Managed latecomer strategies vs. political capture:

Can developing countries handle selective business promotion?

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Industrial policy is a hotly debated issue. The controversy is about selective interventions that favour some sectors over others, and thus interfere with the price mechanism as the main signalling device of market economies. On the one hand, it is generally recognised that there is a theoretical case for industrial policy, mainly because of the existence of coordination failures, dynamic scale economies and knowledge spillovers.[1] This is especially relevant for countries at early stages of market development. It is hard to imagine how a latecomer country with an open economy could embark on a new activity that requires economies of scale and a range of specialist inputs, when it has to compete against foreign companies that enjoy all the advantages of long-established specialised production networks (Collier and Venables, 2007). To succeed despite such disadvantages, concerted efforts would be needed to tackle a range of issues simultaneously. These include technical and managerial skills development, improvement of electricity supply and transport infrastructure, development of capital markets and encouragement of supporting industries and service providers. Last but not least, mindsets and societal institutions inherited from preindustrial phases need to be adapted to the needs of an open economy. Industrial policy requires intensive state-business interaction in order to maximise the exchange of information and mobilise synergies between public and private economic action (Bräutigam, 2000; Evans, 1995).

On the other hand, critics insist that governments are usually not very good at identifying coordination failures or anticipating future knowledge spillovers, and their decisions may well waste scarce resources if they bet on the wrong sectors. Moreover, the fact that politicians interfere strongly in the relative profitability of economic activities – via differentiated taxes, tariffs and subsidies – creates rent-seeking incentives for investors as well as for bureaucrats. Industrial policies should therefore be subject to checks and balances, including controls through auditor generals, parliaments and a free press, systematic impact evaluation and the application of results-based management in implementing agencies. However, developing countries tend to rank very low with regard to almost any indicator of government effectiveness. Here, state-business relations (SBRs) are often of a corporatist nature, whereby protected cartels of business 'insiders' benefit from state support, whereas the state gains support from the respective faction of the private sector. Protected cartels tend to be inefficient, as they are not fully subjected to market discipline. Their protection thus implies a (usually anti-poor) in-transfer of surpluses from consumers and taxpayers. Close trust-based collaboration between state agencies and business is thus a double-edged sword when favouritism is a key mechanism to stay in power and checks and balances are not well established.

Hence, developing countries face a dilemma: they are confronted with the strongest market failures and need to intervene most actively in the governance of productivity development; at the same time, the probability of achieving the pursued welfare effects is less than anywhere else. A few countries have managed to escape this dilemma, gradually increasing their competitiveness and improving the quality of their economic institutions in parallel. These include Brazil, Chile, Malaysia, South Korea and Taiwan, and more recently mainland China. These cases are well documented (e.g. Amsden, 2001) and testify to the feasibility and importance of industrial policies. However, critics argue that more than 100 developing countries that have pursued industrial policies have remained stuck in a vicious circle of low productivity and weak economic and political institutions (Pack and Saggi, 2006).

Against this background, the German Development Institute carried out a research project in seven low- and lower-middle-income countries: Egypt, Ethiopia, Mozambique, Namibia, the Syrian Arab Republic, Tunisia and Vietnam.[2] The main purpose was to understand the specific conditions for industrial policy in poor countries, to assess to what extent industrial policies can obtain the desired results even when overall government effectiveness is low and to identify which institutional arrangements and policies work best in their conditions.

In all countries included in the research project we observed an increasing recognition of private business as the main driver of productivity enhancement and economic growth. Most of the countries had experienced long phases of central planning and had felt the limitations of this type of economic management strongly. Today, all seven countries embrace the principles of the market economy, have privatised a number of state enterprises and have established mechanisms for public-private dialogue.

At the same time, most governments are reluctant to privatise state-owned enterprises in certain strategic industries and to deregulate factor markets. There are different reasons for this. First, there are concerns about social costs of liberal market reforms. Second, political considerations play an important role – although they are usually not addressed openly. All countries are still undergoing major system transitions; their political institutions are still vulnerable and the political balance among different political or ethnic power groups is often fragile. Governments therefore try to maintain important assets that enable them to buy in political support from specific constituencies; moreover, they avoid certain reforms, e.g. labour market or land market liberalisation, which might provoke political resistance.

All countries of the sample apply selective policies in favour of specific industries and groups of firms. These include special export promotion programmes, value chain programmes, industrial parks and a range of small and medium-sized enterprise (SME) policies, among others. Some of these selective programmes have been quite successful – e.g. creating a seafood industry in Vietnam, promoting cut flower exports from Ethiopia, creating supplier linkages around an aluminium smelter in Mozambique and improving manufacturing practices in the Tunisian export industry. Policies have been effective when they have built on comparative advantages and established collaborative relationships with private enterprises. Many other selective policies have failed, because governments offered inappropriate support that did not address the most binding constraints or that turned out to be insufficient. Typical examples are industrial parks or business incubators that fail to attract investors.

The degree to which governments intervene at the company level varies considerably, however. Ethiopia and Tunisia engage strongly in hand-holding of firms, arguing that (besides some traders) they do not yet have a business sector that might trigger technological development and productivity growth, and therefore need to create a critical mass of efficient manufacturing enterprises. In Tunisia, this has been rather successful, whereas in Ethiopia the process is still too recent to assess its results. Most other countries engage much less with individual firms – with varying success: in Vietnam, entrepreneurship sprung immediately up when the restrictions of the centrally planned economic policies were lifted, whereas local enterprises in Namibia and Mozambique showed very little progress. The appropriate level of enterprise-level support thus obviously depends on country conditions.

In many cases, industrial policies are designed in a top-down manner rather than through systematic deliberations with the business community. As a consequence, policy priorities are often set in a non-creative technocratic manner. Most priorities are derived from the desire to develop forward or backward linkages in order to develop integrated value chains. To strengthen forward linkages, Namibia for example subsidises value addition of diamonds and other raw materials, Mozambique taxes raw cashew exporters to promote investments in national processing and Ethiopia taxes exports of unfinished leather while supporting an incipient leather products industry. As an example of backward linkages, Vietnam supports the textile industry in order to improve national supplies for its large garment industry.

At first glance, such strategies to move on to higher-value activities within existing value chains look quite plausible, but they have rarely been successful to date. In most cases, the countries have lacked competitive advantages (e.g. economies of scale) in the targeted upstream or downstream industries. Shifting to more demanding activities is a difficult task that requires a deep understanding of industry conditions. It calls for policies which are closely coordinated with the private sector, which encourage experimentation and which support innovative risk takers. Regular feedback loops with market actors to fine-tune sector strategies are important.

In sum, selective industrial policies may work even in countries with limited government effectiveness. The risk of failure is high, however, especially when strategic decisions are taken without sufficient involvement of the business community.

Endnotes:

1. That is, investments are not undertaken because they depend on investments in related areas which do not materialise unless governments coordinate a big push of simultaneous investments; and entrepreneurs under-invest in activities that might create manifold spillovers in the future but do not pay off immediately for the individual investor.

2. Results are summarised in Altenburg (forthcoming); the first published case studies can be downloaded at www.die-gdi.de.

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