Foreword

Industrial policies – strategic interventions designed to reshape an economy's production structure – have experienced a remarkable global resurgence. These policies can be effective and justified when addressing clear and pressing market failures, such as climate change and environmental degradation. However, their overall track record is mixed, particularly when considering their actual benefits, the costs incurred and the consequences of missteps.

Indeed, with every market failure that they seek to correct, there is a looming risk of government failure. With 80 to 90 per cent of industrial policies discriminating against foreign interests, such measures can undermine the level playing field and place strains on multilateral cooperation. There is also a risk that industrial policies may be viewed as a "quick fix", diverting attention away from necessary – but more demanding – tasks such as improving the business environment, enhancing infrastructure and raising skill levels.

Yet voters in the EBRD regions and beyond are increasingly expressing a preference for government intervention, large states and subsidies. And active pursuit of industrial policies by large economies – often to the detriment of their trading partners – is compelling more and more governments to embark on similar endeavours. Thus, domestic political economy considerations, geopolitical tensions and the actions of others are steering policymakers away from optimal economic solutions and international cooperation.

As a result, industrial policies are increasingly being rolled out in economies with lower levels of income per capita, less fiscal space and weaker institutions. As this report shows, those economies tend to use less costly but much more distortionary instruments to achieve their policy objectives, such as export bans and quotas, or licensing requirements for exports and imports. When implemented poorly, these have the potential to cause a misallocation of labour and capital, increase costs for local producers and breed corruption.

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This report provides a rich characterisation of industrial policies in the EBRD regions and beyond using several novel datasets. It offers several principles that can increase the chances of success and reduce the chances of failure when pursuing industrial policies. In most cases, though, the conclusions of our analysis are somewhat nuanced. For instance, investment promotion policies can be effective in attracting foreign investment in targeted sectors – but only in economies with sufficient state capacity. Where state capacity is low, such policies are costly but yield no significant benefits. Similarly, tax incentives can be a good means of developing knowledge-intensive service sectors – but only in regions where the right human capital is available. Elsewhere, the returns may not be sufficient to compensate for the tax revenue that has been forgone. Moreover, special economic zones often have some positive impact on economic activity at a local level – but this impact is conditional on a variety of local circumstances, including the skill base of the local population and proximity to key physical infrastructure such as ports.

Applying the various principles that increase the chances of an industrial policy being a success is easier said than done, judging by the landscape of industrial policies that is surveyed in this report. Clearly articulating the goals of each policy – at least privately, and preferably publicly – and establishing a hierarchy of objectives is key. However, most policies combine two or three different objectives, and those goals often clash with each other. For example, the objective of speeding up the transition to a green economy often runs counter to the objective of protecting domestic employment or the desire to control the supply chain owing to security considerations. Consequently, a lack of coordination and a clear hierarchy of objectives can mean that a country's industrial policies cancel each other out or pile distortions upon distortions. Lastly, there is scope to make industrial policies – especially state assistance for firms – much more targeted by tailoring them more explicitly to targeted firms' age, growth potential and capacity to innovate.

In conclusion, industrial policies have the potential to deliver results, but making this happen is hard enough in the economies with the strongest institutions. If emerging market economies want to scale up the use of industrial policies, they will have to learn fast with little room for mistakes. The costs of failure – increased government spending, economic distortions and forgone revenue – can pile up quickly in the balance sheets of overburdened governments.

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