

Private Sector Development Synthesis Note

Industrial Policy

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Key take-aways:

- Some argue that Industrial Policy is the only one to deliver real growth; others that it has almost never worked. Sometimes, the same evidence is cited in support of both arguments.
- There is an ongoing debate over which, if any, sectors Industrial Policy should target. Not all industries are equally useful for development, some can be good for mass employment, but allow little technological learning.
- Industrial Policy is a relatively demanding approach. To be effective, its design and implementation needs to take into account both government's capabilities and political will.

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Industrial policy is defined as the strategic effort by the state to encourage the development and growth of a sector of the economy. [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”. [Pack and Saggi \(2006\)](#) 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.” This Note explores five key issues and debates within industrial policy.

Supporters of Industrial Policy argue that it is the only paradigm that delivers real economic growth and transformation. From this perspective, development is a matter of identifying and promoting the technologies and activities that are most relevant for economic growth. For example, some economists advocate for an “entrepreneurial state,” which restlessly searches out new opportunities for growth ([Mazzucato, 2013](#)). Such advocates argue that 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” ([Rowden, 2011](#)).

Others argue that markets already allocate resources efficiently, and that governments are unlikely to improve this. Economists highlight the difficulty of achieving well-targeted and effective interventions in practice. 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](#)).

>> 1. Does Industrial Policy work?

Two factors have led to the growing interest in industrial policy among development practitioners in recent years. Firstly, Western governments have sought to intervene much more strongly in domestic industries after the financial crisis. Secondly, the success of many East Asian economies, most recently China, is often associated with industrial policy. Some advocates of industrial policy 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](#), [Mazzucato, 2013](#)).

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 that lack of transparency and technical capacity among policymakers in low-income countries often lead to poorly-designed industrial policies. 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. (see also [Khan \(2012\)](#) for a similar argument) They will accumulate human and physical capital in the process. This capital, Lin argues, can be reinvested over time in more productive industries. Several methodologies are available to donors and governments seeking to identify competitive advantages (see for example [German Development Institute, 2016](#)).

[Ha-Joon Chang](#), in contrast, argues that developing countries should define 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.

[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”. **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 creating Special Economic Zones (e.g. [World Bank, 2016](#)). Critics argue that such an approach may only attract short-term investment, achieving little, if any, positive spill-over into the wider economy ([Farol and Akinci, 2011](#)). The [World Bank \(2016\)](#) summarises success factors of Special Economic Zones, based on experiences in different countries.

There is also some debate on whether green technologies in particular deserve special policy attention. [Dani Rodrik \(2014\)](#) identifies the ways in which “the availability of green technologies both lowers social costs in the transition to a green growth path, and helps achieve a satisfactory rate of material progress under that path.” [Harrison et al. \(2017\)](#) have provided an overview of the arguments for and against such a “Green Industrial Policy”.

>> 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](#)). A strong administrative capacity on the part of policy makers is required. This includes “**clear goals, detailed policy measures, adequate budgets, and effective monitoring**” ([Asian Development Bank, 2015](#)). The government must have a full grasp of market information gathered in the field.

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 ([Lall, 2004](#)). [Dani Rodrik \(2008\)](#) 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 in 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. [Lall, 2004](#)). 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, 2011](#)). [Altenburg \(2011\)](#) however observes that some **governments have succeeded in promoting industrialisation** and have 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 start with critical constraints in potential growth sectors where it seems feasible to develop relevant governance capabilities, and to deliver results. The economist Joseph Stiglitz argues that “limitations on the capacity of government should affect the choice of instruments for carrying out industrial policies, but not whether they should undertake industrial policies.” ([Stiglitz, 2016](#)).

>> 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 all businesses, and promoting competition ([DCED, 2008](#)). This is often seen as very different to industrial policy, as the latter involves direct interventions targeting specific businesses or sectors and aims to change the structure of the economy.

A DCED paper ([DCED 2013](#)) assesses how compatible these two approaches are and finds that **business environment reform is compatible with what some authors refer to as ‘strategic industrial policy’: this approach focuses on developing entire sectors, technologies or activities and encourages time-bound, results-based management** (see also [DCED, 2016](#)).

>> 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](#)). Of major interest to the development community is the question whether or not industrial policy is pro-poor.

Disagreements over the poverty impact of industrial policy reflect the range of views on how likely the poor are to benefit from economic growth in general. Some argue that industrial policies should be used to target social enterprises, while others point to the poverty reduction achieved by emerging economies focused on promoting productivity-based growth (see also the [DCED \(2016\)](#) working paper on business environment reform for inclusive business). [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](#)).

>> 5. What can donors do?

Donor-funded technical experts can help to design and implement reforms that **improve the performance of public agencies which support the overall functioning of the target industry**. Many donor agencies have provided technical assistance to investment promotion agencies (see [OECD, 2011](#)).

Donor-funded experts can also help to improve the policy formulation process. As [Ansu et al. \(2016\)](#) noted, **effective public–private collaboration for transformation requires collaborative experimental learning**. Improvements to policy formulation can be implemented 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. Such experts can also connect recipient governments with information on business realities.

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 ([Wade, 2015](#)). 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 ([Dietsche, 2017](#)). 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/implementing-psd/industrial-policy/