Background Paper for the 2023 Financing for Sustainable Development Report – private investment and sustainable industrialization

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- **Chapter 1 – Introduction: why private investment and sustainable industrialization**

The world has made significant progress in its fight against extreme poverty but in recent years the effort has stagnated. The latest trends suggest that the poverty objectives of the Sustainable Development Goals – hence also various SDG objectives linked to poverty, such as healthcare, education and food security – are unlikely to be attained by 2030. In Zambia 60 per cent of the population still lives on less than $2.15 per day, while in Mozambique its 64 per cent.[1] In Africa's most populous country, Nigeria, this data point stood at 30 per cent in 2018 and it is expected to have risen after the COVID pandemic. In India, this stands at 10 per cent. Challenges such as slow economic growth in many of the world's poorest countries, rapid population growth in Africa, economic imbalances, food insecurity, education gaps, and climate change stand in the way. The COVID pandemic has also exposed the vulnerability of many countries to such shocks.

To accelerate progress it is essential to build on the evidence of what works. Advanced countries such as the United States, the United Kingdom, Germany, France, China, Japan, South Korea and Singapore, and emerging economies such as those of Chile, Morocco, Mauritius, Colombia, Costa Rica, the United Arab Emirates, Botswana, Brazil, Mexico, India, Vietnam and Israel, all point to the same factor of success in their ability to fight poverty and improve the quality of life on a national scale. This was private sector entrepreneurship and innovation enabled by the leadership of government to unlock sectors and areas that accelerated broadbased and inclusive economic growth.[2]

The successful agrarian and industrial expansion of the United States, Canada and Mexico across North America; the first and second industrial revolutions of the United Kingdom and mainland Europe, India's green revolution and its more recent expansion into services and targeted manufacturing; and Japan's, South Korea's and later China's economic transformation from agrarian poverty to highly industrialised nations, were led by the strategic economic empowerment of local private sector actors to directly invest in the economy and thereby innovate, expand, create value, create jobs and eventually, export.[3]

The most important policy tool that countries used to achieve high and upper middle-income status was industrial policy, and predominantly export-oriented industrial policy. When done well, it was crafted in such a way to not constraint the private sector, but rather to coordinate the various arms of government to facilitate and deliver an enabling environment, both in key sectors and across the board, to unleash private investment that created value locally, provided jobs at scale and invested in local human capital. And in doing so, it helped the private sector to advocate for and support the strengthening of institutions and government capability, creating a positive policy feedback loop. In each case, the deliberate strategies to unlock private investment set by Alexander Hamilton, Park Chung Hee, Lee Kwan Yew, Carlos Lleras Restrepo, Ben Gurion, Deng Xiaoping, Seretse Khama, Aziz Akhannouch and Narasimha Rao, were critical to foster healthy collaboration between the public and private sectors. Each of these pursued a targeted industrialisation strategy that aligned public investment across disparate parts of government and other public actors (e.g. donors) in key areas such as investment, land management, agriculture value chain coordination, industrial parks, development financing and tertiary education around sectors that had the greatest potential to see rapid private investment growth, local value addition, large scale job creation and income provision, and innovation. This is the definition of a market-based industrial policy.

[1] Our World in Data https://ourworldindata.org/poverty
[2] Inclusive economic growth is defined as economic growth that increasingly benefits more and more people, rather than being mostly all captured by the same small proportion of the population.
[3] Chang, H., *Kicking Away the Ladder,* Anthem Press, 2002.

This has been the underlying key to the progress achieved so far globally. The approaches, timing and speed of implementation were all different and specific to country contexts. In some cases progress was rapid, systematic and consistent. In others it was slow, messy and full of multiple steps backward. In others it was repetitive stops and starts. But all were ultimately market-led and in each case, it was ultimately the combination of local private and public vision and leadership, and the collaboration between the two, that was the determining factor to build the firm and public sector capability required to sustainably and consistently raise the incomes of households on a national scale and of the public sector through the widening of the tax base. These in turn allowed households and the government to increase investment in human capital via education, health, food systems, welfare systems; and today, increasingly in environmental capital.

In today's lower income countries and lower middle-income countries, unlocking a healthy and developmental collaboration between the public sector and the private sector is ever more critical. Without this collaboration, the potential of many Low Income Countries (LICs) and Lower Middle Income Countries (LMICs) will not only continue to be squandered, but they would be at risk of further instability, discord and crises – whether from war and conflict, climate change, pandemics or political instability. As the population surges in many of today's LICs and LMICs, most of which are in Africa where extreme poverty is concentrating and rising, the cost of failing to unlock direct investment is immeasurable, with rising debt and macro instability, overwhelmed health care, education and welfare systems; rising mass youth unemployment, rising crime (see Nigeria, for example) – and the basis for harder stances toward law and order by governments, at the risk of progress in gender equality and human rights.

Scaling up direct private investment and sustainable industrialisation strategies, particularly in countries and continents that are struggling the most, is the fundamental bedrock for the success of the Sustainable Development Goals. Without a rapid scale up of private investment and the directing of that investment to productive sectors and geographies – a key role for the public sector – it will be hard to achieve the progress sought. Hence, without robust, market-oriented industrial policies in LICs and LMICs, the SDGs will struggle to be met.

This paper makes the case for the importance of strengthening the quality and delivery of market-oriented industrial policies in LICs and LMICs, such that it unlocks the power of direct investment by the private sector to drive poverty reduction and development. It starts by setting out different types of private direct investment and then identifies the major bottlenecks to scaling such investment. It then set outs a suite of policy options for governments to encourage investment that will promote inclusivity and sustainability, and concludes with recommendations on how the international community can better support.

- **Chapter 2 - Types of private direct investment**

Investment is the action or process of allocating resources to an activity with for profit or for material gain. Investment can either be direct into a private company, indirect into a public asset such as infrastructure, or financial into a financial intermediation product itself ultimately based on multiple direct investments. The purchase of shares, bonds, mutual funds or options would qualify as a financial investment. Direct investment is defined as the dedication of a private asset – hence an asset of a business – to attain an increase in value over a period time.[4] This paper focuses on direct investment.

There are different ways to categorise direct investors. For the purposes of this paper, direct investors are categorised by business model. This is important for understanding the policy demands and

[4] www.investopedia.org

implications of direct investment because in many LICs and LMICs the enabling environment and the investment climate, which in turn determine the scale of direct investment, are shaped by the nature of the policy asks by businesses and investors.[5] The market matrix developed by Werker, Pritchett and Sen, provides a useful framework to categorise investors by business model and hence frame the likely policy asks of different types of businesses to governments and politicians.[6] Under this framework there are four categories of private investors as per Table 1 below.

Table 1: Market Matrix

	High-rent	Competitive
Export-oriented	RENTIERS Natural resource exporters, agricultural concession exporters	MAGICIANS Manufacturing and service exporters, other agricultural exporters
Domestic market	POWERBROKERS Legislative monopolies or oligopolies, natural monopolies or oligopolies, government services	WORKHORSES Importers, traders, retailers, subsistence farmers, local manufacturers, producers of non-tradeables

Source: Werker, Pritchett, Sen: Deals and Development

In this framework, two distinctions are made. One is between firms that are predominantly export oriented and those that target the domestic market. This distinction is important because of the political economy differences: in LICs and LMICs where domestic markets tend to be small, the incentives for competition and for the opening of the business enabling environment by business leaders may differ from businesses that depend on access to foreign markets. The second distinction is between high rent firms (or firms with abnormal market power) and those that operate in a highly competitive market. This distinction also matters for political economy reasons: if a business survives and grows by accessing high rents or abnormal market power, then the owner has an incentive to maintain the privileges that provided the high rent or abnormal market power. Often time these may be provided as a result of deliberate government policy, whether formal or informal – or as a minimum require some form of tacit government endorsement.

In this framework there are four types of private direct investors:

a. Rentiers: business model centers on the export of high rent products or services, e.g. mining or raw agricultural commodity exporters.
b. Powerbrokers: business model oriented to selling in the domestic market but high rent, e.g. many LMIC financial sectors and oligopolistic manufacturing sectors
c. Value-adders: business model oriented around exporting of products or services to competitive markets, e.g. export-oriented manufacturing or tourism. This does not mean they cannot also sell locally, it's that their business model is oriented to compete in international markets.
d. Workhorses: predominantly domestic market oriented but competitive, e.g. most SMEs, hairdressers, hawkers etc.

[5] Pritchett, L., Sen, K., and Werker, E., "*Deals and Development*", Oxford University Press, 2017
[6] Pritchett, L., Sen, K., and Werker, E., "*Deals and Development*", Oxford University Press, 2017

Understanding the underlying business model of private direct investment is important to capture the typical policy asks business owners may require of policy makers in return for their political support. It is also important to understand what types of state capability they require because those in charge of developing the right type of government capacity to support private investment – and reduce barriers to entry and transaction costs for all investors – are politicians, and many such politicians tend to get a large part of their backing from business leaders. This is likely to be proportionally higher than in HICs, particularly those with robust democracies and large civil societies. Therefore it has a strong bearing on whether politicians and government leaders are incentivised to develop the organisational capacity of government and open up the enabling environment for other direct investors, or otherwise.

Within each of these four categories there is likely to be variation across factors like foreign and local ownership and size of business. Distinguishing between majority foreign and majority local owned is important as both have a role to play, but their roles may differ. Foreign owned businesses can steer international private capital to areas of the economy where local private capital may be limited. It can also bring expertise, networks and organizational capacity that may be unavailable in a particular sector. However it could also be more footloose and potentially be more inclined to repatriate earnings (although foreign transfers can also be common for local investors). Local investment is important to unlock untapped local savings by households, companies, banks and the diaspora; and ensure such savings are incentivized to stay in country. Capital for productive businesses in LICs and LMICs is in short supply so every dollar of domestic private capital not directed to productive sectors comes with a large opportunity cost.

Such a distinction is also important for political economy reasons. Domestic businesses play an additional role in a country beyond their economic role. Many of the local business owners in LICs and LMICs are political actors in that as a minimum they have a vote, an often-powerful advocacy voice, and some of the larger ones can directly influence party politics by funding or supporting politicians. As political actors they are at the forefront of state-business relations. In addition domestic business owners often have their relatives, friends and colleagues in government and in politics. It's a social connection, beyond an economic or political one. They therefore have a role in supporting the government to understand business and markets, and understand the ability of domestic capital to help transform the country. Foreign business owners can also influence policy, but they tend not to be part of local party politics or at the heart of local social networks. They may also be less vested in the local real economy, although whether local business owners hold their assets in country or abroad can also have significant implications.

In many lower income countries with high rates of extreme poverty, many foreign businesses tend to be rentiers (e.g Glencore in Nigeria) or powerbrokers (Unilever selling imported soap locally), while many local businesses tend to either be powerbrokers (e.g. local manufacturers selling only locally) or workhorses (e.g. SMEs, smallholder farmers).

It also matters of investors are large enterprises or Small and Medium Enterprises (SMEs). One area this tends to affect is issues of market structure and competition. Large firms are more likely to enjoy abnormal market power, particularly in LICs and LMICs where markets tend to be underdeveloped. Knowing their influence on the structure of markets is essential. The flip side to this is that SMEs tend to foster more competition, even though larger firms are more likely to also be competing in international markets. Business size can also affect issues of inclusivity and scalability. Most High Income Countries (HICs) have secured inclusive growth and employment growth through SMEs.[7]

[7] https://ec.europa.eu/docsroom/documents/16106/attachments/3/translations/en/renditions/native

However both sizes of firm have a critical role to play. Large firms can be important to bring depth of expertise and operational and organizational capacity to problem solving, that may be lacking from SMEs. In underdeveloped markets, there may be a need for lead firms to cost-discover a new product that the country can compete in. This can of course happen from SMEs, but sometimes it has to come from larger firms as the upfront investment may be large and larger firms may be better placed to manage the investment risk; or they may have more capacity for innovation. In this respect, larger firms may be the pioneer or lead, but smaller firms are the mass mobiliser.

In the market matrix, rentiers can be both large and small and it is common to find both. For example small scale mining is significant in many LICs and LMICs. Powerbrokers tend to be larger companies given the space for them to grow rapidly via the high rents they have access to. Workhorses are most often where most SMEs are to be found, while value-adder businesses can be of any size. Sometimes it is SMEs, not large firms that transition into the value-adder category – JPAL in Liberia is one such example. In other occasions investment in the value-adder category by large firms, whether domestic or foreign owned can take place.

A final subcategorization is less to do with the type of business, its size and its ownership and more about whether investments have a public component to them or are fully private. Public private partnerships are inherently important because they are investments in assets that are in support of public goals; and hence are a key tool for industrial policy. These may be in large and highly complex strategic projects that require public investment as well as private capital and expertise. In industrial policy, PPPs are an essential policy tool to combine public and private capital for flagship and catalytic projects needed to provide infrastructure or to unlock an industry or product. The nature of, and governance around, the collaboration between the public and private entities involved is an essential determinant of the success of such investment, and of its wider developmental objectives. It's useful to think of the role of fully private investment as the large-scale mobilisation of private resources for economic transformation, industrialization and inclusive growth; while PPPs' role is targeted investment that requires both public and private involvement to unlock that mobilization.

Implications of asks of different types of investors

In Table 2 below are the typical economic policy asks expected from each category, and in Table 3 the inclusivity and sustainability implications that are typically seen and expected.

Table 2: Economic policy asks across the market matrix

	High Rent	Competitive
Export Oriented	RENTIERS Low tax and royalty regime, preferential licenses, reduced red tape, non-intervention, extractive infrastructure, low capability to regulate and enforce; indifferent on exchange rate	VALUE-ADDERS Low tax regime, reduced red tape, market-friendly intervention (productivity, problem solving), capable government, good infrastructure (can be cocooned, e.g. Special Economic Zones), pressure on central bank for forex access, exchange rate depreciation for finished product, appreciation for inputs
Domestic Oriented	POWERBROKERS High barriers to entry; preferential licenses, government contracts, high tariffs, market distortions, weak institutions, order without rule of law, lack of transparency, pressures on central bank for forex access, overvalued exchange rates	WORKSHORSES Low taxes, minimal red tape, good generic infrastructure, some government capability (roads, power etc), would prefer rule of law to compete with powerbrokers but will settle open for ordered deals with more transparency.

Source: Werker, Pritchett and Sen, with author additions. Open ordered deals are defined as an informal agreement between business and political leaders that will actually be met by both parties (ordered) and that opens up the enabling environment so others can benefit (open). The opposite of this would be closed and disordered deals where only a few benefit and where government ability to follow up is limited.

As Werker and Pritchett indicate in their paper, "this typology does not imply that rentiers and powerbrokers are bad, and that value-adders and workhorses are good. Indeed, it may be the rentiers that provide the main engine of growth in the start-up phase. And it may be the powerbrokers that provide the essential services that give citizens access to trade, water, sanitation, electricity, and communication. But firms…may have very divergent interests. Understanding those divergent interests is important to understanding how the businesses may or may not have an interest in inclusive growth."

In many LICs and LMICs rentiers tend to be foreign owned large business, albeit this is not always the case.[8] These actors tend to be highly influential with governments, even if foreign, because they are often one of the largest tax payers. Firestone in Liberia, Chevron in Nigeria and BHP Billiton in Bolivia are examples. One common challenge with this type of investment is that the infrastructure they build or promote tends to be about linking mines or fields to ports rather than connecting people. In this way they tend to develop an extractive economy around them. Another is that they often provide relatively little by way of local spillovers and while individual firms pay are major tax contributors, there are too few of them to widen the tax base.[9] Local content policies have typically failed to shift these dynamics because in many LMICs there isn't sufficient firm capability to provide the bulk of the inputs needed – which tend to be highly complex products and services. Often local inputs are constrained to services like food and catering supply and security. Another challenge is the relatively limited job creation and investment in local human capital relative to the needs of many LICs and LMICs, and limited investment in upskilling at scale. One can also add issues of Dutch Disease, whereby political leaders become complacent to develop job-intensive industries because of the tax revenue – and personal gain – that rentier industries, and supporting powerbroker industries such as security

[8] Pritchett, L., Sen, K., and Werker, E., "*Deals and Development*", Oxford University Press, 2017
[9] Nhabinde S., and Heshmati A., '*The Extractive Industry's Impact on Economic Growth in SADC Countries*', Institute of Labour Economics, 2020

and financial services, which tend to be domestically oriented high rent sectors in extractive economies – can provide.[10] This complements the policy-ask stance by many rentiers, who for the success of their business model often promote a low tax, a low bureaucracy business environment as all they need to do is be able to extract their product from the country and little more. They might also be cautious on environmental impact, although there are increasing instances of these firms proactive on climate change because of corporate social responsibility reasons, new business opportunities e.g. by investing in renewable energy, and a high capacity to invest in modern technological climate solutions if so desired. Because they compete globally, global competition and the political growth of the climate agenda might increasingly encourage this.

Powerbrokers also have their challenges, even though as mentioned they can also bring benefits. Their challenges are typically a tendency to end up being insular and protective of a relatively small domestic market pie in an LIC or LMIC market. This insulation can make them cautious of openness to trade and uncompetitive and uninventive over time. In many cases, such firms become established or strengthened due to preferential deals with government – such as the provision of preferential licenses to import key commodities and preferential tax deals. Or they do so via oligopolistic behaviour after reaching a settlement with the few other competing businesses on how to divvy up the pie. The financial sector in many LICs and LMICs suffer from this; as do many importers of most of the commodities for sale in may supermarkets of LIC and LMIC cities, or of other major consumed goods such as cars and fertiliser. Some such powerbrokers establish or grow their business off the back of accessing government procurement contracts, as is the case of some of the main fertiliser imports in countries like Malawi.[11] As mentioned in the table, the asks such businesses may have for policy makers and for state capability may be challenging when viewed from the lens of inclusivity, economic growth and potentially also environmental sustainability – depending on the industry.

Value-adders are typically the hardest category to grow but it can lead to the greatest rewards for development. Their positive externalities are extensive, particularly around inclusivity because of their relatively high spillovers, job-creation and importance of human capital to their business model. It is typically also the category of businesses where most bankable projects may emerge, and the one with the greatest scope to widen the tax base for domestic resource mobilisation. However, this category is hardest to succeed in because business success depends much less on personal connections or access to a natural resource, but rather from providing a good or service that the market values relative to the competition; and at a price that allows for cost recovery.[12] Their environmental sustainability can be mixed, and very much depends on the industry; although some could provide climate-positive opportunities to exploit or integrate.

This type of direct investment is especially important because it is the most likely to lead to product and process innovation; and to help the country to cost-discover new products it can compete in, thereby helping the country deepen its complexity on the product space.[13] Also because it needs to rely on highly competent management to succeed and allow for multiple firms to succeed and grow,

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[10] Isham J., Woolcock M., Pritchett L., and Busby G., '*The Varieties of Resource Experience: National Resource Export Structures and the Political Economy of Economic Growth*', World Bank Economic Review, 2005

[11] Said J., and Singini K. '*The Political Economy Determinants of Economic Growth in Malawi*', Global Development Institute, 2014.

[12] This is predominantely about foreign markets since value-adders are export oriented, but it also applies to local markets where such products could compete. Sometimes export oriented firms start off by targeting the domestic market.

[13] Hausmann R., and Klinger B., '*The Structure of the Product Space and the Evolution of Comparative Advantage'*, 2007.

it is best placed to grow the private sector fastest. This category of direct investors has a further critical benefit in that it tends to support a more developmental positive political economy. What its business owners are likely to ask policy makers for are reforms that tend to benefit other businesses too by reducing their barriers to entry and transaction costs. And such policies would require political leadership to invest in the organisational capacity of the government, rather than merely make a side deal that requires not capacity strengthening of the relevant government department.

Table 3: Inclusivity and sustainability implications across the market matrix

	High Rent	Competitive
Export Oriented	RENTIERS Inclusivity implications: few spillovers; few jobs (relatively) ,dependence on imported inputs, cocooned local economy, little local procurement, high tax contributions but narrow tax base, disconnect with local communities, relatively little investment in local human capital; high CSR efforts Sustainability implications: can be at a tension with environmental protection; could be highly polluting	VALUE-ADDERS Inclusivity implications: high spillovers; high jobs, both imported inputs & local procurement, can be cocooned if solely export SEZs, high tax contributions and widen tax base, strong link to local communities, invest in human capital and innovation, low CSR efforts Sustainability implications: can be at a tension with environmental protection (e.g. heavy manufacturing); can solve sustainability issues (Depends on sector); climate-smart innovations possible
Domestic Oriented	POWERBROKERS Inclusivity implications: few spillovers; some jobs, dependence on imported inputs, integrated in local economy, high local procurement, support service to other sectors, high tax contributions but narrow tax base, some investment in local human capital; little innovation, low CSR efforts Sustainability implications: can vary: some sectors are low impact (E.g. banking); others can be high (E.g. heavy manufacturing)	WORKSHORSES Inclusivity implications: high spillovers; few jobs (but high self-employed), dependence on imported inputs, integrated in local economy, high local procurement, low tax contributions (informal sector) but potential wide tax base, minimal investment in local human capital; little innovation, low CSR efforts Sustainability implications: can vary: some sectors are low impact (E.g. hairdressing); others can be high (E.g. transport in polluting buses)

Source: Author using the matrix of Eric Werker, Lant Pritchett and Kunal Sen

For example, if a business wants to export a new food product to another country, it requires the standards lab to be accredited and to actually function and certify the product for export. This is typically run by the Standards Bureau which tends to fall under the tutelage of the Ministry of Industry and Trade. Such certification is not required for the import of fish or cars into a country: although quality requirements for such imports are important, e.g. food health standards for fish, it is relatively easier to bypass the enforcement of such a requirement for political economy reasons discussed in the powerbroker section, such that in many LICs it is easy to find low quality imports on the market.

The generally developmentally-aligned asks by value-adder firms creates a positive feedback loop between the private sector and the government. A further benefit of value-adder firms and sectors is that they create an incentive among private investors to collaborate with each other. This is not for the oligopolistic reasons as is typically the case with powerbrokers, but to collectively target larger markets abroad, given their export orientation. There is increasing evidence of the value of this type of collaboration among industries and between the industry and the government for driving inclusive growth. Israel’s success in horticulture, Kenya’s in floriculture, Vietnam’s in cashew, Indonesia’s in palm oil, the Gulf States’ and Ethiopia’s in aviation, Bangladesh’s in textiles and garments, Malta’s tourism industry, Chile’s in salmon and fruit, and Morocco’s success in car manufacturing and tourism are some examples to consider where local firms collaborated, also with the government, to jointly target lucrative foreign markets.[14]

The challenge with value-adders is the need for government coordination of policies: they need electricity, roads, financing, skills, regulations, market access and so on all to work and align. This is where industrial policy becomes crucial because the role of this policy tool is specifically to bring such policy coordination around productive sectors.

The final group – the workhorses – are a critical type of private investment because they often constitute most of a country's resource – its people. And it's where most of the poor are. In many LICs and LMICS, some 60 to 70 per cent of people secure their income from highly competitive, domestic oriented sectors such as low-value agriculture, street vending, hairdressing, or low paid, unpowerful government jobs.[15] The challenge with this category is simply the sheer amount of people involved combined with the little amount of income and capital to go around. It is the category least likely to have savings, access to information, capability and, hence, capacity to invest. However it can also lead to some innovation – such as Nollywood in Nigeria[16] and J-Palm in Liberia[17] - although to scale it would likely need passage to the value-adder category – as has eventually happened with Nollywood and J-Palm - even if starting from targeting import substitution with an eye to international competitiveness, which counts as export orientation.

The type of investment made by these four categories matters for the feedback loop between the private and public sector. Beyond investment in their existing business models, which may deepen the nature of their asks to policy makers, and hence the ability of the country to open up the space for more poverty-reducing investment, or otherwise, it is also important to consider if they invest in other categories. For example, it would be transformative if power brokers or rentiers shifted to be value-adders. In some sectors this may be hard, as mining companies are mining companies, not manufacturers, but in others it may be possible, for example shifting importers of plastic goods to start producing such light manufacturing goods – Arkay Plastics is an example of this in Southern Africa.[18] Another example would be moving the domestic-oriented high rent financial sector from a dependence on rentier, powerbroker, aid and trade finance lending toward value-adder lending.

Typical financing relied on

It is helpful to consider the typical financing that these different types of direct investors tend to rely on. As can be seen from Table 4 below, there is significant variation across the 4 investors types. The table below does not imply these are the only types of financing, but reflects what is commonly seen in many LICs and LMICs. The overall picture shows that it is mainly rentiers that can rely on formal, standard financing – having access to global equity and debt markets. Powerbrokers can rely on this too, but often access their financing from more informal sources such as family networks and loan subsidisation by Ministries of Finance and Central Banks off the back of lobbying and economic dependence. Magicians tend to rely much more on development finance and need access to a wide range of sources and types, from angel investing through to late stage investing). Because magician sectors and firms tend to be less developed in LICs and LMICs, their access to formal financial markets

[14] Abraham D., Ngoga T., Said J., and Yachin M. 'How Israel Transformed Its Agriculture Sector: Five Insights for Africa', Volcani Institute, AGRA and Tony Blair Institute, 2019

[15] Pritchett, L., Sen, K., and Werker, E., "*Deals and Development*", Oxford University Press, 2017

[16] https://www.legit.ng/1190518-brief-history-nollywood.html

[17] https://penniur.upenn.edu/uploads/media/09_Nanka.pdf

[18] https://buymalawi.mw/members/arkay-plastics/#:~:text=Incorporated%20in%201997%2C%20and%20began,took%20the%20market%20by%20storm.

like the stock exchange or corporate bond issuances tends to be limited. Workhorses tend to rely on informal and localised financing schemes, such as micro-finance or village and savings loan schemes. Venture capital and private equity could support these but are quite limited as returns tend to be low.

Table 4: Typical financing needs of different types of direct investors

	High Rent	Competitive
Export Oriented	RENTIERS - Equity: typically traded on global stock exchanges - Debt: corporate bonds, commercial bank loans etc - Corporate savings: e.g. group of companies - Large deals development finance (E.g. by large Development Finance Institutions) - Loan subsidization by Ministry of Finance/Central Bank where at risk of insolvency (e.g. rubber industry in Liberia) - Private equity	VALUE-ADDERS - Private equity - Venture capital (from Angel investor through to late stage) - SME development finance (if SMEs are net exporters); e.g. challenge funds, matching grants, some local development banks - Export development finance - Value chain financing (e.g. contract farming; warehouse receipts etc) - Innovation development finance
Domestic Oriented	POWERBROKERS - Family network financing, e.g. importers and domestic oriented manufacturers are often family owned private businesses (Lebanese and Indian family networks prevalent in Africa are examples). - Preferential gov't subsidies via deal-based tax breaks - Extended credit on government procurement contracts - Debt financing: commercial bank loans; can be corporate bonds for e.g. banks, telecoms - Trade financing (i.e. import financing) - Development financing (e.g. first loss guarantees for banks)	WORKSHORSES - Micro-finance - SME developmental finance - Innovation development finance - Value chain financing - Village savings and loan schemes - Savings and credit cooperation organisations (SACCOs) - Government agricultural subsidies (E.g. for farm inputs) - Venture capital

Source: author categorisation based on experiences working on industrial policies and economic development in various LMICs.

- **Chapter 3 – Bottlenecks to investment in developing countries**

This paper considers two types of bottlenecks to private direct investment in developing countries: bottlenecks that hold back the private sector from directly investing, and bottlenecks that hold back the government from addressing private sector bottlenecks and setting a suitable enabling environment. These can be thought of as market failures and government failures. Within government bottlenecks, this paper also captures political economy challenges: these are essential because they speak to the interaction and influence between those who lead government and those who run businesses: in other words, it captures the feedback loops between the private sector and the government.

What holds back the private sector from directly investing

The main driver for the private sector to directly invest or not in an economy is the capital risk return trade off. In the minds of investors in developing countries – whether foreign or domestic, large or small – there is often a certain appetite for risk and what ultimately matters is how this squares with the expected, and eventually, actual returns of investing in a firm or a project. A project where this ratio is favourable is often called a bankable project and it is common to see a shortage of bankable projects in LICs and LMICs. It is therefore helpful to view bottlenecks in this frame, so that they speak directly to the private sector's decision-making process.

Returns are determined by the business case of an investment opportunity – a firm or a project. In addition, transaction costs can eat into the return. Transaction costs include essential activities such as accessing leads, conducting due diligence, negotiating deals and structuring financing. High transaction costs – which can occur for example due to delays, cumbersome processes or excessive fees for such activities - can lead to under-investment.

There are four sources of investment risks[19]:

1. **Information gaps.** Investment decisions are based on information. Asymmetries in information always exist and what matters is their extent and nature. Investors invest based on confidence in an investment opportunity. The larger the information gap, the less likely they are to invest. Information is needed on the firm or project under consideration, on the business case, and on the environment within which a business or project need to succeed. This all affects the perception and confidence of investors, as ultimately investment requires trust and information is the source of building trust. The greater the information gap, the weaker the perceptions and the weaker the confidence. The mood around a business, industry and country plays a major part in affecting investment decisions, potentially even more so in developing countries than in developed.
2. **Business-specific risks.** A second source of risks is the quality of management and governance of ventures being invested in to – be they firms or projects. The higher the quality of the management of a firm or project, the lower the risk. The higher the quality, the more likely that a firm or project is well-run, good business decisions are made, mistakes are learned from, risks are managed, and unexpected and uncontrollable shocks are mitigated. This is also important to maintain a focus on the strongest business case and value proposition, as opposed to diluting the firm or project resources across multiple opportunities and ventures.
3. **Enabling environment.** A third source of risk is the space within which firms and projects need to operate. Various factors play a part in shaping this environment and these can have a direct effect on the business case and the risk return trade off. Expectations of the enabling environment are therefore critical in advance of an investment decision.
4. **External shocks.** A final source of risks are external shocks that are largely uncontrollable. Such factors may include pandemics, weather-related events such as failed rains or floods, crop or animal diseases, geological events such as earthquakes and tsunamis, and conflict and political instability.

<u>From risks to bottlenecks to enablers</u>

For the purpose of promoting direct investment, bottlenecks can be considered as factors that increase risk or that fail to mitigate risks that could be mitigated. Below is a list of typical bottlenecks categorised by investment risk[20]:

1. Information gaps
    a. Access to information and data
    b. Access to investment promotion and facilitation services
2. Corporate governance
    a. Management capability
    b. Access to business development support, including leadership training, corporate culture, legal and accounting services and technical/product services
3. Enabling environment

[19] https://www.ifc.org/wps/wcm/connect/region__ext_content/ifc_external_corporate_site/sub-saharan+africa/resources/sme-ventures-nov-2018

[20] Sourced from various inputs, such as Weder B., 'Obstacles Facing Smaller Businesses in Developing Countries', World Bank, 2003 and Akileswaran K., Huss A., Hymowitz D., and Said J. '*The Jobs Gap*', Tony Blair Institute, 2017

   a. Access to land and property rights
   b. Access to suitable financing including settlement issues
   c. Physical inputs such as seeds and fertilizer for agriculture or raw materials for manufacturing
   d. Access to infrastructure such as reliable electricity, roads, water and internet connectivity
   e. Labour and skills
   f. Technology and research and development
   g. Access to markets
   h. Macro-economic stability and access to foreign exchange
   i. Regulatory and tax obligations
   j. Environmental impact and mitigating for and adapting to climate change
   k. Informal requirements, such as corruption
   l. Policy incoherence from government
4. External shocks
   a. Access to suitable insurance products

This a long list of bottlenecks, and some are more important than others in different contexts and at different points in time. In some instances any one of these could be a binding constraint – and in such cases, removing them could strengthen value chain linkages and lead to an outsized benefit in stimulating the local economy. In others it might be a major or a minor constraint. In others it might not be a constraint at all. The scale and importance of the bottleneck will depend both on how many direct investors see it as such at to what degree, and also on the ability of a country – across both the public and private sectors – to address them: the longer a country is unable to address a bottleneck, the more of a bottleneck it may become.

Considering the market matrix described in the prior section, these bottlenecks could be especially critical for value-adders and workhorses, because rentiers and powerbroker businesses are much more able to use the high rents they have access to in order to protect their business model through informal deals. In some cases they may actually favour a difficult business enabling environment, so that barriers to entry to other firms remain high and their privileged position is protected. In the case of value-adder and workhorse businesses, the enabling environment around them is critical.

In considering the ability of countries to address bottlenecks, it is helpful to flip them around to 'business enablers'. It then becomes important to understand who can provide specific enablers and what role do they play. Some enablers are typically provided by private actors, such as telecoms, financing, management training or raw inputs for agro-processing or manufacturing. In such cases the government has a role to play in sector development, governance and regulation, as well as in ensuring welfare, e.g. for subsistence smallholder farmers. It can also play a role in stimulating or directing demand, for example through public procurement or periods of fiscal expansion; or even from temporary protection for key industries being developed for future competitiveness. Similarly, so do civil society have an important role to play in ensuring the public perspective is accounted for. The interaction between the public and private sector around such enabling sectors is important. Other enablers may be provided by either, such as electricity, access to information and data, business development support, or upskilling. A third set of enablers are solely the domain of government, such as tax collection, macro-stability, environmental regulation or the summation of public policies and how they impact businesses. Sometimes the inability to provide such enablers becomes the major bottleneck; while in other instances, conflicting policy and objectives can create a stumbling block for direct investors in these areas. One such example is a preference to keep the telecoms industry closed, as has been the case in Ethiopia, while another may be tax policy and the difficult challenge of balancing domestic resource mobilisation efforts with investment facilitation needs.

Access to finance is a common bottleneck that is common in many LICs and LMICs. Often a major part of the challenge is that businesses and investors often need developmental finance, such as patient capital that allows for enough time to breakeven, in line with the product cycle, and for favourable terms, but the financial sector remains underdeveloped in its ability to provide this. This tends to happen due to multiple structural weaknesses – which manifest themselves in high interest rates and limited financial products for businesses. Structural weaknesses tend to include high risk perceptions, weak insurance markets, weak wholesale finance markets (including stock exchanges and bank lending), market structure issues such as oligopolistic competition in many small economy domestic markets, and a dependency on high rent sectors like imports, aid and mining, which limited the need to develop financial products for less developed sectors (like value-adder sectors).

In many LMICs and LICs, support services for environmental sustainability and for exploiting new climate opportunities are also limited, creating another bottleneck. This ranges from environmental advice to the cost of adopting climate friendly technologies, to accessing renewable energy fit for the business, to climate smart agriculture, and through to firms' ability to access carbon credits. In addition, in many countries the legal and regulatory framework for these remains underdeveloped.

<u>What holds back governments from providing the enablers needed to scale direct investment</u>

The government is the most important actor in shaping the enabling environment within which businesses and business ventures – i.e. bankable projects for direct investors – need to be developed and succeed. Governments in developing countries face multiple challenges in providing this, and often end up being a major barrier to direct investment. This could manifest itself either directly through one of the factors mentioned in the prior sub-section, such as through overly challenging regulations, or the pursuit of tax revenue with a short-term lens, or cumbersome licensing or land access processes. It could also manifest itself by failure of government to provide, either directly or directly, a key enabler such as reliable and affordable electricity, or property rights, or suitable roads or macro-economic stability. It could also affect business indirectly through, for example, failure to apply competition policy to the financial sector and ensure suitable development financing; or failures of the education system and the quality of the labour pool.

Policy incoherence by government can also be problematic as this creates uncertainty and confusion for investors and entrepreneurs. This speaks to conflicting policies across key areas like land, tax, regulation, infrastructure, investment facilitation and so on; as well as to conflicting changes within policies over time, such as through export bans suddenly introduced on key products that the private sector invested in (be they smallholder farmers, or larger businesses) to export. Coordination failures between various government policies and departments play a major role in contributing to this.

Evidence in this area suggests that the typical failures that hold back governments in developing countries from setting a suitable enabling environment for businesses are[21]:

1. Organisational weaknesses – the struggle of key government agencies to effectively and efficiently meet their functions required by their mandate.

[21] Andrews M., Pritchett L., Woolcock M. '*Building State Capability: Evidence, Analysis, Action*', Harvard University, 2016 and Hickey S., '*Pockets of Effectiveness*' Global Development Institute, 2019 and Hymowitz D. '*Art of Delivery*', Tony Blair Institute, 2015

2. Managerial failures – limited capability to carry out critical management functions such as direction and strategy setting, maximizing use of evidence, follow up, coordination structures, prioritization, performance management and problem solving.
3. Political settlement implications – government organisations are led by politicians, who in turn are driven by domestic politics and the political system within which they need to succeed. This may have implications on their ability, incentive and bandwidth to develop the government capacity needed to facilitate the business enabling environment
4. Policy trade offs – sometimes governments are faced with genuinely hard decisions around conflicting policies. For example domestic resource mobilization efforts in the short term tend to clash with efforts to facilitation of business growth. Consumer and export standards tend to clash with business growth facilitation. In the literature, governments are said to be 'doomed to choose'[22], reflecting the fact that they often have to settle for second or third best options, simply because the first best option is just not feasible.
5. Conflicting mandates – in developing country contexts, it can be common for governance systems to evolve in a piecemeal manner, and evolve based on political exigencies rather than mandate. This is often seen in numerous developing countries through the regular creation of new ministries and entities, sometimes solely to appoint a politician a ministerial job. This coupled with weak organizational capability can lead to confusion and duplication of functions across ministries. For example, in many countries clashes often arise between the Ministry of Industry and Trade and the Investment Promotion Agency over who leads on what: the line between trade and industrial policy on the one hand, and investment and export facilitation on the can easily be blurred.
6. Communication gaps – in many governments there are often communication failures across officials and leaders both because of management challenges such as weak coordination processes and structures; but also because of political issues, personal conflicts,
7. Conflicting pressures by stakeholders – the challenge with government is that everyone is a stakeholder in it, including the international community. This is of course a good thing, but it raises the challenge of multiple stakeholders wanting different things from the government. Hence it is easy for the government to be pulled in multiple directions, stretching the limited organizational and leadership capacity available. In terms of investment, this can lead for example to an inability to prioritise certain value chains or sectors for development, coordination and facilitation, or to all of the priorities of e.g. the SDGs to be local priorities, which in effect means none of them are priorities.
8. Constrained financial resources – in many LIC and LMIC governments, as standard of living demands and expectations rise, the demand for government resources, whether for welfare, public services or public investment will often outstrip the capacity of the economy to contribute tax revenue, leaving many governments with minimal discretionary spend. This in turn will limit its ability to spend money on what is needed to facilitate private direct investment.[23]
9. Entrenched patronage systems – many of today's least developed countries have economies in which the leadership and more affluent people make their money off clientelist arrangements, typically from high rent sectors like extractive industries, importation, oligopolistic services (e.g finance) and even aid. Accessing government procurement contracts would also qualify. Such systems are often well established: they function and serve their

[22] Rodrik D., 'Doomed to Choose: Industrial Policy as a Predicament', Harvard University, 2006.
[23] Mushtaq K 'Governance Lecture, 4 part series'. https://www.youtube.com/watch?v=EdZOltzT8OE

purpose. This in turn makes it much harder to develop the capacity required to facilitate competitive and value add private sector; and also makes it harder to reduce barriers to entry.

The political economy perspective

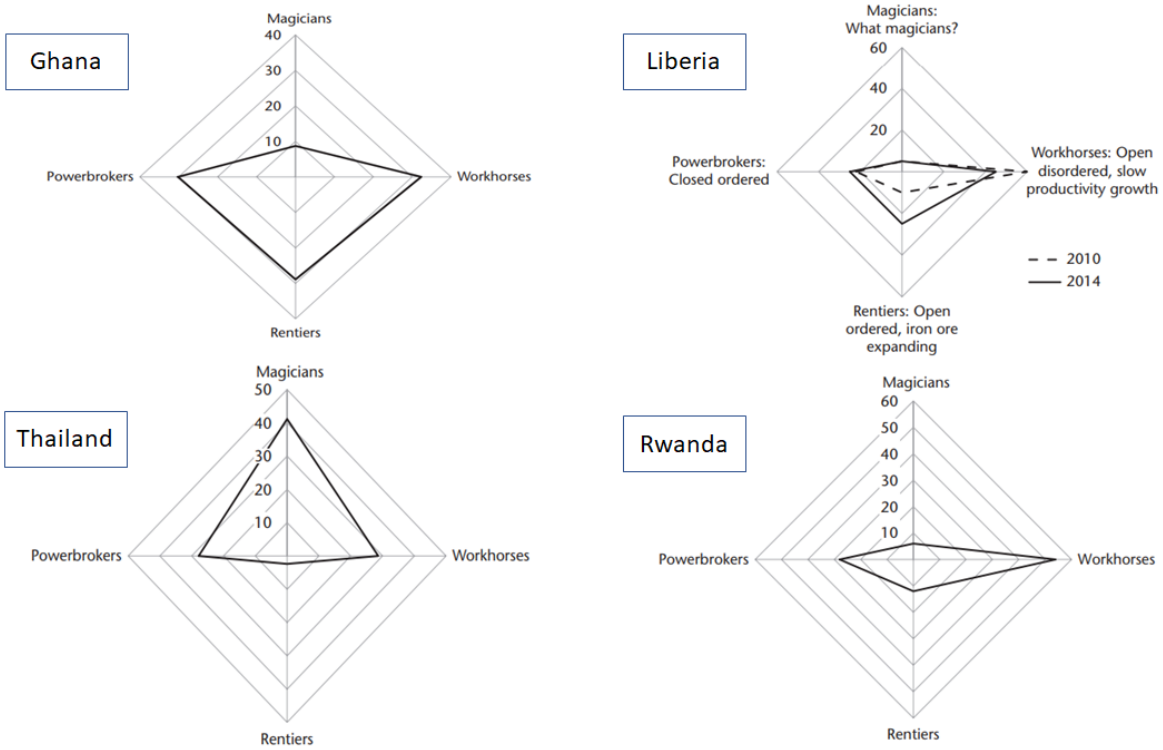
The nature of these government challenges to address market failures speaks to the importance of the relationship between public and private actors around direct investment. The reality is that a lot of public private interaction takes place on a regular basis and sometimes the line between the two is blurry: many government officials and politicians are also business people running their own farms, taxi businesses or group of companies; or the brother or sister of a politician or government official are politicians; or people from a village or community reach out to someone in government regularly for support and patronage – because that is the custom. In addition, even where the linkage is less obvious, social networks and ties between the business leaders and political and government leaders in a country tend to be tight and entrenched over generations. The economic, political, social and cultural all intertwine. In such settings, understanding where the effective power lies for business enabling environment decisions, as well as for how sectors are run – and whether they encourage or discourage direct investment is important.

The market matrix is used to understand the nature of deals that business leaders can typically make with political leaders. The 'Deals and Development' book[24] presents case study analyses for a number of countries and found that many low and lower middle income countries have a predominance of rentier and powerbroker businesses, as seen in Figure 1 below in the graphics for Ghana, Liberia and Rwanda. In Ghana, powerbrokers and rentiers account for 60 per cent of the economy, while value-adders only account for 10 per cent. Value-adders are also 10 per cent or less in Liberia and Rwanda too, signifying the lack of orientation of the political economy toward value addition and external trade-based competition. This can be contrasted with an upper middle income (UMIC) country like Thailand that has seen its GDP per capita rise from $2,000 in 2000 to $7,200 today.

Having an economy that is dominated by powerbrokers and rentiers is typically a major bottleneck to scaling up private direct investment. In such instances, it can make it harder for SMEs to flourish, and for government to improve the enabling environment. Powerbrokers and rentiers play important contributory roles in the economy and can be important for kick starting economies after periods of instability or crisis (an example was the role the iron ore mining industry played after Liberia's civil war ended), but it is important to be aware of how much political and economic influence and power they have, and what incentives they are placing on political and government leaders. For example, many influential powerbrokers in various LMICs are importers of consumed goods, such as cars, fertiliser and food. If they secured a strong market position through preferential trade licenses and tax breaks, which could easily be the case, then their core incentive would be to protect those licences and tax breaks and they could use some of their gained rents to back politicians in return for that protection. This may also hinder efforts to improve the enabling environment for local manufacturing of those same goods to take place.

[24] '*Deals and Development, the Political Dynamics of Growth Episodes*', Pritchett, Sen and Werker, Oxford University Press, 2018

Figure 1: Market Matrix of Ghana, Liberia, Rwanda, Thailand around 2010. Percentage of economy captured by each grouping of private sector.



Source: '*Deals and Development, the Political Dynamics of Growth Episodes*', Pritchett, Sen and Werker, Oxford University Press, 2017.

The key finding of the Deals and Development research, which was originally commissioned by the UK's Department for International Development (now called Foreign Commonwealth and Development Office) through the University of Manchester's Global Development Institute, was the extent to which state-private sector relations in LMICs tend to be led by rentiers and powerbrokers, limiting the incentive to invest in the enabling environment for direct investment on a transformative scale.

- **Chapter 4 – Industrial policy as the key policy tool to scale direct investment**

When confronted with so many bottlenecks and challenges to scale private direct investment in the economy, it can be difficult and overwhelming for government leaders and officials to know where to start. Does one start with energy reform, or land reform, or tax reform, or transport reform, or doing business reforms, or macro-economic policy, or agriculture policy, or digitalisation, or special economic zones, or tertiary and vocational education and training (TVET) policy? It's a long list of challenges and reforms needed. It becomes particularly challenging when one considers the weak organisational capacity of governments in LICs and LMICs, the rapidly rising populations of many of the world's developing countries, the rising expectations of the population for improved standards of living, the back-to-back crises to manage such as COVID, the fallout of the Ukraine war and climate change, and the highly competitive nature of many political systems and five-year election cycles.

The importance of trade-friendly industrial policy as the policy of economic policies

Countries that have made major strides in recent years – particularly in growing the value-adder firms and through this, the workhorses – have shown that **what matters most is a healthy collaboration between the government**, **the private sector and civil society** to problem solve the greatest bottlenecks of the day holding back specific industries and sectors – particularly the value-adders that have the potential to diversify the economy, unlock other industries, address problems that afflict other sectors, and be new sources of inclusive and sustainable economic growth. This has been the key to delivering coherent policy for private investment. A **vertical focus** on sectors with the greatest potential to create jobs, value addition, firm growth and improved incomes is important because it allows limited government bandwidth and management capability to focus on the largest bottlenecks holding back sectors that have the greatest transformation and poverty reduction potential. A **market-oriented approach** rather than one that is protectionist import-substitution is an essential component of such a policy. Crucially the most rewarding approach is one of soft government-led coordination and problem solving, **while ensuring that cross-sectoral reforms and programmes in enabling sectors like finance, telecoms, energy, water, labour, skills, and transport are coordinated** to provide a coherent investment product in sectors and geographies with the greatest potential. Such horizontal reforms are important although the evidence shows that reliance solely on such horizontal reforms without a focus on sectors may do little to restructure the economy fast enough to keep up with the rising welfare requirements of the population and of government.[25]

One can point to all the major success cases on each continent and find this same policy pattern. In North and Central America, Mexico's growth in private investment came off the back of collaboration between investors and government around key sectors such as agriculture, manufacturing and tourism.[26] Mexico's third largest city, Monterrey, is an example of this. It hosts a thousand manufacturing companies across 50 industrial parks in the city, which are backed by state and federal incentives, a skills training ecosystem and a supportive logistics system and supply chain.[27] In the United States, initial growth in agriculture and manufacturing was enabled by Alexander Hamilton's economic vision, which included 'support for the nations' new emerging industries'[28]. Similarly in Costa Rica and the Dominican Republic through the focus on the green economy and the medical manufacturing sector respectively.[29][30] In South America, Chile's growth was fuelled by the investments in the salmon and fruit industry, apart from the traditional copper sector which grew in the refining area, as was Colombia's rapid growth in coffee in the 1960s.[31] Likewise Brazil's progress in areas like meat, soya, cars and aircraft also benefitted from such a collaboration of state and private sector.[32] In East Asia, Japan, South Korea, China, Thailand, Vietnam and Malaysia all saw heavy collaboration focused on problem solving for agro-processing, manufacturing and tradable services. The Chaebols in South Korea – such as Samsung and Kia – are prime beneficiaries of this. They were rent-capturing mechanisms backed by the state, but because of their net export orientation and governance standards they built productive capacity internally, but also opened the space for other domestic firms to grow.[33] In Malaysia the oil palm and electronic industries make for interesting case studies, as does

[25] Rodrik D. '*Industrial Policy for 21st Century',* Harvard University, 2004
[26] Santarcangelo J., Schteingart D., and Porta F. '*Industrial Policy in Argentina, Brazil, Chile and Mexico: a comparative approach'*, Revue Interventions Economiques, 2018
[27] https://www.monterreygov.org/
[28] https://www.gilderlehrman.org/history-resources/spotlight-primary-source/hamilton%E2%80%99s-report-subject-manufactures-1791#:~:text=Hamilton's%20vision%20for%20the%20economic,the%20new%20nation's%20emerging%20industries.
[29] https://www.ilo.org/wcmsp5/groups/public/---dgreports/---inst/documents/publication/wcms_315671.pdf
[30] https://pharmaboardroom.com/articles/dominican-republic-a-hidden-manufacturing-gem/
[31] Lebdioui, A., '*Debunking the free market miracle: how industrial policy enabled chile's export diversification.'* LSE Latin America and Caribbean Blog*, 2021*
[32] Santarcangelo J., Schteingart D., and Porta F. '*Industrial Policy in Argentina, Brazil, Chile and Mexico: a comparative approach'*, Revue Interventions Economiques, 2018
[33] Choi J., and Levchenko A., *'When industrial policy worked: the case of South Korea'* , CEPR, 2021

electronics and rice in Vietnam, and of course the industrial park and special economic zone approach of China to boost manufacturing.[34]

In South Asia, the cases of Bangladesh in textiles and garments, which was led by the private sector, and micro-finance, driven by civil society (BRAC), drove the political class to follow suit and help problem solve; and the case of car manufacturing in states like Tamil Nadu, are also testament to this phenomenon.[35][36] In the Middle East, although financed by the oil resource of Kuwait, Qatar, Oman and United Arab Emirates, such a public private collaboration in services such as air transport, finance and tourism, also took hold. This was also the case in Mediterranean countries such as Israel with Ben Gurion's leadership in engaging the kibbutzes in agriculture, or Turkey's industrial parks geared to food processing and other light manufactures, or Malta's industrial parks, tourism and gaming industry, or Morocco's car manufacturing industry in Tangiers, its agriculture boom around citrus and olives, and its tourism growth.[37][38][39] In Africa too, countries that have made major progress, such as Mauritius in textiles, tourism and financial services, Botswana in the meat and diamond industries, Lesotho and Ethiopia in textiles, Kenya in software-based services, floriculture and manufacturing[40], Rwanda in tourism and horticulture, Togo in maritime services and call centres, and Cote d'Ivoire in cashew nut production. In each of these cases, success was based on a constructive and problem-solving oriented relationship between the government and the private sector, in which the government had the capability to follow up to bottlenecks holding back the private sector, both existing firms and new potential investors.[41]

This stands at the core of a successful industrial policy. In all of these cases, a sound industrial policy approach was key to unlocking private investment into these sectors and helping these nations diversify, grow and develop. It is essential to view industrial policy not as manufacturing policy or even as purely a policy to develop productive sectors. While it includes these, it is more than this: a strong industrial policy is one that pragmatically brings to life the leadership's vision of how to transform an entire nation's economy and society. It provides the means to build coalitions of reform around specific sectors that are competitive, broadbased and inclusive, and that through them can help coordinate various disparate other economic policies such as monetary policy, tax and fiscal policy, investment policy, trade policy, education policy, financial sector policy, labour and skills policy, energy and transport policy, climate and environmental policy, agricultural policy and so on. When it comes to scaling direct investment in countries, industrial policy is the policy of policies, in that it allows for all these other divergent and sometimes conflicting policies to not be designed and implemented in isolation of each other, but 'packaged up' and be anchored to a central vision for how to develop the productive and job-creating capacity of a country, and how to steer and unlock private

[34] Lall S., '*Malaysia: Industrial Success and the role of the government*', Journal of International Development, 1995

[35] Mahmood A., '*Bangladesh's remarkable development journey: Government had an important role too',* Brookings Institute, 2021

[36] Akileswaran K., '*Inclusive Growth in Tamil Nadu: the role of political leadership*', Tony Blair Institute, 2020

[37] Said J. '*From Colonial Dependence to Blockchain Leader*', Tony Blair Institute 2020

[38] Abraham D., Ngoga T., Said J., and Yachin M. 'How Israel Transformed Its Agriculture Sector: Five Insights for Africa', Volcani Institute, AGRA and Tony Blair Institute, 2019

[39] Triki C., '*Trade, investment and employment in the Southern Mediterranean Countries*', International Labour Organisation, 2022

[40] https://www.cipe.org/blog/2015/03/24/successful-public-private-dialogue-the-kenyan-perspective/

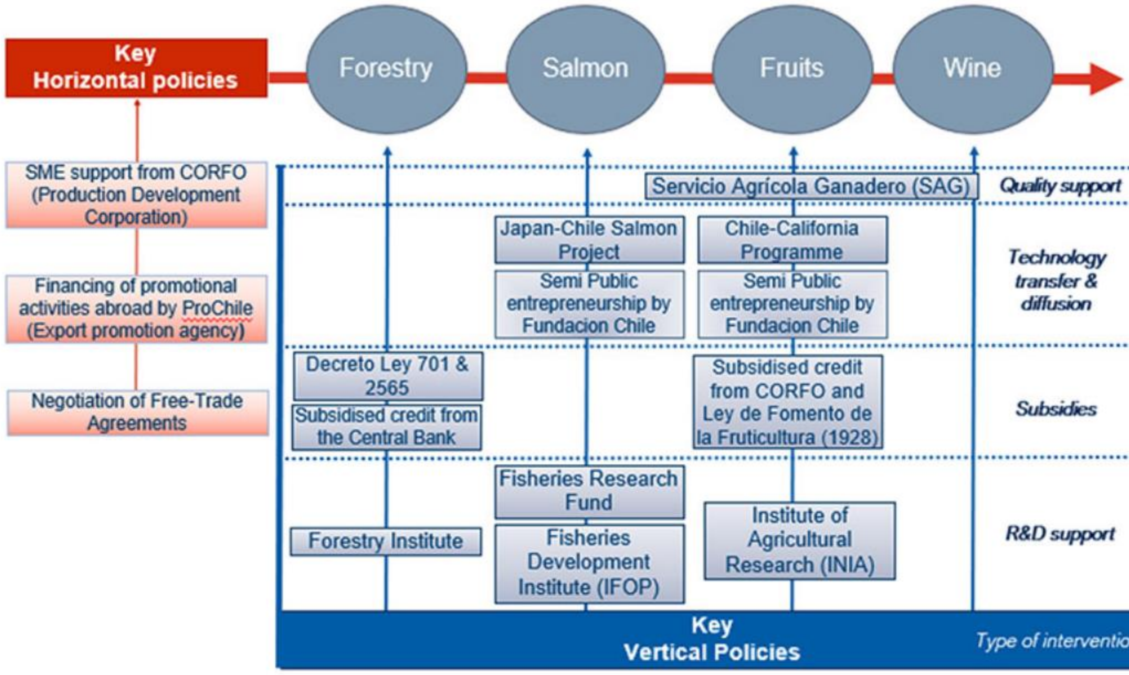
[41] Bird K. '*Progress in Economic Conditions in Mauritius: Success against the odds',* Overseas Development Institute, 2011

direct investment toward that goal. In this way it can extend through to how international financing policies for economic development can be accelerated.

Case study evidence shows that when government leaders – at the level of Presidencies, Prime Ministerships and Ministers of Finance and Economy – take hold of an economic transformation strategy anchored in market-led and private sector based industrial policy, significant economic bottlenecks are solved that create spurts of investment and inclusive growth; and in turn increase the possibility for further investment and spillovers. The leadership in Tamil Nadu in India is one such case.[42]

The graphic below is a summary of Chile's industrial policy, which – over the course of many years, through many trial and errors and not without its share of problems and issues – was successful in developing industries like salmon, wine, fruits and forestry products that complemented its main resource, copper, to scale investment and broaden economic growth. Chile successfully combined sector specific support programmes (vertical policies), with cross-cutting (horizontal) policies such as trade policy, financial & business development support.[43] It is this targeted combination that allowed for the nationwide scale up of direct investment into productive, net exporting sectors that could transform the economy and in turn unlock investment in other 'follow-on' sectors such as retail and domestic agriculture. In large part as a result of this, Chile grew its GDP per capita from $2,500 in 1990 to $16,500 in 2021 – the highest in on the Americas mainland below the United States and Canada.

Figure 2: Summary of Chile's non-copper industrial policy 1970-1990.



Source: Lebdioui, 2019

When these areas of policy combined – and one can easily add energy, transport, fiscal and other policies to the above case of Chile – then the domestic investment climate improves, there is a coherent 'investment product' to enable governments to facilitate investment, tax incentives can be tied to the needs and incentives for productive industries, and even training and upskilling efforts can

[42] Akileswaran K., '*Inclusive Growth in Tamil Nadu: the role of political leadership*', Tony Blair Institute, 2020
[43] Lebdioui, A., '*Debunking the free market miracle: how industrial policy enabled Chile's export diversification.*' LSE Latin America and Caribbean Blog*, 2021*

engage the productive industries and develop programmes with them. In each of these areas, dialogue, negotiations and collaboration between policy makers, service providers and businesses in the productive industries are essential to find practical solutions that work for each stakeholder. Inv

Sector prioritisation

An important aspect of modern industrial policies is to support governments to prioritise sectors better. In doing so, it is important to encourage governments to prioritise, but also to remain open and flexible to supporting promising private sector progress in other sectors that have inclusive growth characteristics. In prioritising, two key principles need to be kept in mind. First, prioritisation is a regular exercise, not a one-off, needing revision every few years, albeit not too frequently to not allow sufficient progress and sufficient learning. Second it is important for international partners to not conduct their own analysis in isolation of the government – as typically happens. Rather, it should be conducted together with the key government officials – this literally means ‘sitting together’ and conducting the analysis as a team. In this respect it is important for government to lead such exercises, and for multiple partners to be present and to be constructive, flexible and supportive. In many respects, it matters less if a sector deemed a poor choice is prioritised, than objecting to the government’s approach to the extent that an international partner extracts themselves from the exercise. Industrial policy is a matter of institution learning. For example Israel at one stage prioritised the cotton value chain, and after a few years it realised it was going very badly. It learnt from that and switched the approach to other value chains that proved highly successful.

CrossBoundary and the Tony Blair Institute provide a suggested framework for how to support governments to prioritise sectors.[44] It proposes a two-step process: first an economic development analysis to identify sectors and subsectors with the greatest transformative potential, as well as attempt to understand and respect the government’s existing priorities and political economy/power implications of the sectors. The second step is to apply firm-specific investment criteria to the sectors and firms within them, such as the viability of the business model and quality of the management. The first step has six criteria, has presented in Figure 3 below.

[44] Cusack J., Flahive T., Said J., Tilleard M., and Yadav P. ‘*Scaling up Investment for Jobs in Africa’*, CrossBoundary and Tony Blair Institute, 2020

Figure 3: Economic criteria for sector and sector priorisation for industrial policies

Source: CrossBoundary and Tony Blair Institute, 2020

Under this prioritisation framework, all of the first five elements should be present to justify prioritisation. The final criteria only applies to international bilateral partners seeking to facilitate investment from their home country to the LIC or LMIC.

- **Chapter 5 – Policy options in each bottleneck area**

Access to Information and Data

To improve investor access to information, there are three approaches that can be taken. The first is improving the quality and availability of economic data. This ranges from strengthening local statistical offices, to strengthening international databases (ITC's trademap, Harvard's Atlas of Economic Complexity and UNCTAD's Productive Capacity Index are practical examples), to improving private sector data sources (GroIntelligence is an example), to improving public open databases. The strengthening of data management systems within governments, to pull data from different parts of government – where data can be siloed and be unavailable to many potential investors – is a key part of this. So is the collation of both public and private sources. The latter is partly bound by confidentiality, but not all of it: surveys of firms, such as Enterprise Maps done by the International Growth Centre and Enterprise Surveys by the World Bank, are good examples of firm and sector level data captured from private firms. Such surveys should be conducted annually for LICs and LMICs, to serve as a practical and useful source for investors.

A second approach is to strengthen business councils and fora where investors can interact with target firms and projects. The African Development Bank's Africa Investment Forum and AGRA's Agribusiness Dealroom are two examples that can be strengthened and emulated. Such efforts are labour intensive and required a lot of preparation to prepare the requisite information and to ensure the right audiences on both the investor and investee side are in the room. However they can be highly rewarding when done well. Government actors can also be present to help address government related information gaps. This benefits government too, as they can better understand what investors need from them to be able to invest.

The third area is about investment promotion and facilitation. This is covered in the next sub-section.

Investment Policies

Investment policy is the sharp edge of a robust industrial policy because, together with value chain facilitation efforts with existing businesses, it is what feeds in private sector challenges and opportunities into the policy space. Without it, industrial policy would be running blind and would not be market-based. It is the client facing edge of industrial policy.

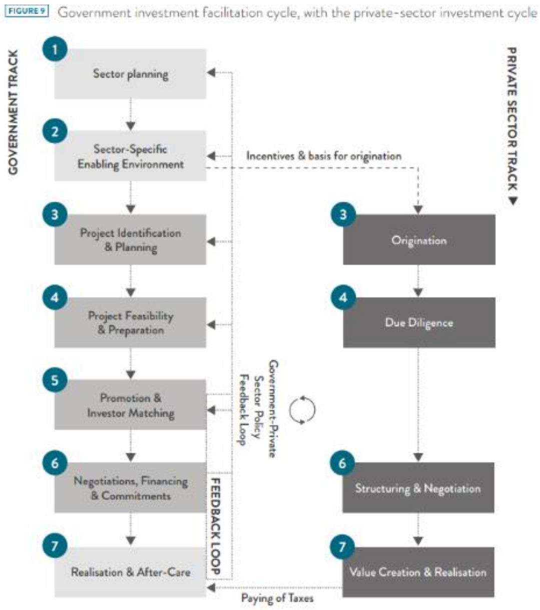
There are three aspects to investment policy: investment promotion, investment facilitation and international investment agreements. The former is more of a marketing exercise to address the information and perception gap that targeted investors may have of a country, a sector or a business. This would include presentations at investment conferences, investor roadshows or communicating via websites or even cold calls and emails. Such efforts can easily be seen as a waste of resources, and many such efforts by LMIC governments have often given little by way of return. This tends to happen when outreach is untargeted – maybe with the wrong audience in the room - and when government's are not well organised to provide the right type of information fit for an investor audience.

Investment facilitation is arguably the most important aspect of investment policies as it is about the process governments need to undertake to actually support investors to overcome transaction costs and improve the risk return ratio to secure a deal: i.e. an actual direct investment by a private entity. There are two types of processes to facilitating investors: for government-conceptualised investments and for private-sector conceptualised investments. The former can be 100 per cent private investments (and does not need to be a PPP investment, even though many end up being one), but the initialisation would have came from government: this can happen where the government deems the need for a new actor in a market, and wants to find private investors to take the lead. Sourcing a new agro-processor for an agriculture product not processed in country is one such example. In 2012, the Government of Malawi did this by putting out a tender for a new sugar processor to set up in the country. The government could contribute resources toward it, though it doesn't need to. If it does, it becomes a PPP. The second type is where the private sector initialises its own investment and seeks some form of government engagement. This could be for licenses, land access, tax support, development financing or other forms of support. This is quite common in many LMICs.

In investment facilitation efforts it is important to consider twin tracks of investment intermediation: a private sector track and a government track. Both need to be carried out in parallel, particularly in LICs and LMICs where market failures tend to be extensive. The private sector track is intermediation necessary between a direct business and a capital provider. It is hence private to private. This is where a business seeks capital for a planned investment, such as expansion or a a venture into a new product line. The process here involves activities like origination, due diligence, structuring and negotiation, and closing.

The government intermediation track are the activities governments need to do to ensure an investment deal takes place: as per above this can include support such as development financing, licensing, providing various pieces of information to investors, providing regulatory waivers and adaptations, ensuring access to land and electricity, and so on. In private sector-initiated investments, the government facilitation process is largely one of responding to the asks (bottlenecks) raised by the investor and negotiating an agreement, ensuring realisation of the deal and providing investment aftercare support. In government-initiated investments, the government intermediation track process is longer and involves project identification and planning, project feasibility and preparation, project promotion, investor match making, negotiations and financing, realisation and after care.

Figure 4: Twin tracking investment facilitation on the government and private sector sides of deals



Source: CrossBoundary and Tony Blair Institute, 2020[45]

What is typical in many LICs and LMICs is for governments to initiate many investment projects, or to receive unsolicited proposals from the private sector for government support – some of which strong projects, some not – and for all this to take place outside of a broader industrial and sector strategy process. This is also common in infrastructure sectors like energy. In many cases in LICs and LMICs, this can lead to problematic investments or raw deals for the public sector. While it is important for governments to be open to private sector initiatives and to different arms of governments being propositional on new investment projects, two things are essential:

1. That proper due diligence is done on behalf of the government, so that what is being provided by way of support is proportionate to the benefits and to certify that the project is genuine, viable and well managed by the private sector
2. That investment plans are anchored to and to some degree shaped by an industrial strategy and a sector development plan. Knowing how to develop an industry or sector, including enabling sectors like energy, telecoms, finance and digital, apart from productive sectors, is essential. This should not mean being rigid and dogmatic and only approving project as per the sector plan. It's important to be open to new initiatives and ideas and risk-taking projects. But on the flip slide, it's essential that governments can see how a project fits into a plan to develop an entire industry or sector, and how the sector plan can evolve as a result of each investment. This is also so that the sector coordination that needs to happen (the provision of enablers like energy, development financing, skills, market linkages, business development

[45] https://institute.global/advisory/scaling-investment-jobs-africa

support etc) remain coherent and joined up. In turn this is also important to ensure the success of the investment, both from a private sector and a public sector perspective.

When viewed in this way, investment policy is not run loosely, but is an integral part of industrial policy. It can also allow for the twin tracking necessary, as per Figure 3 above. Twin tracking and a clear anchoring of investment policy in industrial policy (i.e sector planning and sector-specific enabling environment in Figure 3 above), can allow for more bankable projects to emerge, hence a larger pipeline of investment opportunities and a higher likelihood of investment success once investment actually takes place.

The third aspect of investment policy is international investment agreements. These are agreements between two countries to promote investment between them. UNCTAD's World investment Reports cover these in extensive depth. A key challenge relates to the reconciliation of such agreements, which can be driven more by foreign policy priorities, with actual local investment needs and various other local policies, such as tax policy. It is important these are coherent with local efforts to develop productive sectors and that they are in line with policies such as fiscal policies. Anchoring these to an industrial policy is important because it allows for different arms of government, including foreign affairs, foreign trade and foreign direct investment functions to align with domestic policy arms, such as tax policy, with clarity also on priority value-adder sectors and their needs.

A related but distinct area to this is the provision of contract negotiation support to governments with large international investors. many LICs and LMICs have limited capability to negotiate big investment agreements and individual contracts with large foreign countries and firms. Germany and the EU's Connex Programme is an example of such support that is useful for negotiations with rentier and powerbroker firms in sectors like mining and public-private partnerships in major infrastructure projects or special economic zones.

<u>Management capability and access to business development support</u>

Strengthening the ecosystem of support to firms, particularly small and medium enterprises in the value-adders and workhorses categories of the market matrix is critical. This can be done in various ways. Providers of such support can be both public and private. Private providers range from private legal services, to accountancy and audit services, to leadership, coaching and team building services, through to services for product development, marketing and advertising, human resource management and so on. It can also extend to value-chain specific technical and research services.

Fostering a competitive landscape in these sectors is critical, so that firms have quality of service, choice and reasonable pricing. Weak competition policy in these sectors, to the point they become oligopolistic powerbrokers can be detrimental. Many countries tend to struggle with this, even in advanced countries such as Italy. Strengthening competition commissions and giving them the institutional capacity, tools and political backing to ensure fair competition in such sectors is important. However political economy challenges tend to undermine these efforts. Another way to strengthen such private services is through standards, which can also come through self-regulation, and through education and skills development by ensuring high quality university and non-university courses. In addition, private entities could be encouraged or facilitated to provide below-cost or pro-bono services, so that smaller firms with less capacity to afford such services – particularly workhorses – can access them. The International Legal Services Programme is one such example.

However, in reality the markets in such service areas in many LICs and LMICs tend to be underdeveloped or face significant market failures. There is often a need for public actors to step in. Public actors can range from local and international not for profit organisations to the government.

These actors can provide such services often at a subsidized or even free price, thereby having boarder reach. They can also agglomerate the various business development services for example into incubators and accelerators, or micro industrial parks, which also provide base infrastructure such as office space, factory and storage space, electricity and internet connectivity. SEBRAE in Brazil and Fundacion Chile are good examples of such a government actor. In other countries, the not-for-profit business development space is flourishing and this should be encouraged. Various types of actors can support including religious organisations, UN agencies, local and international non-governnment organisations and bilateral development partners. The main thing is to provide a high-quality service and be responsive to the needs of firms, in particular value adders and pioneer firms that are testing a new product or sector.

Arguably, the most important business development service that is needed is management and leadership support. This is because without strong corporate governance, the best product ideas and technologies can fall to be commercialised and scaled. Strengthening areas like leadership coaching and mentoring and leadership trainings is therefore essential. This also extends to workhorse SMEs such as farmer and other non-farmer cooperatives. In such cases providing a management advisor for the long haul, whether in a full-time embedded way or with regular visits, can be tremendously helpful. The Netherlands Business Support Offices, which works in 9 countries, and Scotland Development International, are two examples of agencies that provide such support.

Access to land and property rights

The largest effort to address investor bottlenecks relate to land is around supporting countries to develop or adapt fit-for-purpose land governance laws and titling systems. Land is a highly political and sensitive topic, as it is a defining feature of many sub-groups within countries and comes with many historical legacies. It's important that the land rights of both local populations and investors are protected and most bottlenecks arise where there is lack of clarity and standard rules in the system. The roll out of customary land titling in many LICs and LMICs is a key and important feature of modern land governance in LICs and LMICs to help address this challenge. Using electronic systems for land demarcation and titling is essential too – as most issues are either about property rights and asymmetric information. There are various examples of countries that have done this, either at a national level or at a pilot, sub-national level for now. One example is Rwanda that in 2012 completed a four-year project to map 10.4 million parcels of land across the entire country and prepare title documents for 8 million landholders: the universe of land and landholders in the country.[46]

Industrial parks, tech parks, agro-poles and special economic zones are policy tool for providing access to land to direct investors. These have the added benefit of providing key infrastructure services such as energy, water, sewage solutions, internet connectivity, labour and transportation to a number of firms at the same time. There are many cases of success and of failure across LICs and LMICs. The successful cases have typically been those where such projects were developed as a core part of a country's industrial policies, rather than in isolation from other government policies and initiatives. In the case of the latter there is greater chance of failure due to part/zone governance and management issues, failure to provide a key public service and respond to the needs of investors, failure to ensure access to right quantity and quality of raw inputs, over investment and capture by a a few oligopolistic or anti-competitive tenants. These are the typical factors that need to be guarded against to ensure the successful use of such tools to provide access to land, infrastructure and other property rights.

[46] https://successfulsocieties.princeton.edu/publications/securing-land-rights-making-land-titling-work-rwanda-2012-2017

In addition to land and special economic zones, property rights can be strengthened in various other ways. Commercial courts for dispute strengthening, business registration processes, and intellectual property rights are some examples. These tend to be longer-term cross-cutting reforms, encouraged by programmes such as the Doing Business Reforms. An important learning in recent years has been that while these are important, these efforts should be complemented by sector-specific property rights as part of vertical components of industrial policies. This is because factors like sector-specific regulations and value chain contracting terms (e.g. contracting between an anchor farmer and satellite farmers) require a sector lens and can often be a larger constraint for that specific sector than cross-cutting property rights. Contracting between smallholder farmers and off-takers around non-perishable crops such as rice and maize is one example; such that 'side-selling' is a prevalent issue that undermines investment by off-takers.[47] Another way to look at it is that addressing sector-specific property rights may sometimes be easier through a sector specific approach, given political economy considerations. In other cases though, a cross-cutting approach may be needed.

Beyond formal property rights, some rights are ensured through informal and social means, depending on the culture and system of local communities. Sometimes, strengthening these can be valuable: customary land titling is an example.

Access to suitable financing and insurance

Strengthening access to finance can be considered across two aspects: the strengthening of the local financial sector, which is primarily about commercial finance, and development finance. Financial sector strengthening is one that often requires a lot of attention in LICs and LMICs. In terms of the market matrix, it is helpful to think of the financial sector as a derivation of the sectors that it depends on for its business model. As was discussed in the political economy section, many value adder sectors tend to be weak, and as such many banks and other financial institutions tend to derive a lot of their income from powerbroker, rentier and workhorse sectors. The workhorse sector reflects most household and retail banking and insurance, which powerbroker and rentier lending reflects most commercial banking and insurance services. These tend to be the relatively more lucrative sectors, and include financing products such as trade finance, which is predominantly import and commodity trading financing, capital projects for extractive industries, services to business service providers. It can also extend to financial services for the aid and not-for-profit industry which brings in foreign wealth into the country. This can tend to exacerbate political economy issues by developing fewer products for value-adder sectors, which can fairly often be seen as more risky and not essential to get into. Like in business development services, competition policy in the financial sector is also paramount given that often in many LICs and LMICs, particularly smaller countries, there may be only a handful or two of financial providers.

In addition to these structural factors, it is also important to ensure macro-economic stability through prudent public and corporate borrowing so as to maintain interest rate stability. Factors like supportive global financial settlements and the ability of banks to be recognised, also in line with anti-money laundering regulations, are also important. In addition, issues of sovereign risk management, and support such as the political risk insurance provided by the World Bank Group's Multilateral

[47] Side-selling refers to a circumstance where an off-take provides a loan (in kind or in monetary terms) to smallholder farmers for agricultural inputs on condition they sell back their crop at harvest to that off-taker, but farmers sell the produce to a third-party before the off-taker shows up for collection. This happens for various reasons, including farmers being desperate for quick income. It directly affects the property rights of the off-take investor.

Investment Guarantee Agency, can be particularly important. The credit rating scores of countries can also have a critical effect on the ability of direct investors to access the financing they need.

Various development financial products have developed over the years, such as micro-finance pioneered by BRAC in Bangladesh, local development banks (such as the Industrial Development Bank of India), sector-specific risk mitigation schemes (such as Nigeria Incentive Based Risk Sharing for Agriculture Lending scheme), challenge funds, incubators and accelerators (which are a form of financial product as they combine with business development services to reduce financial risk and provide development finance, such as SEBRAE in Brazil, Fundacion Chile and Chile's Product Development Corporation CORFO) and matching grant schemes. Such tools have proliferated over the years in LICs and LMICs. The greatest impact has been through the development of sector-specific financing and business development support schemes, as in Chile, such that financial products are tailored to the needs of products and key industries. The terms of financing, such as the loan repayment period and the amount of financing for working capital, matter significantly, especially for workhorse and value-adder firms. Linking financial products with business development support to ensure proper firm governance is also important, helping to ensure viability for financial products and de-risking riskier sectors for the local commercial banking and insurance sector. In such instances such pro-active development finance has helped evolve the local private financial sector by in effect de-risking new financial products deemed too risky by commercial banks, who often preferred sitting back in their comfort zone as a powerbroker industry.[48] Crucially it's important for support to be given to local development banks and funds, so they can accelerate suitable development finance.

Where value adders are few, local development and industrial banks can be critical useful. South Africa has an Industrial Development Corporation and the Development Bank of South Africa to service this area. Where workhorses are not showing enough dynamism and entrepreneurialism, SME funds such as one set up in Brazil jointly by the Brazil Development Bank (BNDES) and SEBRAE, accelerators and incubators can be used. Where the financial and insurance sectors need support to innovate with new products for value-adder sectors or workhorses, financial de-risking mechanisms can be used. For example USAID's had a Development Credit Authority, which has since been folded as part of the Development Finance Corporation is an example of a de-risking mechanism attempting to get local commercial banks to develop financial products for sectors and customers deemed traditionally too risky.

<u>Access to physical inputs</u>

Industrial policy is essential to help ensure suitable and affordable access to physical inputs by investors, particularly for agriculture and goods manufacturing although also for service industries like tourism and call centres. Value chain facilitation – which is a core part of good industrial policy – is an important policy tool to ensure that a private sector system functions from market all the way back to raw inputs and other key enablers. It allows the public sector and other relevant players to ensure that bottlenecks that hold back suppliers that produce or import such physical inputs (e.g. agriculture for agro-processing; or fertiliser for agriculture) are addressed. Value chain working groups are a mechanism that can be used to support such a problem-solving process. Where inputs are critical for an important sector, e.g. seeds for agriculture, and there are many market failures that limit sufficient production and distribution at a suitable cost, there is a case for subsidisation. Many LICs and LMICs have subsidy schemes for such inputs – these can typically be inefficient and be poorly run, and hence strengthening their governance, also through electronic tools, is important. Another policy that affects

[48] Said J., and Singini K. '*The Political Economy Determinants of Economic Growth in Malawi*', Global Development Institute, 2014.

this bottleneck is trade policy: ensuring low taxes on imported inputs is an important policy tool – and yet it is one that tends not to happen in the absence of a clear industrial policy.

Access to infrastructure

There are two policy approaches to accelerate infrastructure access for direct investors. One approach is through Special Economic Zones and Industrial Parks, which were already alluded to. Another is through central coordination of economic policies at the heart of government, using vertical strategies of industrial policies (i.e. priority sector development efforts) as the anchor. Typically in many LICs and LMICs infrastructure ministries, agencies and providers operate in a generic fashion, which means that many infrastructure development plans, such as energy, telecommunication, water and transport master plans, are developed without a strong connection to productive sectors and their needs, including in a geographic and spatial sense. In LICs and LMICs, considerations of productive sector needs in infrastructure policy tend to be too high level and not specific enough to the needs of those sectors. Therefore what tends to happen is that plans are developed for an industry to be developed through an anchor investment – eg. a hotel by a certain tourist site – but this does not feature in the energy or transport or telecoms plans of the ministries of energy, public works and telecoms, and their corresponding implementers – be they public sector or private. This is a common scenario that leads to investor challenges to access the infrastructure services they need.

What has worked in countries such as Ethiopia and Chile is the pro-active use of the vertical components of trade-oriented industrial policies to guide programming at infrastructure ministries and agencies. Without such a focus, which is best facilitated through the centre of government – such as the President's Office, Prime Minister's Office or Ministry of Finance – it becomes hard for infrastructure ministries to align their programming. This is key also because programming cycles in infrastructure sectors tends to be long, so lack of clarity on priority sectors and geographies linked to those sectors can take many years to rectify. In this way, there can be a twin track approach – overall infrastructure development plans looking at the needs of the country as a whole; and also productive sector-specific infrastructure plans. Problem-solving mechanisms can also be applied – e.g. developing a list of key firms in the priority sectors and working with infrastructure agencies to ensure they are connected and services, resources permitting.

Such an approach can also identify opportunities for tailored solutions, particularly from a green economy perspective. For example developing renewable energy solutions for climate smart agriculture and for rural agro-processing zones or tourism sites, as well as for other forms of manufacturing. Beyond solar and wind solutions, crops like sugar and oil palm can also produce bio-energy. Similar solutions may apply in other infrastructure: for example making use of locally grown soya based polymers for asphalt, as is done in the United States, thereby developing synergies between agriculture and transport infrastructure and extending the lifetime and durability of roads. Synchronisation in water management between household and commercial or industrial use is also essential and supporting the roll out of water and waste recycling solutions, like countries such as Israel have done, in LICs and LMICs would also benefit direct investment. As in Israel in its early stages of development where the water recycling plans were directly tied to plans for the agriculture sector, as well as urban centres, closely anchoring infrastructure policies to industrial policies is important.

Labour and skills

A critical policy intervention in this area is the strengthening of the labour market to allow for a better match of demand and supply of skills: from the investor perspective, this means the ability to find the required labour. Typically this market struggles with a number of market failures but the most prevalent is asymmetric information. Finding ways to address this gap is an important way to strengthen this market. Jobtech solutions – the use of software applications to increase awareness of job seekers and candidate seekers and link them to each other – provide one way to address this market failures and such solutions are proliferating. Like with most other bottlenecks, another way is to facilitate dialogue and better articulate the skills 'ask' to skills providing institutions, such as the Tertiary, Vocation and Education Training (TVET) sector. This can be done by supporting the priority value-adder sectors to get organised through associations and collaboration with the government and hold constructive dialogue with such providers. In many LICs and LMICs the linkage between the TVET agency, the Ministry of Labour and the Ministry of Education on the one hand and the Ministry of Industry and Trade and the Investment Promotion Agency on the other, tends to be rather weak. Similar is true between job-creating investors and such institutions, unless it is critical for the business model – in such cases the push factor can be strong enough by investor to actively engage the skills providers. Various countries have developed skills councils or skills working groups to facilitate this. Others have raised a levy to support TVET institutions, although the governance of this revenue in LICs and LMICs has faced challenges. As with other bottlenecks, the clearer the ask through industrial policy, the easier it is to address this challenge. Encouraging collaborations between skills providers and industry is also essential to strengthen the labour market – and the approach of countries like Germany with its apprenticeship schemes, for example, where applicable can be helpful.

Beyond such mechanisms, facilitating dialogue between labour unions, value-adder sectors and the government is also essential and an important component of industrial policy and of addressing challenges in the labour market and in industry-labour relations.

<u>Technology and research and development</u>

Many HICs have invested significantly over the years in research and development as a core part of their industrial policies and linked this to direct investors. The Advanced Research Projects Agency for Energy (ARPA-E) and the Defence Advanced Research Project Agency (DARPA) in the Untied States are prime examples. Chile's These are core parts of HICs' industrial policies, and similarly should be considered and supported as a core part of industrial policies to facilitate direct investment in LICs and LMICs. Establishing such entities and providing public sector support for them requires clarity on which sectors have a business case and real potential to transform the economy: a key role of a robust industrial policy. Such an approach should focus both on the creation of new home-grown technologies and on mechanisms to facilitate the import of technologies through investor facilitation and public-sector research exchanges – as was done by many East Asian Asians between the 1950s and 2000s, starting with Japan. Many LICs have such agencies in the agricultural space (as per Figure 2 for Chile) while those for manufacturing and services tend to be weak in capacity or potentially non-existent.

<u>Access to markets</u>

In this area there are three strands of policy intervention. One is around export promotion, another is market structuring and a third is trade facilitation and trade policy. Export promotion is similar to investment promotion in its goals: it aims to address an information gap in market knowledge and linkages. Many government agencies provide this service as part of their investment promotion agency, or through their Ministry of Trade as well as embassies and consulates, but in many LICs and LMICs the capability across these public agencies tends to be weak. It can be strengthened through institutional strengthening and supportive resources, including linkages to private data sources, business councils, database development and sharpening the targeting of markets. This latter point is a key feature of a sound industrial policy because knowing which foreign market are targeted by value-adders – and which serve as opportunities for growth – is critical to direct align relevant policies and state capability, such as sanitary and phytosanitary standard policies, standards laboratory capability and sector-specific regulations and facilitation.

Market structuring relates to policy efforts to strengthen the structure of a particular market in order to improve market linkages. This is commonly needed in agricultural markets, for example: when agricultural produce at the farm gate is sold to consumers in country as raw commodity or exported as a raw commodity, as happens in many LICs and LMICs, prices can fluctuate significantly year to year both because of climatic factors such as variations in rain patterns and crop disease prevalence, and because of demand fluctuations. Large price volatility can be problematic as it leads to underinvestment by smallholder farmers – who are often a large proportion of the workhorses in LICs and LMICs – because the year following good prices they risk overplanting and in the years following low prices they risk underplanting. It also affects which crops they plant. Lack of information along the value chain on demand also contributes to this problem. This challenge also arises in agricultural input markets such as fertiliser, pesticides and seed. These market failures can lead to agricultural commodity booms and busts and exacerbates poverty traps by eating into the ability of smallholder farmer houses to save consistently year after year. In such instances market structuring efforts can be vital. These are ways to address information gaps between producers (smallholder farmers) and buyers (who could be processors or consumers. Mechanisms such as contract and satellite farming with corresponding off-take schemes, market-led and well-governed electronic subsidy schemes for agricultural inputs, warehouse receipts and even the deliberate investment promotion targeting of agro-processors in value chains without any, can increase market structure. The goal is to strengthen the value chain from inputs and production through to storage and processors and on to final markets, be they in country or abroad. Often the processor component is critical: without it difficult to reduce price volatility. Processors do this by stabilising demand for smallholder agricultural produce, in effect providing a more stable market for them. They are more proximate to final consumers and can tap into higher value added and feed it back up the value chain. If trade-oriented and not merely domestic and oligopolistic, processors tend to be value-adders, with great potential to increase incomes for workhorses. As mentioned in the sub-section on access to inputs, value chain facilitation is a critical policy tool for addressing this challenge as its scope ranges from final export and domestic markets all the way up to producers and input providers.

As discussed above in relation to business development services, competition policy is another key feature of market structuring – and an important component of industrial policies, particularly in industries with a sizeable number of players. Ensuring that value chains do not become diverted through abuse of a dominant position, or oligopolistic behaviour by buyers within a value chain is an important policy action. Many countries have established competition commissions, and they are part of regional trade bodies – but they are often weak for political economy reasons. Focusing this policy on less contentious sectors could be a good way to build their capacity.

Trade facilitation relates to efforts to remove non-tariff barriers to trade, such as delays, corruption and complicated procedures at border posts; meeting trade standard requirements, trade licenses and similar. Like with other bottlenecks, there are many important generic efforts – i.e. without a vertical sector component - to address such challenges. Trade Mark East Africa is a good example here. However, the nature of patronage systems around trade barriers tend to mean that progress may not be fast enough. Hence, like with other bottleneck areas like infrastructure and finance, it is important to twin track generic reform efforts with targeted facilitation for priority sectors in the country's industrial policy (i.e. complement horizontal efforts with vertical efforts). This allows for a more surgical approach and has the benefit of allowing specific challenges to be highlighted with agencies causing the challenge and to dialogue to find a workable solution. It's about biting off a manageable amount of food to chew, rather than eating the whole pie. The latter approach tends to run into all sorts of systemic challenges – because of the entrenched patronage systems in such areas like border control and standards. Taking on smaller, specific issues that are relevant to a priority sector for direct investment allows for a more targeted conversation and contracting with agencies that need to change their behaviours or lose a source of formal or informal revenues, without threatening the entire existing patronage system at the risk of a stall in any progress. Such incremental reform can also reap benefits for other sectors that struggle with similar bottlenecks.

Trade policy – which relates mostly to policy around import and export tariffs – has typically also been disconnected from industrial policy such that most trade policy agreements have typically led to rapid growth in imports in many LICs and LMICs, with excessively slow growth in exports. This is major cause for balance of payment and debt crises in many LICs and LMICs and is a challenge that few have been able to overcome. A stronger alignment between these trade and industrial policies can ensure that productive and tradable sectors are being built to the extend they can largely keep up with imports. Industrial policy can provide clarity of what to offer and what to ask for in trade negotiations, it can provide clarity on what export markets matter more than others and for what goods and services; and it can provide clarity on critical imported inputs. It can also provide a basis for finding common ground around contentious issues – such as rules of origin – and regional value chains and markets in customs areas and free trade area negotiations and processes. Clarity and policy consistency here is critical for direct investors.

In aligning, it is important that trade policies 'follow' industrial policies (as long as industrial policies are developed in a market-led and trade-oriented way), rather than the other way round. This is so that trade policy opens up target markets where priority sectors have greatest possibility to gain a foothold. In this sense, trade policy should be at the service of the efforts of LICs and LMICs to develop competitive productive sectors (rather than finalising trade agreements and then trying to develop capacity, as has happened in many cases).

Macro-economic stability and access to foreign exchange

Like in other areas, the linkage between monetary policy, fiscal policy (including debt policy) and industrial policy is essential. This is an area that for the past 50 years has not been pursued across many LICs and LMICs. While each policy needs to maintain its independence and stay focused on its core purpose – which in turn is key for macro-economic stability direct investors require - it's important in scaling direct investment to fight poverty and meet the SDGs that industrial policy serves as the anchor policy: a guide to transform the entire economy by diversifying it to increasingly competitive and trade-oriented sectors. Fiscal policy needs to stay focused on fiscal discipline and the sustainability of the public financial system, but it is important that in doing this it prioritises a sufficient proportion of public investment and discretionary recurrent expenditure toward the needs of industrial policy. The same applies to revenue policy, and this is discussed further in the next sub-section. This is key to also fight systemic debt distress challenges: ultimately if the tax base remains dependant on rentiers and powerbrokers, many forms of debt management will ultimately fail. Widening the tax base by growing value-adders, and through them workhorses – who represent the bulk of household tax payers, is critical.

Exchange rate policy should also stay focused on balance of payment and inflation stability and foreign exchange availability – but likewise, the synchronisation with the needs of industrial policy is essential. Particularly in times of foreign exchange shortages – prevalent in many LICs and LMICs due to large trade imbalances – it is important to ensure value adders' forex needs are prioritised as much as the political economy permits. The needs of industrial policy are also critical for selecting the type of exchange rate regime – to the extent there is a choice available. This is closely linked to monetary policy and the effort to control inflation: finding the right balance between the narrow targeting of inflation and targeting employment (and hence industrial policy and direct investment) is important.

<u>Regulatory and tax obligations</u>

Many regulations tend to be set based on the area of protection, for example health standards, labour standards and environmental standards. However in many LICs and LMICs these are often set without sufficient consideration of the needs of direct investment. Finding the right balance is critical and this requires sufficient dialogue between regulators and businesses. It is essential that such dialogues are collaborative and constructive in nature and this is where industrial policy can play a role: it allows such actors to focus on a specific value chain and specific challenges, while providing the platform for dialogue and this helps to identify both the public concern and the investment or business implication.

The market matrix provides interesting insight regarding investment challenges related to tax and domestic resource mobilisation. The first key point is to consider differentiation of tax policy for rentiers, powerbrokers, value-adders and workhorses, and to also look at these as a package. In terms of supporting direct investment and economic transformation, there is a case for high rent sectors to subsidize competitive sectors, and in particular value-adders given their large positive externalities in terms of the political economy. This might seem counterintuitive as it might equate to higher taxes for a large proportion of investors interested in a country. Yet, this is where the tax package point comes into play. High rent sectors are sectors that do not thrive by creating value-added products and investing in human capital as a core part of their business model. Rather their model is based either on the extraction of resources belonging to the state and the country as a whole; or by assuming an abnormal position in an economy. Rentier sectors merit relatively higher rates of royalties and taxes – albeit these should not be exorbitant or unsustainable - even if purely to capture a fairer share of the value of the resource being extracted. The service the rentier provides is the capability to extract (or grow in the case of large scale crops exported raw, such as tobacco in many LICs and LMICs), but the value of what is extracted is the property of the country.[49] Royalties are meant to provide a share of this to the government. Ad hoc windfall profit taxes can also be used - they provide a variable tool to account for fluctuating commodity prices. The United Kingdom used these in its 2022 budget.[50] Powerbroker sectors also merit relatively higher rates of tax as compensation for the high rents captured through capture of major and often strategic domestic facing sectors.

While this is the theory according to the market matrix, in practice political economy pressures tend to mean that these sectors tend to receive tax breaks or pay relatively lower levels of tax than their high rent products might merit. Because of narrow formal tax bases prevalent in many LICs and LMICs, they can often be among the biggest taxpayers, even inspite of the tax breaks they may have. Arcelor Mittal is Liberia's largest taxpayer, for example.[51] This is the key challenge that occurs when domestic resource mobilisation efforts and tax policy are not grounded in industrial policy and is the reality in many LICs and LMICs. Often it can be difficult for governments to adequately tax such firms because of their influencing power, and because they already are top taxpayers.

In contrast because of their capacity to create jobs (and hence household tax), grow the firm base (i.e. widen the narrow tax base), innovate, generate spillovers to other firms, and support net exports,

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[49] Pritchett, L., and Werker, E., "Developing the guts of a Grand Unified Theory: Elite Commitment and Inclusive Growth' Global Development Institute, 2014
[50] https://www.reuters.com/world/uk/uk-extend-windfall-taxes-energy-firms-the-times-2022-11-02/
[51] https://thenewdawnliberia.com/liberia-lra-names-arcelormittal-largest-taxpayer/

value-adder sectors merit to be subsidized through government transfers, either through lower relative tax rates or subsidies. These can take many forms, through tax breaks, tax incentives, tax holidays and various subsidy forms. In doing so it is essential governments ensure that such firms are actually value-adders, and not pretending to be, as often happens in LICs and LMICs with investment proposals received by governments by untoward businessmen. It is also essential that such transfer tools are not done in isolation, but as part of a wider effort to develop the industry in a trade-oriented and market-led way.

The risk with blanket tax approaches that don't use the market matrix to differentiate between types of sectors and investors is that the typical tax crunch that takes place at the end of the fiscal year (most LICs and LMICs face a fiscal crises most years, if not every year) falls equally on all firms, but disproportionately on firms that deserve it least. This also can backfire as it can lead to underinvestment in value-adder sectors, while reducing the incentive for workhorses to become value adders, or to escape the informal sector and enter tax and business registration formality. This keeps the tax base narrow and relatively more dependent on rentiers and powerbrokers, which leads to budget deficits, rising debt, balance of payment challenges and in effect, a tax trap – because it raises tax revenue pressure on value-adders too and often disproportionately as their lobby power is often weaker. Rentiers and powerbrokers tend to be in a relatively more comfortable position than value-adders precisely because of the high rents they have access to. From a market matrix and direct investment standpoint, while them leaving will cause short term pain and this may be not be politically feasible – from an economic standpoint is not a large problem because in the medium term other investors would come: global competition for resources is high so governments should realise they are in a privileged position (and not the other way round). Likewise competition to become a powerbroker among domestic and foreign business leaders is also high: such industries are generally lucrative; and if they weren't the lobbying to protect the powerbroker sector would not be as strong.

This raises the importance of having a holistic tax policy that is tailored to the industrial policy plans to develop the value-adder sectors. It needs to be calibrated each year, and this can be a challenging exercise to do. Such a tax policy should offer tax breaks and advantages to value-adder sectors as a complement to wider sector development. The calibration is important both with high rent and competitive sectors, as in each it is important not to under or over tax. For this a direct line of communication is essential. Support to value-adders – and powerbrokers being incentivised to become value adders and with a genuine effort by them to do so - should include tax payment facilitation to such players, a clear and progressive tax incentives scheme as part of investment promotion efforts, and also active dialogue to listen to tax challenges raised by direct investors. Such support can extend to workhorses but the scale of players and low amounts of revenue make it highly expensive. Value adders through their spillovers, discovery of new products and services and innovation in effect pave the way for many workhorses and raise revenue for them. In larger LICs and LMICs, these actions can also happen through workhorses (the growth of Nigerian fintech in the past 10 years is an example), but this is typically less often the case given the typically small sizes of LIC and LMIC domestic markets.

<u>Environmental impact and mitigating for and adapting to climate change</u>

This industrial policy approach works well when it comes to climate change and developing the green economy and low carbon development strategies. It allows for the environmental sustainability aspect to be mainstreamed within the economic strategy, such that the two mutually reinforce each other rather than pull apart from each other. Costa Rica is one of the best global examples of this. In the 1970s it started to promote numerous novel environmental policies which kick started the green transition of its economy. It wasn't always sustainability oriented: forest coverage declined from 75%

in 1940 to below 40% by 1987.[52] In the 1990s, recognising that progress wasn't fast enough, it decided to accelerate its sustainability plan by developing a fully green industrial policy. Deliberate investment policies were introduced to reverse environmental decline. It conducted an in-depth analysis to identify the various economic benefits of conserving healthy ecosystems and set about developing national parks (it has 28 national parks, covering over a quarter of the country's territory), the ecotourism industry, conservation agriculture, the forest sector based on reforestation, green transport systems, renewable energy development, and also health-environmental linkages, waste management programmes and education programmes.

Costa Rica's strategy is a pure industrial policy approach. It set about with a vision for where the country wanted to go, and used a specific focus on key sectors, aligned to its green economy goal, to align and benchmark most policies in the country. Crucially it didn't view climate and sustainability in isolation, but as an inclusive economic growth strategy. One could view it as a nationwide coordination effort anchored to the leadership's own vision for the country. Costa Rica's GDP per capita rose from $2,600 in 1990 to $12,000 today, one of the highest in the Americas south of the United States. From the investment lens, this meant policy coherence, a stable and positive investment climate, and a basis for a healthy relationship with the public sector to problem solve together. Other countries, such as Gabon, Guyana and Indonesia, are attempting to follow a similar course.

<u>Informal requirements, such as corruption</u>

Addressing this problem is challenging. One suggested approach is to view industrial policy as the mechanism to align the political economy toward the needs of economic reform so that it is the interaction between private sector and public sector itself that pushes for the strengthening of institutions and rule of law to curb corruption. Corruption is ultimately a manifestation of the political economy and the prevailing patronage and clientelist systems in a country. In its simplest form, it's just a manifestation of how people earn a living, make money and increase their power in a system that has the inability to enforce fair rules consistently. In many LICs and LMICs it's the informal way many livelihoods are sustained and power is competed for. The market matrix gives an indication of the types of informal deals (corrupt deals) that different types of private sector (the largest source of wealth creation and storage, with the government) can sustain or promote informal and corrupt practices. Deliberating reinforcing sectors with a vested interest (i.e. it's at the core of their business model) in a fair system and in government capability to develop and enforce such a system is a critical approach to addressing corruption. The Anti-Corruption Evidence programme led by the School of Oriental and Asian Studies in the United Kingdom is an example of a programme that has increasingly adopted such an approach – and the work of Mushtaq Khan, who leads this programme, is important in accelerating the application of this thinking in this area.[53]

In applying industrial policies to accelerate domestic and foreign direct investment that can accelerate poverty eradication, it is important for countries to develop their own home-grown industrial policy: this means factoring in local informal norms and social and cultural considerations into the design of policy. The emphasis needs to be on finding local solutions to local problems and challenges, and using local customs and norms as a boon, rather than seeing them as a burden. The adaptation of customary law into land reform efforts in one such positive example.

How governments can build their capability to improve the enabling environment

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[52] https://www.unep.org/news-and-stories/story/costa-rica-living-eden-designing-template-cleaner-carbon-free-world

[53] Khan M. '*Political Settlements and the Governance of Growth-Enhancing Institutions*', 2010

The final consideration of this chapter is less to do with what governments can do to scale up private investment, but how. In an increasing number of countries – both with high and low government capacity – delivery and coordination mechanisms geared toward supporting private investment have shown encouraging results. Malaysia, Serbia, Rwanda, Ethiopia, Peru, Nigeria and countries like Liberia, Sierra Leone, Togo, Senegal and Malawi have all been able to make good progress by setting up a pocket of effectiveness under the authority of the government leader – often the President him or herself, to focus specifically on problem solving and facilitating private investors and key industries – both productive sectors and enabling sectors. Such delivery mechanisms can take different shapes and sizes. For example, Rwanda followed Singapore's model with its Economic Development Board to set up dedicated entities such as the Rwanda Development Board, the National Agriculture Export Board and the Rwanda Mining Board. These are authorised and empowered to coordinate with investors and to coordinate sector development efforts within the government. Malta Enterprise is another example of this approach.[54]

Others like Malaysia, Serbia, Ethiopia and Liberia set up a delivery unit in the Presidents' or Prime Minister's Office. A delivery unit is a relatively small team of people typically with strong analytical, management and problem-solving skills reporting directly to the principal to oversee and facilitate the implementation of the principal's priority projects and reforms. Such units do not carry out implementation, for the most part, but challenge and support the ministries and agencies that implement, while solving cross-ministerial coordination issues. Such mechanisms are not typically institutionalised with a legal statute but served a similar function of flagging critical bottlenecks and using the authority of the office of the head of state to unlock many of them, even in low-capacity government settings. Other governments set up sector specific delivery agencies within certain priority sector ministries – for example Morocco's Agriculture Development Agency and Kenya's Agriculture Transformation Office. Some integrated these activities within the structure of Cabinet, hooking them to Cabinet sub-committees on the Economy or Economic Management Teams, as in Nigeria. Some, like Nigeria, also developed a range of such mechanisms both at the national level and also at sub-national level such as in Nigerian states under certain state governors.

What matters is less where it sits and what structure it takes, but rather that the functions of prioritisation, focus, continuity, follow up, problem solving and private sector dialogue take place; and that the functions are politically empowered and championed by the leadership. Such mechanisms depend a lot on the people involved and whether they are vested, empowered and focused; and whether they receive the political backing they need to drive through the agenda.

In the context of low-capacity governments and complex bureaucratic and political systems, such mechanisms and structures are critical to efforts to scale direct investment and to improve the quality and implementation of industrial policy to help deliver the SDGs. This is particularly key where the political economy is highly problematic (e.g. highly centered on rentiers and powerbrokers) and where bandwidth and political capital for facilitating value-adders is weak. Where done well, such pockets of effectiveness with a strong culture of public service delivery and sound economic policy can be a starting point for strengthening government capabilities more broadly across the civil service and political class, hence addressing a number government failures.

- **Chapter 6 - How international community can better support**

[54] https://maltaenterprise.com/about-maltaenterprise

LICs and LMICs require significant support if they are to scale direct investment to a level and quality that can drive poverty reduction and the faster attainment of the SDGs. There are four main ways that the international community can better support.

1. Better support to LIC and LMIC industrial policies.

This can take many forms, but the underlying principle needs to be one of supporting the local industrial policy, led by the government and its engagement with the private sector in productive sectors, to emerge and take hold.[55] Typically a lot of support is provided to areas that overlap with a local LIC or LMIC industrial policy – for example agriculture sector support and energy sector support. However this needs to extend to other productive sectors like agro-processing, manufacturing, tourism and other tradable services and there needs to be paradigm shift in how such support is provided. It requires genuine partnering with countries to support the core premise of the local industrial policies and their central mechanisms. It requires listening to the core strategies, asking what support they need, and being responsive to it. This is different to what tends to happen in current development programmes where projects are for the most part not genuinely jointly designed. They tend to follow the donor preferred approach, with consultants engaged by them, not one that directly speaks to the central industrial policy of the LIC or LMIC government.

There are positive examples to point to and learn from, albeit not many: the United States' support to the Dominican Republic to establish its medical manufacturing sector is one example. Another is the United Kingdom's flexible support – much of which was via budget support, not a typical modern day five year project – to Malta to develop its manufacturing and tourism industries in the 1960s.[56] US flexible support for Israel's agro-industrialisation strategy since the 1950s is another example; as is Japanese support to Brazil's agriculture strategy from the 1970s.[57] One can also point to the World Bank's first loan, which was to France to support its reconstruction after World War II, funding infrastructure and the purchase of equipment and raw materials.[58]

These were genuine local term (multi-decade) commitments to develop key industries, supporting the local public and private leadership to conduct sector development and facilitating investment into those sectors. In these cases there was strong geopolitical and geo-economic interest to see the success of these countries and initiatives – by the donor country's highest leadership – and this was key for this support to be given in this way.

Such an approach also requires moving away from a narrow focus on three or five year projects, and focusing instead on building market systems, and the capabilities around them, including in the public sector – with a longer planning horizon. This is also important to move from piecemeal, uncoordinated interventions to an ecosystem building approach, and an approach that addresses the greatest needs of the industrial policy owners within the government, rather than a separately identified need. For example translating some of the gains of market systems work, promoted by USAID, FCDO and SIDA in recent years into more of an industrial policy ecosystems lens, rather than a narrow five-year projectized lens, could reap significant rewards.[59]

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[55] The United Nations' Integrated National Financing Framework is one such tool that is being used to support this, through its framework centred on binding constraint identification and facilitation.

[56] Baldacchino G., '*The Industrialisation of Malta: A historical analysis of the formation, control and response of labour',* 1988

[57] https://www.jica.go.jp/jica-ri/news/topics/post_272.html

[58] https://www.worldbank.org/en/archive/history/exhibits/Digitized-Records-World-Bank-First-Loan

[59] https://beamexchange.org/

This engagement should also include capacity development and implementation support both to the central organs of government driving an industrial policy – which as mentioned earlier is by far the most effective in LICs and LMICs when led by a President, Vice-President or Prime Minister – as well as to the critical economic ministries and agencies: Ministries of Finance and Economy, Ministries of Trade and Industry, Investment Promotion Agencies, Ministries of Agriculture (or Tourism), and the Ministry of Digitalisation – and increasingly the Ministry of Environment for green growth strategies. If these can align and coordinate around an industrial strategy, then it becomes easier for other parts of government to align, and for the enabling environment for direct investors to improve.

In exploring how to provide support along these lines, it is important to identify relative progressives within a government system and work with them. It's important to try to support as high as possible based on government interest for support. The more responsive, flexible and adaptive the support, the more likely government would be open to it. Crucially, in this exercise it is important not to assume that the political settlement and political economy are so bad that support is futile. In many LICs and LMICs there area often many relative progressives to be found across the government system – as there are in the private sector and in civil society. Identifying them and tailoring support and expectations to their needs and reality is important. If there is no political window at present, then its important to support what can be supported, and be ready for when political windows of opportunity arise. This effort with governments can complement efforts in the private sector to develop value-adders, or support powerbrokers to transition, and workhorses to strengthen.

Norway is an example of a country that has provided significant support to countries developing industrial policies – particularly low-carbon development and green growth strategies. Its support in countries like Guyana, for example, spanned strategy development, analysis, flagship project financing and capacity development to key agencies and regulatory institutions.[60] Another example is China. It has linked the development of its own firms and economy with that of foreign nations. Its 12th Industrial Five-Year Plan set out five priorities for foreign investment by Chinese industrial sectors: the outsourcing of production to locations with established domestic technologies; the establishment of industrial parks abroad; international corporation in energy and natural resources; construction of R&D centres abroad; and large engineering projects complemented with integrated value chains.[61] The goal is one that mutually supports Chinese economic development as well as the industrialisation of recipient countries. It has set up an extensive support structure to support this, ranging from financing and fiscal support for investors, risk management support, investment facilitation, provision of information, development finance support for government flagship projects and technical assistance programmes. One such tool is China's EXIM bank and China's Development Bank which offer concessional lending rates, a fast approval process and flexible terms. Crucially, while various countries have similar tools to facilitate foreign investment into LICs and LMICs, the focus on industrial and value adding sectors – beyond the typical focus on access to natural resources and energy - stands out.

It may be more common in current times for such industrialisation alignment between development partner countries and recipient countries to happen with upper middle income countries, such as China, India, Brazil, Indonesia, Turkey and the Gulf States, than with higher income countries where it might be less likely that the self-interest goals align in this way.

[60] https://lcds.gov.gy/guyana-norway-partnership/

[61] Sauvant K and Chen. V., '*China's Regulatory Framework for Outward Foreign Direct* Investment', China Economic Journal, 2014

2. Facilitating intra-governmental coordination, not inadvertently worsening it

LICs and LMICs that tend to have weak government coordination capacity may struggle when international partners who provide support do so in a disparate manner that can inadvertently pull different ministries and agencies in LIC and LMIC governments away from each other, thus making it harder for the government to provide policy coherence and a suitable enabling environment for direct investors.

For example, in Liberia in 2016 there is a documented case where the Ministry of Commerce was following the World Trade Organization-led agenda and International Trade Centre analysis, the Ministry of Agriculture was driven by the UN- and US-led food security agenda, the Ministry of Labour followed the International Labour Organization-led labour standards agenda, the National Investment Commission followed an IFC agenda and analysis, and the Ministry of Finance and the Revenue Authority the International Monetary Fund/World Bank and Millennium Challenge Corporation agenda which focused on public financial management and its own analysis.[62] In distilling this situation, it was clear that each of these agencies was paying more attention to these international partners, than to each other, or to the Presidency's economic agenda. This was because these partners were a source of financing and the conditionalities placed and the separate analyses done led to major inconsistencies. When viewed from the perspective of the private sector and investors, it was identified as a major deterrent because it led to policy incoherence. Similar cases can be spoken of in other countries.

This issue is critical for a coherent intra-governmental industrial policy to take hold. It starts from the level of sector prioritisation: it is not uncommon to see multiple economic ministries with their differing priority sectors across them, identified through studies carried out by or funded by different development partners. Some development partners may even have their own sector prioritisation work that they use to guide their own programming. Such issues can extend through to programming, planning and implementation.

Cohering such exercises is critical and this is the role of a nationwide industrial policy. An important way to facilitate this and reduce the inadvertent consequence of having multiple, disparate international partners is to fully recognise – even unofficially – the government as the main coordinator and to follow the government's central lead across the policy cycle: from analysis and strategy to implementation and on to capacity development. Government is a coordination anchor, and in turn this requires the core economic ministries and agencies (President's Office, Ministry of Finance and Economic Planning, Ministry of Industry and Trade, Investment Promotion Agency, Ministry of Agriculture or Tourism) to be aligned. Where needed this can be facilitated, by supporting working groups, joint problem solving sessions and helping find common ground and benefits from collaboration.

3. Facilitation of value-adder foreign direct investment into LICs and LMICs

Traditionally, international investment in LICs and LMICs has tended to be more extractive in nature – typically falling in the rentier and powerbroker categories outlined in Chapters 2 and 3. Hence the most important way to support is to scale direct investment from the HICs into magician sectors, in other words businesses with a competitive market orientation focused on local value addition and business models that empower local human capital and support the development of the local public sector.

[62] Akileswaran K., Huss A., Hymowitz D., and Said J. '*The Jobs Gap*', Tony Blair Institute, 2017

This can be encouraged in various ways. One is to establish intra-country business councils that facilitate connections between businesses – in productive sectors – across two countries; while also providing investor origin country businesses with as much information as possible to reduce factors like country bias and information asymmetry. The Netherlands is one country that provides a good example here, through its Netherlands-Africa Business Council set up by Heineken and other Dutch companies. It provides pragmatic in-country facilitation to Dutch businesses to find local business partners, and to navigate the local investment landscape. The Corporate Council of Africa in the United States is another. Many such business councils exist, but what matters for poverty reduction is that they are primarily focused on value-adder investment, followed by investment in key enabler sectors (which could be powerbrokers). If the focus is predominantly on rentier industries, or else on enabler sectors without value-adder investment – then it's likely to be insufficient help for the LIC or LMIC, given the scale of the economic transformation challenge faced.

Encouraging exchanges and business partnership forums as well as industry specific fora with multi-country representation may be another way. City-level partnerships can also facilitate such engagement.

4. Local SME support

A fourth way to support is through business development support schemes for local SMEs. In the past there was a greater focus on financing, through challenge funds and matching grant schemes. However in time it has become clear that a key challenge is SME managerial, governance and technical capacity.[63] Where this is robust, development finance can be highly rewarding. However where weak, development finance can reap little results. Organisations like Argidius have conducted significant research on what works for SME support, focusing on countries like Colombia, Guatemala, Kenya and Uganda.[64]

Such support also extends to women-owned businesses and to climate smart and green growth businesses – both of which are important to prioritise. Likewise, in supporting SMEs it is also important to keep an eye to the industrial policy of a country, so that efforts move from a piecemeal approach, to building inclusive market systems and sectors, with well governance SMEs with strong business models as their bedrock.

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[63] https://api.cofraholding.com/media/2612/report-fulfilling-the-potential-of-bds.pdf
[64] https://www.enterprise-development.org/agency-strategies-and-coordination/argidius-foundation/