

## A targeted investment climate?

Creating an investment climate conducive to job creation in the private sector is a top policy priority. The question is whether the government should aim for a level playing field or focus its efforts on the specific areas, types of activities, firm sizes, and sectors with the greatest potential to create good jobs for development. Jobs challenges vary depending on a country's level of development, its endowments, its demography, and its institutions. Ensuring free entry and competition across all sectors is a fundamental requisite for growth. But given the often limited fiscal space and administrative capacity of developing countries, creating an enabling business environment across the entire economy can be challenging, and the relevant question is how policy priorities should be set.

The conventional wisdom views targeting with a skepticism that stems from often disastrous experiences with industrial policy. While targeting was common in Latin America during its import substitution phase, by the 1980s the consensus was that interventions favoring specific sectors led to rent seeking, economic stagnation, and external vulnerability. Slow growth in India until the 1990s was also attributed to policies that favored local industrial groups and undermined competition. The success of several East Asian countries in industrializing has reignited the debate on the merits of targeting and the role of the state, but the potential for institutional failures remains the main concern.<sup>118</sup> The dominant view holds that policy makers lack both the information and the capacity to “pick winners” when they select activities to target. In the absence of a solid information base, and taking into account the institutional failures common in developing countries, a risk exists that potential beneficiaries from targeted support could unduly influence the decision process.

### *Targeting is not necessarily industrial policy*

The investment climate is the set of public goods and public policies that shape the opportunities and incentives for firms to invest productively, create jobs, and expand.<sup>119</sup> It encompasses a wide

range of policy levers: ensuring stability and security, enhancing financial markets, providing infrastructure services, reducing regulatory and tax burdens, and improving the quality of the workforce. The natural inclination is to equate a targeted investment climate with industrial policy. If some activities result in large productivity spillovers (because of learning-by-doing, for instance, or because of greater specialization and integration), targeting can imply supporting such activities. In recent years, productivity spillovers associated with various activities have been reexamined from different viewpoints, with both academics and practitioners proposing practical approaches for their identification (box 6.9).

The targeting of the investment climate may not necessarily be aimed at industrial sectors, however. Targeting can focus on gender, as when policies aim to increase labor market participation by women, or on spatial concerns, as in urbanization policies or policies for regional development. Or it can focus on firm size, as when policies support the development of small and medium enterprises. Good jobs for development differ across countries. The jobs agenda may involve making smallholder farming more productive in an agrarian economy, preserving international competitiveness in a resource-rich country, or fostering competition in activities employing skilled labor in a country with high youth unemployment. In each case, the logic for targeting lies in tackling market imperfections or government failures that are preventing jobs from contributing more to development.

An example is targeting in the agricultural sector. The underlying logic is based on the notion of public goods. The biggest obstacles to agricultural development are the lack of appropriate technologies and adequate infrastructures. As arable land becomes scarce, the development of yield-enhancing technologies is indispensable.<sup>120</sup> But incentives to generate these technologies are undermined because they can be replicated freely.<sup>121</sup> Thus, public policy plays a role by supporting the development and dissemination of such technologies. Because yield-enhancing technologies are fertilizer intensive

**BOX 6.9** *Once again, the debate rages over industrial policy*

Industrial policy is an approach to state economic stewardship in which direct support is given to particular sectors in pursuit of national goals. Industrial policy fell out of favor in the 1980s, but today it is getting recognition again. The emerging views, however, draw criticism and have led to a new round of debate.

Arguments for industrial policy rest on three types of market failures: knowledge spillovers and dynamic scale economies, coordination failures, and information externalities. In the first, industrial policy is derived from the observation that knowledge spillovers and dynamic scale economies differ across industries. Coordination failures arise when markets fail to correctly signal the future payoffs of investment projects, such as large-scale infrastructure projects, and the private sector tends to underinvest on its own. Information externalities exist when knowledge on the profitability of investment opportunities is limited and the risk of free riding discourages investment and innovation.

Building on these rationales, several approaches further develop thinking on industrial policy. The New Structural Economics stresses the shift in comparative advantage that results from changes in endowments. The large productivity spillovers from infrastructure and associated coordination failures justify a leading role for the state. To identify the industries to be supported, this approach proposes to learn from countries with similar endowments but somewhat higher income levels. Exports with a solid track record by these countries indicate which sectors could have a comparative advantage as the economy grows.<sup>a</sup>

A second approach emphasizes the policy process and especially public-private partnerships. In this view, the dialogue between the government and businesses can help to overcome coordination failures and elicit information from the private sector on the most relevant productivity spillovers.<sup>b</sup>

For a third school of thought, what matters is not just any coordination failure or externality, but spillovers of productive knowledge—mastering ways of doing things. Such knowledge is different from codified, public knowledge and is acquired and accumulated through experience. This approach claims that spillovers of productive knowledge associated with different industries can be sizable. To identify industries worth supporting, the approach proposes to rank products by how much productive knowledge is embedded in them and to focus on products that are similar to what is being produced currently but embody a higher knowledge content.<sup>c</sup>

Opponents of industrial policy cast doubts on its alleged rationales, but above all, they question the practicality of its implementation. For instance, while admitting the existence of potentially sizable knowledge spillovers and dynamic scale economies in certain industries, skeptics question the whether the public sector has the capacity to identify these industries. A related concern is the ability of the public sector to make industrial policy a dynamic process: applying credible sunset clauses to old industries, and reallocating resources to new industries. More generally, skeptics believe the knowledge and skill requirements for successful implementation exceed the capacity of the public sector.<sup>d</sup>

Source: World Development Report 2013 team.

a. Lin 2009, 2012; Lin and Monga 2011.

b. Harrison and Rodríguez-Clare 2010; Rodrik 2004, 2007.

c. Cimoli, Dosi, and Stiglitz 2009; Hausmann and others 2011; Nuebler 2011.

d. Noland and Pack 2003; Pack and Saggi 2006.

and sensitive to the availability of water, public investments in infrastructure—including roads and irrigation facilities—are often essential. The Brazilian government, for example, viewed investment in adaptive agricultural research as a prerequisite for development. It therefore supported a research corporation (EMBRAPA) that focused on technology generation and transfer and played a critical role in the success of the Brazilian agribusiness sector.<sup>122</sup>

The emergence of dynamic cities is another case in point. From Dublin to Shanghai, competitiveness initiatives increasingly involve cities, more than countries. This shift is a result of agglomeration effects: the level playing field evokes a flat world, whereas urbanization policies correspond to a world with spikes of economic activity. Dynamic cities may offer more favorable tax treatment, easy access to land, simplified administrative procedures, and sup-

port for public-private partnerships. More efficient logistics and public investments in major infrastructure facilities usually complement the package of incentives. A recent version of spatial targeting is the idea of charter cities: to attract businesses to a country with low credibility in the eyes of foreign investors, sovereignty of a city could be handed over to another country in exchange for the enforcement of a credible set of rules.<sup>123</sup> The objective is to strengthen the investment climate in a small part of the country, potentially providing a demonstration effect for further reforms, while not threatening the rents of powerful local elites elsewhere.

***The information base for targeting exists***

When there is clarity on the challenges faced by a country, it is also possible to determine which types of jobs would help address these

challenges. Thanks to efforts in research and data collection, the information set for deciding whether and how to support the creation of more of those good jobs for development is far from empty.

Consider jobs in farming. Among staple crops, rice, wheat, and maize are more promising than sorghum and millet, but the latter crops are grown in drier and harsher conditions where farmers are particularly poor.<sup>124</sup> Modern cereal varieties are high yielding primarily in favorable rain-fed and irrigated areas.<sup>125</sup> Thus, agricultural policies are bound to affect the well-being of the rural population differently in different regions. The choice depends on the country's natural endowments and societal goals.<sup>126</sup>

In nonagricultural sectors, the main obstacles to job creation can be identified through quantitative and qualitative assessments of the constraints faced by enterprises. While these assessments need to be interpreted with caution, differences in responses across enterprises reveal patterns that can also be used for developing targeted policy interventions (box 6.10).<sup>127</sup>

If creating competitive cities is a feature of a country's jobs agenda, enterprise surveys can provide information on how different the constraints faced by businesses are in cities of different sizes (figure 6.10a). If the jobs agenda

requires the inflow of foreign direct investment, enterprise surveys indicate that foreign companies are less concerned about finance, but view customs administration, transportation, and licensing as more severe impediments to firm activity and growth (figure 6.10b). One country may choose to focus on microenterprises, because their success contributes to poverty reduction, and another on young and large firms, because they tend to be the most innovative. In both cases, enterprise surveys can be used to uncover the most relevant constraints (figure 6.10c, 6.10d). For example, shortages of skilled labor, delays in customs, and stringent labor regulations are viewed as more severe constraints by medium and large enterprises than by smaller companies. In contrast, micro- and small enterprises consider access to finance and competition to be more serious obstacles to their growth. Recently, enterprise surveys have been conducted for household enterprises operating in rural areas in selected countries. They can serve as additional tools for countries to foster nonagricultural sectors in rural areas.<sup>128</sup>

The effects of removing those constraints also differ across businesses. Reducing barriers to entry fosters the growth of industries that experience higher natural turnover rates. Improving access to finance stimulates the development

### **BOX 6.10** *Caution is needed when interpreting results from enterprise surveys*

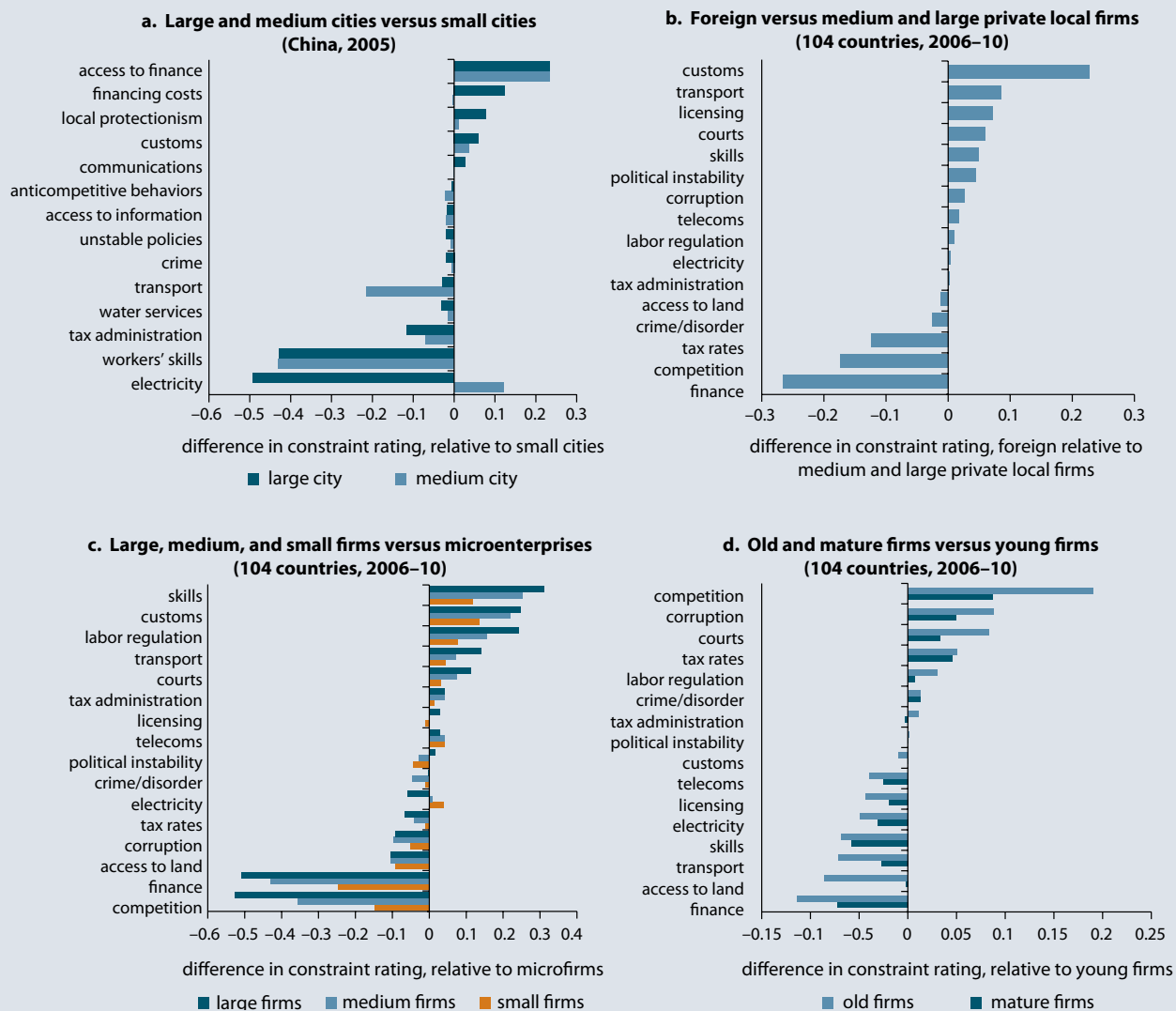
Surveys of entrepreneurs and senior managers can provide feedback on what the private sector sees as significant constraints to private sector development. Some care in interpreting their responses is necessary, however. The respondents will give answers that reflect constraints on their bottom line—without regard to the broader societal or welfare implications. Almost every entrepreneur will complain that taxes and interest rates on loans are too high. But that does not necessarily mean that taxes should be lowered or that interest rates are out of line with risks faced by creditors. Constraints to the individual respondents need to be weighed against the broader social goals.

In addition, enterprise surveys only target incumbent enterprises. The surveys do not reach discouraged entrants and so do not ask about the constraints to entry they could not overcome; nor do they reach those who recently closed down to ask why they are no longer in business. Thus the issues that may have an important role in shaping who is even asked the questions are unlikely to be identified.

Any survey that asks subjective questions has to address issues of comparability of responses. Where possible, more objective questions are preferable. Thus, instead of asking how constraining the supply of electricity is on a scale of one to five, questions can ask for the frequency and length of outages, or the costs of running a generator. These responses can more easily be compared across respondents and over time.

One further complication in interpreting responses from enterprise surveys and linking them to enterprise outcomes is the potential for a two-way causal relationship between them. It could be that more onerous conditions are hindering an enterprise's ability to stay in business. But a firm's poor performance, perhaps stemming from weak management, could also be affecting the degree to which the respondent complains. Performance also affects which dimensions of the investment climate matter the most; for example, the availability of skills may be more constraining to expanding firms, whereas labor regulations may be of greater concern to firms that are contracting and facing the need to shed workers.

**FIGURE 6.10** *The assessment of constraints to business varies across enterprises*



Source: World Development Report 2013 team based on the World Bank's Enterprise Surveys 2006–10.

Note: The analysis is based on a city-level enterprise survey of China in 2005 for panel a, and surveys of more than 60,000 urban enterprises in 104 countries in 2006–10 for other panels. The bars indicate differences in the rating of constraints between firms in two groups. Ratings in the surveys range from 1 (no constraint) to 5 (severe); they are net of the average rating of constraints by each firm, to assess relative severity. The analysis controls for firm age, size, ownership structure, export orientation, industry, and year.

of industries that rely more on external funding. The impact of removing constraints also varies across firm size, age, ownership, and other characteristics.<sup>129</sup> For example, infrastructure bottlenecks tend to stunt the growth of medium and large businesses but do not affect microenterprises significantly. Similarly, when the judiciary system is viewed as a hindrance, foreign

companies are more likely to withdraw from the market than private local firms.<sup>130</sup>

***Not all targeting is vulnerable to capture by interest groups***

Capture by vested interests is arguably the most important concern about targeting. The risk

that the potential beneficiaries could unduly influence the decision process is a real one. A too-cozy relationship between businesses and government can make it extremely difficult to remove support, even in the event of a blatant failure. Policy capture by vested interest groups could undermine the often weak capacity of governments in many developing countries.

Targeted activities that involve a large number of beneficiaries are less subject to capture. For example, support for smallholder farming, competitive cities, or female microentrepreneurs is less likely to be influenced by beneficiaries. In every country, thousands, if not millions, of

farmers, urban businesses, and female microentrepreneurs are all bound to benefit from targeted policies aimed at their group. But individually they do not have the power to influence such policies, and they may not be able to organize as effective interest groups.

Targeted government interventions are justifiable only if they are based on a solid understanding of what good jobs for development are in a particular context and only if they can be designed to be resistant to capture. One example is the involvement of the private sector in the design and management of special economic zones (box 6.11).

### **BOX 6.11** *Special economic zones have a mixed record*

Special economic zones (SEZs) are demarcated geographic areas within a country's boundaries where the rules of business are different from those that prevail in the national territory. These differential rules principally deal with investment conditions, international trade, and customs. The zones have a business environment that is intended to be more liberal from a policy perspective and more effective from an administrative perspective.

Before the 1970s, most SEZs were operated by developed countries. Then, starting with East Asia and Latin America, developing countries began to use SEZs to attract foreign direct investment, often as a part of export-led growth strategies. The objectives broadened over time, as SEZs became instruments of trade, investment, industrial, spatial, and even broader economic policies. In 1986, there were 176 zones in 47 countries; by 2006, there were 3,500 of them in 130 countries.

SEZs have a mixed record. Their rates of return are still a topic of heated debate among economists. Their performance critically depends on their design and management. SEZs are more likely to be successful when they are an integral component of the country's development strategy, are aligned with the country's comparative advantage, are cluster-based, and establish linkages with the rest of the economy.

For example, in Bangladesh, the SEZ program initially aimed to attract high-technology investments, but the government shifted the focus to garments, where the private sector had shown signs of success. The shift proved to be critical for the performance of the SEZ program. Building effective partnerships with the private sector is an important mechanism through which coordination challenges can be overcome. Institutionally, the partnership can be established through representation of the private sector on the board of the SEZ, as in the Dominican Republic and Lesotho.

A common element of many successful SEZs is the technical competency of the bureaucracy responsible for constructing and implementing them. While this cautions against targeting when government capacity is weak, several Latin American countries have recorded successes by relying on private sector ownership and management. In the Dominican Republic, where public and private zones coexist, there are no clear differences in employment, investment, or exports by zone ownership. But the private zones generally offer higher-quality infrastructure and more value-added services than the government-run ones and, accordingly, charge higher rents.