

The Industrial Policy Governance Challenge

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Industrial Transformation or 'Good' Governance? Which comes first?

- The question is actually not whether industrial policy needs 'good governance', but whether it needs developmental states of the East Asian variety
- Good governance usually means governance by rule-following states enforcing generalized rules: not seen in developing countries
- However, the successful industrial policies in East Asia required strong governance capabilities to enforce appropriate conditions
- For most developing countries this is just as unrealistic
- East Asian developmental states were based on 'political settlements' (internal distributions of organizational power) that most developing countries do not have
- Nevertheless, industrial policy may still be possible if we can devise policies whose critical components *are* enforceable in their political settlements

What makes industrial policies succeed or fail?

Industrial policy success depends on policy working at three levels

- a) Policy identifies the most critical contracting failures. Most contracting failures require 'policy support' but the *monitoring requirements* and *withdrawal conditions* vary hugely
- b) Governance capabilities exist to implement these conditions
- c) Fortunately contracting failures have *multiple solutions* with different allocations of rents and conditions: experimentation critical to discover what can be implemented in particular political settlements
- Industrial policy has often had poor results because it did not begin by targeting the right problems **or** did not target them effectively **and** did not evolve because rents got captured
- For instance East Asian industrial policies failed in South Asia and failed to evolve to become more effective

Inclusive growth and Organizational Capabilities

- A fundamental problem blocking broad-based growth is the absence of ***organizational capabilities*** to set up competitive organizations even when the appropriate capital and labour are available
- **Difference between quality of capital and individual worker skills and *team productivity***
- ***The ‘knowledge’ of organizational capabilities is embedded in organizational routines*** that can be learnt only through ‘learning-by-doing’ but these investments are subject to substantial contracting failures
- Policy support has to have monitoring and withdrawal capabilities that create effective compulsions for high effort by the team in the learning process: Doing can happen for a long time without much learning

Design of the instruments financing learning is critical

- i) If policy support for learning is provided *ex ante* (eg subsidized credit or import protection) there has to be credible *ex post* penalties to compel high levels of learning effort: in South Korea failure to achieve export targets could result not only in a loss of the subsidy but also a transfer of the plant to other *chaebol*
- ii) Most developing countries do not have political settlements that allowed this kind of enforcement: as a result similar financing instruments usually produced poorer results
- iii) However, there are examples of successful capability development where learning was financed with instruments that were designed differently and created the right ***incentives*** and ***compulsions*** for high effort in other political contexts

Bangladesh's garment industry: Learning using MFA rents

- Multi-Fibre Arrangement or MFA, set up in 1974, created critical but unintended policy rents for less-developed countries
- But critical ingredient was Desh-Daewoo agreement of 1979 underwritten by President Zia of Bangladesh
- Daewoo hosted around 150 Bangladeshis at its factory in Pusan
- The cost of hosting was borne by Daewoo to be paid back in the form of an 8% royalty on the eventual sales of Desh
- The returns for both would come ex post, Desh because of MFA, and Daewoo because of the 8% royalty: both had strong incentives to put in effort, and the promise of future returns allowed them to raise money and invest their own money
- Results were spectacular. Desh grew at close to 100% a year and of the 130 mid-level managers who went to Pusan, 115 set up their own garment factories
- Today close to 5000 factories employing 4 million workers

India's motor car industry

- In the 1960s India produced 50,000 cars of low quality
- But by 2009, India produced 1.8 million globally competitive cars and became fourth largest exporter, including Indian brands
- Success based on the development and upgrading of medium-technology Tier 1 and 2 *domestically owned* component producers
- Central role of a joint venture between an Indian SOE (Maruti) and a Japanese MNC (Suzuki)
- The government provided rents in new ways to create credible incentives for Suzuki to invest in developing capabilities of Indian component producers
- Suzuki was offered a significant prize in the form of a protected domestic market: tariffs were 85% and only declined to 60% by 2006-07
- But Indian government required it to work with Indian-owned Tier 1 and 2 producers to achieve 60% local production in 5 years

Why did these policies succeed in terms of rent management?

- **i) The Size and Time Horizon of the Rents:** Rents have to be sufficient to enable learning-by-doing for long enough for learning to be feasible but not so long that compulsions disappear.
- **ii) The characteristics of the firms getting the rents:** The enforcement conditions are more credible with some types of firms
- **iii) The Policy-Defined Conditions on Rents were Credible:** Governance agencies were enforcing conditions that were credible given the political settlement (exclusion of Suzuki if domestic content was not achieved, conditions of MFA and phased withdrawal could not be manipulated by domestic garments firms)
- **iv) Leadership commitment was real and not rhetorical**

Political Settlements and credibility of financing instruments

