DCED

The Donor Committee for Enterprise Development

Private Sector Development Synthesis Note

Industrial Policy

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Some argue that Industrial Policy is the only paradigm that delivers real economic growth and transformation. "Development is fundamentally about structural change: it involves producing new goods with new technologies and transferring resources from traditional activities to these new ones" (Dani Rodrik, 2007). Similarly, developing countries can never emerge from aid dependency "if they are unable to use the industrial policies (which) they will need to transform their domestic industries, diversify their economies and build up their own tax bases over time" (Rick Rowden, 2011).

But others argue that it has rarely worked, because it can be captured by vested interests, or because it is not possible for civil servants to 'pick winners'. The evidence used to support both arguments may be based on the same examples, yet interpreted or framed in different ways; India's car industry and Bangladesh's garment industry are used to show both that liberalisation 'works', and that industrial policy 'works' (Khan 2014). Clearly more research and clarity are needed to resolve these debates; meanwhile, this Note starts with an overview of industrial policy definitions; it then explores six key issues of relevance for anyone interested in industrial policy.

>> Definition of Industrial Policy

UNCTAD defines industrial policy as a "concerted, focused, conscious effort on the part of government to encourage and promote a specific industry or sector with an array of policy tools". The World Bank considers industrial policy as "government efforts to alter industrial structure to promote productivity-based growth". Pack and Saggi provide a more detailed definition: "any type of selective intervention or government policy that attempts to alter the structure of production toward sectors that are expected to offer better prospects for economic growth than would occur in the absence of such intervention, i.e., in the market equilibrium." Industrial policies can apply to manufacturing as well as agricultural or service sectors. For example, Dani Rodrik states that industrial policy "is not about *industry* per se", but that "policies targeted at non-traditional agriculture or services qualify as much as incentives on manufacturers".

>> 1. Is Industrial Policy Good? If So, When Is It Practical?

The growing interest in industrial policy among development practitioners partly relates to Western governments' interventionist responses to the Financial Crisis. Meanwhile, the success of many East Asian economies, most recently China, is often associated with industrial policy. Some advocates of industrial policy such as Ha-Joon Chang also argue that despite their promotion of free markets abroad, **rich countries have often used industrial policy as part of their own development strategies** (Chang, 2008).

On the other hand, critics stress that **poorly-designed industrial policies risk having worse outcomes than the market failures they seek to address**. Some argue frequent shortages of transparency and technical capacity among policymakers in low-income countries make poorly-designed industrial policies likely. A separate concern relates to the practicality of industrial policy; international trade agreements outlaw many active industrial policy tools, although Least Developed Countries are sometimes allowed greater flexibility.

While debates continue over the merits of industrial policy, attention is increasingly focused on *how* to design and implement it. Four "how to" issues currently discussed among experts and practitioners are outlined below.

>> 2. What kinds of industrial policies are effective?

One aspect of this debate is **whether governments should use industrial policies to make the most of their country's current comparative advantage, or instead invest in higher-productivity industries that are not competitive in the short-term.** According to Justin Yifu Lin, World Bank Chief Economist, where industrial policies fail this is "due mostly to governments' inability to align their efforts with their country's resource base and level of development" (Lin, 2010). For Lin, developing countries should first seek to profit from the (mostly labour- and resource-intensive) products and services that they are currently most competitive in. They will accumulate human and physical capital in the process. This capital, Lin argues, can be reinvested over time in more productive industries. An article in The Economist draws similar conclusions.

Ha-Joon Chang, in contrast, argues that developing countries should defy their comparative advantage. For Chang, the cost of moving capital between industries (e.g. from sewing machines to car plants) means that countries should actively promote high-productivity industries at an early stage in their development. A debate between Justin Yifu Lin and Ha-Joon Chang provides more information on this topic.

Based on empirical analysis of 20 developed countries, a report by the McKinsey Global Institute supports Lin's view that industrial policymakers should care more if an industry is competitive, than if it is high-tech. The McKinsey report also finds that the growth and job creation potential of non-tradable sectors such as retail and telecoms is often underestimated.

Some argue that while manufacturing should be given special policy treatment, governments should not favour particular manufacturing industries (UNIDO, 2011). One way to do this is by improving the infrastructure that manufacturers require, e.g. by promoting industrial clusters (UNIDO, 2009). The creation of export-oriented Special Economic Zones is a well-known example of this. Critics argue that such an approach may only attract short-term investment, achieving little if any positive spill-over into the wider economy (Good and Hughes, 2002).

>> 3. How does Political Economy affect industrial policy?

One dilemma for policymakers in developing countries is that while the "the *need* to correct market failure is much greater than it is in rich and institutionally advanced societies, the *ability* of the public sector to tackle such failure is also much more limited" (Altenburg, 2011). Similarly, it is frequently argued that successful industrial policies in East Asia were only possible because of very specific organisational and structural distributions of economic and political power which may not be present in the many of today's developing countries.

For example, governments in East Asia had good relations and continuous dialogue with the private sector. In some developing countries the reverse is now true: the majority of business owners are allied to the political opposition. Fairness was another critical success factor in East Asia's industrial policies; the granting of privilege was made conditional on export performance (Sanjaya Lall). Dani Rodrik points to a related factor: governments' ability to recognise mistakes and withdraw their support before it becomes too costly. In South Korea, for example, failure to achieve export targets could result not only in a loss of the subsidy but also a transfer of the plant to another *chaebol* (industrial conglomerate) (Khan, 2014). Where the threat of such enforcement practices is credible, firms have the incentive to increase their competitiveness; this is however unlikely to be the case where clientelistic and patrimonial governance systems increase the risk of policies being captured by special interest groups (Khan, 2013). Furthermore, the skills and resources needed to design, implement and monitor industrial policies are often lacking in developing countries.

Some therefore argue that **the lower the government's capabilities, accountability and commitment, the lower the sophistication of industrial policies that the government can be trusted with** (e.g. Sanjaya Lall). Where certain pre-conditions are not present, and the risk of political capture is too high, it may be necessary to focus on accountability-enhancing measures and the promotion of a business-enabling environment (e.g. Kaufmann and Krause 2009). Altenburg however observes that **some governments have succeeded in promoting industrialisation** and developed more efficient and transparent bureaucracies, **despite their poor performance in other aspects of governance**.

This resonates with Khan (2012) who suggests that **gradual successes in industrialisation can also be achieved in countries with less favourable political settlements**, through narrowly defined and pragmatic industrial policy strategies that take into account the country-specific economic and political context. Strategies should be designed in incremental ways, starting with critical constraints in potential growth sectors where it seems feasible to develop relevant governance capabilities, and to deliver results. Similar to Lin (see section 2), Khan argues that the simplest strategy for a country would be to begin with sectors which have already achieved global market presence or where growth has been higher than in others. "If we begin with these sectors and ask how capacity expansion, technology upgrading and increases in value addition could be accelerated, government agencies and governance capabilities could be developed accordingly" Khan (2012). Over time, new capabilities and lessons learnt could then gradually be transferred to strategies for other sectors.

>> 4. Is industrial policy compatible with business environment reform?

The donor community for many years has been supporting reforms in developing countries that improve the business environment by reducing legal, institutional and regulatory constraints for doing business and promoting a better investment climate (DCED, 2008). Though this also aims to contribute to the development of the private sector, it is often seen as very different to industrial policy as the latter involves direct interventions to overcome market failures and change the structure of the economy.

A recent DCED paper (DCED/Weiss, 2013) assesses how compatible these two approaches are. **Business environment reform is more reconcilable with strategic industrial policy, a more recent approach that focuses on horizontal (non-selective) and market-supporting interventions**, and encourages government and private sector dialogue. The potential for contradiction is greatest where industrial policy uses vertical measures, focused on specific sectors or firms. The paper suggests that differences can be reduced by industrial policy focusing on limited priority areas where an economy has a latent comparative advantage that can be turned into actual competiveness with relatively modest and short-lived support.

>> 5. Does industrial policy serve the poor?

Industrial policy is often guided by multiple objectives. These may include stimulating innovation, productivity and growth, reducing regional and income inequalities, food and energy security, job creation and poverty reduction (Lütkenhorst 2010, in Issue 3 of *Making it*). Of major interest to the development community is the question whether or not industrial policy is pro-poor.

Assuming that poverty reduction is a major priority, and accepting that there is often a short-term trade-off between equity and growth, disagreements over the main aim of industrial policy reflect the range of views on how likely the poor are to benefit from economic growth in general. Altenburg (2011) cites evidence that growth is not inevitably good for the poor and argues in favour of **'inclusive industrial policies'**. He defines these as policies that aim to promote "structural change in a way as to enhance competitiveness and productivity growth while increasing the incomes of the poor more than proportionally". Such policies may involve safeguards for vulnerable groups, a focus on labour-intensive industries, or the strengthening of linkages between SMEs and larger firms.

Others argue that industrialisation and labour-intensive manufacturing may offer great economic opportunities for the poor in the medium to long term, but that it is critical to **complement industrial policies with measures to improve incomes for poor workers in the short-term** – in particular through support to agricultural productivity and rural household enterprises (e.g. Louise Fox, 2014; Page and Shimeles, 2014).

>> 6. What Can Donors Do?

Donors can pay experts to **build partner governments' capacity to design, implement and monitor their industrial policies.** For example, experts can advise partner governments on how to update the regulations governing their target industries. Donor-funded technical experts can also help to design and implement reforms that improve the performance of public agencies which support the overall functioning of the target industry. GIZ and UNIDO, for example, have provided technical assistance to investment promotion agencies.

Donor-funded experts can also help to improve the **policy formation process**, both from a technical point of view, and by using their influence to push for transparency in public-private dialogue. The latter helps to reduce the risk that industrial policy is unduly biased towards special interest groups.

As a complement to industrial policy, donors can support partner governments' efforts to grow priority industries by ensuring that the **service markets which support these industries** function well. Strengthening markets for business development services, for example, can assist firms to upgrade their management practices, make well-informed decisions about which new technologies to adopt, and lower their costs through greater resource and energy efficiency. The Ethiopian-German Engineering Capacity Building Program and UNIDO's Resource Efficient and Cleaner Production Programme are two examples of programmes in this area. Donors can also assist technology transfer by helping firms in target industries to partner with technologically-advanced firms in their home countries, through their network of contacts or through trade fairs. Similarly, donors can promote investment in the physical infrastructure that target industrial clusters depend on. Better railways, roads and ports in the areas where governments' priority industries are concentrated help these industries to grow.

It may however not be enough for donors to simply rely on technocratic approaches to industrial policy support; an important success factor is **how industrial policies are communicated to partner governments**. Because of public perception that industrial policy has failed in many cases, some governments are demoralised and lacking in confidence. Other governments may themselves be sceptics of the development potential of industrial strategies. This means that donors not only need evidence and success stories of industrial policy when communicating with governments; 'framing' industrial policy support in a way that resonates with the values and beliefs of public officials may be equally important. Adapting rationales and language in responsive, flexible ways when discussing whether and how governments should promote structural change can therefore be a key ingredient of successful donor strategies.

>> Click on the following link for the DCED's Industrial Policy Knowledge Page, with a range of useful resources on the theme: www.enterprise-development.org/page/industrial-policy