Climbing Up the Value Chain: What Role for Policy?

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Value-added acquisition

- Diversification as part of development and growth
- In a GVC context, how can developing countries acquire a larger share of value-added and skilled jobs?
- Broadly, three kinds of situations:
  - Natural resource extraction or agriculture, where the start of the GVC is exogenously determined
  - Assembly location for final product, limited domestic upstream or downstream inputs
  - Component (good or service) intermediate produced nationally, with or without significant backward/forward linkages

What does up upgrading mean?

- Upgrading means innovating better than your competitors
- Four main types of upgrading:
  - Process upgrading: make the same products better
  - Product upgrading: introduce new / better product(s) (composition)
  - Functional upgrading: change the mix of activities, upstream or downstream
  - Chain upgrading: move to a different (better) value chain
- Upgrading only succeeds where necessary conditions are present (e.g. inferior or excessively costly processing can lead to reduced economic gains)

Constraints to upgrading: a firm-level perspective (1)

- Constraints external to the firm
  - Infrastructure, connectivity
  - Innovation capacity
  - Business simplicity and certainty
  - Access to finance
  - Macroeconomic stability
  - Tax regime
  - Own trade regime
  - Trade costs (facilitation)
  - External trade regimes, including NTMs and market access

Constraints to upgrading: a firm-level perspective (2)

- Constraints internal to the firm or specific supply chain
  - Scale and capital threshold for upgrading
  - Supply-side: quality, quantity, consistency
  - Governance along the chain
  - Capacity to comply with standards
  - Firm-level agility
  - Technological and innovation capabilities

The role of industrial policy

Industrial policy

- Can things be left to the market?
- A broad distinction interwoven in the industrial policy debate:
  - Enabling diversification and development through removing constraints
  - Changing incentive structures and relative prices
- Standard (avoidable) risks of structural industrial policy:
  - Lack of adequate information
  - Misreading information (poor analysis) or a lack of foresight
  - Political capture

A policy-maker's toolkit

- Trade policies: tariffs, quantitative restrictions, local content, export obligations
- Fiscal incentives
- Other subsidies such as
  - Domestic
  - Export
  - Infrastructure
- A host of regulations on trade and investment

A typology of industrial policies

Diversification policies reliant on the domestic market:

- Import substitution
- “Internationalized” domestic market industrialization

Diversification policies reliant on export (and domestic) market:

- Export policy-driven industrialization
- Outward-oriented industrialization
- Export processing zones

Horizontal and “smart” industrial policy

Strategies based on the domestic market

Import substitution

- Build diversification/industrialization relying on domestic demand
- Tariffs and quantitative restrictions structured to combine cheap inputs and expensive competing imports
- Problems with anti-export bias – limits of the domestic market, a lack of competitiveness, and adverse exchange rate effects leading to foreign exchange rationing
- In its purest form, a policy *cul de sac* with high economic costs
- Domestic market size is crucial

“Internationalized” domestic market industrialization: the GVC context

- Build diversification/industrialization on domestic demand, but in large countries
- Presence of domestic lead firms
- Lure internationally competitive suppliers of inputs to lead national firms (e.g. tax breaks in exchange for domestic content obligations)
- This assumes there will be a transition to international competitiveness and the scope to move beyond domestic sales – the jury is out

Strategies based on exporting

Export policy-driven industrialization

- Diversify on the back of the domestic market, but by using export restraints on industrial inputs rather than import restrictions
- Need to possess the necessary domestic natural resources
- The terms-of-trade issue, foreign sensitivities
- Domestic distributional implications
- Assume capacity to produce at world prices over time, or else no different from the import substitution policy *cul de sac*

Outward-oriented industrialization

- Diversify through both domestic and export markets
- Equalize cost structures for domestic and export sales – elimination of the anti-export bias
- Need to pick winners and ensure time-limited support
- Assumes a range of prior conditions present relating to infrastructure, skill levels, governance etc. in order to enter export markets

Export Processing Zones

Export processing zones (EPZ) are enclosed policy spaces dedicated exclusively to production for exports

- May foster:
  - Additional economic activity and job creation
  - Possible technological spillovers
- But:
  - Often favours foreign firms
  - Race to the bottom competition on tax breaks etc.
  - Sustainability in terms of labour standards and environment
  - Lack of backward and forward linkages
  - Attracts foot-loose industries attracted mostly by infrastructure/fiscal subsidies and cheap labour

Horizontal and “smart” industrial policy

Horizontal industrial policy: the economy-wide approach

- Connectivity: infrastructure, ICT, competitive key services
- Ease of doing business: e.g. business registration regulations, contract enforcement, import export documentation, improved transparency + promotion of entrepreneurship
- Trade facilitation
- Financial access and inclusivity
- Focus on innovation, R&D and science and technology policy.
- Stable macro-economic environment e.g. manageable rate of inflation, competitive exchange rate
- Multilateral cooperation – international rule setting, specific initiatives e.g. economic corridors, harmonization, eradication of tariff escalation and peaks

"Smart" industrial policy

- What combination of policies yields the best results?
  - Policy mix and orientation that avoids or can overcome domestic market size constraints
  - Emphasis on horizontal policies that support diversification
  - Ability to adjust policies to changed circumstances or to reverse errors
  - Time-frame: supports are not forever
  - Adequate governance, avoidance of dead-weight cost income transfers, ensure policy predictability
  - Avoid firm-size discrimination
- No magic bullet and plenty of risks

Thank you