

SUPPORTING BUSINESS ENVIRONMENT REFORMS

PRACTICAL GUIDANCE
FOR DEVELOPMENT AGENCIES

ANNEX: COMPLEMENTING BUSINESS ENVIRONMENT REFORM THROUGH INDUSTRIAL POLICY SUPPORT



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The Donor Committee for Enterprise Development

Supporting Business Environment Reforms: Practical Guidance for Development Agencies

Annex: Complementing Business Environment Reform through
Industrial Policy Support

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Preamble

In 2008 the Donor Committee for Enterprise Development (DCED) published guidance for donor and development agencies in their support of business environment reform (BER) in developing countries, entitled *Supporting business environment reforms: practical guidance for development agencies*.¹ Since the publication of this guidance, increasing attention has been given to a number of specific and closely related topics, which have been published as annexes to the original guidance. In 2011, an annex entitled *How Business Environment Reform Can Promote Formalisation* was published.

This annex focuses on the complimentary relationship between donor-supported BER and the use of strategic industrial policy (IP). It is based on a series of deliberations by the DCED Business Environment Working Group, including a discussion paper, which was commissioned.² It presents a series of principles on how IP can complement and build-on BER in order to contribute to the development of a more productive, competitive and diversified economy. While there are many, a selection of the most significant contested issues in this field has been highlighted in the text.

¹ The donor guidance is available from:

<http://www.enterprise-development.org/download.aspx?id=586>

² Weiss, J. (2012) *Strategic Industrial Policy and Business Environment Reform*, DCED Background Paper, October, DCED, available from:

<http://www.enterprise-development.org/page/ber#OtherPublications>

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I Introduction

The Opportunity for Defining Industrial Policy as a Complement to Business Environment Reform

IP refers to any government intervention aimed at steering the structure of production towards areas that are expected to offer better prospects for economic growth than would have been the case in the absence of those interventions. Where BER improves the conditions in which private enterprises operate (at regional, national, local or sectoral levels), IP intervenes more directly to overcome market failures and change the structure of the economy. IP builds on the better framework conditions created by BER by addressing market and coordination failures and by identifying and investing in new markets that provide an opportunity for growth, development and the creation of more and better jobs. IP stimulates the creation of more competitive industries that can be used to contribute to the transformation of the economy. A key challenge of IP is to balance a business environment that encourages productive private investment and market-driven structural change with targeted interventions that accelerate productivity, growth, inclusiveness, and environmental sustainability.

IP and BER share a common objective: to contribute to the development of the private sector in developing and transition economies in order to generate economic growth, increase livelihoods, create more and better jobs, and reduce poverty. Both approaches recognise that entrepreneurship and the private sector development are central driving forces for the achievement of these goals. While BER aims to reduce business costs and risks, and promote competition, IP addresses market failures and supports the transformation of the economy. Donor and development agencies should work with their partners (i.e., government, business and civil society) to make changes to the systems in which private sector and economic development occurs through the use of a variety of IP and BER approaches.

IP can be applied as a horizontal or vertical intervention. While there are strong links between each, horizontal interventions, like BER, focus on the economy as a whole, whereas vertical interventions are more selective, usually focusing on a specific sector or sub-sector to promote competitive industries. IP can also be used to stimulate development in selected localities. In its vertical form, IP aims to alter market incentives and to anticipate future market developments. Vertical IP can be used to support existing competitive industries as well as new and emerging industries. A third dimension is represented by the territorial integration of IP interventions and BER. This is the case when horizontal and vertical interventions are combined through a place-based approach aiming to establish or boost clusters/pole growth. In the latter, IP and BER can be interlinked and influence both people targeted (e.g., on skills, labour market conditions, including a focus on young, women and informality) and area-based interventions (e.g., provision of infrastructure, finance, business development and innovation services to a given cluster).

Contested Issue Box 1: IP that is “Comparative Advantage Defying”

While there is general agreement of the importance of a facilitating state that uses IP measures to support innovation and correct short-term market failures, there is some contest over the extent to which governments should use IP to pursue economic activities that require skills and capabilities the economy does not yet possess. These have been called “comparative advantage defying policies” because they go beyond aligning government support to clearly defined national comparative advantages. This makes government investments into these sectors more risky. However, others have argued that the transformation of economies requires exactly this kind of vision and calculated risk. The pursuit of these opportunities requires the sharing of risks and funding between public and private sectors, with the government channelling support selectively to sub-sectors with the greatest perceived potential. Thus, the concern is how governments should invest their own limited funds to try to depart from their existing specialisation and how far they should aim to move into products that require significantly new skill sets. There is also a concern with the means governments can use to successfully mitigate these risks.

Risk Definition and Management

There are a number of dangers inherent in an IP approach that donors and their development partners need to be mindful of. These include the risks created by basing IP decisions on political motives rather than clear economic ones or on old, inaccurate or irrelevant information. While IP may distort markets in order to achieve a desired outcome, there are dangers that emerging distortions can be taken too far or for too long. There are also risks that arise by failing to accurately monitor, respond to, and learn from the impact of IP interventions due to rent-seeking and political capture of bureaucrats by lobby groups.

Donor and development agencies can more effectively manage these risks through an approach that builds on past experiences and improves on the management of IP and BER systems. While support for private sector development (PSD) is influenced by the political economy of a country,³ it will often require a combination of complementary IP and BER interventions, some of which are more closely focused on reforming the business environment and reducing regulatory burdens for businesses, others going further by stimulating structural change and the search for new dynamic activities. Donor support in this field can include support for the design of policy initiatives that promote the generation of new knowledge (e.g., R&D, feasibility studies) and innovation (e.g., new funding mechanisms, venture capital), while identifying and removing critical bottlenecks and constraints to enterprise competitiveness and economic growth. IP can also support the coordination of other related policy fields within these sectors, such as finance, technology, skills development and public procurement.

II Principles

Donor and development agencies can support governments and their partners by subsidising IP and BER interventions, building the capacity of these actors to assess, implement and monitor their interventions, and increasing transparency and accountability around the decisions that are made. The following principles guide the use of complementary IP and BER interventions. They are presented according to the four phases of programme development contained in the Donor Guidance.

Phase 1: Diagnostics

1. **Start with a systems and sector diagnosis:** Donor and development agencies are encouraged to draw from the findings of a variety of assessments to better understand the opportunities for, and obstacles to private sector and economic development.⁴ While broad, economy wide assessments provide a useful starting point, it is important to better understand the issues affecting firms in different sectors and sub-sectors. Sector-specific business environment assessments may be a useful starting point, but these too are preferably complemented with studies that assess the overall competitiveness of the sector. Thus, more focused and gender-sensitive assessments at the market and sector level are often required. Donor and development agencies can work with public and private partners by providing technical assistance and support for strategic sector reviews. Support can be given to governments to improve their capacity to obtain and analyse this information, as well as to business membership organisations to develop the skills required to analyse economic data and to interact more capably with government on strategic industry and economic issues.

³ See Davis, P. (2011)

⁴ Further details on business environment assessment and sector-specific diagnostic tools can be found on the DCED website. Go to:
http://www.businessenvironment.org/dyn/be/be2search.search2?p_phase_type_id=1

- 2. Consider as many relevant reform and policy options as possible:** Governments should be advised to take care to avoid the use of IP interventions when BER would lead to more sustainable and less costly results in the long term. More may be gained, for example, from reducing the barriers to cross-border trade than promoting exports among a few selected sectors. Similarly, strengthening the national quality infrastructure may produce more competitive firms in the long run than selecting sectors that require upgrading. These choices are not necessarily mutually exclusive. Indeed, a combination of BER and IP interventions will often optimise the factors that lead to the desired result. However, donor and development agencies should help governments to identify and assess the trade-offs that arise and to anticipate the costs, risks and results of all possible options.

Phase 2: Design

- 3. Support for expanded public-private dialogue and engagement:** As presented in the Donor Guidance, successful BER is based on close and regular interaction with the private sector. While BER and IP are government-led and owned actions, government is also required to facilitate the involvement of others. Regular and structured public-private dialogue (PPD) mechanisms should be established, ensuring that these are broadly representative of the business community, including businesses that are owned and run by women and informal entrepreneurs. PPD should encourage the use of objective evidence to inform and guide discussions and provide business with an opportunity to respond to the progress made through BER and IP. The private sector should be directly involved in decisions regarding the selection of strategic sectors. Donor and development agencies should encourage governments to be more transparent and accountable to the private sector on the decisions it makes regarding selective IP. While PPD can be used to deal with a range of general private sector, industrial and enterprise development issues at the national level, it is also essential to ensure PPD mechanisms are established at the sectoral level and within competitive industries.
- 4. Help governments formulate a long-term vision for a competitive economy:** Donor and development agencies should help governments formulate a realistic, long-term vision for the development of their economy. This promotes a shared approach to the development of the private sector and the transformation of the economy, and will guide BER and IP interventions. The vision should be based on objective economic evidence. It should describe the first and second order objectives the government is pursuing, the direction of structural change that is anticipated, and the broad principles that the policies and reforms will adhere to. The private sector, through its representative business membership organisations, should be closely involved in the formulation of this vision, along with other civil society organisations. However, care should be taken to help governments avoid capture by the private sector in these processes.

Contested Issue Box 2: Focus of Industrial Policy

While it is recognised that IP is generally designed to stimulate structural change in the economy in order to increase productive capacity, there is some debate concerning its primary focus and the extent to which this focus can be expanded. IP has at times been called upon to deal more directly with issues such as employment creation, development of low-carbon industries, pro-poor and inclusive growth, and small business development.

The concern is that expanding the focus of IP will produce contradictory goals and create difficulties in decision-making among policy-makers. Too many goals can diffuse efforts and increase coordination problems. Rather than treating IP as an all-purpose set of measures to be used to meet any desired development goal, it is argued that IP should maintain a central focus on economic transformation and productivity.

However, a middle position on this issue argues that IP instruments can be used within a clearly defined issue-specific policy framework. In the case of environmental sustainability, for example, government would require its own specific policy framework that describes its approach to this issue. Within this framework, various IP measures could be developed to promote key elements of government's concern, such as investments into the development of renewable energy.

5. **Promote sustainable, growth-oriented and inclusive approaches:** Donor and development agencies should encourage governments and their partners to adopt an approach to BER and IP that is sustainable, growth-oriented and inclusive. Processes should be specifically designed to ensure women, workers, marginalised and vulnerable groups, including those in the informal economy, are specifically involved in and benefit from BER and IP processes. In addition to inclusive PPD processes, described above, this may involve the use of social protection mechanisms and the use of policies and reforms that justify short-term restrictions on trade, foreign investment and land ownership.
6. **Support for mechanisms that promote green growth:** IP can be used to support the transformation and sustainability of the economy through the promotion of green growth. Donor and development agencies can work with governments and their partners to mitigate the effects of climate change and promote the use of renewable and more efficient energy and competitive, low carbon industries. This requires strong and effective mechanisms to coordinate the various strands of government activity required in this field. While BER processes can be used to assess the effectiveness and efficiency of environmental protection laws and regulations, IP measures can be used to incentivise investment in new industry sectors. Here, private returns may be low in the short-term, but there are clear social and public benefits to be gained (e.g., clean air, lower carbon emissions, less fossil fuel depletion) and specific economic spinoffs (e.g., new jobs). Achieving this involves technologies that require further development and R&D funding. Moreover, there are areas of economic activity that may involve win-win situations that can be quickly agreed, such as initiatives to improve energy efficiency.
7. **Encourage innovation and diversification:** As reforms to the business environment reduce business costs and risks, while increasing competitive pressures, IP can be used to realise the ambition of these reforms by supporting innovation and economic diversification. Donor and development agencies can help governments to formulate policy instruments that spread the costs and risks of these initiatives across government and the private sector as well as the use of clearly defined, gender-sensitive performance indicators. Businesses can be encouraged to research and experiment more and to introduce new approaches to their processes and services.

8. Qualify the use of policy instruments and incentives: Donor and development agencies should help governments to qualify the use of instruments and incentives. IP should be used to support activities that:

- Are not too distant from existing comparative advantages, building on existing capabilities, resources and advantages in order to reduce the scale and duration of selective support (see Contested Issue Box 1: IP that is “Comparative Advantage Defying”);
- Favour sub-sectors and activities or possibly technologies, rather than individual firms; and
- Carefully target interventions in order to challenge entrepreneurs and encourage learning and innovation, rather than creating a protected environment that suffocates entrepreneurial dynamism and technological learning.

All proposed interventions should be:

- Justified with a clear economic rationale in terms of what problems are to be overcome and why the intervention selected is the best option;
- Transparent to the public, with clear targets and criteria for success;
- Include reciprocity requirements and sunset clauses; and be
- Regularly monitored and assessed.⁵

Contested Issue Box 3: Government Capacities for Selective IP

IP can be used to identify new markets and sectors that contribute to the transformation of the economy. However, there are often concerns raised regarding the capacity of a developing-country government to do this effectively. Many governments are constrained by poor, old or incomplete economic data, limited analytical, strategy and policy development skills, and limited implementation and monitoring capabilities. In addition, many governments don’t have sufficient financial resources to stimulate the kinds of changes required among competitive industries or the broader economy, and in their attempts to do this can neglect other important social issues. Thus, encouraging governments without these capacities to intervene in the market can put these investments at risk and can lead to even greater market and coordination failures.

9. Support open, competitive-focused trade policies: Wherever possible, donor and development agencies should encourage their partners to implement an open trade policy. Indeed, trade and customs reforms that reduce the cost of cross-border trade are largely oriented in this direction. While this will increase competitive pressures that may create short-term difficulties for domestic firms, in the long run this will lead to a more competitive and productive business sector. At the same time, IP measures can be used to help domestic firms develop the capacities required to engage successfully in foreign markets and to benefit from technology spill-overs by foreign investors. This may include the use of import substitution strategies. Moreover, there might be a need for short-term assistance to firms in the transition from a restricted to a more open trading framework.

Phase 3: Implementation

10. Support effective institutional frameworks for coordination: Because of the wide range of elements and actors involved, effective BER and IP require good coordination across all levels of government. While the nature of these structures will vary from country to country, donor

⁵ Reference to *The DCED Standard for Measuring Achievements in Private Sector Development* and the forthcoming Donor Guidance annex on Measuring BER Results:

<http://www.enterprise-development.org/page/measuring-and-reporting-results>

and development agencies should encourage coordination structures that are run by government, but with strong private sector and civil society representation.⁶ While these structures provide for PPD, they are typically more narrowly focused on coordinating government reform and policy initiatives. Attention should also be given to establishing sub-structures (e.g., sub-councils or committees) that report to the coordination structures, but focus in detail on the specific concerns, such as strategic sectors or cross-sector issues such as training, innovation, infrastructure development, public procurement, etc.

Phase 4: Monitoring and Evaluation

11. Establish independent monitoring: Governments should be encouraged to establish an apolitical, independent and results-oriented monitoring mechanism that tracks the progress of BER and IP interventions. It is important to measure the progress and impact of reform and policy measures and to make adjustments to these when required. Independence is important in order to ensure that political influences don't bias the collection and analysis of monitoring results.

12. Support the establishment and embedding of evaluation and learning mechanisms: BER and IP are continuous activities involving search and experimentation. This requires an evaluation mechanism that is embedded within government institutional frameworks. The results of evaluations should be used to identify lessons that can be learned from the practice of IP and BER. This requires an open system of learning that responds to domestic experiences and global changes. It calls for a more flexible and dynamic approach, which integrates evaluation and feedback mechanisms. Governments and their development partners should be encouraged to search for emerging opportunities and to reflect on and learn from experiences and trends, and to develop and update their skills and methods.

Donor and development agencies should also establish mechanisms they can use to learn from their experiences in the field and to improve on their practices in support reform and policies in developing and transition economies. This requires their participation in inter-agency networks and knowledge management processes, such as the DCED.

⁶ For example, in Ghana and Kenya, Private Sector Development Strategies have been established, which are coordinated by the ministries responsible for these sectors, with participation from all relevant government ministries, departments and agencies, as well as representatives from the peak business representative bodies

III Recommended Reading and Resources

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