

Executive summary

This report takes an extensive look at industrial policies in the EBRD regions and beyond. Such policies, which are aimed at changing the sectoral composition of production in an economy, have seen a resurgence in recent years, seeking to address increasingly pressing market failures such as environmental degradation. Their track record is mixed at best, with their growing popularity being shaped primarily by domestic political economy considerations and rising geopolitical tensions. While industrial policies are typically employed by higher-income economies, they are also being seen more frequently in economies with less administrative and fiscal capacity to implement them. A typical policy pursues multiple objectives, and these often clash, with no clear prioritisation. Firm-specific policies and policies discriminating against foreign firms are common, and the use of subsidies is on the rise. At the same time, sunset clauses have become more common, perhaps reflecting past experience with addiction to subsidies, but they only apply to a minority of policies.

Pursuit of manufacturing export-led growth has become increasingly challenging for most economies, while the advent of digital technologies has transformed the service sector, facilitating cross-border trade. At the same time, manufacturing has also become more reliant on service inputs. However, this new service export-led growth model is dependent on strong human capital, high-quality infrastructure and well-developed institutional capabilities. Many post-communist EBRD economies have successfully become top exporters of computer and information services, but others need to upgrade their infrastructure, skills and institutional capabilities if they are to excel in a service-based world. Service trade liberalisation and targeted industrial policies can support a shift towards high-value-added services, provided that the right economic and institutional fundamentals are in place.

Special economic zones (SEZs) have proliferated globally as a way of attracting foreign investment, boosting growth and exports, and addressing persistent regional income inequality. The establishment of SEZs tends, on average, to be associated with some strengthening of economic activity, but the effects are highly localised and vary considerably from zone to zone. Economic outcomes tend to be better when SEZs benefit from a strong skill base, high-quality infrastructure and robust local governance. Overall, however, the success of an individual SEZ appears to be very difficult to explain after the fact, let alone predict in advance. Experience with SEZs and European Union (EU) cohesion policies highlights the importance of tailoring place-based interventions to the local context.

Among small and medium-sized enterprises, young firms tend to be characterised by stronger employment growth and higher returns to capital. Direct state assistance for firms is on the rise in EBRD economies, although such policies remain less prevalent overall than in advanced European economies. Direct state assistance can take various forms, including in-kind and financial grants, production subsidies, loans, loan guarantees, interest payment subsidies, tax relief of various kinds and equity capital injections. Tailoring such policies to targeted firms' age and growth potential is crucial in order to maximise their benefits relative to their costs. Thus far, very few policies in the EBRD regions specifically target young, fast-growing firms when deploying state assistance.

CHAPTER 1

An introduction to industrial policy

Industrial policies have seen a resurgence recently, seeking to address market failures such as environmental degradation. Their track record is mixed at best, with their growing popularity shaped primarily by domestic political economy considerations and geopolitical tensions. While industrial policies are typically employed by higher-income economies, they are also becoming more common in economies with less administrative and fiscal capacity to implement them.

Increasingly, industrial policies target multiple objectives, with no clear prioritisation. While such policies have traditionally targeted economic growth and productivity, green objectives are gaining prominence, particularly in advanced economies – often in combination with a strategic goal of ensuring a secure supply of critical materials and technology. Regional development objectives have also become more important, particularly in EBRD economies. Against that background, policymakers need to articulate (ideally publicly or at least privately) the dominant objective of each policy and establish evaluation mechanisms to determine whether a policy will achieve its aims or should be modified or abandoned.

While industrial policies can overcome coordination failures and promote the creation and transfer of knowledge, they can entail high explicit fiscal costs and cause significant implicit costs by distorting the efficient allocation of labour and capital. The risk of capture by special interests is also high. Less-distortive policy instruments typically require greater administrative capacity and more revenue-raising ability.

To minimise distortion, policies can incorporate competitive selection and specific end dates. While the percentage of policies with sunset clauses has risen, firm-specific policies and measures discriminating against foreign firms are common, and use of subsidies has increased. Where administrative capacity is low, policymakers could phase in policies, prioritise projects falling within the remit of a single ministry and establish specialist units to oversee initiatives.

<https://2024.tr-ebrd.com/an-introduction-to-industrial-policy>



CHAPTER 2

Promoting structural change

Before 1990, many developing economies had growth models that prioritised industrialisation, supported by investment in capital equipment, training and infrastructure. Over time, however, the pursuit of manufacturing export-led growth has become increasingly challenging.

At the same time, the advent of digital technologies has transformed services, facilitating cross border trade, and manufacturing has become increasingly reliant on service inputs. Within services, digitally enabled, tradable services – especially global innovator services such as information and communication technology (ICT) services – exhibit particular growth potential. These have increasingly driven improvements in the labour productivity of the service sector. Such services require high skill levels, can be traded across borders and have strong linkages to other economic sectors.

While many post-communist EBRD economies are top exporters of computer and information services, others need to upgrade their infrastructure, skills and institutional capabilities in today's service-based world.



Service trade liberalisation and targeted industrial policies can support shifts towards high value added services, provided that the necessary fundamentals are in place. For instance, economies with strong state capacity see marked increases in service-related foreign direct investment after investment promotion agencies start to target foreign investment in specific service sectors. No such effects are observed when state capacity is weaker, however. Similarly, tax incentives granted to computer and information service firms in Romania have succeeded in supporting employment growth in that sector, but primarily in regions with strong endowments of specialist human capital.

Service trade liberalisation is also associated with increases in the competitiveness of manufacturing sectors. However, lowering restrictions on trade does not necessarily mean having a regime where anything goes. For example, legislation equivalent to the EU's General Data Protection Regulation has been found to facilitate trade in services by establishing fair and transparent rules on data.

<https://2024.tr-ebrd.com/promoting-structural-change>



CHAPTER 3

Regional inequality and special economic zones

Place-based industrial policies are strategic interventions aimed at promoting economic development in specific geographical areas – typically those that are underdeveloped or have specific endowments of natural resources or skills. One such policy, the establishment of SEZs, has become increasingly popular as a way of attracting foreign investment, boosting growth and exports, and addressing persistent regional income inequalities.

Such regional inequalities can be seen in both official data and night-time light data, with large – and growing – differences between rural and urban areas as regards economic opportunities. Coastal regions and areas bordering higher-income economies also tend to be richer. Analysis reveals that the average annual rate of intra-country convergence across the EBRD regions was approximately 1 per cent over the period 2010-19. At that rate, it will take about 70 years to halve the existing regional income gaps within EBRD economies.

The number of SEZs in EBRD economies has risen from less than 200 in 1990 to more than 1,100 in 2020, mirroring global trends. While some SEZs are in lower-income regions, others are in richer areas. SEZs in higher income regions tend to be larger and may leverage existing endowments of natural resources or skills.

Analysis of night-time lights suggests that establishing an SEZ is associated with increased economic activity over time within an immediate radius of up to 20 km. Economic outcomes tend to be better when SEZs benefit from a strong skill base, proximity to a port and robust local governance. Analysis also reveals that firms situated near technology development zones in Türkiye have seen stronger increases in employment, exports, investment, sales, profits and total factor productivity. Overall, however, the success of an individual SEZ appears to be very difficult to explain after the fact, let alone predict in advance.

<https://2024.tr-ebrd.com/regional-inequality-and-special-economic-zones>



CHAPTER 4 Industrial policies supporting firms

In the EBRD regions, a relatively small number of large firms – those with 100 employees or more – account for the majority of employment as a result of their economies of scale, higher levels of productivity and greater propensity to innovate. Meanwhile, the largest listed firms account for a sizeable and rapidly growing share of economies' total output and exports (a trend that can also be observed in other emerging markets), with private-sector firms accounting for most of the recent increases in the total revenue of the largest firms. Among small and medium-sized enterprises, young firms – those that are five years old or less – tend to enjoy stronger employment growth and higher returns to capital.

Direct state assistance for firms is increasing in EBRD economies, although such policies remain less prevalent, on average, than in advanced European economies. The most common forms of direct state assistance in EBRD economies are financial grants and state loans, with other forms of assistance including in-kind grants, production subsidies, loan guarantees, interest payment subsidies, tax relief of various kinds and equity capital injections.

Direct support for firms – including young firms – can be highly effective, as illustrated by the EBRD's Star Venture programme, which targets startups under the age of 10, providing tailored advisory services, training and mentorship. Participation in that programme results in firms securing more funding, employing more people and having more followers on LinkedIn relative to other firms that are shortlisted for participation but ultimately rejected.

At the same time, most direct state assistance policies do not target particular types of firm (such as young or small firms). Tailoring such policies to targeted firms' age, growth potential and innovation potential is crucial in order to maximise their benefits relative to their costs.

<https://2024.tr-ebrd.com/industrial-policies-supporting-firms>



CHAPTER 5 Structural reform

This final chapter presents updated transition scores for EBRD economies, tracking progress in the area of structural reform. It focuses on six key qualities of a sustainable market economy, looking at whether economies are competitive, well governed, green, inclusive, resilient and integrated.

This year, for the first time, the analysis in this chapter also covers six comparator economies in sub-Saharan Africa (SSA): Benin, Côte d'Ivoire, Ghana, Kenya, Nigeria and Senegal. Their scores tend, overall, to be lower than those of EBRD economies, broadly in line with their lower income per capita at market exchange rates. The largest gap between the SSA region and EBRD economies is in the area of integration, reflecting scarce infrastructure and low levels of intra-regional trade and investment in sub-Saharan Africa. Indeed, the SSA region stands out for its low levels of cross border trade and the scarcity of transport and fixed-line broadband infrastructure, even when its modest levels of income per capita are taken into account. There is also a large gap in the area of competitiveness, reflecting low levels of productivity and skills in SSA economies.

Meanwhile, the average inclusion score for SSA economies is, if anything, slightly higher than the average for Central Asia and the southern and eastern Mediterranean – EBRD economies with fairly low levels of income per capita. This reflects the relatively high male and female labour force participation rates in SSA economies.

In the period since 2016, EBRD economies' scores for integration and the green economy have increased the most overall, with competitiveness, inclusion and governance scores improving the least. In SSA economies, meanwhile, scores for competitiveness and resilience have improved the most, with little progress being observed in the area of integration.

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