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Industrial Policy for Inclusive Growth: An Analysis of Experiences of India and China

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Introduction

The role of the state in promoting economic development remains the subject of lively and evolving debates particularly with reference to industrial policy. The desirability of industrial policy has been a contentious issue among economists. Economic theory can clearly illustrate the market distorting/interfering effects of industrial policy or conversely shows the market failure conditions under which industrial policy is justified. The empirical evidence remains mixed and fraught with conceptual and methodological issues.

In fact, it is not difficult to find instances where industrial policies have failed. The more important point, however, is that it is difficult to find examples of catch-up industrialization where industrial policy has not been widely used. Across the board, industrial policy has enabled rapid industrial restructuring and growth in almost all economies in their respective catch-up phase. The current paper makes a case for industrial policy with special mention to the two emerging global giants, India and China.

Industrial policy has the potential to directly alter the industrial structure of an economy in desired directions. Since industrial restructuring is at the heart of industrialization-based economic growth, the role of industrial policy will need to continue to be an important policy tool. In other words, industrial policy will need to continue to be an integral part of the wider set of government policies. In fact, this paper argues that industrial policy will need to be a fundamental component of policies to achieve the goals of rapid and inclusive growth in Asia. The market on its own simply cannot effectively overcome all the externalities involved. A public-private partnership will be needed to nurture infant industries, develop industry-specific capabilities and achieve scale and coordination. However the role of industrial policy will evolve with changes in the domestic and international economic environment with changes in institutions, technology and human resources, regional integration, new multilateral rules, competition from emerging nations and greater proliferation of economic and global production networks. Moreover, the effectiveness of industrial policy will depend upon the quality and nimbleness of its conception and execution.

The paper commences with an elucidation of the meaning of industrial policy. This is a crucial step in the discussion, since not only does the term mean different things to different people, but the traditional and narrow definitions lead to significantly different conclusions than the more recent and relevant definitions. In the context of definition of the term, the paper also reviews the arguments for and against industrial policy**,** with emphasis on recent viewpoints. The next section discusses industrial policy in the context of globalization, including the evolution of multilateral trading rules. The historical experience of Northeast Asia is brought to bear upon the discourse of global trading rules, because it has been argued that the evolution of those regulations may not permit today's developing economies the same latitude. This section also

touches on the implications for capital controls and financial liberalization of pursuing an industrial policy for catch-up development in the style of Japan and the Tiger economies.

The next two sections discuss the Chinese and Indian economies respectively, exploring in particular their past experience with variants of industrial policies. The similarities of the "China model" to past East Asian experience are explored, while the contrasts of Indian development and the distinction between liberalization and reform are examined. These two major countries form the basis in the subsequent section for a consolidation of recent conceptual ideas, where effective and successful industrial policy is viewed as part of a social contract, creating a pathway to inclusive growth. Regional and other dimensions of inequality are touched on in the discussion of inclusiveness, adding the regional perspective to industrial policy as well. The concluding section provides a summary conclusion of the contentions of the paper.

Meaning and Definition

The term "industrial policy" can have disparate meanings and connotations. It can be defined as any type of selective government intervention or policy that attempts to alter the structure of production in favour of sectors that are expected to offer better prospects for economic growth in a way that would not occur in the absence of such intervention in the market equilibrium. As per the definition, some of the components of the industrial policy are coordination of complementary investments, coordination of competing investments, coordination of policies, economic regulation of technology imports, regulation of foreign direct investment, workers training for firms above a certain size, export promotion and government allocation of foreign exchange, etc.

The foregoing discussion highlights several important conceptual points with respect to the term "industrial policy." Despite differences about the extent and nature of selectivity or about the narrowness versus breadth, the conceptual underpinnings justify and guide the formulations and interventions of policy measures. This is not surprising, since there really is no alternative theoretical basis. Differences in language and in the implications drawn for policy implementation have to do with the nature and extent of market failures. The new conceptualizations of industrial policy, by focusing on the realities of the policy process, incorporate and internalize the broader "State v/s. Market" debate that took place over roughly the last two decades. Again, there are differences in opinions of state capacity and the relative roles of the private and public sectors. But there is a recognition that conflicts of interest exist and have to be dealt with in the heart of the policy process. The middle ground sought by this view stresses "pragmatism" and "balanced strategy.

Globalization and Industrial Policy

The introduction and the conceptual discussion of industrial policies in the previous section included references to comparative advantage and to policies that affect trade. Trade is important for development strategy because it potentially allows developing countries to access higher-

income markets, to achieve economies of scale, to move up the ladder of sophistication and complexity of products, and to provide competitive discipline. These effects are in keeping with a view of recent economic history as one of increased trade openness as an important positive dimension of globalisation. However, there is a possible tension involved in the case for trade liberalization policies because the theoretical case for free trade is principally based on static efficiency gains.

In fact, the precursor of more general justifications for industrial policy was the 19th century infant industry argument, which constituted a case for trade protection to allow domestic producers to achieve learning by doing and scale economies without having to face foreign competition that might never let them take off. In the context of standard trade theory based on comparative advantage, the infant industry argument differentiates between static and dynamic, or current and future comparative advantage, with temporary trade protections, allowing a country to evolve comparative advantages in industries or sectors more conducive to long run growth and higher living standards. Baldwin in 1969, provided an important analytical critique of the infant industry argument, testing it against modern economic theory. He made the case that the requirements for trade protection for infant industries are quite rigorous. Furthermore, potential sources of market failure that could justify policy intervention, such as capital market imperfections, would logically be best tackled by more direct attention, rather than a second-best instrument such as trade restrictions. One of the key newer ideas is that protection against imports is not enough. A developing economy needs to undergo a structural transformation, part and parcel of the process of economic development, and successfully exporting promotes a process of discovery with respect to long-run comparative advantage. This reasoning reinforces the old statement that exports contribute to the development process in more traditional ways, by imposing competitive discipline as well as providing a defence against balance of payments problems. Many economists have identified export promotion as a key characteristic of the East Asian success story, though they differ in the extent to which they credit "industrial policy" interventions by the respective governments.

The importance of trade in considerations of industrial policy for development finds expression in the framing of policy choices in terms of "comparative-advantage-conforming" versus "comparative-advantage-defying" policies for industrial upgrading. The first of these perspectives emphasizes the need to upgrade a country's endowment structure with the state facilitating the best use of activities based on the current comparative advantage. In this view, a country can gradually climb the industrial ladder with the support of a facilitating state. The second, alternative view argues that adjustment costs and the demand for technological catch-up require a greater push from the government. To some extent, the differences in these theoretical perspectives also reflect differences in interpretation of the East Asian experience, and the role played by industrial policy in the export-led development of the success stories of the region.

To the extent that comparative-advantage defying industrial policies have been successful in the past, and provide a framework for the future development strategies of other countries, one important aspect of globalization may restrict this possibility. Globalization has included the development of a stronger and broader institutional framework of rules governing multilateral trade. Indeed, the rapid growth of international trade has been an important portion of the development of the world economy, and the rapid growth of certain lands. Over time, the rules of the World Trade Organization (WTO) have expanded in scope, so that many domestic policies to boost exports - directly or indirectly - that were used by economies such as Japan, South Korea and Taiwan in the 1960s, 70s, and even 80s, no longer conform to multilateral trade rules.

Having argued the case that the WTO's approach may not be allowed adequate policy space for developing countries to pursue industrial upgrading, one must also add a caution that arises from a different aspect of globalization. International production networks, as well as retail-chain buyer-led networks, have become increasingly significant in international trade. These developments do not remove the conceptual basis for industrial policy: externalities and adjustment costs will still matter. If anything, the need for coordination, for achieving scale, and for technology upgrading is greater than ever. If a country has the right start, it may be that multinational firms will themselves invest in achieving these goals with suppliers in that country. A few observations on capital account openness are also in order. The Asian Tigers grew under a global regime of fixed exchange rates and capital controls. One view that emerged in the 1980s favoured capital account liberalization to promote the efficient global allocation of capital. However, capital account openness with flexible exchange rates is incompatible with comparative-advantage-defying industrial policy, and such openness also creates problems for maintaining fixed exchange rates. The experience of regional and global financial crises, however, has diminished calls for full capital account liberalisation.

To sum up the central discussion of this section, the international component of industrial policy has always been significant, because exports support disciplined industrial upgrading. Globalization through greater trade openness has expanded the potential for this policy route. However, globalization has also contributed to the emergence of vertical production networks that increase the complexity of required policies and the demands on state capacity, thereby making it harder to achieve effective policies. Concurrently, the approach of the WTO may not permit adequate recognition of the policy space needed by developing nations that need to upgrade their industrial structures. These issues will be explored further in the context of discussions of China and India in the next two parts, as well as in the subsequent attempt to synthesize arguments for "new" industrial policies as pathways to inclusive growth.

The China Model

In the 1980s, Japan came to be viewed as the first non-Western power to meet the economic clout of Western nations. Its economic success was also regarded as creating an exemplar for the rest

of East Asia, if not all developing countries. While China at the present remains far from Japan's level of development thirty years ago, its size and rapid rise in world trade, particularly for manufactured goods, have made it even more of a focus for observers trying to understand its model of development, and lessons that can be drawn from its experience. The "China model," therefore, is a convenient shorthand term for the distinctive combination of economic policies and political characteristics that appear to have determined China's economic success. The essence of the China model can be summed up as a combination of political authoritarianism with a version of capitalism that combines some free market competition and some elements of state control. In this broad sense, this is not dissimilar to 19th century Germany, pre-World War II Japan, or indeed, South Korea and Taiwan in the 1960s and 70s. The purpose of politics is postponed to a subsequent section, in the context of considering inclusive growth, while in this section the role of the state and industrial policy in China's rise is considered.

It is impossible to do justice in a short space to all aspects of China's development experience over the last three decades, but one can provide a brief overview as a prelude to a discussion of China's approach to industrial policies. In addition to the selective embrace of some characteristics of capitalism, one can mark the important role played by foreign direct investment (particularly from "Greater China," including Hong Kong and Taiwan), regional clusters, as export processing zones, the entrepreneurialism of regional and local government officials, and levels of literacy and health that were probably above the average for countries with similar initial income levels. China has also achieved extraordinary high rates of saving and investment, particularly for its income level. Enormous investment has gone into physical infrastructure, and now the Chinese government is seeking to achieve similar gains in human capital, by upgrading higher education.

Initially, China's growth surge began to labour-intensive manufacturing consistent with its level of income and comparative advantage at the time. Nevertheless, it has been argued that one of China's distinguishing features has been its pursuit of structural change through exports. As a result, China has ended up with an export basket that is significantly more sophisticated than what would be normally expected for a country at its income level. This has been an important determinant of China's rapid growth." To be sure, China exports labour-intensive manufactures that are consistent with its current factor endowments and its levels of income and wages. But it also exports many more sophisticated goods. One therefore has to have an empirical criterion of overall export sophistication.

Even so, the numbers are striking enough to suggest that China has, to some extent, successfully pursued a comparative-advantage-defying strategy. The implications of this analysis are that "what you export matters" not just how much, that China's growth, success cannot be attributed just to high savings and investment rates, and that a country may successfully accelerate its climb up the ladder of industrial sophistication. The empirical analysis does not, however, directly assign the

credit for this process to government policy. For this, one has to rely on case studies of the Chinese experience.

Strategic Emerging Industries

No longer content with being considered the "world's factory," Chinese planners has included several preferential tax, fiscal and procurement policies designed to develop seven "Strategic Emerging Industries" (SEIs). Planners hope these industries will become the mainstay of China's economy in the decades ahead, and they have been chosen sectors where Chinese corporations are expected to succeed on a planetary scale. The seven industries are biotechnology, new energy, high-end equipment manufacturing, energy conservation and environmental protection, clean-energy vehicles, new materials, and next-generation IT. The government is reportedly prepared to spend more than RMB 4 trillion on these industries during the 12th FYP period, with an aim to increase SEI's contribution from today's approximately 5 percent of GDP to 8 percent by 2015 and 15 percent by 2020.

India: Liberalization vs. Reform

While China has caused a dramatic change in policies to pursue economic growth, India's path has been less clearly delineated. It is true that 1991 saw an important shift in Indian economic policy. The Indian rupee was devalued, trade barriers were brought down, and much of an extensive system of industrial licensing controls was dismantled. Nevertheless, it is reasonable to say that India did not immediately embrace the maxim of Deng Xiao Ping, that "to get rich is glorious." Liberalization of controls was not followed by quick or certain institutional reforms that might be required to create a high growth environment. Nevertheless, India has developed rapidly in the last two decades, and its history is complex and somewhat unusual India became independent in 1947, and followed a strategy of "regulating the market," including infant industry protection, import substitution, and industrial policy more generally. Nevertheless, it diverged from the East Asian model in its failure to focus on export promotion or technological catch up through technology imports or foreign direct investment. The exchange rate was overvalued, and inward flows of capital and technology were severely curtailed. While private property was permitted (unlike China) and disasters like China's Great Leap Forward were avoided, India lagged behind China in basic health, nutrition and education indicators, while matching it in per capita income until China's 1978 policy reversal. The acceptance of private property was tempered by a deep mistrust of business, and of market forces: price controls were commonplace.

The Indian apparatus of economic policy making came to be dominated by Five Year Plans, modelled originally on the Soviet version, but without the full array of command and control devices. Even after liberalization, indicative planning has continued as a staple of India's economic policy framework, although it is now mostly a budgeting and strategic thinking exercise. While private sector firms continued to operate, state-owned firms were favoured in sectors viewed as core to industrialization, such as steel, cement, transportation and a range of

engineering goods. A major step taken in 1969 toward state-led industrialization was the nationalization of the banking industry. Despite the inefficiencies, rent-seeking and relatively slow growth of the 1960s and 70s, a case has been made that various facets of India's industrial policies laid the foundations for future growth. Nationalization of banks apparently increased rural lending and lending to the poors even if public sector banks were not efficient. Bank nationalization may also have led to an increase in the savings rate, private equipment investment, and infrastructure development. The investments in heavily subsidized higher education created a skilled workforce that was instrumental in the rise of India's software industry.

Some analyses have argued that India's growth rate began to accelerate in the late 1970s or 1980, well before the liberalization of 1991, and as a result of India's state-led development strategy. Several authors have focused on various aspects of the 1980s, when there was a policy shift away from hostility to "big business," and the beginnings of liberalization in the telecoms sector (albeit in a world where the technologies were very far from today's completely digital networks). The statement made in these cases is that it was more business-friendly attitudes, rather than market-oriented liberalization, that changed India's growth path. Aside from the difference in clarity of policy shifts, India also differs from China in the sources of growth. China has, in many respects, followed the "East Asian" model, not merely in terms of a corporatist state, but particularly in its emphasis on export-oriented manufacturing. India's manufacturing sector, in contrast, has not had the same kind of impressive growth. The share of manufacturing in India's GDP has not changed much, and the services sector has been the leading source of growth. The services sector is quite heterogeneous, and includes transportation, trade and even government services. One of the most dynamic elements of the sector has been business services, including software development.

India's software sector stands out as its most obvious global success story. It has been almost entirely exporting-focused, and been a major contributor to easing India's balance of payments constraints since the 1990s. Its growth rate has been spectacular by any standards. In the early days of the software industry's rise, concerns were expressed about the nature of the work being performed - low-end testing and programming - but the leading firms successfully upgraded their skills and have provided increasingly sophisticated services over time. In many ways, the software sector in India is a classic illustration of industrial upgrading. It has been argued that the foundations of success for India's software sector were set by the industrial policies of the 1960s and 70s - India had a relatively large pool of trained engineering graduates (whose education had been heavily subsidized) and a cluster of public sector science and technology-oriented organizations in Bangalore, where the software industry took off. An alternative view is that the success was accidental, and not the result of deliberate targeting. India's government had envisaged developing a computer hardware industry, and provided investment in that, but the hardware was not at all a part of the growth of India's information technology (IT) industry. Nor was it the case that the engineering graduates who initially got into the industry were specifically

trained in computer science or even electronics - chemical and mechanical engineers also were raised. One of the founders of Infosys, an iconic successful IT company, has also emphasized that the company's success was aided by its freedom from the stifling controls that formed part of India's industrial policy - they were able to fly under the radar because the package was not yet recognized as an "industry" to be specifically determined.

A major distinction between India and China has been in the skill-intensity of their export sectors. Software development involves a much higher degree of education and skills than factory assembly lines, and lower levels of labour intensity. While the success of software services spilled over to a much broader class of business services (IT-enabled services), including call centres, medical record processing, and analytical services, even these require higher education, and language skills not possessed by the vast majority of India's population.

The causes of this state of affairs in India will be taken up in the next section. The symptoms are summarized here. India's employment generation - the elasticity of employment with respect to growth - has continued to be relatively small, although it picked up in the last decade, vis-à-is the 1990s. Composite measures of "economic freedom" or, more specifically, the ease of doing business in India (the World Bank index, in particular) continues to rank India very low, with no upward movement in its rankings in the last few years.

Naturally, there are exceptions, and oligopolistic structures were not inconsistent with the growth of labour-intensive manufacturing in East Asian successes such as Japan and South Korea. Hence, the Indian situation is not necessarily one of unmitigated gloom. If anything, even China still faces challenges of generating additional employment and sustaining its growth. The next section therefore draws on the experiences and situations of the two giants, China and India, to develop an integrated case for a "new" approach to industrial policy.

Pathways to Inclusive Growth

History and recent case studies suggest that industrial policy has been an important aspect of many successful development strategies, even if this conclusion is difficult to support with hard statistical analysis. Industrial policy in this view is not narrow targeting or "picking winners," though every policy has potential differential effects across sectors. The core of the conceptual justification for industrial policy is that market failures are common, especially in developing countries. The cases of India and China illustrate a range of experience with regard to industrial policy, with neither country having hewed closely to the Washington consensus of light-handed government participation in the economic system.

The pre-liberalization Indian case, in particular, illustrates some of the pitfalls of industrial policy, as well as benefits. Government interventions can not only fail to correct market failures, but introduce their own distortions. Industrial policies can create rents that are defended by vested

interests, leading to stifling of innovation rather than encouraging it. The Indian case also illustrates the possibility of discovery of new opportunities, and the need to adapt to these: India sought to acquire capabilities in engineering, including computer hardware, but the information technology opportunity that presented itself came in software, in ways that would have been difficult to foresee even a few years earlier.

More generally, the Indian and Chinese growth experiences illustrate the possibilities of growing inequality along with rising average levels of income, and the challenges that such inequality poses for political and social stability. The management of inequality is often viewed solely as a component of social policy, through redistributive tax policy or transfers, rather than having anything to do with industrial policy. If anything, social policies to ameliorate inequality are viewed as potentially damaging to growth, especially in some developed countries. However, an alternative view, one that is probably more relevant to developing countries, is that growth that is sustainable in the long run has to be inclusive enough, both to upgrade and utilize a country's human resources, and to avoid internal political conflict. This perspective is the punch line of this paper, that successful industrial policy has to be part of a social contract.

The remainder of this section expands on this key idea, of industrial policy for inclusive growth. First, it talks about what it means to for industrial policy to be part of a social contract, relating this formulation to earlier ideas of the developmental state, and of "embedded autonomy." Second, we extend the implications of this approach for domestic regional policy. Third, we relate domestic and international trade aspects of industrial policy, especially in the context of the rise of global vertical production networks. In the end, this section discusses some implications for future possible policy approaches in China and India.

Looking at China, its trajectory may still pursue this path. Its governmental structures and methods of reaching consensus are not dissimilar to other East Asian successes that come before it. The main, and dominating, the difference is China's size and geography, which has taken a very different regional strategy. Export-oriented growth was concentrated in well-demarcated coastal regions, contributing to a significant increase in regional inequality. The regional concentration was also initially influenced by the political target of geographically containing what was then a radical experiment, of shifting quickly from collectivism to capitalist enterprise. The regional events are discussed later in this section. China's size has also meant that it had a much bigger body of rural labour to absorb than the earlier East Asian Tigers, and this contributed to a policy of keeping wages low to fuel continued export growth. At its core, though, China's leadership probably has a well-defined sense of its population as a national entity, and its legitimacy as deriving from that population as a whole.

India's social contract has been much more tenuous. Indian identities are considerably more heterogeneous, and also variable across regions. India's leadership has either been successors of colonial-era models, or had strong regional identities. Furthermore, vertical divisions in Indian society have always been keener than in China. One symptom of these parts has been greater inequality in human development outcomes such as basic health and training, and the failure to create avenues for large-scale employment outside agriculture. The difficulties of managing ruling coalitions in such a diverse democracy, and possibly also lingering ideological suspicion of business may have contributed to India's failure to integrate industrial policy into a "developmental state," or a broad-based, growth-supporting social contract, despite avowed objectives of poverty alleviation and inclusive growth.

The size of China and India creates challenges for Evans' ideal of "corporate coherence." Centralization is not possible to the degree that is achievable in smaller areas. Coordinating layers of governance in both countries add an extra dimension to the social contract and industrial policy formulation. China's initial experiment with capitalism was highly concentrated in particular provinces and even zones within those states. Provincial and local governments, given the opportunity, raced ahead where they could. The central government then had to reassert control, including reforming the tax system to gain more direct control over revenues, rather than relying on the provinces to gather and share taxes. Nevertheless, the variability of the pattern of growth continued, favoured by the initial differential treatment, and the continued emphasis on export-led growth. The coastal provinces that have been the core of manufacturing in China have become much fatter than their inland counterparts. India's regional inequalities have been influenced less by government policy, and more by earlier history. Well before independence, the southern states began to undergo a civil society movement by lower costs for higher rank. After independence, this translated into political power at the state (provincial) level, and policies that tended to support greater social equality, including in areas such as access to education. These lands were therefore better poised for growth after liberalization. The fact that the software industry took off in Bangalore, in the south, was also a significant factor in the recent pattern of regional growth. In other instances, such as those of the western states, longstanding strengths in finance and certain other industries also conveyed advantages after liberalization. Meanwhile, many of the poorer states continued to lack the pre-conditions for substantial growth: literacy rates, health indicators and physical infrastructure lagged well behind other countries. India's pattern of regional development has therefore been somewhat less deliberately determined by policy than China's, and it may be harder to change this pattern through deliberate policy than is likely the case for China.

It is useful to realize, however, that from an economic point of view, external and internal integration are not any different. Industrial policy that promotes the export capability in assembling a particular final product may seek to upgrade by moving on to making some of the

parts that go into the final product. However, the simpler assembly stage does not have to be lost to another country - it may only make a motion within the country to a lower-cost location. For this to happen, industrial policy has to anticipate this possibility, and weigh its costs and benefits. A Singapore does not have any hinterland, and a Taiwan or South Korea is also relatively small, but the regional options for an India or China are many and diverse. Conceptually, therefore, the pure economics of geographically dispersed production networks does not have to be closely tied to national boundaries.

One has to recall that the discussion of the geographic dimensions of industrial policy, as part of a pursuit of inclusive growth, is ultimately tied to the need to generate productive employment throughout a country. China has adopted the classic example of pursuing labour-intensive manufacturing for development and growth. Nevertheless, it has sought to focus on export demand rather than domestic use. This focus has also contributed to increased regional inequality, as has a policy of keeping wages and the exchange rate lower than a possible market equilibrium. Much of India's employment growth has come outside the formal manufacturing sector, either in services or in the "informal" sector. In that sense, India's divergence from a traditional path of inclusive growth is more striking, and less driven by regional inequalities or export-led growth. To the extent that India has to restructure its industrial landscape more dramatically, while facing a demographic bulge in its working-age population, its coming policy challenges may be larger than China's.

Conclusions

The industrial policy for economic development has worked in the past and can work in the future. An important part of this assertion is how one understands industrial policy. It has to be more than top-down targeting or "picking winners," encompassing collaboration with the private sector, and openness to discovery of new opportunities for innovation and growth. This argument is distilled from a considerable body of recent work, which seeks to counterbalance a view that had emerged in the 1980s, downplaying the capabilities of government as a driver of economic progress.

The globalization has altered the economic landscape, creating global production networks that can get to the task of industrial policy more complex. The paper also talks about the role of global trading rules, and notes the dangers of carrying those in ways that unfairly constrain new industrialized among the community of nations. The new academic perspective on industrial policy encompasses these issues. This paper makes a contribution by pointing out the connections between the global and the region, for large countries such as China and India.

There is a lot of importance of the social contract within which any set of industrial policies is formulated and implemented. In the literature, argues, the notion of a social contract as a prerequisite for successful industrial policies is not fully articulated, and this paper begins to fill that gap. The applicability and relevance of this perspective are illustrated here with a detailed comparative consideration of India and China's past experiences with economic policies (including each country's version of industrial policies) and the future challenges that each country faces in pursuing sustained high growth that will take one third of the world's population up to sensible levels of living standards. The arguments presented in this report are therefore central to debates about the role of the government in society more broadly, and in economic development in particular.