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Structural change and industrial policy: A case study of Ethiopia's leather sector

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Abstract

Recent empirical evidence underscores the vital role of industrial development in fostering structural change and promoting a country's long-run development objectives. Devising sound industrial policy institutions emerges as a key policy option to promote the reallocation of human, physical and financial resources to high value added sectors of the economy. This paper examines the rationale for industrial policy, why it has been ineffective in most African countries and what policy lessons should be distilled from past experiences. Using the Ethiopian leather and leather product sector, it examines how industrial policies are formulated and implemented in practice. The paper concludes by highlighting key industrial policy instruments that other countries can take into account in order to accelerate industrial development and structural change in Africa.

JEL classification: L52; L67; L78; O55
Keywords: Industrial policy; Structural change; Institutions; Ethiopia

1. Introduction

Several developments in the global economy underscore the imperative for Africa to industrialize and engage in the production of manufactured and high value-added products. Industrialization is essential if Africa is to foster structural change and translate its recent high growth rates into significant social development. Promoting structural change hinges on sound industrial policies and selective government interventions that redirect an economy's production structure towards more productive sectors. To this

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end, manufacturing emerges as a key sector due to its ability to foster forward and backward linkages, dynamic economies of scale, innovation and technology diffusion and positive spillover effects within and across sectors. A key finding from recent empirical literature is that countries that diversify away from traditional sectors experience a decline in poverty rates and a sustained increase in technology accumulation and international competitiveness (Rodrik, 2013; Joachim and Poncet, 2012; McMillan and Rodrik, 2011; UNCTAD and UNIDO, 2011).

Whereas the theoretical justification for industrial policy is a strong one, its practicability raises numerous challenges. Proponents of industrial policy argue for it due to the presence of market and coordination failures, knowledge spillover and dynamic scale economies (Stiglitz et al., 2013; Rodrik, 2009; Pack and Saggi, 2006). While this notion receives considerable support, at least in theory, critics also point to the inability of governments to precisely identify sectors or firms that industrial policy should target. They also allude to corruption and rent-seeking induced by government intervention as well as deficiencies in the transparency and accountability of state policies. As a result, industrial policy is argued to reduce allocative efficiency in an economy by interfering with the price mechanism (Altenburg, 2011).

Earlier attempts by African countries to industrialize were mostly unsuccessful and economic production remains largely agrarian, subsistence and portrays limited value addition (Elhiraika and Mbate, 2014). Some of the main reasons for this failure include the defiance on comparative advantage, domestic policy failure such as unsustainable subsidies of production inputs and inappropriate monetary and fiscal policies, political economy issues, and structural impediments such as infrastructural and human capital deficits (Stiglitz et al., 2013; Mkandawire, 2015; Chang, 2013). As a result, manufacturing has either stagnated or declined over time. The share of manufacturing in Africa's GDP has remained at around 13% between 1980 and 2010, compared to 31% in East Asia, where labour-intensive industrialization has induced high growth and addressed challenges to job creation, poverty and inequality (ECA and AUC, 2013).

In this context, the focus of industrial policy in developing countries has shifted away from its justification to its practical implementation (ECA and AUC, 2014; Rodrik, 2013). While there is a consensus on the need for industrial upgrading and state interventions, there are divergent views on whether industrial policy should favour a country's comparative advantage or not (Lin and Chang, 2009). Practically, this raises concerns as to whether industrial policy should be based on commodities and natural resource endowment, which are abundant in most countries, or whether government interventions should help firms to venture into new sectors that are independent of natural resources as production inputs. In addition, there exist opposing viewpoints on whether governments should implement industrial policies that are sector specific – vertical policies – or those which are broad and neutral — horizontal policies (Lin, 2012). This paper uses the Ethiopian leather sector as a case study to shed light on these issues.

Irrespective of these opposing views, successful experiences from emerging economies strongly underscore the need for industrial policy to place greater emphasis on institutions and policies that promote strategic collaboration between the government and the private sector (ECA and AUC, 2014). According to Wade (2009), successful industrial policy encompasses several features, such as institutions that facilitate coordination between top political organs and the private sector and incentive schemes that target specific activities and possess an exit mechanism such that they are withdrawn if ineffective. In the African setting, empirical evidence tends to support the positive impact of industrial policy on industrial development. Roubaud et al. (2005) examine the role of Export Processing Zones (EPZs) in Madagascar. They show that EPZs have been the main driving force behind export growth as they have resulted in lower labour costs, high productivity and increased foreign investment due to favourable incentives targeted at domestic and foreign firms. Matshediso (2005) examines the role of

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