Do strong activist policies have their place?

Debate over the form industrial policies should take have been going on for centuries. **Ha-Joon Chang** argues that despite current thinking which is seeking to dissuade adoption of active industrial policies, developing countries should not give up on industrial policies but become more creative in policy design and implementation.

The debate on industrial policy has a long pedigree, going back at least to Renaissance Italy. However, in its modern form, Alexander Hamilton, the first US Treasury Secretary, started the debate when in his 1791 report to the Congress he first formulated the theory of infant industry promotion and proposed a plan to promote US industries through protection and subsidies. In doing this, Hamilton was challenging the leading economists of his time, such as Adam Smith and Jean Baptiste Say, who were arguing that the US should specialise in agriculture (see the quote from Adam Smith on p29). And until the American Civil War settled the matter for good in favour of strong industrial policy, there was a constant struggle within the US regarding the direction of its industrial policy.

Similar debates raged in virtually all of today's developed countries, most of which actually used active industrial policy of the kind usually associated with Japan and other East Asian countries, until they became rich.

After the Second World War, most developing countries adopted interventionist trade and industrial policies, typically known as import-substitution industrialisation (ISI) policies. Today, the orthodoxy argues that ISI policies have failed and therefore developing countries should adopt open trade policy and laissez-faire industrial policy. However, the reality is the reverse – the developing countries grew much faster during the 'bad old days' of ISI than they have done in the last 20-25 years of neo-liberal reform.

And in this post-SWW experience of industrial policy, the East Asian countries stand pre-eminent. While some orthodox economists still try to deny it, most people now accept that active industrial policy played the key role in East Asian economic development at least up to the 1980s.

WHY NO TO EAST ASIAN MODEL?

As it has become increasingly clear that East Asian industrial policy was a success, the orthodox economists have started arguing that, whatever its merits may have been in East Asia up to the 1980s, East-Asian-style industrial policy is not applicable to other developing countries today.

The first variety of this argument is what I call the 'Do not try this at home' argument. The argument is that East-Asian-style industrial policy is too difficult for other countries without the necessary institutions like a competent bureaucracy and therefore is likely to do more harm than good. While it is true that policies need to be calibrated to the capacity of the bureaucracy, the problem with this line of argument is that bureaucratic capabilities are not given but can be built through investment and learning-by-doing.

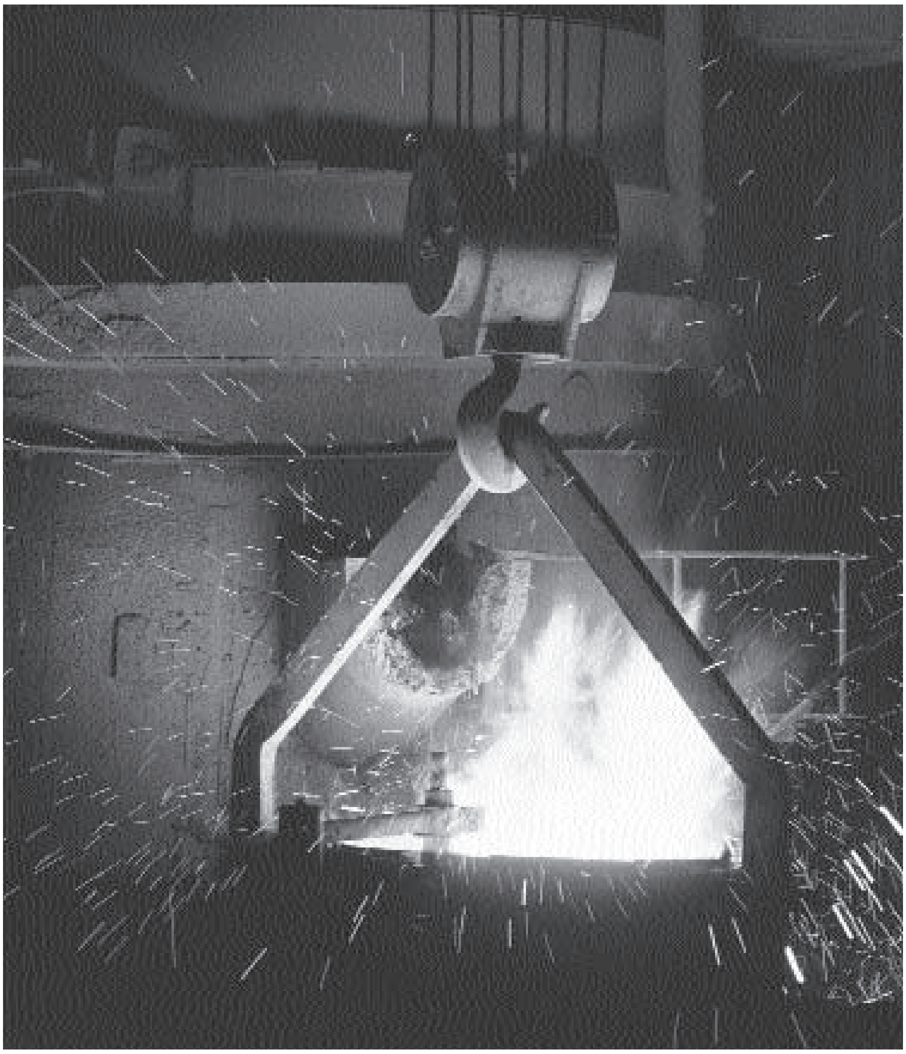
Another variety of the argument against the adoption of East-Asian-style industrial policy in other developing countries today emphasises the recent changes in the global economy. First of all, it is said that nationalistic industrial policies are counter-productive because they will repel foreign investments, which have become vital for economic growth in the new global economy. Second, it is argued that the rules of the global economy have changed, making many tools of active industrial policies illegal.

But how valid are these arguments? Let us examine these two arguments one by one.

In arguing that globalisation has made strong industrial policy counter-productive, the orthodox economists are assuming that deregulation leads to greater foreign investment, which then leads to higher growth. However, empirical studies show that it is growth, rather than deregulation, that attracts foreign investment – China and Vietnam are the best examples. You have to organise a party before people come and play with you – you cannot expect the others to come and organise the party for you. Moreover, whether greater foreign investment helps growth or not depends on the kind of investment you attract, the kind of economy you are, etc.

Having said that, it is true that the development of global value chains has opened up new opportunities to develop through closer integration with Transnational Multinational Corporations (TNCs). However, there is a clear limit to this kind of strategy, as powerfully illustrated by the case of Mexico.

Then how about the changed rules of the global economy, especially the World Trade Organisation (WTO)? It is true that under the



'Were the Americans, either by combination or by any other sort of violence, to stop the importation of European manufactures, and, by thus giving a monopoly to such of their own countrymen as could manufacture the like goods, divert any considerable part of their capital into this employment, they would retard instead of accelerating the further increase in the value of their annual produce, and would obstruct instead of promoting the progress of their country towards real wealth and greatness' (Adam Smith, The Wealth of Nations, 1776, the 1937 Random House edition, pp. 347-8).

However, South Africa is not a helpless victim in this – it has the power to influence the course of events. Its emerging alliance with India, Brazil, and Argentina is slowly but surely beginning to change the geometry of international trade negotiations.

WTO, rules on the use of tariffs, subsidies, etc. have become tighter, but I am not sure whether this means that developing countries should basically give up on activist trade (and industrial) policy.

First, it is not as if everything was allowed under the old regime. Second, tariff reduction under the WTO does not mean a total abolition of tariffs. Third, infant industry protection is still allowed (up to eight years). Fourth, there is still a provision for 'emergency' tariff increase (import surcharge) on grounds of either sudden surge in sectoral imports or overall balance of payments problems, for which almost all developing countries qualify. Fifth, not all subsidies are illegal for everyone – for example, the least developed countries are allowed to use export subsidies, while subsidies for agriculture, regional development, basic R&D, environment-related technology upgrading are still allowed. Sixth, the TRIMS agreement has prohibited certain restrictions on TNCs like local content requirements, but it allows other restrictions such as export requirements. Last but not least, the WTO restrictions only cover 'trade-related' policies, which means that there are many 'domestic' industrial policy measures.

Of course, the currently available policy space for the developing countries is constantly under pressure. There is an on going, albeit currently dormant, attempt to restrict foreign investment regulation (the key element in the so-called Singapore issues). If the developed countries have their way in the current non-agricultural market access (NAMA) negotiations, average industrial tariffs for the developing countries will come down to 5-15% - a level that is historically unprecedented, with a few exceptions – and possibly to 0.

However, South Africa is not a helpless victim in this – it has the power to influence the course of events. Its emerging alliance with India, Brazil, and Argentina is slowly but surely beginning to change the geometry of international trade negotiations.

CONCLUSION

Changing global environment has put new restrictions on the conduct of industrial policy. However, this does not mean the end of industrial policy – it only means that countries need to be more creative in policy design and implementation. There is still considerable room for manoeuvre and in certain areas new opportunities are opening up (global value chain, service outsourcing). Especially when the developed countries are still using industrial policies under different names, it will be unwise of developing countries' governments to give up industrial policy.

LB

This is an edited version of a paper presented by Ha-Joon Chang at a DTI seminar on industrial policy held on 12 October. Chang is an industrial policy expert and professor of Economics, Cambridge University.