



INDUSTRIAL POLICY: PROS AND CONS. A LITERATURE REVIEW

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Abstract. The discussion amongst economy professionals and academics about the necessity and possible best solution of an industrial policy and state intervention concept regained its importance over the last year. Usually the debate is about comparing several development stages in industrial policy thinking: e.g. modern industrial policy versus industrial policy of the 20th century or industrial policy of the East-Asia countries. This literature review undertakes analysis of industrial policy concepts focusing on discussions about development of thinking and about the pros and cons of industrial policy.

The aim of the study is to restart a discussion amongst economy professionals and academics in Latvia about necessity of having an industrial policy in Latvia, and possible benefits or disadvantages of this economic concept.

Key words: *industrial policy, role of state*

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1. Introduction

The question about industrial policy is very contradictive in economic literature and has changed during the 20th and 21st centuries. Let's start with the term "Industrial policy" itself. The use of the term "Industrial policy" in economic literature and among analysts is very broad. Common understanding of the term is that it describes only industrialization of economy, meaning increasing the share of manufacturing. Other understandings of the term industrial policy are more used in recent studies. It implies that industrial policy equals the role of state in an economy, or state intervention made in order to tackle market or government failures.²

The highest level of state involvement in industrial policy in different regions all over the world was reached from the 1950s till 1970s, when the governments of Latin American, African and Asian countries were engaged in economic planning at various levels, changing the structure of economy and market protection.

As regards Latvia, a debate on the necessity of industrial policy was initiated comparatively late after the independence, i.e., in 2008/2009, when the first analytical studies concerning necessity of the concept of industrial policy in Latvia were conducted, thus defining the role and activities of the State in fostering economic development. The first research was followed by recommendations from the Ministry of Economics regarding the role of the State in the economy. It should be noted that the recommendations of the Ministry of Economics and empirical studies highlighted the fact that theoretical and empirical studies of the economic science prove the benefits of an active state intervention in the economy which ensures that future development and welfare of the state can be free of restrictions and conditions imposed by the economic structure, and it forms an essential challenge for the present growth in Latvia.

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² The term "Industrial policy" is used according to how origin researchers mention it, and may slightly vary during paper



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The aim of the paper is not to describe historical experience of Latvia’s state intervention policy within whole time frame of recent 20 years independence time, but to analyse development of industrial policy concept in economic literature as well as to analyse recent activities of local economic experts and state authorities on elaboration of industrial policy approach in Latvia.

The method used: review of economic literature on development of industrial policy approach and analysis of Latvia’s policy documents.

The paper is organized as follows: Section 2 describes industrial policy thinking in economic literature and changes in it during 20th century. Section 3 describes efforts of Latvia regarding development of industrial policy approach.

2. Industrial policy

2.1. What is “Industrial policy”?

Let me start with type of activities that form the term industrial policy. I will start with the early descriptions of the term. Reich (Reich R., 1982) described “Industrial policy” as the set of governmental actions designed to support industries that have major export potential and job-creation capacity, as well as the potential to directly support the production of infrastructure. Pinder (Pinder J., 1982) proposed a definition that includes all policies designed to support industry, including fiscal and monetary incentives for investment, direct public investment and public procurement programs, incentives for investment in research and development, major programs for the creation of “national champions” in strategic sectors, and policies to support small and medium enterprises. Johnson (Johnson C., 1984) defined industrial policy as government activities that aim to support the development of certain industries in a national economy to maintain international competitiveness. Chang (Chang H-J., 1994) describes industrial policies as governmental actions supporting the generation of production and technological capacity in industries considered strategic for national development. Pack (Pack H., 2000) defines industrial policy as actions designed to target specific sectors to increase their productivity and their relative importance within the manufacturing sector. Nabli (Nabli M., Keller J. et al, 2006) argue that any policies or interventions that influence how industries expand are referred to as “industrial policies”, but there is distinction between “horizontal” and “vertical” industrial policies. Vertical policies usually target the economic output of specific industries and even firms. Horizontal policies essentially focus on improving the quality of inputs in the production process, which presumably benefit all firms. Most common examples of policies are included in Table 1.

Table 1

Examples of vertical and horizontal industrial policies

Horizontal policies	Vertical policies
<ul style="list-style-type: none"> • Education and vocational training; • Building appropriate and efficient public infrastructure; • Encouraging international technology transfers; • Fostering research and development; • Supporting for production activities. 	<ul style="list-style-type: none"> • Targeted attraction of Foreign direct investments; • Sector-specific trade negotiations; • Incentives and subsidies for specific sectors or activities; • Support of the competitiveness of given industrial activities; • Import tariffs and quotas; • Export subsidies and credits.

Source: Nabli M., Keller J. et al, 2006; Peres W., Primi A., 2009; Author



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Peres and Primi (Peres W., Primi A., 2009) argue that the scope of policy depends on two dimensions: firstly on policy-making capacity, which in turn relies on a set of factors including institutional capacity for design, implementation and assessment, and secondly on the numbers and scope of the instruments used, which depend on the development strategy and its specific objectives. These two dimensions define a policy space, where three types of policies operate. These policies are horizontal, selective and additionally: frontier policies. Here meaning that frontier policies respond to a broader national development vision, and aim at creating capabilities in key strategic technological and science areas. This definition of frontier policy is highly relevant to recent efforts of the European Commission to define Key Enabling Technologies. But looking on a definition of frontier policy it's clear, that it is part of a selective policy and therefore any additional definition of a new subgroup is questionable, being possible within a more generic framework as a subgroup of “vertical policy” actions.

Here it is worth looking again at the definition of “Industrial policies”: from the perspective of *proponents and opponents*. Benhassine and Raballand (Benhassine N., Raballand G., 2009) argue that proponents of industrial policies dismiss public governance problems and the risk of capture when compared to the needs of addressing market and coordination failures. Opponents of industrial policy dismiss market failures and argue that structural reforms and markets will address them, and that any public intervention will lead to capture. Analysing opposing arguments we could describe state capture as an insufficient capacity of state institutions to correctly identify the sectors to support. The consequences like distraction of structural reforms in government sector, rent seeking activities and generation of government failures outweigh market failures. Summarised arguments of both parties are included in Table 2.

Table 2

New industrial policies: arguments for and against

Against	For
<ul style="list-style-type: none"> • Government intervention leads to increased corruption and state capture; • Governments do not have the necessary information and capacity to pick winners (sectors who have already have pace or emerging comparative advantages); • Industrial policy distracts from key investment climate and trade policy reforms; • If public support is carried out, government support should be limited to non-selective policies (horizontal policies) such as providing public goods (infrastructure, education, R&D); • Little empirical evidence of working industrial policy. 	<ul style="list-style-type: none"> • Market and coordination failures as well as symmetric information in developing countries justify interventions in markets; • Trade policy, investment climate reforms and providing public goods do not lead to sustained growth because of fundamental market failures; • Most success stories have been based on smart interventions at the industry-level; • Selective and sector-specific public interventions make it possible to tackle several investment climate constraints effectively.

Source: Benhassine N., Raballand G., 2009; Author

Despite arguments by Benhassine and Raballand that they looked at a “new industrial policy” approach, their analysis was highly relevant to the industrial policy approach known in the late 1990s.

A more recent attempt to define industrial policy was introduced by Rodrik (Rodrik D., 2008). Rodrik describes industrial policy as a process of on-going dialogue between state and the private sector to generate information for identifying and removing the binding constraints to development.



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2.2. Evaluation of Thinking about Industrial policy

By reviewing evaluation of the term it is clear, that together with a definition, thinking about industrial policy and its role within the economy has changed rapidly. Naude (Naude W., 2010) summarized key ideas of industrial policy dividing them into three phases (Table 3). The first phase is dominance of market failure often used and cited lasting from the 1940s till 1960s. The second phase completely reshuffles the emphasis of industrial policy from market failures to government failures. The third phase started a new discussion by introducing a new discussion topic of “how industrial policy has to be implemented”.

Table 3

Evolution of ideas of industrial policy

Phase	Key ideas	Representative contributors	Country examples
1940s to late 1960s	<ul style="list-style-type: none"> Industrialization is necessary for development; Market failures would prevent this from happening automatically; Market failures are pervasive in developing countries; Industrial policy is needed, particularly infant industry protection, state-ownership and state coordination. 	Rosenstein-Rodan P. (1943) Hirschman A. O. (1958) Prebisch R. (1959) Myrdal G. (1957)	South Korea Malaysia Japan Taiwan Singapore
1970s to 1990s	<ul style="list-style-type: none"> Practical obstacles to industrial policy are considered significant; Government failure is worse than market failure. Industrial policy is invitation to waste and rent-seeking; Trade liberalization (exports), privatization and attracting foreign direct investments together with macroeconomic stability and minimum government interference are the basic requirements for growth and industrialization; The era of the Washington consensus, especially after the debt crisis of the early 1980s and the ubiquity of structural adjustment programs. 	Baldwin R. E. (1969) Krueger A. O. (1974; 1990) Pack H. (1993; 2000)	Argentina Nigeria
2000s to present days	<ul style="list-style-type: none"> Market and government failures are present; The “how” rather than “why” of industrial policy is important; Institutional setting matters but design difficult. Need to understand political context; Flexibility in the praxis of industrial policy is important; Differences exist with respect to the extent to which comparative advantage needs to be defined, not the principle; Innovation and technological upgrading should be a central objective of industrial policy; Promoting national innovation systems should be an important objective of industrial policy. 	Amsden A. (1989) Dosi G. (2009) Rodrik D. (2004; 2008) Chang H-J. (2002; 2003; 2009) Lall S. (2004) Lin J. (2009) Nelson R. R. (1993) Robinson J. A. (2009)	Finland France Latvia

Source: Naude W., 2010; Author



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As we can see over time, the ideas behind an industrial policy concept have changed rapidly. Of course it's possible to define more precise phases of development of an industrial policy concept, but the aim was not to describe historical development, but rather to show how controversial the development was, and how rapidly the ideas behind one concept can change. Partly this shift in thinking can be explained by the rise and fall of the Washington consensus, which was widely adopted across countries all over the world as part of the World Bank and the International Monetary fund lending policies. There is a growing amount of literature on analysis and assessment of inefficiency and inadequacy of the Washington consensus policy.

3. Latvia's approach in development of a National Industrial policy

Industrial policy has been applied controversially in the course of the last 20 years in Latvia. On the one hand, the State has taken an active part in the economy concerning State-owned companies and has carried out direct and indirect intervention measures. On the other hand, industrial policy has not been described or defined before 2008, when the first attempt was made at describing industrialization and defining its goal. Beņkovskis et al (Beņkovskis, Rutkaste, Vītola, 2009) performed an empirical study to identify priority sectors in Latvia's economy. Defining of priorities was based on considerations which emphasised that it is necessary to concentrate the resources available by the State (financial and human) to foster the growth of national economy thus improving purposeful investment and efficiency of resources and that the defining of priority sectors is a requisite instrument of structural policy. The authors acknowledged that the market fails to guarantee a high income and prosperity level that would be comparable to indicators of the developed countries, and therefore an active and targeted economic policy is required. However, when production factors are considered, the authors admit that sectors and products have their own specific set of production factors, which in the course of time have developed among the existing industries taking into account production circumstances of the specific products, and therefore, due to the established production factors in the country, it is highly possible that companies will focus on the production of the existing or closely related products. The export structure that derives from Latvia's economic openness and dimensions served as the basis for sector identification, and it was assumed that promotion of export would help to enable faster economic development and increase prosperity. When comparing historical development of the concept of industrial policy and Latvia's approach to the defining of industrial policy, it is essential that alongside the identification of priorities the authors provide also several crucial restrictions. Firstly, they argue that open protectionism and subsidies are not the instruments to be employed by the State to support priority sectors. Industrial policy should focus on provision of production factors and, primarily, on the preparation of human resource base.

The next stage of industrial policy development is related to the actions of the government in respect of its definition. In 2009 the Ministry of Economics prepared and the Cabinet of Ministers approved report on recommendations for economic recovery in the medium term. The project provided for two courses of action. Firstly, strengthening of the competitiveness or horizontal support policy aimed at the improvement of general business environment and, secondly, the defining of priority sectors. Similarly as in the previous research, assertions of the Ministry of Economics were based on the presumption that the resources needed to be concentrated to achieve greater yield and efficiency. State intervention, in particular selective intervention, was specified as the leading instrument, i.e., the defining of priorities is necessary in order to get out of the economic structure that emerged during the crisis and as a result of it. In contrast to the research performed by Beņkovskis et al, the Ministry of Economics extends the selection instruments to include not only identification of priority sectors and products, but also specific companies that show high growth potential even though they do not represent priority sectors. The priority sectors that were defined from practical perspective were comparatively widely supported in the activities performed by ministries representing various sectors and aimed at the improvement of production factors, including also direct subsidies and grants.



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Present approaches to the concept of industrial policy in Latvia are based on the latest contemporary theories, primarily on the works of Rodrik, Hausmann et al. In 2012 the Ministry of Economics presented a new structural policy approach to national economy, naming it as the National Industrial Policy. Experts from the Ministry of Economics have performed an up-to-date analysis of the economic structure and development, as a result of which several corrections have been introduced in respect of the previously offered instruments for the implementation of the concept of industrialization in Latvia. Though the document mentions that the development of export-oriented sectors and the change of economic structure for the benefit of such sectors should lie at the centre of industrial policy, it does not define priority market segments, producers or sectors, but rather the basic principles. As mentioned earlier, the latest industrial policy in Latvia is based on the opinions of Rodrik, Hausmann et al, as a result of which an emphasis in the development of the concept of industrialization falls on a single crucial basic principle that industrialization policy is not aimed at "picking the winners" but rather the process that includes a dialogue between the public and private sector to identify the binding constraints that prevent new economic activities and to offer solutions how to prevent or overcome such constraints. In the document prepared by the Ministry of Economics this process is emphasised as a crucial element of industrial policy and lies at the basis of the analytical part of the document.

Assessing the current proposal of National industrial policy from the perspective of implementation instruments, it can be concluded that six courses of action are recommended: addressing labour force availability and qualification issues, development of industrial zones, facilitating access to finance, increasing innovation capacity, promoting export and reduction of energy costs. As becomes obvious from this list of actions, the activities are primarily related to the tackling of horizontal issues by minimising the presence of selective instruments. Analysis of the recommended instruments clearly shows that broad selectivity has been abandoned in favour of horizontal support instruments — tax initiatives, financial instruments, as well as instruments that promote knowledge and skills of the labour force, innovation and entrepreneurship. A minor selectivity will be retained during the phase when certain planned State intervention instruments are applied and it will be necessary to make criteria-based ranking in order to select the most successful cooperation partners or projects.

Conclusion

1. Industrial policy is still a controversial issue in economic literature and there is a place open for future debate on what the meaning of industrial policy is and how to implement it in countries with different environments, levels of economic flexibility and economic development.
2. More and more countries are developing their approaches to industrial policy even without recognizing it, but some countries, like Latvia, do it with a clear set of preconditions and goals to achieve.
3. The best proposal for developing an industrial policy is that every country has to take its own way in development: by starting with a close and open dialogue process with key stakeholders, by taking into account the economic environment and by reasonably assessing the possibilities of the national institutional framework.
4. Latvia's approach in development of industrial policy firstly has been based on very selective and narrowed scope of proposals, the set of priority industries has been determined, but upon one year of implementation the approach has changed to those based on findings and works of Rodrik, Housmann et al, which implies that "picking winners (priorities)" approach has to be eliminated and strong dialogue between government and stakeholders is essential to assess economy with the aim to find out market and government failures.



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