Reconfiguring Industrial Policy: A Framework with an Application to South Africa

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Policy Brief

The market failures that slow down structural change are not a rarity, but a rampant feature of the landscape in a developing country. But neither economists and public officials, on the one side, nor private actors, on the other, know where the relevant distortions are. A key feature of the industrial policy process is to identify them, or, more precisely, to organize "searches" to identify and respond to them.

The private sector needs the government to help internalize the various externalities associated with this "self-discovery" process and to provide many of the public inputs (standards, infrastructure, certification, property rights) that only the government can. The government in turn requires the cooperation of firms and entrepreneurs because it needs to elicit the relevant information about the obstacles and opportunities they face and because it has to be able to influence their behavior in the desired direction. We take "good" industrial policy to consist of those institutional arrangements and practices that organizes this collaboration effectively.

Hence a government needs to evaluate its industrial policy framework not by asking questions of the type: which tax breaks or subsidies are we using? which sectors have we identified? what is the budget we have allocated for industrial promotion? The relevant questions instead are: have we set up the institutions that engage the bureaucrats in an ongoing conversation of pertinent themes with the private sector, and do we have the capacity to respond selectively, but also quickly and using a variety of updated policies, to the economic opportunities that these conversations are helping identify?

We propose that industrial policy activities be oriented around two different axes:

1. Industrial policy "in the small."

A parsimonious strategy for industrial policy would focus on existing economic activities, and consist of putting mechanisms in place to ensure that roadblocks facing these activities can be identified and removed. Such a strategy is based on improving the provision of public inputs to existing activities with the hope that this will lead to higher productivity and quality for existing activities and a higher likelihood that nearby products will emerge. The best source of information for the identification and co-development of public inputs is existing firms. This differentiates this approach from strategic bets, where the relevant actors may not yet exist.

We propose an approach which has four elements: (i) a mechanism to promote, under public auspices, systematic discussion among firms with the aim of identifying, and proposing solutions to, specific coordination failures; (ii) a new budgetary procedure to increase the responsiveness of the public sector to the requisite actions; (iii) a new monitoring procedure to discipline project selection while diffusing the lessons of its successes; (iv) a set of operating principles.

2. Industrial policy "in the large": strategic bets

Producing the leaps that are often required to sustain economic growth—from coffee to garments, from garments to electronics, or from electronics to biotech—requires additional instruments. One possible model is that of a venture fund: an institution that is continuously scouting for opportunities, which has the technical capacity to evaluate projects and their proponents as well as the financial resources to get business plans off the ground; can recognize the new venture's mistakes as they occur; can orchestrate their correction or, failing that, pull the plug; and is guided by the bottom-line concern to generate profitable companies that the private sector will want to take over.

Often the requisite capabilities for developing a public venture fund are lodged in development banks. Development banks, such as those in Brazil, Turkey, and South Africa, have technical expertise, close knowledge of the real sector, financial resources, and some degree of autonomy from the daily pull-and-push of politics—all of which make them suitable for the execution of the venture fund role. Development banks have been typically seen as sources of long-term finance and have been used for various social and commercial goals. We can rethink them as instruments of strategic bets in the sense used here—as sources of ideas about high return activities and about the obstacles that need to be addressed to increase the chances of success of projects that attempt to realize those ideas.

Specific implications for South Africa

South Africa has at present a plethora of instruments and agencies involved in formulating and implementing industrial policies. But we do not believe that current policies pass the acid test above. There is too much disconnect between the private sector and the government, information does not flow adequately, needs are not well identified, policy instruments are not appropriately targeted, and self-correction mechanisms are not in place. The good news, however, is that many elements of a better policy apparatus are already in place.

1. A new budgetary procedure to elicit information on missing public inputs and pay for them.

We propose that every year a certain share (4%) of economic cluster department budgets be allocated to a central fund the main purpose of which is to finance specific public inputs. Allocation of funds would be made on the basis of proposals coming directly from the private sector. We interpret "public input" broadly: it may consist of infrastructure (road improvement), training (artisanal skills for a specific industry), fast-track bureaucratic procedures (work visas for skilled immigrants), research and development activities, or a piece of legislation (regulatory framework for biofuels). The chief criterion would be that the input enhances productivity (and not just profitability). Preference would be given to projects that enhance productivity in the tradables sectors.

2. Reorienting the IDC towards self-discovery activities

The IDC is ideally positioned to undertake self-discovery activities: scanning the economy for investment opportunities in *new* industries, lending or taking an investment position in the early stages of the development of the industry, and communicating information about obstacles and constraints identified during the process to the relevant agencies of the government. There are exceptional instances in which IDC has acted in precisely this way. The role that institution has played in the development of the berry sector and in cashews provides examples of the kind of activity we have in mind. We would like to see this becoming the core of IDC's portfolio, not a peripheral activity.

3. A revamped MIDP focused on strengthening the supplier base

The existing MIDP program has fulfilled its goal of retaining and growing an auto industry that has the potential of becoming competitive in the global industry without government support—but the industry is not there yet. Going forward, the central issue faced by the sector is one of large-scale coordination. The solution is to focus the incentives away from exports and towards incentivizing capacity expansion and generation in supplier industries directly. We would recommend a gradual phasing out of the IRCC scheme, and its replacement by a supplier-base promotion scheme that consists of two "windows:"

a. A standard incentive that takes the form of a subsidy on the wage bill or the capital cost for new capacity by first-tier suppliers to OEMs.
b. An 'open window' where the support depends on specific needs of the firms in question.

4. Improving the CSP processes

In principle, the CSP consist of a deliberation forum at the industry level and would function along the lines that we sketched earlier. But the CSP is not a systematic program with characteristic advantages and disadvantages at all, but rather a collection of very disparate industrial policy initiatives grouped under a common rubric. The effectiveness of the program varies from sector to sector. Given these difficulties we think it advisable to supplement the CSP with the project selection and monitoring mechanisms established in connection with the central fund.

5. Avoiding forced beneficiation

We think that beneficiation, in the sense of incentivizing the domestic processing of natural resources, is not a sensible policy. The capabilities developed through mining can be exploited in a number of different ways, but these potential developments are only accidentally connected to the further processing of ores and minerals.