Source : www.thehindu.com Date : 2019-05-19

WHY AN INDUSTRIAL POLICY IS CRUCIAL

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Industry & Services Sector incl. MSMEs and PSUs

The contribution of manufacturing to GDP in 2017 was only about 16%, a stagnation since the economic reforms began in 1991. The contrast with the major Asian economies is significant. For example, Malaysia roughly tripled its share of manufacturing in GDP to 24%, while Thailand's share increased from 13% to 33% (1960-2014). In India manufacturing has never been the leading sector in the economy other than during the Second and Third Plan periods.

No major country managed to reduce poverty or sustain growth without manufacturing driving economic growth. This is because productivity levels in industry (and manufacturing) are much higher than in either agriculture or services. Manufacturing is an engine of economic growth because it offers economies of scale, embodies technological progress and generates forward and backward linkages that create positive spillover effects in the economy.

In the U.S. and Europe, after the 2008 crisis, the erstwhile proponents of neo-liberal policies started strategic government efforts to revive their industrial sectors, defying in principle their own prescriptions for free markets and trade. The European Union has identified sector-specific initiatives to promote motor vehicles, transport equipment industries, energy supply industries, chemicals and agro-food industries. The United Nations Conference on Trade and Development or UNCTAD finds that over 100 countries have, within the last decade, articulated industrial policies. However, India still has no manufacturing policy. Focussing (as "Make in India" does) on increasing foreign direct investment and ease of doing business, important though they may be, does not constitute an industrial policy.

Even neo-classical economists accept government intervention in the case of market failures. Mainstream economists point to specific instances of market failure that require a government-driven industrial policy: deficiencies in capital markets, usually as a result of information asymmetries; lack of adequate investments inhibiting exploitation of scale economies; imperfect information with respect to firm-level investments in learning and training; and lack of information and coordination between technologically interdependent investments. These are good reasons why an economy-wide planning mechanism is needed in India. However, the Indian state should steer clear of the "command and control" approach that harks back to pre-1991 days

So why have an industrial policy in India now? First, there is the need to coordinate complementary investments when there are significant economies of scale and capital market imperfections (for example, as envisaged in a Visakhapatnam-Chennai Industrial Corridor). Second, industrial policies are needed to address learning externalities such as subsidies for industrial training (on which we have done poorly). In fact, industrial policy was reinforced by state investments in human capital, particularly general academic as well as vocational education/training aligned with the industrial policy, in most East Asian countries. However, a lack of human capital has been a major constraint upon India historically being able to attract foreign investment (which Southeast Asian economies succeeded in attracting).

Third, the state can play the role of organiser of domestic firms into cartels in their negotiations with foreign firms or governments — a role particularly relevant in the 21st century after the big business revolution of the 1990s (with mega-mergers and acquisitions among transnational corporations). In fact, one objective of China's industrial policies since the 1990s has been to support the growth of such firms (examples being Lenovo computers, Haier home appliances, and mega-firms making mobile phones).

Fourth, the role of industrial policy is not only to prevent coordination failures (i.e. ensure complementary investments) but also avoid competing investments in a capital-scarce environment. Excess capacity leads to price wars, adversely affecting profits of firms — either leading to bankruptcy of firms or slowing down investment, both happening often in India (witness the aviation sector). Even worse, price wars in the telecom sector in India have slowed profits (even caused losses), which hampers investment in mobile/Internet coverage of rural India where access to mobile phones and broadband Internet, needs rapid expansion. The East Asian state managed this role of industrial policy successfully.

Fifth, an industrial policy can ensure that the industrial capacity installed is as close to the minimum efficient scale as possible. Choosing too small a scale of capacity can mean a 30-50% reduction in production capacity The missing middle among Indian enterprises is nothing short of a failure of industrial strategy. Contributing to the missing middle phenomenon was the reservation of products exclusively for production in the small-scale and cottage industries (SSI) sector (with large firms excluded) from India's 1956 Industrial Policy Resolution onwards. By the end of the 1980s, 836 product groups were in the "reserved" category produced only by SSIs (which encouraged informal enterprises). Astonishingly, in 2005, there were still 500 products in this category, 15 years after the economic reforms were launched. Thereafter the reservation of products of small firms was cut sharply to 16 products. By then, small scale and informality had gotten entrenched in Indian manufacturing. Incentivisation to remain small in scale cost India dearly.

Sixth, when structural change is needed, industrial policy can facilitate that process. In a fast-changing market, losing firms will block structural changes that are socially beneficial but make their own assets worthless. East Asian governments prevented such firms from undermining structural change, with moves such as orderly capacity-scrapping between competing firms and retraining programmes to limit such resistance. Finally, manufacturing will create jobs; its share in total employment fell from 12.8% to 11.5% over 2012 to 2016.

Unfortunately, the potential role of industrial policy has been consistently downplayed in developing countries outside of East Asia ever since the early 1980s after the growing dominance of the orthodox paradigm with well-known consequences in much of India, Latin America and also sub-Saharan Africa.

The East Asian miracle was very much founded upon export-oriented manufacturing, employ surplus labour released by agriculture, thus raising wages and reducing poverty rapidly. This outcome came from a conscious, deliberately planned strategy (with Five Year Plans). The growing participation of East Asian countries in global value chains (GVCs), graduating beyond simple, manufactured consumer goods to more technology- and skill-intensive manufactures for export, was a natural corollary to the industrial policy. India has been practically left out of GVCs. Increasing export of manufactures will need to be another rationale for an industrial policy, even though India has to focus more on "make for India". From 2014 to 2018 there has been an absolute fall in dollar terms in merchandise exports.

In this quest for increased exports, economies of scale are critical. Such economies were not possible with the policy-induced growth of micro-enterprises and informal units (the unorganised sector accounts for 45% of India's exports).

If evidence is still needed that the state's role will be critical to manufacturing growth in India, the state's role in the success story of India's IT industry must be put on record. The government invested in creating high-speed Internet connectivity for IT software parks enabling integration of the Indian IT industry into the U.S. market. Second, the government allowed the IT industry to import duty-free both hardware and software. (In retrospect, this should never have continued

after a few years since it undermined the growth of the electronics hardware manufacturing in India.) Third, the IT industry was able to function under the Shops and Establishment Act; hence not subject to the 45 laws relating to labour and the onerous regulatory burden these impose. Finally, the IT sector has the benefit of low-cost, high-value human capital created by public investments earlier in technical education. Without these, the IT success story would not have occurred. These offer insights to the potential for industrial policy when a new government takes over soon.

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