The Continuing Need for Industrial Policy

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A panel discussion in Doha, Qatar, as part of the Thirteenth UN Conference on Trade and Development (UNCTAD XIII) brought together some economists and policy makers to provide new perspectives on industrial policies in the South. It became evident that industrial policies have been significant, if unsung, forces behind the much trumpeted "emergence" of some developing economies as major players in the world stage.

For some time now, in different parts of the world, industrial policy has been making a comeback. Indeed, as participants in the panel noted, it never really went away, especially in the more successful countries, even though for at least two decades it was decried and generally given a bad name by the dominant Washington Consensus.

What exactly is industrial policy? Robert Wade - whose book "Governing the Market: Economic theory and the role of government in East Asia" (Princeton University Press 1990) remains an essential classic for anyone even vaguely interested in this issue - was able to provide the simplest definition: selective government support for some activities over others. This does not relate only to "industry, but to any economic activity. The basic purpose is to shift the economy towards higher value added activities in a process that cannot occur based simply on free market forces.

This has been described simplistically as the strategy of "picking winners". And this in turn is obviously prone to all sorts of difficulties, which is why such a strategy has been criticised roundly for the possibilities it generates for wrong government choices, creating rent-seeking behaviour and crony capitalism, thereby wasting public resources, other forms of elite capture and so on. While these are certainly problems that must be recognised and dealt with, overall this is far too unsophisticated a response.

In the first place, the best industrial strategy is not about picking individual firms or even sectors. Rather, as Richard Kozul-Wright pointed out, UNCTAD and other have stressed over the years that it is about creating appropriate economic environments and generating incentives for economic diversification in a wide range of ways: through fiscal and monetary policies, financial, trade and investment policies, infrastructure creation, education (particularly higher education to develop the required skills dometically) and so on. Indeed, at some level, all countries are pursuing industrial policies, whether or not they recognise it, although of course the quality of the interventions varies.

In a fascinating and thoughtful intervention, Joao Carlos Ferraz, Vice President of the Brazilian development bank BNDES, brought out how this can work in practice. BNDES (whose assets currently are greater than those of the World Bank and Asian Development Bank put together) has emerged as a critical player in Brazil, allowing for the development of some now internationally competitive industries, providing more funds for investment to some poorer regions, and even enabling faster recovery in troubled macroeconomic circumstances such as those generated by the global crisis of 2008.

Ferraz noted that tenacity, flexibility and realism are key elements in any successful industrial policy, and also that much of it consists not of forceful direction but gentle and persistent nudging to develop certain sectors. He also pointed to the need to align different elements of policy: trade and industrial policies, financial strategies, exchange rates, fiscal and monetary policies. The firm commitment of the Brazilian government to industrial policy geared towards productive diversification was strongly evident.

This is sharp contrast to India, where industrial policy is still explicitly criticised and apparently sought to be dismantled and avoided by governments - not just the current government, but most previous governments for the past two decades. Indeed, the conventional narrative about the Indian economic growth story is that it is all about "economic reforms" that liberated productive forces in the economy from the shackles of government intervention. It is generally believed that the previous import substituting industrialisation strategy created a high cost economy that stifled enterprise and innovation, and so opening up to domestic and international competition was the critical force making for growth. In other words, moving away from industrial policy is seen as the cause for success.

Despite some elements of truth in this argument, it is also far too simplistic. Indeed, it can plausibly be argued that many of the more sustainable elements of the Indian growth success actually reflect the effects of past and present industrial policies, even when these are not officially recognised.

This can be illustrated with examples of four sectors that are currently seen as examples of India's economic achievement: software, pharmaceuticals, chemicals and automotive ancillaries.

Representatives of the software industry tend to be the biggest exponents of the argument that they "did it all by themselves", without any support from government, and only because they were freed from the deadening hand of the state. Yet the emergence of this industry in India cannot be imagine without the Nehruvian higher education policies that created institutions like the IIT and universities that could provide the skills required. (Incidentally this was in the teeth of opposition from the World Bank and others who argued that India should only focus on primary education.) And the industry has benefited for decades from prolonged tax holidays and a range of other incentives, all of which can be seen as examples of industrial policy.

In the case of pharmaceuticals, the fundamental factor behind the expansion is clear: the patent regime until 2001-05, which allowed only process patents in pharmaceutical products. This enabled domestic firms to engage in reverse engineering to produce generic alternatives to existing drugs, and thereby created the cheapest drug industry in the world with significant economies of scale. There is no question that such a law (which was both an industrial policy and a means of ensuring affordable drugs for the population) was critical in the growth of the industry to enable it to compete globally.

The auto ancillary industry was the unusual child of two very different parents: a liberalisation of the production of final products, including more FDI; and a strategy of first insisting on and then encouraging increasing levels of indigenisation among the domestic players in the newly liberalised industry. The chemical industry too, especially in its large-scale petrochemical form,

cannot be imagined without the many trade policy, fiscal and infrastructural benefits that certain players (such as Reliance) received from the state.

All of these are certainly forms of industrial policy, and while the specific policies in turn may have various drawbacks, it would be foolish to deny their role in the growth of these sectors. The point is, however, that these occurred under the aegis of a state that was officially in denial about industrial policy, and therefore these were mostly ad hoc or individual decisions rather than part of a more systematic and developed aggregate strategy. This in turn has been associated with several weaknesses or even failures of the overall economic strategy, which are now becoming even more prominent as the Indian growth story loses some of its shine even for those who have not been excluded from its benefits.

The first major failure is in employment, which has simply not kept pace either with the GDP expansion or with the requirements of the growing labour force. This in turn has meant that incomes of the majority of the population have not risen sufficiently to enable broad-based growth of consumption demand. Instead, the market has been delivered by increasing income and asset inequality and credit-driven bubbles.

The second major weakness of this "industrial policy that wasn't", is the lack of synergy between industrial sectors. Small and medium enterprises have mostly been the Cinderellas of the expansion, doing most of the work but denied even the ability to survive with dignity, and any systematic strategy for SMEs has been conspicuous by its absence. Other gaps resulting from lack of synergy are also evident: for example, the domestic steel industry does not produce auto-grade steel, so the automobile industry must import its requirements.

This leads to the third significant failure: the growing lack of positive synergies between agriculture and non-agriculture, and the continued languishing of the agricultural sector (which continues to employ at least half of the labour force despite its shrinking share of GDP) even in period of high product prices.

Another major lacuna has been the lack of sufficient development of infrastructure, which has so many direct and indirect effects on economic diversification that the point does need to be laboured upon. Finally, this has been inadequate as a really positive industrial policy also because there has been no technology policy and until very recently, no attempt at taking the issues of research, development and innovation seriously. Indeed, the most basic way of improving aggregate productivity – providing credit and access to technology, inputs and new knowledge to the small producers who generate the bulk of the productive activity in India – is still ignored.

So India has much to learn from other developing countries that have explicitly and successfully employed industrial policies even in largely market-driven economies. Indeed, if India does not learn from these very different experiences to develop its own more coherent and sustainable industrial strategy, its future economic trajectory is likely to be even more uncertain.

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