Scaling the Efficiency Frontier
– Institutions, Innovation, and Inclusion

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Malaysia’s Achievements

- One of the fastest-growing economies in the world in the last half a century

- Has upgraded itself out of ‘traditional’ natural-resource industries (rubber and tin), first into ‘new’ natural resources (e.g., palm oil), then into processed natural resources (e.g., processed palm oil), and into manufacturing (electronics and others)

- Reduced inter-ethnic economic imbalances since the 1970s

Malaysia's Challenges I

- However, not as fast-growing and not as structurally transformed as countries like Japan, Korea, and Taiwan (Middle-income Trap?)
- Inequality is still high (Gini coefficient 0.45; Sweden 0.23, Finland 0.25, Korea 0.30, US 0.38, Mexico 0.47, as of the late 2000s)
- Has failed to develop national firms that can compete at the top ends of the world market (that is, no Toyota, Samsung, or HTC), even in government-promoted industries like automobile and steel (petroleum is a partial exception)

  - The high share of high-tech goods in manufacturing exports is basically thanks to foreign companies.

Malaysia's Challenges II

- Given all of this, Malaysia needs to think about a new development strategy.
  – Need to become far more than a high-income economy according to the World Bank classification (per capita income over $12,746 at the moment) – countries that we typically call 'advanced' typically have per capita incomes above $35,000
- This requires developing productive capabilities, which in turn means:

  - increasing the capacity to innovate

  - providing institutions to encourage innovation and its diffusion

  - making the process more inclusive, not simply to increase equality but also to help innovation itself

How to develop the economy I

- ***Not* by doing what comes ‘naturally’.**
- Except for a few oil-states, no country has become rich by relying on natural resources and no country, even including those oil-states, have become economically developed in that way.
- A lot of ‘natural’ resources are actually the results of someone else’s industrial policy in the past.

- Malaysian rubber (the British)
- Indian tea (the British)
- Indonesian coffee (the Dutch)
- Ghanaian cacao (the British)
- Australian wool (the British)
- Argentinian beef and leather (the Spanish)

How to develop the economy II

- ***Not* by following comparative advantage**
- Comparative advantage simply means that you are better at some things than others, even though you may be worse than everyone else at those very things ("specialise in things in which you are the least bad at.")
- In the short run, sticking to comparative advantage industries may maximise the benefits of international trade for developing countries.
- However, in the long run, sticking to comparative advantage usually locks them into activities that have little prospect for productivity growth and hampers economic development.

How to develop the economy III

- ***Not* by following comparative advantage (continued)**
- The smooth transition from labour-intensive industries to capital-intensive industries with a rise in a country's income (and thus rising capital/labour ratio), which is assumed in standard textbooks, does <u>not</u> usually happen.
  - Entering new industries requires acquiring productive capabilities (e.g., organsational structure, managerial techniques, engineering capabilities, worker skills) that can only be developed through production experiences (This is why 'turnkey' projects don't work.)
- All of this means that economically backward countries need to use industrial policy in order to deliberately get out of activities in which they have comparative advantage and get into activities in which they don't.

How to develop the economy IV

- ***Not* by following comparative advantage (continued)**
- This is indeed what today's rich countries have done to become rich.
- When they were poor, they were also suppliers of natural resources and cheap labour and they deliberately protected and subsidised high-productivity activities in which they do not have comparative advantage.
  - British wool, American cotton, German silver, Japanese silk, Finnish logs, Korean tungsten (and cheap labour)
- When it comes to high-end economic activities, countries become good at certain things only because they <u>decide to become so</u>.
  - Japanese cars, Korean steel, Finnish mobile phones

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Ha-Joon Chang

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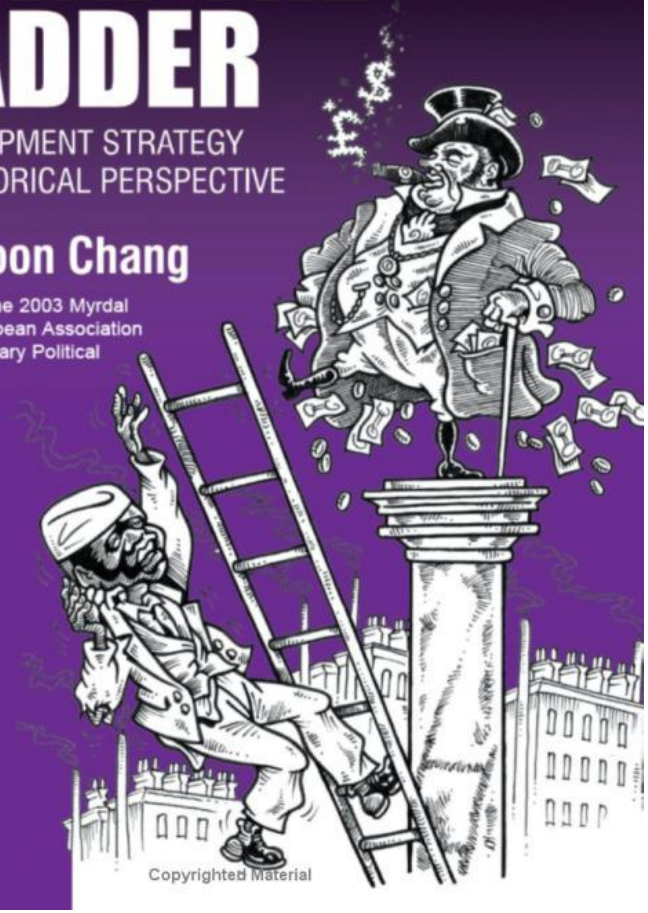

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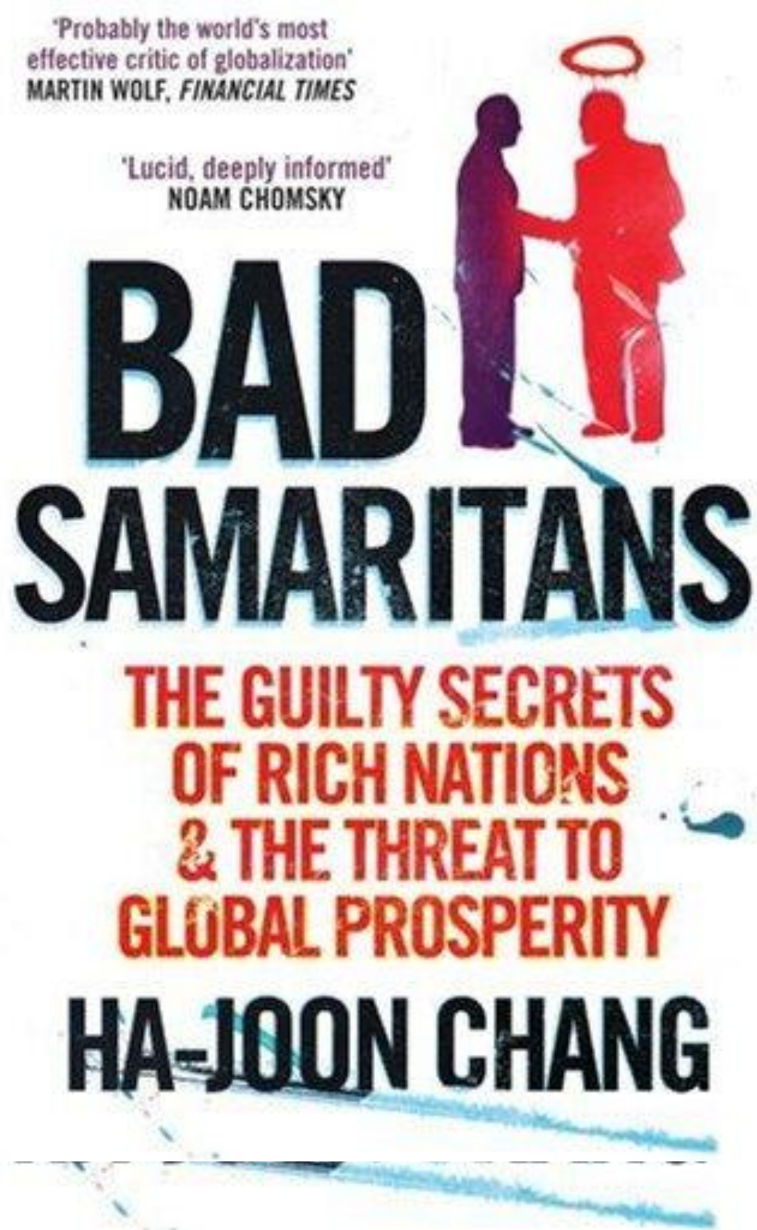
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Economic Development and Innovation I

- The process of economic development can be seen as the process of the enhancement of the ability to 'innovate'.

- People often think of 'innovation' as the invention of world-leading technologies or products, but economic development is in its essence a process of innovation, as it means doing new things – producing new things (Schumpeter's product innovation), producing the same things differently (process innovation), and exporting to new markets (opening up of new markets).

Economic Development and Innovation II

- In this sense, even countries that are not on the international technological frontier are engaged in ‘innovation’ when they develop their economies, as they can do this only by doing new things and doing things differently.

- Indeed, Albert Hirschman, argued that economic development, “depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilised.”

Encouraging innovation I
– Individual vs. Collective Entrepreneurship

- In the classic study of innovation and entrepreneurship, Joseph Schumpeter emphasised the role of visionary entrepreneurs.
  - This is why he – mistakenly – predicted the slow death of capitalism, with growth in firm size and the consequent rise of professional managers (‘executive types’, as he disparagingly called them).

- However, entrepreneurship has always had a collective dimension (which is why capitalism hasn’t died despite the rise of professional managers!) and the collective dimension has become even more important today.

Encouraging innovation II
– Individual vs. Collective Entrepreneurship (continued)

- Today, it is not just the visionary business leaders (very important they are) that determine how innovative a company is.
  - Knowledge and initiatives of 'the other guys'(e.g., middle managers, R&D scientists, production line workers, people working in supplier firms) matter.
  - The company's organisational characteristics (e.g., how the managerial hierarchy is organised, how different units cooperate and compete, how much autonomy workers are given) matter
  - The institutions surrounding it (e.g., the financial system, bankruptcy law, the welfare state) matter

Encouraging innovation III
- How to encourage entrepreneurship

- People often say that entrepreneurship is about risk-taking.

- However, innovation is <u>much more than risk-taking</u>, in which the chance of success is already known in probabilistic terms.

- It involves being ‘irrational’ and leaping into the unknown.
  - Entrepreneurs are irrational by definition because they are doing something that everyone else thinks is going to fail (otherwise everyone else will be doing it too).

Encouraging innovation IV
- How to encourage entrepreneurship (cont’d)

- Many people believe that people become more entrepreneurial when they are not protected and exposed to greater competitive forces.

- This argument is frequently used in advocating deregulation and trade liberalisation.

- It is also frequently used against the welfare state.
  – “The European countries have less dynamic economies than the US because they have bigger welfare states.”

Encoding innovation V
- How to encourage entrepreneurship (continued)

- But people become <u>more</u> conservative when there is too much insecurity and there is no ‘second chance’.
  - Since the 1997 financial crisis, ‘safe’ professions – such as lawyer, civil servant, and especially medicine – have become exceptionally popular in Korea.
  - This is because, following the crisis, job security has fallen dramatically (e.g., virtual end to ‘lifetime employment’, fall in the share of workers with permanent contracts) and the welfare state remains very weak (the second smallest in the OECD, after Mexico).
  - This has resulted in mal-distribution of talents (e.g., 80% of top 2% students in the science stream in Korea are estimated to go to medical schools, which means that a lot of those with greater aptitude for science/engineering are practicing medicine, while potentially good doctors work in science/engineering jobs.)

Encouraging innovation VI
- How to encourage entrepreneurship (cont'd)

- Implicitly recognising this relationship between security and entrepreneurship, societies have built <u>institutions</u> that encourage entrepreneurship by reducing the downside risk of doing new things ('socialisation of risk').
- Limited liability
  - Has encouraged people invest in large-scale ventures by capping the downside losses
- Bankruptcy law
  - Has given second chances to failed businessmen by providing debt standstill (temporary protection from creditors), restructuring, and forgiveness

Innovation AND Social Inclusion I

- In the same way as limited liability or bankruptcy law, the welfare state can also be understood as an institution to encourage entrepreneurship and innovation.

- By providing minimum living standards for everyone, it can encourage aspiring entrepreneurs to try new things more willingly.
  - **"Secure people dare."** – a famous slogan of the Swedish Social Democratic Party

Innovation AND Social Inclusion II

- Moreover, the welfare state can facilitate industrial restructuring and thus economic development by making workers more accepting of changes, especially if it provides not just income support and unemployment insurance but also subsidised re-training and re-location, as in Scandinavia.

- In this sense we can see the welfare state as the ‘bankruptcy law for workers’.
  – workers more willingly invest in acquiring specialised skills because they know they won’t be thrown to the scrap heap of history, if conditions change and their skills become less useful

Innovation AND Social Inclusion III

- The ability of the welfare state to make people more daring and accepting of changes is one reason why countries like Finland and Sweden have grown faster than the US.

- = Especially Finland – despite having a welfare state that is one-and-a-half times bigger than that of the US (as a proportion of GDP), between 1960 and 2010, Finland's average annual per capita income growth rate was 2.7%, against 2.0% in the US
  - This means that, during this period, the US income rose 2.7 times while Finland's rose by 3.8 times.

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A PELICAN INTRODUCTION

Economics: The User's Guide

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Social Inclusion I

- Once we see the welfare state in this way, we begin to see that social inclusion is not just a matter of ‘sharing’ but also of promoting entrepreneurship, economic restructuring, and economic development.

- Of course, many people think that a comprehensive citizenship-based welfare state of the European kind, which I have used as an example, are just ‘pipe dreams’ in developing countries like Malaysia.

Social Inclusion II

- However, let’s not forget that the European countries themselves did not have the kind of welfare state they have today in the past.
  - First welfare schemes were set up in 1871 in Germany by the Chancellor, Otto von Bismarck, and spread only slowly.
  - Sweden, the country with ‘model’ welfare state, didn’t even have an income tax until 1932.
  - In most countries, the comprehensive welfare state they have came into being in the 1950s and the 1960s.

Social Inclusion III

- Moreover, there are other, less difficult-to-establish, ways of providing the ‘inclusion and innovation’ functions of the welfare state, although these are inevitably less equitable than citizenship-based welfare state.
  - Subsidies and other supports for small farms and small and medium-sized enterprises (SMEs)
  - Subsidies and other supports for economically backward regions

Social Inclusion IV

- Empowerment, affirmative action, and other supports for economically disadvantaged groups (e.g., ethnic groups, women)

- Subsidies for products used more by poorer people (e.g., basic foodstuff)

- Greater participation of workers in the running of the production process (e.g., Japanese ‘lean production’) and even in key company decisions (e.g., German co-determination system)

Concluding Remarks I

- In order to take its economic development to another level, Malaysia needs to develop its productive capabilities in ‘non-natural’, ‘comparative-advantage-defying’ high-productivity activities (manufacturing and high-end services).

- This requires encouraging innovation and entrepreneurship in the broadest sense – not just by a small number of visionaries but at all levels of the economy, down to the production line worker.

Concluding Remarks II

- Encouragement of innovation requires the development of institutions that reduce the downside dangers of ‘trying new things’.

- Institutions like limited liability and bankruptcy law are the obvious examples, but even the welfare state can be seen as playing such role by providing the ‘safety net’ to budding entrepreneurs and workers.

- Seen from this perspective, the welfare state is not just a means of inclusion but also of promoting innovation and economic development.

Concluding Remarks III

- Only when we see innovation, institution-building, and social inclusion as complementary elements in an integrated strategy of economic development, will we be able to build a truly dynamic, equitable, and sustainable economy and society.