WHAT WE NEED TO UNDERSTAND IN ORDER TO MOLD ECONOMIC LIBERALIZATION INTO INCLUSIVE DEVELOPMENT

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Context and Policy Problem

In the wake of the debt crisis of the early 1980s, the spread of market liberalizing reform programs throughout the global south was widely seen as the panacea for economies faced with stagnant or negative growth rates. However, the experience of the past twenty years, characterized by periodic economic crises, has raised serious questions about the ability of market liberalization to bring equitable prosperity to most countries of the global south. Only a few of them have been able to take advantage of the opportunities afforded by economic globalization to achieve economic growth and a substantial reduction in poverty. In many cases, unacceptable levels of poverty persist, while inequality has either increased or remained at high levels.

Concerns about poverty and inequality levels gave rise to new initiatives in social welfare policy. Social investment funds, implemented from the mid 1980s, were followed by conditional cash transfer programs, which involved the exchange of small amounts of cash usually to the female heads of households conditional upon taking children to health clinics and keeping them in school. While the original intent of this type of program was to develop human capital among the extremely poor deemed incapable of availing themselves of market opportunities, usually these programs were eventually expanded to include the moderately poor. Conditional cash transfer programs have no doubt contributed to both poverty and inequality reduction. However, while social policy is

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certainly an essential ingredient in the improvement of living standards, by itself it is not sufficient. Inclusive development, defined as a substantial decline in inequality as well as poverty, also (and more importantly) requires employment generating economic growth.

This discussion looks at three cases: South Korea, Chile, and Mexico. Industrial policy[1] played an important role in poverty and inequality reduction in Korea, and in poverty reduction in Chile. The absence of an effective industrial policy in Mexico, has contributed to higher levels of poverty; indeed, since 2006, both poverty and inequality in Mexico increased. There is a very high level of disguised unemployment in Mexico with 65% of the economically active population working in the informal sector. Employment-generating industrial growth is important for inclusive development for two reasons: 1. It raises living standards because it provides employment and therefore steady income for those who had previously been outside of the formal labor force, and 2. It contributes to the tax revenue necessary to provide universal and equitable social protection.[2]

Policy Options

Exactly what kind of industrial policy believed to be preferable has varied markedly over time. From the 1940s through the 1960s, for example, Latin America pursued import substitution industrialization, a strategy supported by the Economic Commission for Latin America (ECLA), which called for the production of previously imported manufactured goods, beginning with light consumer goods and moving backward to intermediate and capital goods. The main policy instruments involved in this strategy were high levels of tariff and quota protection, with the highest protection allocated to light consumer goods, the use of state development banks to provide low-interest loans, and public enterprises to provide cheap inputs such as steel. There were few policies designed to promote exports of industrial products, and little interest (or ability) to target specific industrial sectors for growth and export expansion. Indeed, in Latin America, the penetration of state institutions by industrialists was instrumental in determining which industrial sectors received the greatest support. Both Mexico and Chile pursued import substitution between 1940 and the early 1970s. By the late 1960s, both faced economic stagnation and exhibited uncompetitive industrial sectors, along with a multitude of deficit-ridden state enterprises. Particularly in the case of Mexico, import substitution industrialization failed to provide sufficient employment. By the late 1960s, 40 to 50 percent of the economically active population worked in the informal sector in Mexico.

A much stronger, and more successful, state-led industrial employment-generating expansion characterized the Asian NICs, where state orchestrated export-orientated industrial expansion, produced abundant and increasingly well-paid employment—the key factor in reducing poverty and an important ingredient in keeping inequality low.[3] South Korean policymakers, in particular, took employment considerations into account when formulating industrial policy. Beginning in the early 1960s, the state directed private investment into preferred industrial sectors largely through its ownership of the banking system, nationalized by the regime of General Park Chung-hee (1961-1979) soon after taking power. With a virtual monopoly over bank credit, the government targeted specific economic sectors for export promotion by providing them with low interest loans and loan guarantees. In exchange for such benefits, the government forced business owners to agree to meet export targets and to invest in new factories in the state favored economic sectors since failure to fulfill targets without a plausible explanation risked the recall of loans (and certain bankruptcy) or tax investigation. In this way, the government orchestrated the rapid export expansion of light industries through the 1960s. When in the late 1960s, light industry began to loose its competitive edge, the state used these same methods to support heavy and chemical industries (HCI), targeting industries such as iron, steel, non-ferrous metals, and shipbuilding, electronics and chemical industries.[4] By 1968, total exports were fourteen times greater than they had been in 1960, while the share of manufactured exports of total exports had risen to nearly 75 percent in the same period. Employment in manufacturing, at only 6.8 percent in 1960, rose to 21.7 percent by 1980, higher than Mexico and Chile at the time. Korean manufacturing as a percentage of GDP, at 27 in 1980 was higher than the figures for Mexico or Chile.

A distinguishing feature of South Korean industrial development, important in overall economic growth and employment generation, was the fact that its manufacturing sector became increasingly integrated. Korean government policy explicitly promoted backward and forward linkages among industrial sectors. The state steel company, for example, provided steel plates to Korea's shipbuilding industry, a sector that became a leading exporter. While this input had been 100 percent imported before 1966, by 1976, dependence on imported steel plates had declined to 27 percent. Industrial integration was important for employment generation and poverty reduction because it meant significant expansion and growth beyond just the sectors or firms targeted by government support.

Over the last two decades, however, such statist forms of industrial development have fallen into disrepute given neoliberalism's assumption that state involvement in the economy creates a misallocation of resources with a resultant negative impact on economic growth and export competitiveness. Hence, most Latin American countries, including Mexico from the mid 1980s to the mid 1990s, and Chile between 1975 and the mid 1980s, embarked on market reform programs that involved, among other things, a dramatic reductions in trade protection, the privatization of public enterprise, liberalization of capital flows, and the flexibilization of labor regimes. These policies produced bankruptcies in the import substituting industries of the earlier period. In Chile, especially, a marked de-industrialization (in manufacturing) occurred.

Especially, in the wake of the debt crisis of the early 1980s, World Bank structural adjustment programs, requiring the reduction of tariffs and the elimination of quantitative restrictions on imports, considerably reduced the space for industrial policy. Agreements under GATT and the World Trade Organization (WTO) also restricted the freedom available in industrial policy, although exactly how much maneuverability remains is a topic of some debate. However, TRIPS (Trade-Related Intellectual Property Rights), TRIMS (Agreement on Trade Related Investment Measures), GATS (General Agreement on Trade and Services, and ASCM (Agreement on Subsidies and Counterveiling Measures) have significantly restricted the ability of the state to protect and support domestic industries and to foment their entry into foreign markets. However, for most of the recent period, the multilateral organizations, particularly the World Bank, tolerated, and even promoted, the provision of tax and other incentives for foreign investors to invest in export processing zones.[5]

Most of the policy instruments used by South Korea in the 1960s and 1970s, particularly subsidies to support exports in specific economic sectors, are now no longer allowed under current trading rules. Nevertheless, the Korean case amply illustrates the critical role of an activist industrial policy in achieving inclusive development. Moreover, Korean policy after the mid 1980s and even after 1997 (as we shall see below) retained important activist features which were instrumental in maintaining employment and keeping poverty and inequality low.

Mexico's post mid 1980s economic policies, on the other hand, were woefully inadequate in the area of employment generation, a problem that had been, a long-standing one. Mexican industry features a lack of industrial integration and a sharp dualism. Small and medium firms, providing the bulk of employment (about 70 percent), produce for the domestic market, pay low wages, and have poor working conditions, while large firms, paying high wages, produce for export markets. From the mid 1980s, Mexico abandoned what few sectorally targeted industrial policies it had,[6] and instead, placed faith in the efficacy of its northern export processing zones (*maquilas*) where a quiescent labor force, tax incentives, and lax environmental regulation enforcement, encouraged the establishment of foreign processing plants.

While the Mexican economy experienced spurts of economic growth between the mid 1980s and the mid 2000s, economic crises and sharp economic downturns occurred. In the initial phase of structural adjustment (the early 1980s), the government instituted measures, such as the provision of preferential credit and tax relief, to promote exports among the country's biggest enterprises. Meanwhile, there was the notable absence of an industrial policy supportive of integrated productive chains involving small and medium firms with the potential to become involved in export activities. Instead, the government chose to rely on the maquila program as its primary policy instrument of manufacturing job creation, a poor choice since it came to account for no more than 5 percent of employment. Moreover, given the separation of production stages, the maquilas involved Mexico in an industrialization process that integrated its productive structure into the US economy and involved it in only a single stage of any given production process, thus contributing to the country's lack of industrial integration. Finally, the maquilas, heavily dependent on importation of inputs, failed to stimulate employment in other economic sectors.

On the other hand, from the mid 1980s, Chile was able to develop an export expansion strategy that made an important contribution to poverty reduction. Indeed, an estimated three-quarters of the reduction in poverty that occurred between 1989 and 2000, occurred due to employment creation in new dynamic export sectors and in sectors linked to them. A state-initiated employment-generating export strategy, focusing on non-traditional exports such as forestry products, salmon, fruit and vegetables and wine, began to make headway when the severe financial crisis of the early 1980s forced an abandonment of Chile's radical neoliberal program and allowed this more activist industrial policy to take hold. The policy instruments, however, were considerably less aggressive than those used in South Korea in the 1960s and 1970s and none of them involved semi-coercive measures to ensure investment in favored sectors, nor export targets. State agencies initiated new activities and then turned them over to private sector partners: the state agency, Fundación Chile, for example, began the cultivation of salmon in 1982, and engaged in the first commercial production of salmon in 1986-87. By the 1990s, salmon had become one of Chile's major exports. Moreover, some of the most important state incentives did not involve credit or tax advantages. PROCHILE (Program for the Support of Chilean Exports), which continues its activities today, promoted associations of businesses engaged in developing new export activities, provided technical support and training, and sponsored trade fairs. These types of activities were instrumental in the development of the tomato and wine industries. Mindful of the important role of small and medium firms in employment,[7] Chile also instituted a variety of programs to stimulate and support the export activities of small and medium enterprises (largely through the state development corporation, CORFO). Although assessments of the success of these programs has been mixed, the Chilean government has continued to run programs providing a variety of supports, including preferential credit treatment, to small and medium enterprises with export potential. Nevertheless, Chilean industry, like Mexican industry, remains characterized by dualism and lack of integration. The bifurcation between a high wage earning industrial sector of big export-orientated enterprises and a low wage-earning sector of small and medium enterprises orientated to the domestic market is an important source of inequality. Growing concern for better remunerated employment opportunities and difficulties in moving into markets for manufactured goods not linked to the country's natural resources, prompted a 2006 government report calling for an industrial strategy that would make natural resources springboards to economic expansion. The proposal calls for the introduction of advanced technology in the natural resource sectors where Chile already has a comparative advantage and government support for a variety of sectors including food packaging, food additives, and mining equipment. These industries, the government hopes, will now drive exports and employment growth.

The Korean state has maintained the strongest role in industrial development and export expansion. In the years following the debt crisis, the state maintained its control over the direction of loans by restricting the size of minority stakes and by retaining the government or its agency as the major shareholder of the banks. It was therefore able to increase credit to that important employment-producing sector--small and medium firms.[8] This support, in addition to funds to assist in technological development and tax exemptions, produced an increase in the share of employment and exports accounted for by small and medium firms between 1990 and 1996. During administration of President Kim Young Sam (1993-1997), the government required banks and secondary financial institutions to allocate 45 percent of their annual loan increases to small and medium firms, while local banks were required to allocate 80% of loan increases to this sector. In addition, the government increased investment in research and development so that the ratio of research and development to GDP increased.

With the 1997 economic crisis, South Korea embarked on gradual market liberalization, signing an agreement with the IMF, which stipulated a restrictive monetary policy, the removal of the ceiling on foreign investment, trade liberalization, deregulation, privatization, labor flexibilization, and a close watch on public spending to reduce the deficit. However, the state continued to play an important economic role. In the immediate aftermath of the crisis, for example, the government took decisive measures to improve industrial efficiency through requiring its big conglomerates (chaebols) to concentrate on core industries and by passing regulations obliging them to sell unproductive firms and to reduce the debt ratio of firms. The government also increased its support for small and medium enterprises, establishing a number of programs for the sector, including an export promotion fund of half a billion U.S. dollars to, among other things, help small and medium enterprises with the development of technology and marketing. In addition, the government targeted its support for ten new industries to lead economic growth and it continued to support, largely through the provision of infrastructure, the Information Technology industry. The Korean state has pursued even more vigorous measures in the wake of the 2008 economic crisis including credit guarantees for small and medium firms and targeted support for a variety of industries, including the car industry. Some of these measures appear to violate WTO norms.

Policy Recommendations

1. The successful pursuit of effective industrial policy requires a leadership that is committed to this as a goal. It also requires a bureaucracy that is, at a minimum, sufficiently autonomous from private sector interests so that vested interests, particularly powerful conglomerates, are not afforded the opportunity to engage in rent-seeking that distorts the intent of industrial policy. To counterbalance potential pressures exerted by such interests, policymakers should consider the following:
    a. fostering greater representation for small and medium firms on advisory councils within the state.
    b. stimulating public discussion and support for the expansion and success of small and medium firms in view of their potential positive impact on poverty and inequality reduction.
2. Governments should vigorously pursue industrial policies that fall within WTO

guidelines such as those used by Chile (the promotion of exporting employers' associations, technical support for potential exporters), and infrastructural support and investment in research and development (Korea).

3. Government policy should support the expansion of small and medium enterprises in areas of potential export expansion because policies that support their integration with more dynamic sectors of the economy and into export markets will contribute to more and better remunerated employment opportunities. The most successful policies have been implemented by Korea while neglect of the sector in the case of Mexico has had deleterious consequences.
4. Since today's trade rules currently restrict industrial policymaking space, governments should lobby vigorously for greater latitude in industrial policy.

Notes

[1]I use the term "industrial" broadly to refer not just to manufacturing but also to any new processing/transformative activities.

[2] One of the notable features of most Latin American countries is the historical inequality in social protection with the most generous social protection (social security) going to the most organized sectors of the middle and working class. This has been, to a considerable extent, a reflection of in adequate formal employment generation.

[3] However, the Asian NICs also provided protection to domestic industries, hence pursing simultaneously both import substitution and of export promotion.

[4] In the second half of the 1960s, 60 percent of investments in manufacturing went to only three industries: petrochemicals, steel, and machinery. Initially, the process of allocating large investments discretionally fostered many incompetent firms.

[5] While the WTO has curtailed some tax advantages, others, such as border tax adjustments, remain acceptable.

[6] Sectoral programs existed for auto parts and pharmaceuticals.

[7] If legally recognized microenterprises (5 or less employees) are included, small and medium (SME) enterprises account for 77% of employment; if microenterprises are excluded, the figure is about 50%.

[8] In 1997, small and medium firms accounted for about 69 percent of employment.