

## Avoiding the Pitfalls of Industrial Policy

Building Open and Effective Institutions for Private Sector Development and Jobs

### Problem

Industrial policy in MENA has had limited success and many instances of policy capture by a few privileged firms.

### Analysis

A comparison with successful East Asian economies shows that industrial policy in MENA will be more likely to succeed if the leadership would commit more to growth and reduce the extent of rent-seeking and policy capture.

### Solution

Policies that have been captured should be reformed and most critically governments should adopt a transparent and open policy framework that minimizes the risk of future capture and privileges.

## Summary

*Economic policies in MENA have often been captured by a few politically connected firms and such capture has undermined private sector growth and job creation. However the prominence of politically connected firms is not specific to MENA, instead it is a common occurrence in the economic life of many low and middle-income countries, some of which have experienced strong growth and achieved high levels of employment.*

*What explains the different outcomes in MENA and other regions? In particular, what lessons can be drawn from a comparison of the experiences of successful East Asian countries where the risk of policy capture by politically connected firms was also present?*

*The comparison highlights the importance of vision, policy design and implementation for ensuring that policies are not captured and achieve their intended objectives.*

### LESSONS FROM EAST ASIA

#### *A leadership with strong preference for growth vs. rents*

From South Korea and China to Malaysia and Singapore, the governments of East Asia structured their bureaucracies and ruling parties around **the goal of economic growth**. The political imperative of generating growth motivated leaders to engage in reforms which substantially reduced their discretion and that of the bureaucracy. This commitment contributed to reducing the likelihood that these reforms would collapse into patronage, rent-seeking, and stagnation, as in other parts of the world. Indeed, in the absence of a single-minded focus on

growth, the political cost of catering to vested interests is low, political incentives are correspondingly higher to privilege some firms over others, and to pursue policies even if they have no demonstrated positive effect on development.

#### *Focus on performance-oriented and time-bound support*

In contrast to MENA, the implementation of industrial policies in successful East Asian countries was conditional on firm success in pursuing growth and structural transformation. When they were implemented, subsidies to firms were not only contingent on firms entering new activities – economic activities where

market failures are more likely to have a binding influence - but also on firms' continued success in those activities. That is, even if subsidies might also have been disproportionately channeled to politically connected firms in East Asian countries, these firms still had to meet relevant, measurable and verifiable performance targets aligned with the objective of private sector-led economic growth. Time-bound supports are central in order to provide entrepreneurs with incentives to innovate and grow given the risk that such supports will be withdrawn if performance measures are not met. In Taiwan for instance, one target sector, the video industry, fell slightly below its target growth and the government withdrew support. As a result, three large firms

went bankrupt and in contrast to other East Asian countries, the industry never developed in Taiwan; reflecting its lack of comparative advantage. Moreover, the example sent a clear signal of the government's commitment to results to firms in all other sectors that benefitted from industrial policy support. However, if political incentives to pursue growth are weak, friends of the regime are unlikely to regard performance targets and deadlines as credible. They will anticipate that governments will prefer to ignore targets and extend deadlines in exchange for rents, weakening their incentives to innovate. In MENA, the policy benefits offered to firms were not conditioned on concrete goals, such as export success or jobs. Instead, the policy regime left open the possibility that support to firms could continue indefinitely irrespective of performance.

#### *Stimulating and safeguarding competition and the level playing field*

Economic policies in MENA had a tendency to privilege individual politically connected firms instead of benefitting all firms and new entrants. These policy privileges provided politically connected firms with unearned advantages over their competitors in the same sector through, for instance, energy subsidies, access to cheap government land, tax exemptions or more lenient tax implementation etc. Such policies also often insulated politically connected firms from competition through various barriers to entry of foreign firms in the form of FDI restrictions, or cumbersome authorization requirements, or non-tariff measures. Instead, by linking support to measurable performance indicators that are available to all firms (sometimes in targeted sectors), successful East Asian countries did not undermine competition and the level playing. In particular performance indicators such as exports provided firms

with incentives to compete internationally and innovate instead of focusing on the domestic market and earn rents.

#### *Building strong institutions and a professional and capable administration*

The technical difficulties involved in the design and implementation of effective economic policies and the need to safeguard competition require strong institutions and a professional and capable administration. However, the experiences of many countries in MENA suggest a step backwards, away from these requirements. For instance, the preeminence of the Social Fund for Development, once one of the most efficient and transparent agencies in Egypt, faded in the face of political pressure to use the fund as a source of patronage jobs. A strong public administration is necessary to implement the policy changes necessary to build open markets that are resilient to the risk of capture. These policy changes include a strong competition law and an independent competition authority; appropriate procurement laws and implementation; an independent judiciary, and so forth.

#### **SOLUTION**

##### *What next for MENA countries?*

##### *Reducing the risk of capture*

While policies that are detrimental to jobs can be reformed relatively quickly given the political will, the likelihood that other existing or new policies could be captured or serve privileged firms and undermine competition and open markets is high. A sustainable path should then seek to achieve the twin objectives of increasing the likelihood that policies achieve their objectives and are immune to capture.

The lessons discussed above are indeed key ingredients to achieving such a goal

but they also need to be undertaken in a transparent and open policymaking environment.

This environment will guarantee citizen access to information on proposed and ratified laws and regulations; citizen input into policy design and evaluation; citizen knowledge of politicians' stakes in firms that benefit from government policies; and citizen awareness of the beneficiaries of subsidies, procurement tenders, public land transactions, privatizations, etc. Ultimately a process of consultation, inputs and debate between policymakers and citizens will need to be established.

#### *A framework for effective and equitable policies for jobs*

The ingredients highlighted above indicate that this process should seek to answer the following questions; a negative response to one of the questions below raises a red flag indicating that the proposed policy could lead to inefficient and inequitable outcomes ultimately failing to create jobs:

1. *Does the policy seek to provide a good or service currently not available in the country in an economically efficient and sustainable manner?*
2. *Do all potential market participants have equal access to the benefits of the policy?*
3. *Are the benefits of the policy reversible if rigorous performance measures are not met?*
4. *Will the bureaucracy and courts implement the policy accurately, fairly, transparently?*

For references and detailed analysis and policy recommendations, refer to Chapter III in the complete 2014 World Bank Regional Report: "Jobs or Privilege: Unleashing the Employment Potential of the Middle East and North Africa".