in finding a counteraction that would be both effective and internationally justifiable so as to preclude counterproductive retaliation. Without obtaining international acceptance for any action taken under section 301, the President risks subjecting the United States to both retaliation and loss of credibility as a GATT member.

Most of the other trade laws we have mentioned provide import relief to domestic producers without directly attempting to get the foreign country to stop its targeting practices. Only section 301 explicitly relies upon negotiations to eliminate the targeting practice rather than granting assistance to the industry injured by imports, which may indirectly lead to removal of the targeting practice.

Section 301 is also the only current statute that could deal with the effect of foreign targeting on U.S. firms that compete with targeted foreign firms in their domestic markets or in third-country markets. The other statutes are limited to dealing with U.S. imports. Section 301, furthermore, can be used when nations provide assistance to industries through a variety of mechanisms so that the total effect cannot be precisely quantified; the inability to accurately measure effects hampers use of countervailing duties.

Because the President has wide discretionary powers under section 301, its certainty as a means of protecting a U.S. industry from foreign targeting practices is somewhat mitigated. Because decisions to take action under section 301 are made by the President, moreover, its use is inevitably based on balancing the goals of trade policy with other policy goals. In some cases, these policy goals conflict. A U.S. firm or industry may be able to prove that foreign targeting exists and that as a result it is being injured, yet may find itself unable to get relief from unfair foreign trade practices if, for example, other policy objectives dominate. Such tradeoffs cannot be avoided.

Although section 301 gives the President sweeping powers, it has not been used as extensively as other sections of U.S. trade law to deal with foreign targeting. During 1984, for example, 3 petitions for action under section 301 were filed with the Office of the U.S. Trade Representative[6] while 126 petitions were filed with the Department of Commerce and the International Trade Commission under the antidumping and countervailing duty provisions. Also during 1984, 5 petitions for relief from injury due to imports were filed under section 201.

Although we have not examined in detail the reasons why section 301 has not been used more frequently, nothing suggests that limited Presidential authority or discretion is the reason. The legislative history of section 301 indicates that Congress envisioned the section as giving the President broad

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[6]One petition was withdrawn prior to a decision by the U.S. Trade Representative to initiate an investigation.

powers and intended that these powers be used to enforce U.S. rights under international trade agreements. In the floor debate on the Trade and Tariff Act of 1984, for instance, Congressman Don Bonker noted that:

> "...the conference endorsed a reciprocity bill that will increase the President's retaliatory powers under section 301 of the Trade Act of 1974, as a means of increasing his leverage in negotiations to lift unfair foreign barriers to U.S. investors and exporters of goods and services."[7]

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[7] Congressional Record, Oct. 9, 1984, p. H11661.

CHAPTER 5

CONCLUSIONS

The appropriate U.S. response to foreign industrial targeting depends on resolving a number of practical problems and balancing competing policy goals. Each case of foreign industrial targeting will pose problems in determining the nature and effect of the targeting practice, such as how to measure the effect, if any, of the foreign targeting on U.S. businesses. The policy goals include facilitating international trade and assisting domestic industries injured by imports, as well as balancing other foreign policy goals.

The traditional goal of international trade is to increase national welfare by allowing consumers to purchase goods and services according to their preferences and the prices of the goods and allowing businesses to market their products according to their competitiveness. Following this goal, trade policy ought to remove all artificial obstacles to trade that are not clearly warranted.[1] If the goal of international trade, however, is to increase domestic employment by increasing exports and reducing imports, trade policy should be part of an industrial policy that would promote domestic industries which can compete successfully in world markets and to protect those that cannot.

U.S. trade policy, although it contains aspects of protectionism, has clearly been directed toward promoting free trade. As discussed earlier, however, free markets do not always provide the most efficient allocation of resources; government action is sometimes necessary to correct market failures. Thus, to be consistent with the goals of promoting economic efficiency, any U.S. response to foreign targeting should distinguish between those practices that correct market failures and those that distort the proper allocation of resources. Countermeasures are needed only when foreign targeting distorts resource allocations and thus unfairly injures U.S. firms. The countermeasures should not persist after the unjustified foreign targeting practice is ended and, ideally, should lead to removal

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[1]More precisely, national welfare is improved through increased economic efficiency by allowing a country to export those goods in which it has a comparative advantage and to import those goods in which it has a comparative disadvantage, so trade policy should seek to eliminate targeting practices that encourage economic inefficiency. As earlier discussion notes, however, there are situations where government intervention is warranted and permitted under GATT rules, such as protecting industries that are vital to national defense or infant industries.

of the unfair practice. Unfortunately, there is no definitive method for determining if a particular targeting practice is correcting a market failure or is causing a market distortion. The facts of each case are different and need to be examined closely to determine the effects of the targeting, so some discretion in U.S. law is unavoidable.

The U.S. response to targeting that distorts the proper allocation of resources could either be made explicit, as are the provisions of the countervailing duty and antidumping laws, or it could be left flexible, as are the provisions of section 301, to give the President a wide range of options for dealing with the problem. If the U.S. response leaves the President no discretion, the U.S. industry that has been injured by foreign targeting would receive relief automatically if it can prove its case. An adverse consequence of providing such automatic relief is that overall U.S. foreign policy is made subservient to the protection of an injured domestic industry.

If, however, the U.S. response leaves the President wide discretionary powers, the President can weigh the benefits of providing relief to the domestic industry against the costs of disturbing relations with another country. The cost of providing for discretionary relief is that a U.S. industry that is injured by unfair foreign targeting may not receive any relief from that injury.

Current U.S. trade laws can deal with some aspects of targeting. Subsidized and dumped imports can be addressed under the antidumping and countervailing duty laws. Industries that are injured by imports can petition for temporary relief under section 201 of the Trade Act of 1974. In addition, multinational agreements, such as the Government Procurement Code, provide a way to address the injurious effects of certain foreign targeting practices.

In many cases, however, the practices that nations undertake as part of an industrial policy can extend beyond the coverage of most U.S. trade laws. The effects of home-market protection, for instance, cannot be addressed by any of the aforementioned laws nor can nonquantifiable adverse trade effects.

Current law, however, provides a potentially broadbased remedy that can be used to deal with all forms of targeting that hinder free trade. Section 301 of the Trade Act of 1974 authorizes the President to take all necessary and feasible actions to ensure that U.S. goods are not subject to unfair foreign trade practices. If an unfair trade practice cannot be removed through negotiations, the President can exercise broad power to take "all appropriate and feasible action" to retaliate

against the unfair foreign trade practice or violation of an international trade agreement. The President can retaliate against the nation with the unfair practice by raising tariffs on goods from that country, otherwise restricting that country's exports to the United States, or suspending or withdrawing concessions granted to that nation under existing trade agreements.

Because the President has the discretion to use section 301, moreover, its use is inevitably influenced by other policy objectives, such as maintaining friendly relations with other nations, as well as addressing unfair trade practices. In many cases, these policy objectives may compete, although the competing objectives may not be equally clear. This potential conflict and resulting controversy cannot be avoided, because they result from trying to balance worthy goals: maintaining good relations with foreign countries and respecting their policy decisions while maintaining the rights of U.S. businesses to compete fairly. Presidential discretion permits the government to directly confront the different policy objectives of each case and to integrate conflicting trade, foreign policy, and national security concerns.

We believe that current trade law, particularly section 301, is able to adequately address those foreign industrial targeting practices that are judged to unfairly injure U.S. commerce. Certain provisions, including section 301, also allow the President to defer action if other overriding policy objectives must be met. Thus, we offer no recommendations for changes in the law. We believe that current law does address the subsidy element of foreign targeting. The effects that foreign industrial targeting has on U.S. commerce and the fairness of the targeting practices are difficult to determine, however, and must be addressed on a case-by-case basis.

AGENCY COMMENTS

In commenting on a draft of this report, the Undersecretary of Commerce for International Trade suggested several clarifications in our discussion of issues under Commerce's jurisdiction. (See app. I.) We have adopted most of the suggestions. The Office of the U.S. Trade Representative said it did not wish to comment on the draft report.

APPENDIX I

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

APR 2 2 1985

J. Dexter Peach
Director
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

Thank you for the opportunity to review the draft report, "Foreign Industrial Targeting: U.S. Trade Law Remedies". Our enclosed comments clarify areas related to the responsibility of the Department of Commerce.

The Department is conducting its own analysis of this issue and will be preparing a report for Congress, as directed by Section 625 of the Trade and Tariff Act of 1984. Along with USTR and the Department of Labor, we have contracted independent analyses of the effects of foreign targeting on selected U.S. industries. These results may have some relevance to the GAO conclusion that the effects of targeting cannot be measured, except perhaps as experienced in individual injury cases.

Sincerely,

Lionel H. Olmer

Enclosure

GAO note: Enclosures to this letter are not included in this report because they dealt with clarifications of our discussion of issues under Commerce's jurisdiction and were incorporated in the report where appropriate.

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