The Rise of Innovation Mercantilism

BY ROBERT D. ATKINSON

And the threat to the global economy.

In 1944, representatives from forty-four nations met in Bretton Woods, New Hampshire, to make financial arrangements for the postwar world. It was then that the plans for the World Bank and the International Monetary Fund were created, with the General Agreements on Trade and Tariffs created two years later. This newly designed global trading system worked more or less well for about half a century. But as that era's commodity-based manufacturing system evolved into today's specialized innovation economy, the strains on the Bretton Woods framework have become pronounced.

These strains have been exacerbated by the embrace by a growing number of nations of a new kind of protectionism that seeks to expand domestic innovation capacity and technology exports by manipulating the trading system. As countries increasingly vie to achieve the highest levels of innovation-based economic growth and to attract, grow, and scale the innovative enterprises of the future, an increasing number have turned to "innovation mercantilist" policies that come at the expense of competitor nations and the detriment of global innovation. Collectively these polices represent a major threat to the integrity

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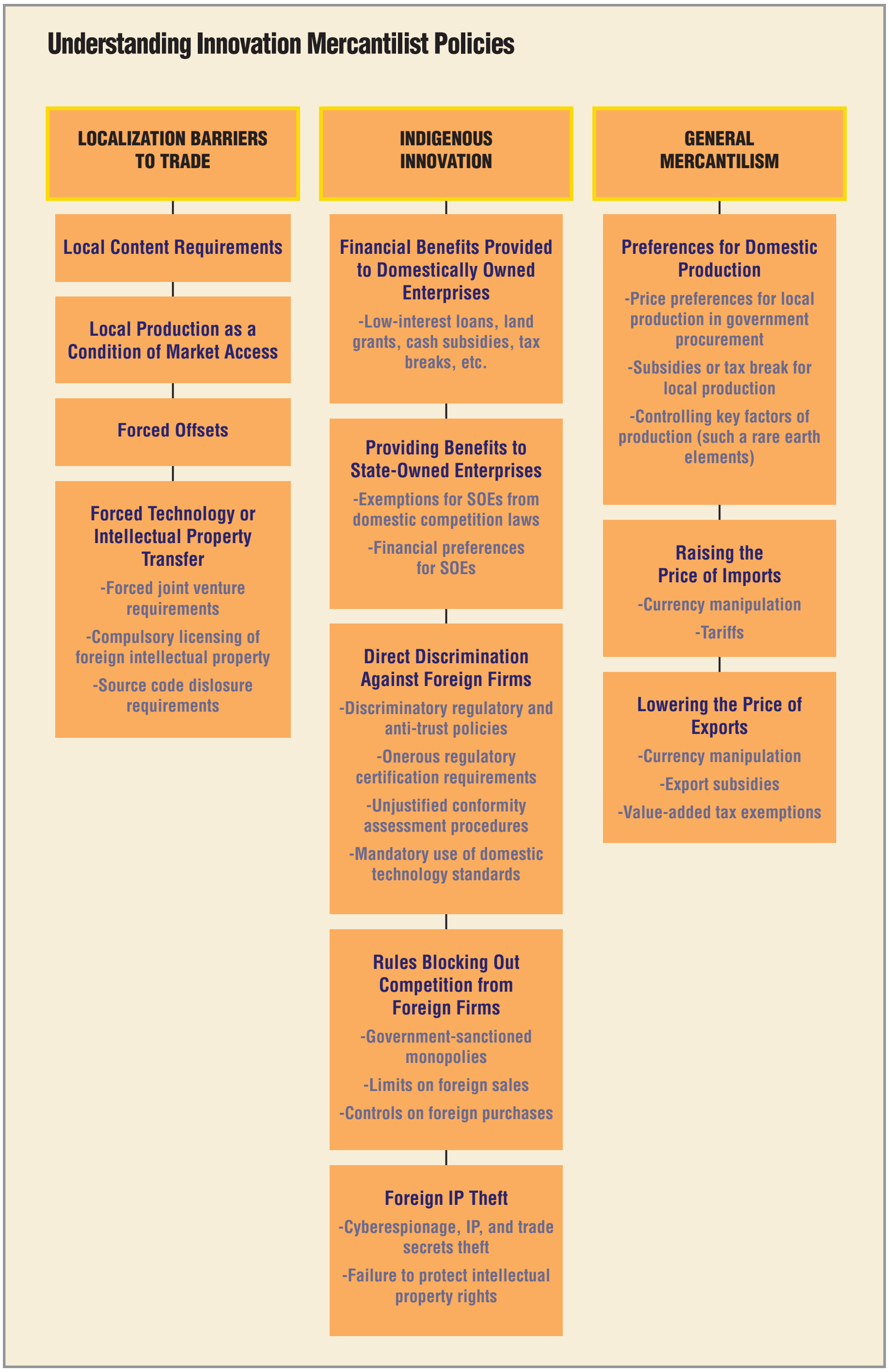

of the global trading system and they demand a coherent and bold response from free-trading nations and multilateral trade and development organizations.

Innovation mercantilist policies come in three types: localization barriers to trade, indigenous innovation policies, and general mercantilist measures (see figure). Localization barriers to trade seek to pressure foreign enterprises to localize economic activity. These include policies such as local content requirements, local production as a condition of market access, forced technology or intellectual property transfer, forced offsets, and compulsory licensing. Indigenous innovation favors domestic enterprises by making it more difficult for foreign enterprises to compete locally, such as by introducing domestic technology standards, onerous regulatory certification requirements, discriminatory government procurement requirements, or limits on foreign sales or foreign direct investment. Finally, general mercantilist policies, such as currency manipulation, export and production subsidies, and high tariffs, endeavor to boost production by increasing exports and/or reducing imports but they are indifferent as to whether they affect domestic or foreign enterprises.

Innovation mercantilism holds a strong appeal for nations wanting to climb the development ladder. While it might result in higher taxes, reduced consumer welfare, and dampened entrepreneurial efforts in the long run, in the short run it offers the seductive payoff of higher-wage jobs in innovation industries. This is why the World Trade Organization reported the number of such "technical barriers to trade" reached a record high of 1,560 in 2012. Just one type of innovation mercantilist tool, local content requirements, impacts 5 percent of global trade and costs the global economy almost $100 billion annually, according to a Peterson Institute study. Some two dozen countries have introduced localization barriers to digital trade, including local data storage laws or requirements, such as Vietnam's

Continued on page 55

Continued from page 31

Decree 72, which mandates that internet companies must use local IT facilities in the provision of digital services. India has introduced a Preferential Market Access policy that favors Indian-based information and communications technology manufacturers in government procurement. Brazil's public procurement policies strongly encourage domestic production by establishing price preferences of up to 25 percent across a number of sectors, including for medical technologies and medications, automobile production, and electricity generation. China has deployed a wide range of innovation mercantilist practices, excelling at mandating technology and intellectual property transfer as a condition of market access, forcing joint ventures, introducing technology standards that favor domestic industries, and showering domestic technology companies with subsidies.

While some may believe that "mercantilists only hurt themselves," in fact, innovation mercantilism does hurt the U.S. economy. While some policies, such as currency manipulation and export subsidies, might help Americans as consumers, they hurt Americans as workers. And by distorting global trade and investment patterns, mercantilism comes at the cost of domestic employment, investment, and even entire industrial ecosystems and value chains. As MIT's David Autor has shown in a 2013 study with David Dorn and Gordon H. Hanson, China's industrial strategy has directly cost the United States at least one-fourth of the 5.6 million U.S. manufacturing jobs lost over the last decade as they have racked up unprecedented trade surpluses.

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But innovation mercantilist policies also damage the global innovation system. Because innovative industries are characterized by high fixed costs but lower marginal costs, they benefit from access to large, global markets. But innovation mercantilist policies introduce market balkanization that limits scale economies, induces excess competition, and fails to protect intellectual property, limiting the profits on which innovative enterprises depend to finance future generations of innovation. For example, a biopharmaceutical firm may only need a single plant to produce a drug for global distribution, but if nations require the firm to manufacture locally in order to sell locally, then it will need multiple plants, thus increasing the firm's costs, which both makes the drug unnecessarily more expensive and reduces the resources available for reinvestment in future generations of therapies.

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Countries have turned to innovation mercantilist policies in part because of the slowing global economy and in part because their use by one country ignites a contagion effect as countries feel compelled to enact similar policies in response. But while the Great Recession provided the impetus for action, interest has been growing for at least a decade, as many nations looked with envy at China. With growth rates of over 8 percent a year, the view is that China must be doing something right. As a result, the "Beijing consensus" (that is, innovation mercantilism) has become more appealing for many nations than the "Washington consensus" (the premise that market forces work and governments should play only a minimal role in promoting economic growth). We see this in nations such as Brazil and India that are emulating the Beijing consensus by ramping up innovation mercantilist policies.

If free trade is to prevail over innovation mercantilism, it's not enough to tout the superiority of the Washington consensus, for it is in fact a model that has outlived its usefulness by placing too many limitations on legitimate government roles to spur innovation and competitiveness. But the Beijing consensus is more flawed while also representing a fundamental threat to global economic integration. Instead, it is time to consider an alternative model, what might be

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termed the "Helsinki consensus." A number of nations, including several in Scandinavia, while committed to a vision of global integration and free trade, at the same time recognize that non-mercantilist innovation policies (such as funding for applied industrial research and technology transfer, support for STEM education, research and development tax incentives, national technology strategies, and so forth) are critical in order to enable them to effectively compete.

As such, it's time for institutions such as the World Bank, the International Monetary Fund, and other multilateral organizations to start advocating for such a "Helsinki consensus" so that nations are not forced into an unproductive choice between the Washington consensus and the Beijing consensus. If that's their only choice, too many will default to the latter, especially as they look at the recent respective economic performances of the United States and China.

As such, the central task of global economic policy should be to encourage all nations to make boosting sustainable innovation and productivity their top economic priority. By "sustainable" we mean innovation focused on boosting productivity and adding to the global stock of knowledge, not beggar-thy-neighbor innovation. This means not only encouraging nations to enact the right kinds of innovation policies, but also stronger enforcement by global bodies such as the WTO against beggar-thy-neighbor mercantilist strategies, such as intellectual property theft, forced tech transfer, discriminatory technology standards, discriminatory procurement, and other similar actions. It also means that organizations such as the World Bank, the IMF, the U.S. AID, and the Inter-American Development Bank need to stop promoting export-led growth as a key solution to development, for it is a short step from that to innovation mercantilism.

America also needs to increase its role. Accordingly, a first step should be for the United States to work with the Europeans, Canadians, Australians, Japanese, and whoever else will come aboard to lay out a renewed vision for globalization grounded in the perspective that markets should drive global trade and investment, that countries should not seek to rack up sustained trade surpluses, and that fair competition leads to constructive innovation policies that leave all countries better off.

This new alliance of free-trading nations needs to get progressively tougher on nations like China until they significantly scale back their mercantilist policies. In addition, these free trading nations should create a new trade zone, involving only those countries genuinely committed to adhering to the principles of open, free, and fair trade. Countries that insist on pursuing mercantilist strategies would not be welcomed into this new arrangement. The Trans-Pacific

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Partnership could provide a model for how to organize such a new trade zone, as could the Transatlantic Trade and Investment Partnership agreement with Europe.

Innovation is the new driver of growth and global prosperity. But we will not realize the full benefit of that if innovation mercantilism continues to grow. It's time for a coherent and bold response from free-trading nations and multilateral trade and development organizations to roll back these destructive practices. ◆