

## Three new practical ideas in heterodox industrial policy thinking

### OVERVIEW

This brief presents three pragmatic industrial policy implementation ideas based on recent heterodox thinking. The examples were identified during the research for a theoretical think piece on current heterodox industrial policy literature. The ideas are presented without the context of supporting theory, but simply as ideas that incumbent industrial policy decision-makers may find interesting.

### INTRODUCTION

Industrial policy (IP) in the 21st century has fundamentally changed in nature. (Mainly) gone is the achingly technical discussion of the motivations behind IP and whether it is a good idea or not. In its place is a recognition that IP is undertaken everywhere in the world, even if it is not openly called industrial policy. It is now widely accepted that IP is a response to market failure just as education policy or health policy are responses to such failures. This normalisation<sup>1</sup> of IP has allowed economists to stop focusing on defending and justifying the pursuit of IP (especially in lagging economies). Instead they can now focus on extant, fine-grained, real world problems facing incumbent policymakers operating in difficult situations. Through this lens, problems with IP design and implementation are viewed – not as insurmountable – but merely the normal course of business which any sensible policy framework must address.

Ha Joon Chang eloquently captures this shift in thinking when he writes, on developing countries, that the new challenge is not getting the content and application of IP right, but getting “the content and application of IP right *in circumstances* where the country is run by flawed leaders presiding over a politically weak and internally fragmented state” (Chang, 2009 p.19). Khan suggests that countries need to be highly self-aware and understand their historical path of development, extant operating conditions and state power balances in order to design IP interventions that will succeed. His emphasis is on compatibility not capacity and he argues that countries with poor

quality bureaucracies and politically constrained governments can still design and implement IP successfully as long as these interventions are supportable given the current balance of power between the state and other actors in the country. For developing countries that have failed to achieve desired IP outcomes in the past he advises “not to abandon all vestiges of their failed policies at the fastest possible rate, but identify the type of IP that is implementable *in their* particular context given critical internal and external political constraints” (Kahn, 2009 p.3). He goes on to say that expectation needs to be muted with this approach. “In many cases, the *feasible* industrial policy may yield less dramatic results than in most of the Asian cases. In others, one must address some of the critical political constraints to allow the implementation of *even very limited* industrial policies.” (Kahn, 2009 p.3)

The three ideas that follow are all compromise ideas which may be more compatible with some developing countries’ power balances and bureaucratic constraints than, for example, South Korean type IP activities.

### SECOND-BEST INSTITUTIONS

Orthodox, neoclassical economists have a highly reductionist view of institutions. They agree that institutions and their quality are important and they maintain that the benchmark for an efficient and effective institution is based on an Anglo-Saxon exemplar which provides inter alia: security of property rights, enforceable contracts, support for entrepreneurship, fostering of global integration, and the maintenance of stability. The World Bank has even gone so

<sup>1</sup> Term first used by Dani Rodrik, 2007

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Policy Brief by  
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It draws on a think  
piece by the author

*Current heterodox  
industrial policy  
thinking: A muting  
of aspirations or  
sound pragmatic  
suggestions?*

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far as to create the Global Standard Institution (GSI) index which measures a country's institutional performance against high scoring countries such as the US, UK and Scandinavian countries. If a developing country scores low on the scale, neoclassicists believe they should work to emulate best practice.

Current heterodox theory contests this one size fits all, first best, best practice orthodox view. One particularly interesting position is that based on the work of Fafchamp (2004) McMillan and Woodruff (1999) Dixit (2004) and Rodrik (2008b). They argue that the "first best" mindset presumes that the primary role of institutions is to minimise transaction costs in the immediately relevant domain. Rodrik argues that "a focus on best practice institutions not only creates blind spots, leading us to overlook reforms that might achieve the desired ends at a lower cost, it can also backfire" (Rodrik, 2008, p.3).

The narrative emerges based on case studies of Ghana and Vietnam. Ghanaian commercial laws and statutes allow for property rights to be protected and contractual disputes to be resolved by due legal process. In reality the courts are highly inefficient and costly to use. Several surveys of domestic and foreign companies operating in Ghana show that fewer than 10% of firms would turn to the courts to settle a contractual dispute with a supplier or client. The neoclassical conclusion in such a case would be to develop a package of judicial reforms aimed at strengthening the capacity, autonomy, efficiency and honesty of the Ghanaian courts as an essential step in promoting economic growth in the country. They would suggest that such a reform process start to emulate the judicial institutions of highly rated GIS country examples (such as the US and UK).

This suggested to observers that informal substitutes to the formal contracting system actually work and that a rush by Vietnam to invest the time and money reforming its legal institutions might not be necessary or justified. Rodrik takes this thinking a step further and suggests that "perhaps it is more effective to enhance relational contracting – for example by improving information-gathering and dissemination about the reputations of firms – than to invest in first-class legal institutions" (Rodrik, 2008, p.5). Further he suggests that considering this evidence, Vietnam could also reasonably argue that it would reform its judicial system incrementally and would prioritise sectors or firms where relational contracting

is especially difficult and only gradually over time work towards a complete overhaul.

The idea being floated here is that best-practice institutions are not always the obvious, necessary, appropriate or optimal solution for developing countries with capacity, capability, political and financial constraints. Developing countries tend to operate in second-best environments, hence second-best solutions may (in many circumstances) be more appropriate. In addition, second-best institutional options often offer options to remove constraints that are more politically palatable and implementable than first-best solutions. The consensus heterodox view is that a developing country will usually be better served by employing second-best instruments efficiently than first-best instruments badly.

### **ISLANDS OF EXCELLENCE**

Heterodox IP literature clearly establishes the central role of the bureaucracy as the check and balance in governments' relations with the private sector. The work of Wade (1990), Evans (1995), Kholi (2004) and Khan (2009) all deal with the idea of government needing to embed itself with the private sector to allow for two-way communication vital to the design and implementation of IP. To ensure that during the process of embedding, the state is not captured by private-sector rent-seeking or other interests, state autonomy should be guaranteed by a competent, capable, insulated and independent bureaucracy. In general these adjectives are not commonly applied to the bureaucracies of developing countries. Heterodox economists note that, despite the level of interest shown by lagging economies in replicating a South Korean-type IP approach, few have tried to systemically upgrade their public services in a meaningful way to support these IP goals.

Brazilian leadership in the 1960s realised the desperate need for a functional bureaucracy if they were to deliver on their election promises. The government of the day, the first democratic government after three decades of dictatorship, enjoyed only a narrow majority and the leadership was well aware that they did not have the political power or connections to systemically reform the civil service. Instead the leadership began to look for, or create, on an ad hoc basis, isolated agencies or groups of people outside the traditional bureaucracy who could help them implement policy that delivers on election promises.

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Many of these agencies were small groups inside state-owned enterprises, a few were groups within government departments at national and sub-national level, and some were entirely artificially created on a needs basis. The policy was called “*bolsoes de eficiencia*” which translates into “pockets of excellence” which somehow in the modern literature has turned into “islands of excellence”.

The islands of excellence concept is a perfect example of Kholi’s idea of balancing instruments with political realities. In Brazil, politicians understood that they lacked the political power and capital to systemically upgrade and reform the civil service; rather they sought to focus on what they could do given their political constraints. They identified islands of excellence and provided them with protection and the necessary resources to accomplish the most important tasks of government (as deemed by the political leadership). The defining feature of all these islands of excellence was that they were insulated from the traditional bureaucracy and the legislature, both of which had been captured by private sector interests, were generally corrupt, and generally staffed by individuals who are not necessarily competent. Ironically this period is viewed by numerous economists as the heyday of Brazilian economic achievement.

Nowhere was the islands-of-excellence approach more successful than in implementing the economic agenda (and industrial policy in particular). In terms of industrial policy, the President of Brazil came up with a list of 30 national economic goals collectively known as the *Plano de Metas* (Plan of Goals). Projects included goals such as increasing: wheat production, installed electricity capacity, kilometres of paved roads, and the country’s petroleum refining capacity. Each project was given a specific timeframe by which to demonstrate results and each project had a specifically enumerated goal, e.g. increase production by x% in period Y. Each project was run by an executive group. Executive groups were set up by presidential decree and the leaders of each group were appointed directly by the president. Each group was responsible only for a single goal. The executive groups were explicitly designed to circumvent the traditional bureaucracy and to “get the project done”. Each group had complete autonomy with its budget and personnel but they were expected to co-ordinate with other groups when required. Consensus is that these groups achieved 102% effectiveness and

Success compared to a 32% success and completion rate by the traditional civil service during the same time period (Geddes, 1994 p.17).

The strategy here is interesting in the context of the conclusions Khan and Kholi draw in terms of constrained states being able to implement IP by balancing the power they have with appropriate tools. What the islands-of-excellence example shows is that most of the bureaucracy can be allowed to continue on its merry way of cronyism and favours in return for support as a means of maintaining a given power relationship, but that government can still be effective in selected areas. Brazil layered onto an inept, corrupt, captured bureaucracy a thin sheet of specific, well-supported interventions which were in the national interest and not open to capture. The plan was undoubtedly a compromise, second-best solution, but it was successful as an IP strategy because it accurately read the balance between its operating environment and the tools and instruments it designed and implemented.<sup>2</sup>

## IDENTIFYING SECTORS TO SUPPORT

In the Southeast Asian model of IP, the government communicates deeply with the private sector but ultimately it is the government that picks certain sectors above others to prioritise and incentivise. This approach focuses on sector priorities and what has traditionally been referred to in IP as “picking winners”. In the current heterodox literature two new ideas are raised about picking winning sectors. The first idea is that in, the new global order, picking winning sectors is no longer sufficient – rather very specific *product* line selection is required.

Second (and related) is the idea that if a government is constrained either politically (lack of autonomy) or due to capacity and capability constraints of the bureaucracy, developing an IP process may be a more realistic approach than writing an actual industrial policy plan and picking sectors and instruments *ex ante*. In this new view, industrial policy is seen as a process without a preconceived list of sectors/products or even policy instruments. The emphasis is on constructing an institutional framework and system that elicits the problems to be addressed and the remedies to be employed through dialogue and deliberation with the private sector.

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<sup>2</sup> *The downside of the solution is that it is very expensive and only effective in the short run.*

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The process approach is primarily focused on answering a simple question: how in the modern era is a constrained state best able to discover what type of goods it should specialise in and diversify into. The current global context in which lagging economies find themselves is very different to the global context within which the Southeast Asian miracles occurred. The existence of India and China as high-volume, low-cost manufactured goods centres; the pattern of production-sharing occurring due to improved sophistication in global value chains; the decreased policy space available to support new infant industries using tariffs; and the increasing blur between final and intermediate goods<sup>3</sup> all suggest that the method by which a developing country figures out what it is it should be producing has become increasingly difficult.

For example, how did India work out that it could compete in software development, how did Columbia establish that it could compete internationally in the cut flower market, and how come Bangladesh and Pakistan with very similar factor endowments and cost structures specialised in T-shirts and soccer balls respectively? All these choices seem obvious in hindsight; but ex ante few of the advantages were visible. More importantly the literature points out that in the current global order countries do not specialise in “clothing and textiles” or in “beneficiated products” any more. Rather they specialise in T-shirts or cotton hats (4 digit and 6 digit SIC respectively), or in aluminium cooking pots or brass fastenings. In the modern era, specialisation and international competitiveness are increasingly focused on specific product lines and a narrow range of goods<sup>4</sup>. At this more fine-grained level of specialisation identification – discovering what goods a country should produce is increasingly difficult and some argue increasingly random<sup>5</sup>.

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<sup>3</sup>*These issues are dealt with in detail in the complete, theoretical paper.*

<sup>4</sup>*It is suggested that products need to be specified at a 6 digit SIC (Standard Industrial Classification) and 8 digit HS (Harmonized System) level to be relevant for an industrial policy.*

<sup>5</sup>*The Columbian cut flower market was initially created by a retired American who loved gardening and had travelled to Columbia to be with his girlfriend. The first software company in India was a summer holiday amusement for three university students during their vacation – who never expected the company to be viable.*

<sup>6</sup>*Governments traditionally only have 2 or 3 digit SIC national data to refer to – and in some developing countries no reliable official data whatsoever.*

The rationale behind the process approach to IP is straightforward. The approach assumes that government has only a vague idea at the outset about whether a set of activities is deserving of support or not and what instruments would be required to support such activity effectively<sup>6</sup>. The information that needs to flow from the private sector to the government to make appropriate decisions on these issues is multidimensional and complex and cannot be communicated transparently through firms’ actions alone (i.e. the market). As one author puts it – “a thicker bandwidth is needed” (Rodrik, 2008 p.26). This thicker bandwidth is the construction of a system of “joint discovery” about: 1) all possible products or processes a country could become competitive in; 2) all sources of uncertainty and constraints these markets face; 3) identifying and designing the most effective interventions to support industrial growth in identified products; and 4) periodically evaluating the outcomes of IP activity, and learning from the mistakes being made in the process. The process suggested is a model of strategic collaboration and co-ordination between the government and the private sector. Essentially this can be understood as a modern-day version of a South Korean type of embeddedness, but for states with less despotic power and lesser capabilities.

A huge perceived benefit of the joint discovery approach to IP is that it negates the need for a capacity-constrained state to pick winners up-front. It is argued that discoveries which meet the thresholds identified in the institutions and processes of the joint discovery process as worthy of state support should be automatically supported. The state at no point needs to pick winners – the collaborative process does this. What the state does need to do, however, is to let losers go. Picking winners and letting losers go are fundamentally different tasks. Picking winners is an ex ante activity and based on predicting a future with no data available to test or reject an hypothesis. Dismissing losers on the other hand is based on data and performance – it is an ex-post activity. The argument is that if states focus on being good at getting rid of losers, there is no need for them to pick winners.

The rub lies in how easy or hard it is for a state to let go of losers. Letting losers go in an authoritarian state with high levels of autonomy and a narrow alliance with business is a relatively simple matter. Letting go in a fragmented, fragile state where state autonomy is limited by the need to meet the broad demands of

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multiple non-state actors simultaneously is another matter altogether. Ultimately letting losers go will be a function of the balance of state-business power relations but it will be partly ameliorated by the rules and institutionalisation created in the IP process architecture.

## CONCLUDING REMARKS

By its very nature heterodox economics puts forward alternatives to the orthodox view. Historically these alternate views span a continuum of ideologies ranging from the more right-wing to the more left-wing extremes of the political economy spectrum. In the industrial policy era of the 1970s to 1990s, when the very existence of industrial policy and the right of lagging economies to implement interventionist industrial policies was the key topic of debate, the heterodox political economy position was considerably more uniform and amassed towards the left-wing end of the political economy spectrum. In this previous era, there was a clear, common, unifying position to fight against.

In the current era, when the existence of interventionist IP and the right of every nation (developed or developing; constrained or unconstrained) to pursue IP is largely acknowledged, the discourse has fundamentally shifted to how to best implement IP within a constrained operating environment.

Against this landscape one of the interesting findings of the literature review, and demonstrated in the three ideas presented, is that the distribution of heterodox IP thinking across the spectrum of political economy positions is more evenly distributed than at any time in the 20th century. If anything, a visible trend is the coalescing of ideas around using markets and private sector capacities and capabilities more intensely (especially in situations of capacity and capability constrained bureaucracies). This does not amount to a decrease in the power of the state to design and implement IP in pursuit of a state-defined developmental goal – but rather a new and more appropriate approach to achieving such a goal in difficult circumstances. Also the acknowledgement that world best practice may not always be the

best solution for a developing country problem should not be read as committing lagging economies to a lower growth trajectory or lesser international status. If anything the literature argues (and the examples illustrate) that second-best solutions may offer superior IP outcomes than the implementation of incompatible first-best solutions.

Whatever incumbent policymakers think of current heterodox IP ideas, there is little doubt that in the current era heterodox IP economists are throwing up more practical ideas and possible solutions to developing country IP issues than at any previous time – but are simultaneously challenging IP decision-makers to think outside the box and further outside their comfort zones than ever before.

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