Industrial Policy: What, Why and How?

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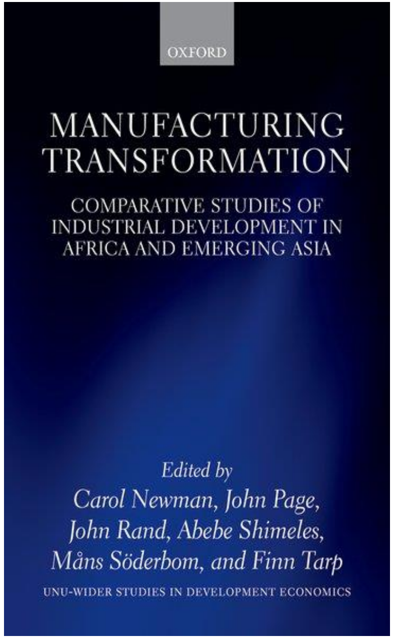
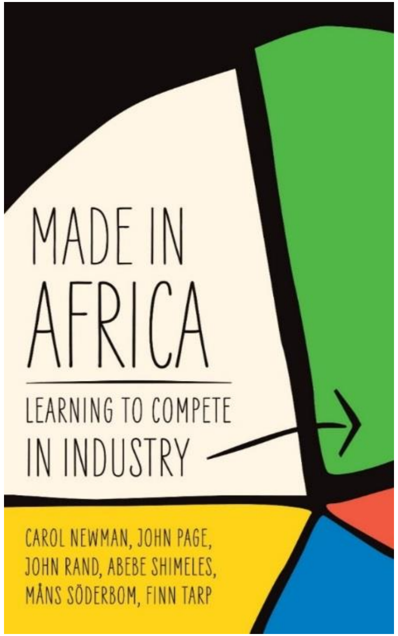
About this MOOC

- Attempting to bring the Brookings-WIDER research program on *Jobs, Poverty and Structural Change in Africa* to a broader audience.
- A multi-year, multi country comparative research program with a focus on firms.
- Use of mixed methods including case studies, quantitative and qualitative analysis

The Brookings-WIDER Research Program

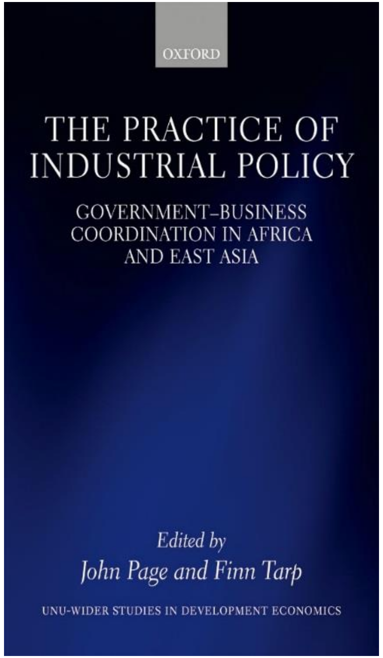
- We began with *Learning to Compete* (with AfDB)
- Which tried to answer the question
  - Why is there so little industry in Africa?





About this Lecture

- *Learning to Compete* got us thinking about the why and how of industrial policy
- That led to research on government-business coordination in Africa and East Asia
- That book is the basis of today's lecture.



What: Industrial Policy Defined

- Policies that stimulate specific economic activities and promote structural change (Lin; Rodrik; Stiglitz)
- Interventions can cut across many areas of public policy
  - Macro policy
  - Trade policy
  - Fiscal policy
  - Regulatory policy
- "Industrial" policy applies to sectors other than manufacturing
  - Growth strategies that emphasize some sectors at the expense of others are "industrial policies"
- East Asia has been the "laboratory" for industrial policy

What: Conventional Wisdom

- "Governments can't pick winners"
  - It is impossible for governments to identify the relevant firms, sectors, or markets that are subject to market imperfections. (Pack)
- "Government failures outweigh market failures"
  - Selective interventions are an invitation to corruption and rent-seeking (Krueger)
- Both of the above!

What: The Investment Climate

- The donor community (led by the World Bank) has focused on investment climate reforms
- These are “horizontal” public actions in three areas
  - Regulatory reform
    - Regulatory constraints to business are important
    - But which regulatory constraints?
  - Infrastructure
    - Firm level studies highlight infrastructure as a significant constraint
    - But what type and where to locate infrastructure?
  - Skills
    - Production skills (capabilities) are the greatest deficit
    - But which capabilities?
- Investment climate reforms reflect the conventional wisdom about industrial policy

What: A Misdirected Debate

- The debate about “picking winners” misses the point: governments make industrial policy on a daily basis via the budget, regulations and trade policy.
- In practice most interventions, even those that are meant to be “horizontal”, favor some activities over others
  - Financial sector reforms favor larger, formal firms
- The challenge is to find the right intervention

What: “Normalizing” Industrial Policy

- As Dani Rodrik has pointed out, in other areas of policy making (macro for example) economists are willing to accept uncertainty and errors.
- For some reason this has been less true over the past 50 years with respect to industrial policy.
- Recently there has been a movement to “normalize” industrial policy and apply the same standards to it as other economic policies.

Why: The Market Place May Not Be Magical

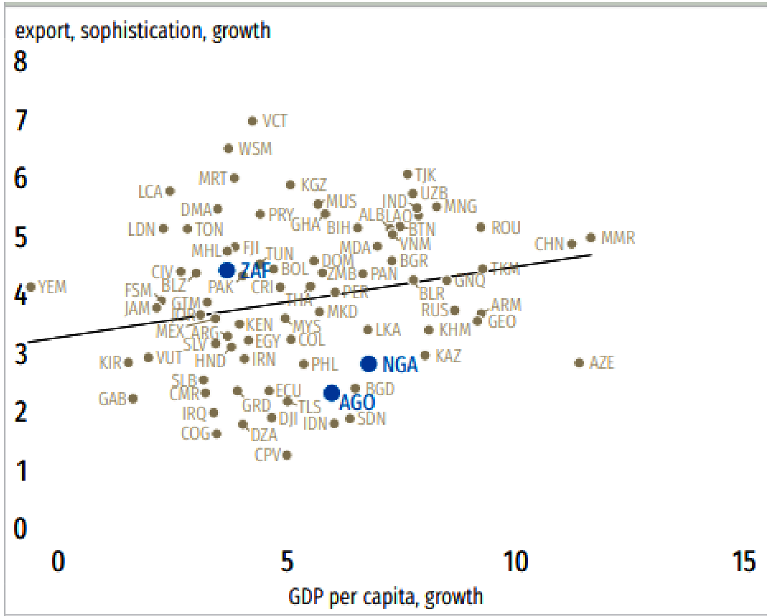
- Market imperfections largely define what it means to be underdeveloped
  - Incomplete or imperfect markets (finance)
  - Asymmetric information (labor markets)
  - Coordination failures (agglomerations)
  - Externalities (learning)
- Structural change is characterized by many of the market shortcomings listed above
  - A key role for industrial policy in low-income countries is to speed up the process of structural change

Why: The Market Place May Not Be Magical

- Market imperfections mean that the social returns in growth-promoting investments exceed private returns
  - This is a (neo)classic rationale for public action
- Externalities and coordination failures call for a coherent strategy of public action
- Both provide the rationale for industrial policy

Why: What you Make Matters

- More diverse economies have better long run growth.
- Some economic activities have larger growth payoffs
  - Unconditional convergence in manufacturing
- Economies with more sophisticated manufacturing sectors grow faster.
  - "Sophisticated" products embody advanced country knowledge and productivity



Source: 6-digit product data (BACI, CEPII) and Hausmann et al. (2007) methodology.
Note: Values are expressed in compound annual growth. The figure shows the four SSA resource-rich MIC and comparators (other lower or upper middle-income countries).

How: The Practice of Industrial Policy

- Knowledge about spillovers, market failures and constraints that block structural change is diffused widely.
  - Public inputs that producers require tend to be specific to the activity
- Recent writing on industrial policy has emphasized the need for consultation and coordination with the private sector.
  - Identify constraints, shape policies and monitor results

How: The Practice of Industrial Policy

- Businesses have strong incentives to “game” (capture) the government.
- Balancing between coordination and capture is the key challenge of the practice of industrial policy.

How: Government-Business Coordination

- Coordination mechanisms have been used by all of the high performing East Asian economies (from Japan to Vietnam).
- Countries differed in the form of coordination mechanisms
  - from “deliberation councils” (Japan, Korea) to local authorities(China, Vietnam).
- All were designed to manage the tension between coordination and capture

How: Coordination in East Asia

- Coordination mechanisms featured four elements:
  - A high level of commitment of senior government officials to the coordination agenda
  - Sharply focusing policy decisions and actions on specific constraints to firm performance
  - A striking willingness to experiment (public policy as pharmacology)
  - Careful attention to feedback

How: Rules, Referees and Rewards

- East Asian countries used both incentives and discipline (carrots and sticks).
  - Subsidies were generous (rewards)
  - But they were conditioned on performance -- especially on export performance (rules)
- Making incentives conditional on export performance set up the right incentives for firms to increase their productivity.

China: “Backing Winners”

- China focused most of its industrial policy efforts at the city and provincial level
- Local authorities would observe which firms or industries performed best
  - This encouraged “self discovery” in the Hausman/Rodrik sense
- They attempted to support the firm/industry by removing constraints to growth only once the best performers were identified
  - This was done through coordination at the local level

Vietnam: Leadership and Decentralization

- Viet Nam gave its successful reform program (Doi Moi) the highest level of political attention.
  - The prime minister championed the reforms, which came directly under his purview,
- Recent decentralization in Viet Nam has made local governments more accountable for the business environment.
  - This has moved the focus of business–government dialogue closer to the provision of local public inputs.

Government-Business Coordination in Africa

- Efforts to achieve government-business coordination in Africa have been less successful
- This reflects
  - An uneasy public-private partnership
  - Lack of coordination within government
  - Rewards without rules or referees

An Uneasy Partnership

- Business and government in Africa are uneasy partners.
  - In Ghana governments headed by President Rawlings refused to engage in a dialogue with long-standing business organizations.
  - One of the first acts of the new South African parliament was to establish the National Economic Development and Labour Council (NEDLAC), but trust between the social partners has declined continuously since.
  - In Ethiopia, a bipolar relationship between the state and the private sector evolved. Formal public-private consultations declined while the government ran highly structured engagements with private investors in cut flowers, leather, and textiles
- The IFIs have attempted to deal with the lack of trust by urging countries to set up high level "Presidential Investors' Councils" modeled on East Asia.

Right Hand-Left Hand

- In Africa, it often appears that the right hand of government is not aware of what the left hand is doing.
  - In South Africa, industrial policy coordination within government is often lacking.
  - In many countries, agencies such as the FDI agency and the SEZ authority do not act in tandem.
  - The failure of many IFI-sponsored President's Investors Councils was attributed to lack of follow-up.
- One reason high level leadership is essential is to achieve coordination.

Rewards Without Rules or Referees

- Industrial policy in Africa has offered rewards without rules and referees.
  - In South Africa, the corporate sector and trade unions have settled into a stable equilibrium, defined by high rents distributed between organized labor and big business.
  - In Ethiopia, the government made thousands of hectares of very cheap land available for floriculture but investors have held it in anticipation of rising land values
  - Ghana’s Local Content Bill gives wide discretionary powers to the Minister of Energy
- In each case performance criteria (rules) were lacking and referees absent.

Strengthening Government-Business Coordination in Africa

- High-level leadership is critical to success
  - In Ethiopia, Meles Zenawi, the late prime minister, was personally involved in the successful promotion of cut flowers.
  - President Museveni of Uganda signaled his commitment to its Presidential Investors' Advisory Council (PIAC) by actively participating in meetings and following up on Council decisions.
  - In Ghana President Kufour could not find time in his schedule to conduct a meeting of its Presidents Investors' Council in more than two years.
- Commitment depends on getting things done which in turn depends on commitment

Strengthening Government-Business Coordination in Africa

- Local initiatives are often more effective
  - In Ghana, business associations such as the Association of Ghana Industries (AGI) and the Private Enterprise Federation (PEF) led to increased engagement between the state and business community
  - The potential of the Ethiopian flower industry was revealed by the private sector. The flower growers association was self-organized
  - A design flaw of the IFI initiative to establish Presidents Investors' Advisory councils was excluding small and medium firms.
- Local initiatives have have been most successful when business has taken a leading role.
  - A message for the aid industry

Strengthening Government-Business Coordination in Africa

- Limit the rewards
  - Requests for support from the private sector should be made public.
  - Coordination with the private sector should be used to identify which public investments in infrastructure or skills receive priority.
  - Any proposed investments should be subjected to rigorous cost–benefit analysis.
- Conditionality, sunset clauses and program reviews, should be features of all incentive programs.

Strengthening Government-Business Coordination in Africa

- Accountability is essential.
  - Good policy making requires accepting a certain failure rate.
  - But who judges success and how do you build the capacity to let the losers go?
  - This is an area where East Asia has been less successful.
- Scrutiny reinforces accountability.
  - Public disclosure is important.

Summing Up

- The institutions that shape government–business relations are a key element of industrial policy.
- There is no single model of success of business–government coordination or industrial policy.
- The experience of successful coordination between the public and private sectors in Africa has been disappointing.
- With committed leadership, Africa can develop the institutions of public–private coordination.