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PRIVATE SECTOR DEVELOPMENT AND INDUSTRIAL POLICY: WHY, HOW AND FOR WHOM?

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INTRODUCTION

There has been a shift towards private sector development (PSD) in development approaches since the early 1990s which stresses the important role of the private sector in furthering economic development, generating employment and reducing poverty. The focus on the private sector goes along with a shift in development thinking that started in the 1980s away from the central role of the state as the prime agent of development towards the private sector, market forces and competition. In the 1980s this shift was promoted by key international organizations, most importantly the World Bank. In the 1990s most national donor agencies followed this trend and developed PSD programs and interventions.

There is generally broad agreement in development thinking and practice that a dynamic private sector plays a crucial role in the economic development process as it is an engine of investment, innovation, and growth and offers an effective way to create employment, incomes, and prosperity. However, disagreement exists about which type or segment of the private sector is best suited for inclusive development and which government policies are required to develop such a private sector. Debates on industrial policy are at the center of this disagreement.

Opponents of industrial policy have their basis in neo-classical thinking. They argue that markets are generally efficient and that the costs of market failures are lower than the costs associated with government interventions which aim to remedy market failures. Therefore, countries should follow their comparative advantage based on their natural endowments and not actively try to change economic structures through selective policies. Governments should focus on horizontal or neutral policies that facilitate the economic sphere by improving infrastructure, ensuring property rights, a favorable investment climate and business environment, reducing regulatory burdens through deregulation, and providing tax or financial incentives.

Proponents of industrial policy have their basis in structuralist or the recently labeled neo-structuralist economics

and argue that structural change is the central engine and outcome of economic development. They stress the existence of substantial market, coordination and system failures which requires governments to shape the economy by interfering with markets, pursuing selective policies favoring certain sectors that are more productive and offer higher learning possibilities and externalities, or by being directly involved in production activities (Amsden 1989).

PSD programs (in accordance with general development policy) broadly followed the first camp opposing selective interventions and industrial policy and putting emphasis on comparative advantage, an enabling business environment and horizontal/neutral policies (Schulpen/Gibbon 2001; Altenburg/von Drachenfels 2006; Staritz 2012). However, more recently the debate has partly shifted and industrial policy has again become en vogue (Aghion et al. 2011; Reiner 2012; Wade 2012; Altenburg 2011). Even organizations such as the World Bank or the OECD – partially – changed their negative attitude towards structural analysis and selective interventions arguing in favor of well-designed industrial policies and sectoral targeting (OECD 2011; Lin 2011). Yet, this paradigm change is still in its infancy. For instance, the past World Bank chief economist Lin, reports that less than 10 % of World Bank economists are sympathetic to his arguments pro industrial policy (Wade 2012). Important drivers of this re-emergence of industrial policy are the financial and economic crisis, green growth initiatives, the obvious success and fear of China as an industrial powerhouse, and the increasing locational competition for high value-added activities.

We argue in this article that PSD programs are well advised to extend their focus from an enabling business environment to industrial policy given the importance of structural change in the development process and the existence of imperfect or even inexistent markets for goods and factors especially in developing countries. Given the limited space, we focus on a selected number of issues. Section 1 discusses the importance of economic structures, structural change and industrialization in the development process. Section 2 sheds light on industrial poli-

cies and commonly identified criticism. Section 3 presents emerging challenges for developing countries that aim to pursue industrial policy in the current global environment.

ECONOMIC STRUCTURE – WHY DOES IT MATTER?

It may seem obvious that economic structure matters but it is far from uncontroversial in mainstream economics. Standard growth theory does not differentiate between sectors and presupposes a homogenous capital stock which is an input factor in an aggregate production function. Standard microeconomic theory assumes a representative firm which neglects firm and business heterogeneity. Also, the Millennium Development Goals (MDGs) focus on overall GDP (gross domestic product), income and consumption levels with only limited reference to structural and production issues. Mainstream economics more directly stresses the importance of focusing on countries' natural endowments and comparative advantage which in many low-income countries is agriculture or other resource-based and low-skill labor-intensive activities given their relative abundance of primary resources and low-skilled labor.

Structuralist or neo-structuralist approaches argue that what countries make matters for growth and that structural change is one of the main drivers and outcomes of development (Chang 2012; Rodrik 2010; Lin 2011; Lin/Monga 2010). Essentially, it is suggested that economic growth and development requires shifting production factors from low-productivity to high-productivity activities which allow for learning, externalities and higher profits and wages. Such a shift has to be incentivized by proactive and forward looking industrial policy actions. Besides sectoral developments, organizational capabilities of firms are important drivers of economic development.

'Indeed, organizational building is one of the most difficult tasks facing developmental industrial policies. The idea that a Toyota, a Samsung, a Tata, an Embraer can just naturally spring up out of a multitude of peasants, just due, again, to the 'magic of the market', is a fairy tale that few ought to be ready to believe.' (Cimoli et al. 2009: 4)

The principal question regarding economic structure and industrial policy in developing countries is the role of manufacturing and if it is still worthwhile or necessary to follow the traditional route of industrialization. Concerns about climate change and an enthusiasm about the prospects of trade in services downplay the attractiveness of manufacturing-based development strategies. Yet, nearly no country grew rich without industrialization (Chang 2002; Lin 2011; Rodrik 2011a). India, which may come close to a service-driven development model, clearly shows the limitations of this approach: only 560,000 workers are employed in the service export sector, mostly in jobs with low returns (World Bank 2009), and advanced service segments usually depend on the existence of a strong manufacturing sector (Guerrieri/Meliciani 2005).

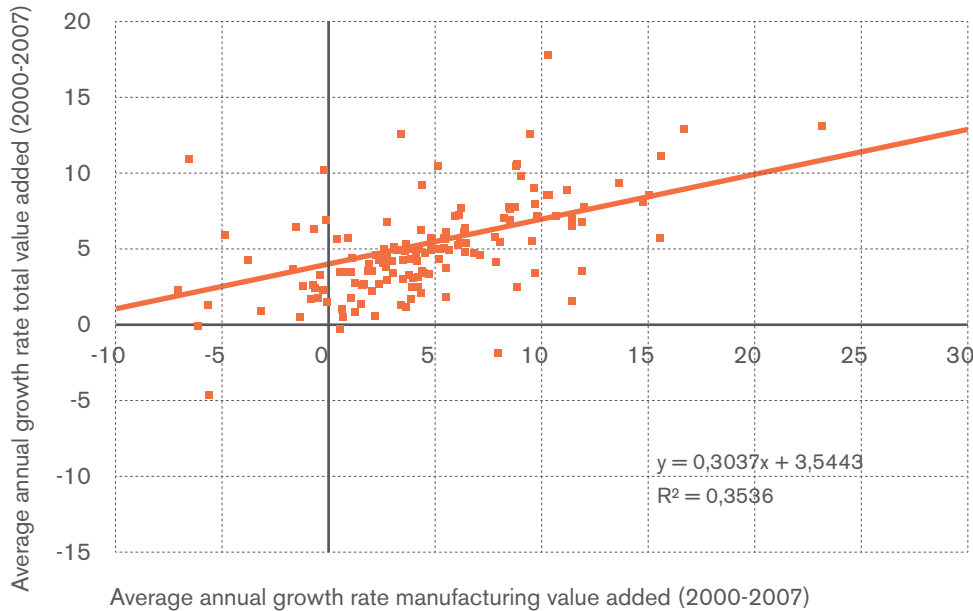
Primary products, on the other hand, are characterised by volatile prices and at least until recently by declining long-term terms of trade vis a vis manufacturers – this may be changing though in the context of the recent commodity price boom (see below; Farooki/Kaplinsky 2012; Morris et al. 2012). Primary commodity production is often characterized by low-productivity, decreasing returns, and lack of stimulating impacts with regard to technological progress, innovation, and skills, and limited value addition, linkages and employment potential.

Manufacturing functions as an engine of growth because of its high potential for employment and productivity growth as a result of economies of scale, learning and specialization effects (Kaldor 1967). From an evolutionary point of view, manufacturing activities provide richer opportunities for learning, knowledge accumulation and associated gains in dynamic capabilities. A further contribution of manufacturing to economic growth emanates from its role in exploiting the 'advantages of backwardness' much better than any other sector. Rodrik (2011b) shows that manufacturing represents an 'escalator activity' due to its unconditional convergence towards the global technological frontier. In other words, manufacturing enables developing countries a relatively faster catching-up with their competitors in developed countries. All this renders manufacturing an activity with high productivity levels and high productivity growth prospects.

Figure A shows for a sample of 151 countries that current data supports a positive relationship between the growth rate of manufacturing value added and GDP growth. Theoretical and empirical analyses suggest that the ex-

pansion of manufacturing is indeed causal for economic growth and not the other way around (Necmi 1999; UNIDO 2009; McCausland/Theodossiou 2012).

Figure A: Manufacturing value added growth and GDP growth 2000-2007 (in %)



Source: UNIDO 2009.

While productivity growth is of utmost importance for development, industrialization also contributes to social goals; historically most importantly through the generation of employment, higher skill jobs and increases in wages. Manufacturing activities, in particular low- and medium-tech ones, are often labor-intensive providing employment, in cases also particularly for women. Agriculture and natural resources are far less inclined to foster social progress in a comparable manner (World Bank 2009).

INDUSTRIAL POLICY AND ITS CRITIQUE

Industrial policy aims to change industrial structure – which can be defined according to sectors, tasks or knowledge intensity – in order to increase productivity, learning opportunities, externalities and dynamic competitiveness. Hence, industrial policy can be understood as an umbrella term which encompasses policy elements from very different policy fields such as education and skill

development, infrastructure, trade, investment or competition policy. Improving the business climate, which is at the heart of many current PSD programs, is an important part of industrial policy proper and might be better classified as an element of a rather neutral growth policy.

The debate has traditionally focused on the existence of market failures such as externalities, asymmetric information, imperfect competition, and uncertainty. This is particularly the case (but not only) in developing countries where markets are highly imperfect, underdeveloped or missing (Pietrobelli 2007). Coordination and system failures represent a further justification for policy intervention. Individual firms' performance crucially depends on the behavior of other actors (e.g. production and investment decisions in upstream and downstream segments, investment in and provision of related infrastructure and public goods), but markets often lack the means to induce consistent behavior, and thus lead to a suboptimal allocation of resources.

As investments by one firm can have a positive effect on the profitability of investments by other firms, everyone would be better off if everyone else also invested but market forces alone cannot take the economy from a low investment to a high investment equilibrium. Public policies need to help this transition by fostering coordination (Rodrik 2004, 2007). These issues are particularly problematic in the area of technology, innovation and learning – which are at the center of the development process (Lall 1992, 2001; Morrison et al. 2008).

Critiques of industrial policy emphasize that governments and bureaucrats in developing countries lack capabilities for industrial policy – particularly for picking winners (in terms of sectors and/or firms) – and are prone to corruption and more or less legal rent seeking. Difficulties arising from a lack of bureaucratic capabilities in developing countries are real but Chang (2012) stresses the importance of ‘good enough’ solutions to such political economy problems. He further questions the extent to which industrial policy is exceptionally more difficult than other types of policies – including macroeconomic management, building a broad education system or public services – and that high quality bureaucracies can be developed by investing in training, organizational reform and improvements of incentive systems and ‘learning by doing’. However, particularly such training related to industrial policy design and implementation has been neglected in the past decades in many developing countries.

Further, the spirit of industrial policy has changed and picking winners is not the core activity of modern industrial policy. It is increasingly acknowledged that policy makers face serious knowledge deficits, but also that bureaucrats do not need this kind of superior knowledge to engage in welfare creating industrial policies. Rodrik (2008) argues that industrial policy should provide the political and economic space for experimentation, but if experiments turn out to be unsuccessful, policy makers need the capacity to let losers go – an activity which obviously requires much less information than picking winners. Rodrik (2010) makes an even stronger case for mistakes:

‘A government that makes no mistakes when promoting industry is one that makes the bigger mistake of not trying hard enough.’

Governments considering the application of industrial policy have to engage in an explicit rent management, which allocates ‘developmental rents to the actors of the ‘great transformation’ (Cimoli 2009: 10). The key problem is to impose discipline among the recipients of these rents. Using carrots and sticks as incentives, competitive subsidy allocation and strict performance based support schemes are important ingredients to impose discipline. There are a number of seemingly subtle issues in the design and use of performance targets which are nevertheless of utmost importance. Good policy design occurs not by chance but by systemic efforts of capable bureaucrats who have the policy space and power and are able to deal with pressure from vested interest groups. Further, transparency and accountability is crucial to prevent rent seeking. The problem of rent management becomes even more complex as governments have to stay in close contact and information exchange with firms who benefit from subsidies. The reason is that firms and policy makers have to learn from each other in order to invest in those activities which promise the highest social returns and sufficient private profit to make them sustainable. This delicate balance between keeping private firms at an arm’s length to minimize rent seeking and cooperation for mutual learning about externalities and other market or system failures was denoted by Evans (1995) as ‘embedded autonomy’.

Recently, empirical research seems to converge towards a new pragmatic consensus on industrial policy. It is widely acknowledged today that almost every rich country applied industrial policy during some period of its development. Industrial policy is seen as a necessary, but not sufficient condition for economic success (Chang 2011). Theoretically, old divisions between strategies of import substitution and export orientation or between competition policy and industrial policy have lost in importance (Aghion et al. 2011; Chang 2011). Pragmatism rules and the questions asked are much more productive and interesting than a decade ago. In the words of Rodrik (2008), up to date research on industrial policy focuses not so much on ‘why’ but rather on ‘how’ to conduct industrial policy in a welfare enhancing way. Design, timing, rent management and collaboration between the government and the private sector with a focus on the relational interdependency and learning are stressed as crucial in order to avoid costly policy failures (Rodrik 2007; Morris 2010).

CHALLENGES AHEAD FOR INDUSTRIAL POLICY IN DEVELOPING COUNTRIES

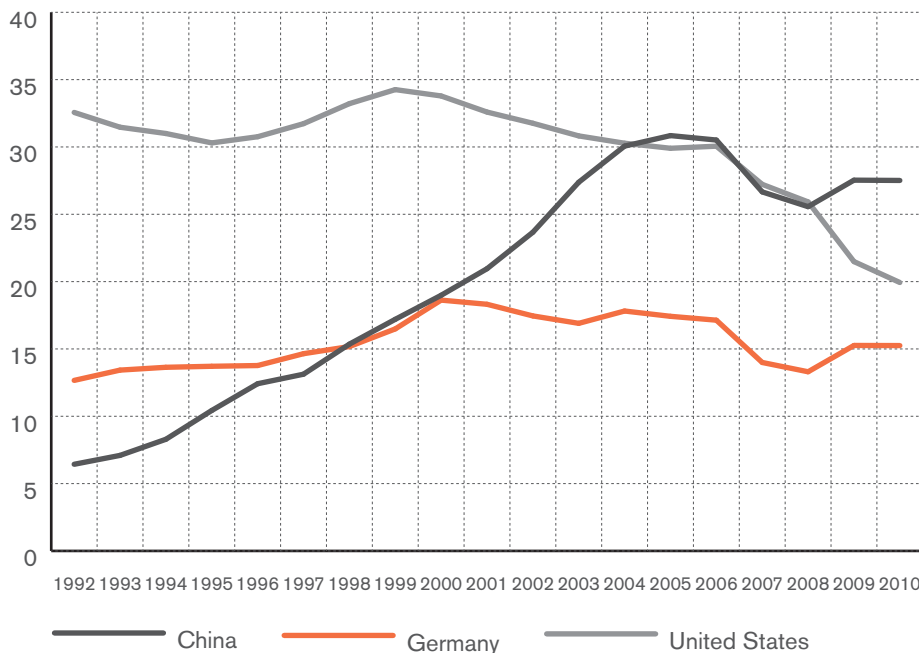
Developing countries face several challenges in their formulation and execution of industrial policy in the context of recent changes in the structure of the global economy.

First, production and trade is increasingly structured around global value chains (GVCs) where transnational corporations (TNCs) break up the production process in different parts – concentrating on their ‘core competencies’ and outsourcing all other activities on a global scale (Gereffi 1995; Kaplinsky/Morris 2001). Lead firms, still largely based in developed countries, structure and govern value creation through product specifications, cost and performance requirements and standards that in turn condition entry and industrial upgrading possibilities of developing country firms in GVCs. The emergence of GVCs has important implications for industrial policy (Gereffi et al. 2005; Baldwin 2012). In the context of GVCs, industrialization is different from the final goods export-led process just two decades ago. The issue facing firms and governments in developing countries is not developing

new, more capital-intensive goods and building national sectors and integrated value chains, which dominated industrial policies until the 1980s. Instead, it requires entering and upgrading in value chains of particular products or group of products (Milberg 2004). This involves fulfilling the requirements and standards and fitting into the corporate strategies of lead firms.

Manufacturing remains an essential part of development, but the distribution of value added along value chains suggests that higher value is often associated with pre- and post-fabrication activities such as design or marketing. However, these are exactly the activities which constitute the core competencies of lead firms and are characterized by rents and entry barriers which makes upgrading contested and difficult. Related to this fragmentation of production, the ‘product-country link’ (Baldwin 2012) becomes blurred, with the result that exports may tell little about the actual capabilities of national producers. For example, when Korea started to export cars this was a clear indication that Korea has achieved a new stage of development, whereas currently the share of high-tech exports of China is to an important part attributable to U.S., Taiwanese or Korean technology and inputs (Figure B).

Figure B: High-technology exports (in % of total manufactured exports)



Source: World Bank data.

Given the importance of GVCs, industrial policy needs to take into account their dynamics, drivers and governance structures (Altenburg 2007; Staritz 2012). Industrial policy needs to find an adequate balance between supporting lead firms in their efforts to upgrade local suppliers and the local business environment and pursuing broader public interests that are often not congruent with those of lead firms, e.g. to capture larger value added and rewards for local producers, to increase local linkages and spillovers, to increase lead firms tax contributions, and to make them more locally embedded.

Second, the rise of China and other emerging countries has created new threats and opportunities for industrial policy (Altenburg et al. 2008). The export-oriented industrialization success of the East Asian tigers and particular of large countries such as China and to a lesser extent India has left less room for others. In the late 1960s and 1970s, when the East Asian tigers embraced export-oriented development strategies, their exports competed primarily with domestic producers in developed countries that were squeezed out of their domestic markets. Today, however, the growth of particularly labor-intensive manufacturing exports from developing countries is largely at the expense of producers in other developing countries (Kaplinsky 2005).

But the rise of emerging and some developing countries also provides new opportunities. In the last decade, and accelerated by the global economic crisis, sustained growth in emerging countries, in particular in the two large economies of China and India, has spurred a shift in the primary drivers of trade and growth (Farooki/Kaplinsky 2012). This shift has crucial implications for global demand and production and may facilitate access to investment, new markets and GVCs for less developed firms and countries and increase their bargaining power (Cattaneo et al. 2010; Staritz et al. 2011). Related to this shift, regional and domestic markets have also increased in importance. However, industrial policy has often focused on exports and production for high income countries, thus neglecting the increasing market potential of emerging countries as well as domestic or regional markets. These markets may provide viable alternatives and better deals in terms of prices, sustainability and learning due to their distinct governance structures and entry and upgrading prospects (Pickles/Smith 2010; Staritz/Morris 2012).

Third, in the context of the recent commodity price boom and the shift in commodity-manufacturers terms of trade in

favor of primary products, commodity based industrialization strategies and related industrial policy have re-gained prominence in commodity-dependent countries. While in the past, developing country governments' economic development efforts largely focused on diversification away from the commodity sectors, now, commodities are at the centre of many national development plans. The commodity price boom can, under adequate regulatory frameworks, provide additional public revenues for much needed social programs, infrastructure and other public investment. It can also provide industrialization opportunities based on backward and forward linkages from commodity to manufacturing sectors in local economies (Hirschman 1981; Morris et al. 2012). The literature on resource-based industrialization shows that countries like Chile and Malaysia have used their existing resource base as a starting point to foster manufacturing sectors and broader economic development based on linkages (e.g. Reinhardt 2000; Morris et al. 2012). This industrialization strategy may be particularly important for commodity-dependent low-income countries as historic industrialization strategies based on labor-intensive manufacturing exports have become contested (see above). Despite these opportunities, the natural resource curse that focuses on political economy structures that encourage rent-seeking and corruption from resource rents remains a significant danger of commodity-based development strategies (Frankel 2010). Furthermore, labor and social conditions in resource-based industries are often quite poor and human rights violations and severe environmental impacts of commodity-related projects on workers and communities occur frequently. Last but not least, the current high price volatility has also highlighted the vulnerability of commodity-dependent export-strategies and associated difficulties in managing economies, including Dutch Disease effects (Nissanke 2011).

Fourth, policy space has been restricted by the international trade and investment regime and particularly WTO agreements on Trade Related Intellectual Property Rights (TRIPS) and Trade Related Investment Measures (TRIMs), bilateral or regional free trade agreements (FTAs) and bilateral investment treaties (BITs). Tight IPR rules (intellectual property rights) in the context of TRIPS and aggressive strategies by U.S. and European firms against even minor infringements create a completely different environment for catching-up compared to the 1970s and before. Further, FTAs and BITs are often more restrictive than WTO agreements in terms of circumscribing classical tools of industrial policy such as tariffs and subsidies; TRIMs and BITs ban measures like local content and trade balancing

requirements. Conditions attached to bilateral and multi-lateral aid and loans also significantly constrain industrial policy space (Chang 2012).

Such international agreements are generally not in the focus of industrial policy, although they have important impacts on developing countries' industrialization process and on how firms and producers are integrated in the global economy. In particular, donors need to play an active role in pressuring for policy coherence in their countries' development, trade and investment policies and for development-enhancing trade and investment policies (Staritz 2012). Important in this regard is also the development of institutional capacity to negotiate such policies in developing countries and of capacity to regulate private sector activities in ways that promote national development and encourage lead firms to adopt more development-enhancing patterns of investment and sourcing. Such capacity and institution building activities could be important components of industrial policy.

Fifth, rich countries have rediscovered industrial policy. Re-industrialization, insourcing and 'the return of manufacturing' are the buzzwords in current policy discourses in the United States and Europe. For example, the EU strategy on industrial policy released in 2012 states the goal 'to reverse the declining role of industry in Europe from its current level of around 16 % of GDP to as much as 20 % by 2020' (EU 2012). US president Obama presents his ideas on industrial policy in the policy paper 'An America built to last' which underlines the importance of manufacturing (White House 2012). The virtues of manufacturing such as good jobs for an eroding middle class, its intimate relationship with innovation and R&D (research & development) and green growth are stressed as motivations to apply industrial policies. All this will reduce the space for industrialization by developing countries and increase competition for manufacturing activities.

Sixth, there are crucial global challenges in particular related to environmental degradation and climate change, poverty and inequality. While green growth strategies have contributed to the renewed justification for industrial policies, the ecological dimensions of industrialization and economic growth pose crucial questions on how to link industrialization and economic growth with environmental concerns. On the social side, high levels of un- and underemployment and global poverty have remained and inequality has increased in most countries – also in countries that have achieved high economic growth. Questions

remain on how to pursue industrial policies that secure inclusive outcomes in terms of employment generation and poverty reduction. In particular, employment at higher than subsistence wages is still the key way out of poverty, requiring that industrial policy focuses on broad-scale employment generation (Amsden 2012). This can not only be done through furthering self-employment and targeting small producers and small or micro firms as it is often the case in PSD programs – often with a link to microfinance. Such micro entrepreneurs regularly engage in entrepreneurship as a necessity due to a lack of other alternatives and provide no dynamic forces in economic development. A striking result is revealed by a comparison of firm-size distributions between rich and poor countries. According to estimations, small- and medium-sized enterprises (SMEs) account for over 50 % of GDP in rich countries and only 15 % in poor countries (Ferranti/Ody 2007). This 'missing middle' is a clear indication of missing growth opportunities for micro firms, which remain at an insufficient scale with low productivity and little technological progress. Exactly this type of micro firms is heavily pushed by microfinance, which fails to finance – the from a development point of view more important – SMEs (see the article of Bateman in this publication; Lützenkirchen/Weistroffer 2012; Bateman et al. 2012; Bateman/Chang 2012; Amsden 2012).

CONCLUSIONS

Industrial policy has become more complex and constrained, but is also becoming more accepted in development policy. Policy makers in developing countries and donors engaged in PSD interventions are well advised to include industrial policies in their policy and program formulation. However, they should be cautious in the use of big money for single firms or projects and adhere to well-established principles in the design and evaluation of industrial policies. Market, coordination and system failures should be seen as a guide to improve decision making and to invest in those activities which promise the highest social returns. Of utmost importance is the collaboration between private and public stakeholders and their engagement in a productive learning process. Further, industrial policy needs to be embedded in a broader development strategy and combined with and complemented by other policies such as education and skill development, infrastructure, social and appropriate trade, investment and macroeconomic policies (see the article of Langthaler in this publication).

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