

The Efficacy of Caribbean Industrial policy in the new era of globalisation

Introduction

Globalisation is not a new phenomenon, but the current episode is probably the most far reaching with respect to the revamping of old ideas and processes. An important area that has come in for serious rethinking is trade and industrial policy. The reality is that the neoclassical paradigm has assumed predominance in this era. This has led to significant acceptance of market forces and open trade policies as catalysts for growth and development. There has been a simultaneous re-evaluation of the role of the state in the economy. The widely held view now is that the state should act as a facilitator to the private sector, rather than directly engaging in productive activity. As a result of these changes, the old import substitution industrialisation (ISI) policies of the 1970s and even 1980s have become largely redundant.

The concern of this brief is whether, and to what extent, industrial policy is still a valid framework for pursuing sustainable development in the Caribbean, in the era of globalisation. It is argued that industrial policy is still relevant in the new era. However, traditional industrial policy must be reformed to accord with the realities of this era of globalisation. Its objective must be to develop long run competitiveness of products and services and therefore should be integrated in an overall economic strategy that promotes the productivity of industries and provide adequate macroeconomic, structural and institutional support. The earlier justification for industrial policy provides a useful starting point for the argument.

The Rationale for Industrial policy

Industrial policy evolved as a basket of policies and strategies to promote industrial development. One definition of industrial policy (Lall 1995) is government intervention in promoting industrialisation. Another is the use of government's authority and resources to administer policies that address the needs of specific sectors and industries, and if necessary, those of individual companies with the aim of raising the productivity of factor inputs (Okimoto 1989). Okimoto's definition better captures industrial policy as practised in most countries, since strategies are geared not only to industrial development, but also to other activities, including services. Industrial policy measures are wide-ranging, including technology subsidies, the provision of industrial parks and facilities, export subsidies, soft credit and tax breaks.

Industrial policy has been justified on a number of grounds. The more important of these include market failure, missing markets and weak technological and institutional capacity. The infant industry argument has provided the classical rationale for industrial policy in developing countries. This refers to the protection of new or infant industries until they are able to compete with foreign competitors. A range of policy instruments was used to provide industrial protection including high tariffs, export subsidies, tax and infrastructure incentives. Advocates argued that protection would eventually be

eliminated since infant industries would grow up. However, in many cases did this not happen in practice.

Industrial policy is also rationalised on the basis of market failure or the absence of markets, a forceful argument in developing countries. Market failure refers to the inability of the market system to provide some necessary goods and services or to provide them in optimum quantities or levels. Classic market failure results where it is virtually impossible to prevent consumers who have not paid for a good or service from using it. This type of good is said to be non-excludable¹ in consumption. This explains the so-called public goods such as defence and education, which have to be provided by the state since the market would not supply them or cannot supply them at optimum levels.

Market failure also results where positive externalities are available. Positive externalities or spill-overs refer to benefits or economies that firms gain from an activity, but which they cannot be charged for. For example, a firm that invests considerable resources to develop a new manufacturing process may not be able to prevent other firms from using it without paying. Positive spill-overs may also result from learning by doing, human capital development and strengthened co-ordination and linkages among sectors. In these cases, social benefits may differ from private benefits and the state might either provide funding for such processes or provide subsidies for firms that undertake them. In South Korea, for example, clusters of firms were promoted through the use of credit subsidies, tax holidays and accelerated depreciation allowances to maximise positive externalities. Today, however, WTO rules limit the use of some of these measures, notably export subsidies.

An important justification for industrial policy in the Caribbean is underdeveloped or missing markets. Undeveloped capital markets, especially for equity financing limit the availability of funding for new investments and reinvestment. Further imperfect competition in the banking sector leads to relatively high lending rates. The banking sector is also strongly averse to risk, particularly lending for green-field investment and to small investors. These structural impediments constrain production and employment creation, since investment in new activities is needed to renew and diversify the production base of the economies. Also, small and medium sized firms (SMEs) are unable to realise their potential contribution to growth and employment. Related to the notion of weak markets is the actual lack of markets for some activities. All of these factors point to a role for industrial policy in alleviating these structural and institutional constraints.

Another rationale for industrial policy is to reduce the high transactions costs involved in doing business in developing countries. Transactions costs are costs that are related to but are not part of the direct or actual production costs. These include the costs of co-ordination of activities among economic agents. In the Caribbean, weak institutional support structures lead to high transaction costs in production and trade.

¹ A good is non-excludable in consumption if non-paying consumers cannot be excluded or prevented from using it or enjoying its benefits.

State co-ordination through industrial policy can help to reduce transactions costs and facilitate industry growth.

In assessing the efficacy of industrial policy today, there is a need to consider the extent to which the justifications provided above hold today. Since the constraints of market failure, positive externalities and other structural bottlenecks continue to exist, the rationale for industrial policy remains relevant.

The Caribbean approach to industrial policy

In the post war period, scholars of development economics in particular Nobel Laureate Arthur Lewis provided the framework for the pursuit of industrial development strategies.² Import substitution Industrialisation was pursued by the Caribbean countries, but not according to Lewis' model of industrialisation, which emphasises export promotion as a significant component. ISI as implemented aimed to replace manufactured imports with domestically produced substitutes to reduce import dependence and to generate employment. Incentives such as tax holidays, the provision of industrial estates, and tariff protection were provided for local industry. Also, institutions such as the Industrial Development Corporations and credit schemes were developed to facilitate industrial development.

Generally, ISI in the Caribbean has failed to meet its objectives. Although it has led to the development of a fledgling manufacturing sector in some countries, especially Trinidad and Tobago, Jamaica and Barbados, it has not met expectations in terms of import replacement, employment and contribution to GDP growth. In fact, it has been argued that import substitution by protecting domestic industry from foreign competition has encouraged inefficient, low quality production in the region. Analysts have argued that ISI primarily benefited rent seeking, enclave industries. Many of the products produced failed to meet international market standards. Further, investment was probably misdirected into areas in which the region had no comparative advantage, while activities with possible comparative advantage were neglected. ISI maintained the high import dependence of the region because of heavy dependence on imported inputs of machinery and raw materials. This led to subsidisation of ISI by the foreign exchange earning export sectors.

Past experience and the realities of today point to two cases against industrial policy. On the one hand, it has not adequately fulfilled its objectives in practice, and on the other, much of it seems to be contrary to trends in liberalisation and globalisation. With respect to the second point, many analysts have argued that industrial policy provides too much of an interventionist role for the state. This it is claimed is contrary to the widely held view that the state should only facilitate private sector activity. Moreover, it is argued that government failure (like market failure) could result in industrial policy going off course leading to the development of uncompetitive industries. In fact, some economists argue that industrial policy is a relic of the past that was suited only to the ISI period. They contend that the focus on export promotion as a growth

² See Arthur Lewis, "The Industrialisation of the British West Indies," Caribbean Economic Review, 1950.

strategy today demands an open and liberalised trading regime with little or no government support for industries. This it is claimed unlocks entrepreneurship and promotes competition that leads to the development of new and better quality products. A classic case has been the rapid development of new products in the Silicon Valley in California in the United States.

Industrial Policy in era of Globalisation

Given the experience of industrial policy and the realities today, one needs to ask, is industrial policy in the region justified today. There are two fairly extreme viewpoints on the issue. One holds that industrial policy is irrelevant and outdated in this era of globalisation, while the other contends that in spite of the new era, industrial policy is still relevant. A more realistic position would lie somewhere between these two extremes. A restructured and reformed industrial policy still has the potential to facilitate sustainable production in the region. The extent to which it is likely to succeed, however, would depend on how far it incorporates the lessons learnt from the mistakes of the past and as well as the demands of competitive production and international obligations. Some aspects of industrial policy as practised during ISI would therefore be untenable today. These include export subsidies, picking of winners and high tariff protection for infant industries.

What type of industrial policy is appropriate today? At the outset, it must be said that industrial policy must be integrated within the overall development strategy of the region. This strategy must entail the development of competitive productive activities to promote growth with improved employment and equity, within an environmentally sustainable framework. The development strategy points to the justification for and the conduct of industrial policy in the new era.

Industrial policy is still justified today for a number of reasons. Indeed, the classical arguments relating to market failure, missing markets and weak institutional structures are still relevant. The real problem lies with the policies that were implemented during the import substitution period. Dispensing with relevant aspects of the policy then would be akin to throwing out the baby with the bath water.

Market failure in the Caribbean today continues to be manifested in areas such as small enterprise finance, technology and skills. In an ECLAC study of the competitiveness of the manufacturing sector in three representative Caribbean countries³ in 1999, the majority of producers noted that affordable finance for business start-ups and working capital was a major constraint on business development and productivity. Careful government intervention through industrial policy is still required to help fill those gaps. Governments still need to provide small enterprise development funds and project development assistance for small manufacturers and agro-businesses in the region. The constraint on government budget means, of course, that assistance must be selective and balanced with suitable output and export performance benchmarks.

³ The countries are Dominica, Guyana and St. Vincent and the Grenadines.

The majority of regional manufacturers and service providers use technology that is below international best standards. Given the crucial role of technology in transforming the production process and driving productivity and competitiveness, it is not surprising that these firms are unable to compete in the domestic and international markets. Many aspects of technology, however, including broad process technology could be classified as public goods. Firms are therefore unwilling to incur the costs of securing such technology on their own. Again, government intervention is necessary to assist in technological upgrading. This is especially vital for small, relatively labour intensive firms that could help to alleviate the unemployment problem in the region. Trinidad and Tobago's "Industrial Policy 2001-2003," for instance, recognises the role of government in promoting and managing a new regime for science, technology, quality and innovation.

Further, because the private sector in the region is fairly weak, selective, targeted technology assistance needs to be provided to small firms. As Lewis noted the engine of growth in developing countries should be technological change, with international trade serving as a lubricating oil and not as fuel. Government action is crucial to accelerating technological change in production in the Caribbean. Government assistance is required to enable firms to obtain basic calibration and other equipment, to increase the use of computer and information technology in production and marketing and to achieve international product standards. Indeed, a number of economists now contend that carefully tailored technology policy, that sought to ensure the best terms for the domestic private sector was crucial to the export take-off in the East Asia Newly Industrialised Countries (NICS). Some of these policies would contradict international obligations today, but proactive technology development assistance is still vital for regional producers.

Another important rationale for industrial policy today is that it could facilitate the development of dynamic comparative advantage based on new technology and research and development applications for example. Dynamic comparative advantage would be built on increasing productivity and efficiency rather than static cheap labour and low price of products. The threat to the Caribbean banana industry results largely from failure to build dynamic comparative advantage. Aspects of industrial policy, including technical, research and development and financial assistance by the state are needed to enhance productivity, product quality and standards. These are crucial to the development of dynamic comparative/competitive advantage in activities such as agro-industry, export manufacturing, information services and tourism. The elements of industrial policy must be clear and transparent with appropriate performance benchmarks to evaluate the performance of firms that receive assistance and incentives. Benchmarks are required to ensure the best cost/benefit ratio in the use of scarce public resources. The use of performance criteria such as export volume contributed to the success of industrial policy in the East Asian NICS.⁴

Aspects of industrial policy are also needed to promote the development of competitive services activities. During the ISI period, little attention was paid to services.

⁴ See Smith, Stephen C. "Industrial Policy in the Developing countries", EPI, 1991.

However, today services are the dominant and fastest growing sector in the region. Moreover, with liberalisation of telecommunications and financial and other services, strategies are urgently needed to enhance the competitiveness of the regional sector. A pragmatic combination of market forces and industrial strategies is required to strengthen productivity and efficiency in the services sector. This relates particularly to the significant impact of technological change on the productivity of the services sector. Given the technology gap, regional producers, especially small producers lack the financial resources and expertise to optimise their use of new technologies. Government assistance and strategies to enhance the diffusion of these technologies are crucial.

A restructured industrial policy can also help to fill some of the structural gaps in the provision of infrastructure in the region. Governments need to generate savings to upgrade and maintain transport systems, ports, custom and other facilities. Some analysts have suggested a targeted percentage of GDP for this purpose.⁵ The United Nations Conference on Trade and Development (UNCTAD)⁶ estimates that the average customs transaction involves 20-30 different parties and 200 data elements. This suggests that improved efficiency of customs systems is crucial to trade facilitation. Information technology should be used to automate customs systems and reduce paper work. Improvement in sea transport, for example, could go a long way in balancing the demand and supply of some agricultural produce for use by the tourism sector at the regional level. Jamaica's industrial policy proposed the use of special investment in infrastructure to reduce costs of doing business in the economy.

Human resource development was also neglected during ISI. However, it provides an important justification for an appropriate industrial policy in this new era. The reality today is that cheap labour is no longer as important an influence on foreign investment as it used to be. The skills, (especially computer literacy) and competence of the workforce of countries are now important determinants of investment flows. In light of the crucial role of foreign investment in the region, industrial strategies for upgrading the skills and productivity of labour are essential. Joint government/private sector programmes are needed to facilitate continuous worker training and retraining, since human capital becomes obsolete like physical capital. Unfortunately, structural adjustment programmes in the region have been weak because liberalisation has proceeded at a pace that runs ahead of the economy's capacity to provide new skills and competencies required by industry [UNIDO 1996]. In a wide-ranging industrial policy document, CARICOM has noted the development of skills, education and training of the workforce to promote entrepreneurship as a priority area. Trinidad and Tobago's Industrial Policy 2001-2003 also highlighted human resource as an area of uppermost priority.

A vital area that is related to human resource development is employment and wages. A reformed industrial policy in the region must make provisions for institutions and incentives that are needed to improve employment and wage levels. One such is the tripartite framework to ensure that wage costs are in line with productivity growth in sectors. In addition, government industrial incentives should strongly promote Small and

⁵ See Wignaraja, G, "Globalisation and Industrial Adjustment", Commonwealth, Secretariat.

⁶ See WTO, "Cutting red tape at the border", 1999.

Medium Enterprises (SMEs) in high value added niches such as tropical fruits and vegetables and furniture, that tend to be more labour intensive. There is also a need for strategies and incentives to promote industries and activities in rural and undeveloped areas to alleviate the problems that result from population growth in urban centres. Technical assistance through business incubators and affordable credit could facilitate cottage industries in these areas.

Industrial Policy and Regional/International Obligations

Other than the mistakes of the past, industrial policy has been criticised for the incompatibility of important aspects with free trade obligations. This is a concern that the region can ill-afford to ignore. The new era has witnessed the increasing “globalisation of domestic policies.” This means that many of the strategies and interventions undertaken during the ISI era are contrary to WTO and the proposed FTAA obligations. WTO obligations limit the use of tariff and non-tariff policies to protect infant industry and export subsidies to promote exports. This means that building infant industries behind tariff and quota protection is now more or less untenable. In any case, both from a theoretical and practical standpoint, the infant industry argument may not be persuasive today.

The Trade-Related Investment Measures (TRIMS) also stipulate boundaries for industrial policy. Importantly, the agreement limits the use of trade-related measures to influence the pattern of foreign direct investment (FDI). For instance, governments are debarred from stipulating that foreign investors use of imported inputs in production be linked to export performance. It is important to note that similar measures such as government co-ordination of foreign technology licensing and measures that linked FDI licensing with trade performance were important in the strategy of the Asian NICS. It seems that developing countries should be provided some scope for selective use of these measures to galvanise production for export. Again such use would have to be linked to performance.

A crucial challenge for developing countries is the prohibition of reverse engineering under the TRIMS Agreement. Reverse engineering-the disassembling of a product to determine how it was designed from the component level up, played a crucial role in industrialisation in Japan and the NICS. Any bar on this mode of technology adaptation and learning could adversely affect the prospects of developing countries in the areas of high value added industry and services such as telecommunications and informatics. Developing countries should be allowed a waiver for a period of time to undertake reverse engineering to develop important industries and services.

The WTO Agreement on technical barriers to trade stipulate that standards, regulations and certification across countries should not hinder free trade. This would limit the scope for the use of such barriers to trade in the region, while also forcing producers to meet international standards in order to export. Industrial strategies in this context must perform a delicate balancing act of facilitating Industrial Organisation for Standardisation (ISO) and other international standards, while ensuring that technical

barriers are not erected against imports. Assistance for ISO certification is vital, since in the UK the average cost of this certification has been put at around £50,000, a prohibitive figure for firms in the Caribbean. It should be noted that in the United States the “competitiveness strategy” provides financial assistance for SMEs to meet such standards. Also, the Airbus consortium in Europe was the product of industrial policy, with the objective of matching the US competition in the airline industry.

Deep industry level targeting or ‘picking winners’ would certainly be frowned upon by the WTO and partners in trade agreements as these would be viewed as too discriminatory. This means that some of the policies that were used in East Asia such as firm level targeting would not be available today. In any case, picking winners may not be a good strategy, as technological change and market changes could quickly turn past winners into losers. What are required are sound institutions and incentives, including prudent macroeconomic and structural policies that stimulate innovation and flexibility among producers.

Conclusion

Industrial policy is still important, even in this market driven era of globalisation. The reality is that market failure, missing markets, structural impediments and the need to develop a pro-business environment mean that industrial policy is still relevant. Industrial policy must be reformed, however, based on the lessons learnt from the mistakes of the ISI period. This means that the specific strategies and the conduct of industrial policy must be changed to meet the objectives of competitive export promotion and international obligations. No longer can incentives be provided to shelter inefficient producers. In fact, there is expected to be much overlap between industrial policy and competitiveness policy. Generally, broad based technology and financial assistance and incentives should be provided. These should facilitate the development of activities in manufacturing and services according to the preference of entrepreneurs. Improved incentives and assistance should be provided to SME’s in agro-industry and manufacturing diversify and strengthen the production base. Strategies for picking winners should be avoided, but this does not preclude the use of selective and targeted financial and technical assistance to some sectors. Indeed, a balanced approach should be taken matching assistance with performance benchmarks where possible. Assistance and incentive must be provided to improve the human resource base through training and retraining, to spur innovation and to increase high quality employment.

International obligations under the WTO and possible the FTAA in the future would constrain the use of direct anti-competitive measures such as tariffs and export subsidies. There is, however, still much room for assistance to promote technology, human capital and research and development. These must be made better use of through joint public sector and private sector co-operation. In the end, however, although industry policy is still justified, its efficacy and success in this new era would depend on the extent to which it is practical, realistic and contributes to growth, employment and sustainable development.

