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Beyond ideological cleavages: A unifying framework for industrial policies and other public interventions

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ABSTRACT

This paper introduces a new framework to characterize the diversity of public policies and interventions to spur investment and growth. Going beyond ideological cleavages on this topic, we argue that two orthogonal features determine how much interventions depart fundamentally from neutral policies: (1) their *degree of selectivity* (in terms of sectors or other targeted categories of firms) and (2) the *extent of price subsidies* embedded in such interventions. These two characteristics of interventions respond to different types of justifications, and they do not necessarily need to go hand in hand, even if they often do in practice. Depending on their selectivity and/or the extent of price subsidies, interventions are shown to vary in their distortions, their benefits, and their opportunity costs. The framework is used to illustrate how different country characteristics affect these pros and cons of interventionism. In particular, we look at the effects of the initial state of the investment climate, the country's institutional capacity, its political economy context and the nature of the State-business interaction. Using the examples of poor countries with a small undiversified industrial base, we show that it is often in the situations where interventions may be the most needed, that the conditions for their success are likely to be the weakest, which does not mean either that some interventions cannot succeed in low-income countries.

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1. Introduction

For decades, a controversy has been raging among economists about the case for interventions to accelerate economic growth in developing countries, as opposed to conducting standard structural policies. The most controversial of these interventions have been the so-called industrial policies.[2]

Recently this controversy has reignited. Striving to replicate the East Asian experience and in the face of disappointing private sector responses to structural reforms in the nineties, there is a new impetus in many developing countries in favor of public interventions to promote growth, in particular in middle-income countries. In North Africa, Latin America and Eastern Europe, many countries are developing or have launched selective "New Industrial Policies".

The debate has also reignited in the academic arena. Proponents of "normalizing" industrial strategies—led in particular by Rodrik (2004, 2006a, 2006b, 2007)—have been arguing that unorthodox interventions were part of the success stories in East Asia and elsewhere and should be considered on equal footage as any other standard public policy, like education, with all their pros and cons. Opponents of new industrial policies, led in particular by Pack and Saggi (2006), argue instead that these interventions explain very little of East Asia's success and are bound to fail.

This paper does not stand on any side of this debate. Instead it tries to go beyond the traditional ideological cleavage by trying to offer a unifying framework that reflects the diversity of such policies. The object is to show how the pros and cons, risks and costs and pre-conditions for governments to undertake this type of policies differs a lot depending on two specific features of interventions: (1) their *degree of selectivity* (in terms of sectors or other targeted categories of firms) and (2) the *extent of price subsidies* embedded in such interventions. Although the literature has flourished on the rationale for such interventions and their associated risks, there has been little work on how these pros and cons' trade-offs vary depending on the type of interventions and country characteristics.

In line with Rodrik's (2007) wish to "normalize" industrial policy, our framework is used to convey the message that this debate should depart from the "structural policies *versus* selective interventions" question, but should rather address the *when*, *what* and *how* questions. The crux of the problem is to find the right balance between structural policies that affect the business environment for all firms—a very wide and never-ending agenda—and more selective policies which can be justified, not least because many aspects of the business environment are very specific to certain sectors, or because economy-wide reforms are not always feasible.

We argue that the optimal policy mix between neutral policies and interventionism critically depends on specific features of governance of both the state and the nature of the private sector and their respective preferences. It also depends on country economic characteristics—the presence of natural resource endowments is one of them—which affect both the extent of market failures in the country and therefore the potential benefits of intervening, as well as the dead-weight losses and political economy costs associated with these interventions.

The paper is organized as follows: Section 2 describes the conceptual framework and offers a typology of public interventions. Section 3 uses the framework to illustrate the trade-offs governments face in terms of risks, costs and benefits when choosing the right policy instrument to intervene. It is also used to show how different country characteristics and initial conditions affect these trade-offs. Section 4 concludes by proposing routes for further research.

2. A conceptual framework for private sector development policies

We cannot think of a policy area where the debate among economists and policy makers is more ideologically polarized than on the topic of *industrial policies*. This partly has to do with the term itself, which carries a controversial historical legacy dating back to the fifties or earlier.[3]

[2] There is no universally agreed definition of industrial policies. Chang (2006) defines them as a "policy aimed at particular industries (and firms as their components) to achieve the outcomes that are perceived by the state to be efficient for the economy as a whole".

[3] See, for example, Gerschenkron (1962). Also, Shafaeddin (1998) shows that the UK has protected selective infant industries before gradually reducing tariff barriers over a period of thirty years in the XVIII century's industrial revolution.