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MALTA'S INDUSTRIAL POLICY AS A VEHICLE TOWARDS SECURING ENHANCED COMPETITIVENESS*

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Abstract. The nexus that exists between industrial policy and competitiveness appears questionable. Authors including Professor Michael Porter reject industrial policy as a means to achieve competitiveness, arguing that this policy distorts competition in favour of a particular location, as opposed to his diamond theory, the latter seeking to remove constraints to productivity growth. This paper argues that despite Malta's size, resource limitations and insularity, enhanced competitiveness resulting from a pro-active industrial policy is possible, provided that the definition and scope of industrial policy is aligned as much as possible to the Porterian diamond concept. This is particularly so if one wishes to see the local economy transformed from its largely current factor-driven state, to a mainly investment-driven stage. Malta's current industrial policy is assessed through Porterian lenses, and it is submitted that the feasibility of business clustering has yet to be comprehensively evaluated. This together with recent initiatives to seriously tackle the competitiveness issue—several of which are praiseworthy—leave a number of unanswered questions, particularly regarding the extent to which the local authorities accept the "diamond" underlying national competitive advantage, as well as the manner in which co-ordination of all aspects of industrial policy should be achieved.

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Introduction

The nexus that exists between industrial policy and competitiveness appears questionable. Michael Porter emphatically rejects industrial policy in his seminal work on national competitive advantage (based upon his diamond approach), adding:

> "While industrial policy seeks to distort competition in favour of a particular location, diamond theory seeks to remove constraints towards productivity growth. While industrial theory rests on a zero-sum view of international competition, diamond theory is based on a positive-sum world in which productivity improvement will expand the market and in which many nations can prosper if they become more productive and innovative" (Porter, 1998: xxvii).

The problem rests with the definition one chooses for industrial policy, or rather, with the extent and scope of the interventionist connotations of such a definition. Jacobson and Andreosso-O'Callaghan (1996) observe that one reason for the diversity of views is that the notion of industrial policy is a confusion of three types of policies, namely policies designed to shape the environment in which the company operates, sectoral policies such as structuring and the promotion of high-tech industries, and the so-called strategy of the shareholding state. They add that:

> "….the record of post-war economic development suggests that best-performing countries in terms of growth and international trade shares were the countries which implemented some kind of an industrial policy: Japan and other East Asian Countries, Germany, France and Italy. The USA maintained its leadership only in areas where it did have an industrial policy, or at least a significant amount of state intervention and support…" (Jacobson and Andreosso-O'Callaghan: 275).

The connection between industrial policy and competitiveness is clearly made by Johnson (1984) who defined industrial policy as the initiation and co-ordination of governmental activities to leverage upwards productivity and competitiveness of the whole economy and of particular industries within it.

Others have reached the same conclusion and view industrial policy as having been a chief factor in attaining national economic competitiveness (see Ferguson and Ferguson, 1994). Additionally, the European Commission in 1992 qualified industrial policy as " the effective and coherent implementation of all those policies which impinge on the structural adjustment of industry with a view to promoting competitiveness"(EC Commission, 1992).

Given that government policy does affect national competitive advantage both positively and negatively, the nexus between industrial policy and the enhancement of national competitiveness—with the former deemed an essential contributor to the latter, and albeit tenuous in the Porterian sense—would be considerably strengthened if by such an industry policy, one understands a strong role taken by the authorities where government acts as catalyst and challenger, transmitting and amplifying the forces of the Porterian diamond and hence creating an environment in which firms gain competitive advantage. From this standpoint some variant of the term "industrial policy" could be considered as

crucial for any state's national competitive advantage. It can therefore be asserted that a holistic approach to industrial policy must affect competitiveness.

Industrial Policy and Porter's Competitiveness Diamond

A very brief review of Porter's model (1998) is necessary in order to better comprehend this paper's main thrust. Essentially Porter states that every nation has four broad attributes, which individually, and as a system, constitute a "diamond" of competitiveness—a playing field each nation establishes for its industries. The four points of this diamond are the country's factor input conditions, demand conditions, related and supporting industries and firm strategy and rivalry. Each of these four attributes defines a point on the diamond of national competitive advantage, with the effect of one point often depending on the state of the others. Thus for example, the presence of sophisticated buyers will not necessarily translate into the generation of advanced products/services unless the quality of human resources permits firms to meet buyer needs. At a broad level, weaknesses in any one of the four determinants will constrain a national industry's potential for advancement, but since these points are also self-reinforcing, they hence constitute a system.

For its part, industry policy relates to four main areas:

- competition policy, covering measures designed either to promote a more competitive environment domestically or to prevent a reduction in competition;
- regional policy, covering measures and policies directing the spatial location of industry to ameliorate regional problems;
- Innovation policy, covering measures which target firm technology usage in order to accelerate the rate at which new products and processes are introduced;
- Trade policy, covering measures designed to influence the operation of particular firms and industries domestically by restricting foreign competition or those measures used as a "second-best" tactic to try to force competitor countries to adopt liberal trade policies.

Cohen (2001:76) identified two approaches to industrial policy, namely the neutral approach and the targeted approach. The neutral approach entails across-the-board stimulation aimed at growth and change, taking the form of "…. generic instruments such as standardisation, provision of information, investment in science, technology, human and physical infrastructure, and the setting up of financial institutions and judiciary systems". The targeted approach, on the other hand, attempts to consciously influence reallocation of production among activities via, among others, exploitation of positive economies of scale and/or of scope and the encouragement of business clusters of linked technologies, industries and firms.

Ferguson and Ferguson (1994) for their part, identified four distinct policy approaches, in this context, as follows:

• *Laissez-faire:* based on the presumption that information flows are perfect, with the market being the better judge of desirable industrial actions than government agencies. Limited intervention is called for through neutral policies.

• *The Supportive Approach:* which assumes an underlying superiority of market forces but acknowledges the presence of imperfect information and transaction costs. Neutral policies are advocated to improve the allocation of property rights, to encourage education and entrepreneurship in order to foster the process of economic change.
• *The Active Approach:* which argues for a wider and more direct government involvement in the industrial sector. Here market forces are supplanted by those of government agencies. Selected industries would be typically given extra financial support to promote restructuring and be protected from external competition by tariff and non-tariff barriers.
• *The Planning Approach:* a more extreme version of the active one, and arguing for central planning with intervention being more wideranging and comprehensive than under the active approach. Both accelerative and decelerative policies are adopted, depending on circumstances, as is also the case with the active approach.

From a Porterian perspective, those industrial policies that succeed are those that create an environment in which businesses can gain competitive advantage rather than involving government directly in the process—with the exception of nations at a rather early stage of competitive development.

The Conditions for an Effective Industrial Policy

Given that experience teaches that governments often intervene in industry for reasons that have only a hazy connection with market failure, then the case for industrial policy must be carefully made. This entails the clear specification of objectives, a correct enunciation of the theoretical justification for such policy and careful analysis of the resource implications therein implied. Unfortunately this is not always so as in industrial policy, as Ferguson and Ferguson have put it, "Nowhere is the contrast between meticulously derived theory and loosely derived policy prescriptions greater than in the area of industry policy" (Ferguson and Ferguson, 1994: 136).

The fact that even well designed policies may fail if badly implemented is often overlooked. A number of essential features are required if industrial policy is to effectively promote overall national economic welfare, namely:
• The close co-ordination of the variety of different measures so that the benefits from their implementation in one area are not outweighed by adverse affects elsewhere; the problem is more likely to occur where policy is implemented by several agencies operating separately.[1]
• Avoidance of conflicting measures, such as the provision of financial assistance to firms located in selected areas that may distort competition and run counter to official competition policy.
• The proper alignment of industrial policy with macroeconomic management to avoid problems of co-ordination.

[1] This probably explains why, in 2003, the Maltese authorities merged the Malta External Trade Corporation (METCO), the Institute for the Promotion of Small Enterprises (IPSE) and the Malta Development Corporation (MDC) into one entity, namely Malta Enterprise.

• The design of industrial package programmes for ease of administration and for effectiveness in implementation, to minimise administrative costs.
• Use of a rules-based programme rather than one based on discretionary powers by the agency administering the policy package.
• Avoidance of any unintentional discrimination against small firms through the administration of policy, given that such entities may require a separate approach as they are less likely to take advantage of assistance (see Ferguson and Ferguson, 1994: 161).

In addition, as Porter (1998) makes clear, competitive advantage in a nation's industries is created over a decade or more, not over a three- or four-year span. For its part, the European Union (EC Commission, 1992: 43) has tended to accept the arguments that accelerative industrial policies nurturing favoured firms or sectors may well hamper the development of other sectors, calling for, rather " …(the) stimulating (of) research and development, improving the training of European workers and developing European infrastructures would be far more effective in improving the competitiveness of Community industry." These arguments can be of assistance in assessing Malta's industrial policy and competitiveness level, which we now turn to discuss.

Industrial Policies: A Porterian Critique

Borrowing Porter's terminology, the current stage of Maltese competitive development appears to lie somewhere between the factor-driven and the investment-driven stages, albeit closer to the former than to the latter, while remaining dissimilar in many respects to either. In the former stage, by and large, the successful industries in Malta draw their advantage almost solely from basic factors of production. Technology is sourced largely from other countries and hardly ever created, and domestic demand for the products of Malta's export sectors tends to be modest at best. The economy is also characterised in this stage as being highly sensitive to world economic cycles and exchange rates. In the investment-driven stage, marked by intense domestic rivalry, national competitive advantage is based not only on the existence of basic factors but on the existence of low-cost more advanced factors, as well as the presence of well-functioning mechanisms for factor creation, such aseducational institutions and research institutes. The ability of a nation's industry to invest aggressively and absorb and improve foreign technology is essential to reach this stage. This suggests that Malta has a "dual economy", and as stated earlier, the situation in Malta is closer to the former than the latter.

The fundamental characteristics of the Maltese economy have been succinctly described by Briguglio and Cordina (2004) and it is worthwhile reproducing the main ones here, encapsulated by the following points:
• high level of dependence on international trade and exposure to international prices;
• poor natural resource endowment and low inter-industry linkages;
• a limited ability to exploit economies of scale and to develop endogenous technology due to small size;

• limitations on domestic competition leading invariably towards oligopolistic and monopolistic structures;[2]
• limited diversification and import substitution possibilities given the island's small domestic market;
• a relatively inefficient and non-transparent government bureaucracy.

Against this background, the Maltese authorities' initial attempt at industrial policy largely consisted in one piece of legislation, namely the Industrial Development Act (IDA, 1988) which introduced significant export incentives and benefits for foreign investment administered by the then Malta Development Corporation (MDC). A few of these incentives were of a discretionary nature, but the entire array of incentives included tax holidays, exemption from withholding tax, accelerated capital allowances, export promotion allowances, subsidised factories, customs duty relief, training grants, reduced tax rates and soft loans. This development followed an import substitution policy and stricter import controls, although subsequent to the Act, import controls remained through the imposition of levies.

More recently, the Business Promotion Act (BPA, 2001) was introduced, basically amending and replacing the IDA, and, taken together with a number of concurrent initiatives, constituted the first serious attempt to introduce a holistic industrial policy, one which was heralded by a White Paper (Ministry for Economic Services, 1999) as well as by a National Industrial Policy document (Ministry for Economic Services, 2003). There followed the introduction, in 2001, of a series of measures designed to provide a strategic basis for industrial development by generating higher manufacturing productivity, establishing the island as a regional trade centre, increasing foreign direct investment (FDI) inflows, expanding exportation and strengthening Malta's overall competitiveness. The BPA incorporated a new incentive package to boost existing and new investment, primarily in manufacturing, and no distinction was made between exporting and production for the local market under this act. However an added innovation here comprised the targeting of a specific list of industrial activities and sectors for special treatment and added incentives.

The recently established Malta Enterprise agency embarked on a strategy to identify and attract firms within select target industries, and, through the Business Promotion a number of promising economic sectors were identified and targeted for development via special treatment and privileged assistance in terms of fiscal and other resource allocation measures in order to promote investment in what government considered to be higher value added activities, while maintaining standard across-the-board incentives for FDI inflows generally.

Among the measures introduced for targeted sectors, there are reduced income tax rates, investment tax credits, value-added incentive schemes, job creation incentives and other non-fiscal incentives. Malta Enterprise was established as a cornerstone of the new

[2] Buttigieg (2004) has observed that a number of commentators have argued that in small island market economies such as those of Malta, it is hardly surprising for economic sectors to develop monopolistic and oligopolistic structures in view of the size and vulnerability of the market for said sectors.

industrial policy approach, while greater investment in vocational, educational and re-training education was announced, including the establishment of the Malta College of Science and Technology (MCAST). Innovation and quality standards via the establishment of the Malta Council for Science and Technology (MCST) also formed one aspect of this multi-pronged approach.

In terms of a critique of Maltese industrial policy from a largely Porterian perspective, including more recent related developments, we have limited ourselves to a number of fundamental considerations of a practical nature.

Classification and Conformity

The mass of the industrial policy legislation package appears to be based on the Supportive Approach (including neutral policies) and the Active Approach (including accelerative policies). In the former case, the package accepts the underlying superiority of market forces, encourages education and entrepreneurship and a number of neutral financial incentives appear aimed at reinforcing market efficiency. On the other hand, the Active Approach is visible in the fact that greater financial and non-financial incentives are awarded to selected target sectors. Furthermore, the policy package avoids decelerative policies characteristic of the Planning and Active approaches.

In itself, there is nothing unusual in this hybrid approach since commonly more than one stance have been simultaneously adopted for different areas of the economy and few governments have chosen to make use of solely neutral policies aimed solely at reinforcing market efficiency. Porter (1998) notes, however, that targeting, namely the practice of singling out particular industries for support and development, distorts market signals by altering the incentives of private firms to compete in an industry. Furthermore, the appropriateness of non-neutral targeting of specific industries for special support requires the selection of industries where the underlying determinants of national competitive advantage are present or can be developed. It may also be argued that once started, direct targeting is hard to stop, and, more importantly it is asserted that direct targeting will give optimal results only when a state has achieved investment-driven national advantage (Porter, 1998: 675). However it should be pointed out that the BPA allows for revisions to the list of targeted sectors. Nonetheless, the targeting approach may be highly questionable on the basis of the foregoing Porterian considerations.

Use of Tax Incentives

One may concur with Porter in emphasizing the superiority of tax incentives over direct subsidies as vehicles to promote industrial upgrading since they constrain firms to undertake projects only when they have the prospect of economic return. In this narrow context, Malta's industrial policy is fairly standard but no different from similar policies employed by most if not all her competitors.

Infrastructure, Education and Human Resources Development

As Briguglio *et al*. (2003) observe, steps to liberalise and improve efficiency in transport and communications, as well as liberalisation of port services are clearly warranted. The same applies to the call to improve the overall capabilities of the island's educational system, employee training and the economy's capacity for research and innovation, which all fall squarely within the standard Porterian policy prescriptions. The MCAST has clearly filled a void; prior to this development, the vocational training system lacked integration. In other respects, enhancing the synergy between industry and local educational institutions has not proved easy, despite the first tentative steps being taken.

Thus the Ministry of Competitiveness announcement, in August 2004, that port reform proposals replacing obsolete work practices were due to be introduced, was long overdue. Yet in the educational and research spheres, the chronic under-funding of Malta's only university in recent years are not in line with the BPA's stated objectives.

On the positive side, we have witnessed the government's voting the Malta Council for Science and Technology (MCST) Lm300,000 by way of grants in the 2003 budget for research and technology development funding outside the academic realm, which resulted in July 2004 in 100 project applications (from which 12 projects will be chosen). Leaving aside the meagre quantum of the sum–not more than about Lm25,000 per project—the response by the private sector has clearly been encouraging.

Additionally the provision of direct research grants or subsidies to firms

> "……. is questionable, and experience with it has been largely unsatisfactory. It is difficult enough under the best circumstances to evaluate the true commercial prospects of a research project. Without having to bear the financial risk, firms often propose bad projects or do not manage them well. They also use government funds to pay for projects they would have conducted anyway, or overstate the amount of research actually performed. Both Germany and the United Kingdom have quite rightly moved away from this approach" (Porter 1998: 634).

However there is merit to the counter-argument that Malta's size and domestic industrial market realities militate against the alternative of partial funding of specialised research institutes connected to industry clusters and partial subsidisation of research contacts between firms and research institutions especially for SMEs.

Furthermore, awarding token prizes of a paltry value by Malta Enterprise to firms in recognition of individual business achievements that contribute to national prosperity will not send sufficiently strong signals that effort, risk-taking and a commitment towards aggressively competing are being tangibly rewarded, although the underlying rationale is commendable.

On the positive side, the government's increasing commitment to intellectual property rights and the current patent legislative framework has proved beneficial to the island, particularly in terms of the pharmaceutical firms currently operational and those in the

process of situating locally (Camilleri, 2004). The underlying concern here is that excessively long patent lives could serve to protect past ideas and impede the process of creating new ones, and hence a careful balance is needed.

Business Cluster Formation

The need for business clusters for the exploitation of sectoral synergies and the stimulation of forward and backward linkages has been recognized locally (Briguglio *at al*., 2003: 55). In the Maltese context, one must realistically accept that government policy has more chances of success if the reinforcing of existing clusters or nascent industry clusters (as the local pharmaceutical manufacturing industry appears to be) is implemented, prior to attempting to promote entirely new ones.

Camilleri (2004) notes that cluster establishment results in the generation of higher value added. This is particularly the case within the domestic plastic industry, which is primarily dominated by two foreign owned firms that have developed a network of locally owned companies to whom they outsource a substantial part of their production process.

Given Malta's small size and limited ability to exploit scale economies, cluster development will not be easy—though the recommendation to encourage cluster development between local firms and enterprises in similar networks in neighbouring states is worth considering (Briguglio *et al*., 2003)—but it is an area where local industrial policy should devote greater focus.

In depth-studies on cluster development locally appear lacking. Cohen (2001) asserts that six success factors at the firm level have been distinguished in terms of cluster formation, namely inter-functional coordination with production and research and development, inter-functional co-ordination with marketing, vertical interaction across hierarchical borders, external interaction with suppliers, end users and other relevant enterprises, knowledge infrastructure, and patience money for risk-bearing long term investments. Hence for specific local industries, an indication can be made of the relevant significance of each of these success factors, and given Malta's business culture it is possible to indicate the presence or absence of these success indicators. Then a picture can be drawn for Malta of the business clusters in which it is likely to be most successful.

Relevance and Scope in View of Malta's European Union Membership

Given the fact that Malta's trade policy will be conditioned to a significant extent by its European Union (EU) and World Trade Organisation (WTO) obligations, and since European Monetary Union (EMU) and the Maltese adoption of the Euro are inevitable corollaries of membership, the question may be asked as to how EMU affects a positive Industrial Policy in Malta. Malta's Euro adoption would clearly eliminate the possibility of compensating losses in industrial competitiveness by exchange rate devaluation, a policy Malta flirted with briefly in the early nineties.

Since a competitive devaluation will not prove an option in the future—both for Malta and for other EU member states—economic adjustments will increasingly have to take place at the structural or industrial levels. Monetary integration clearly necessitates a positive industrial policy in EU members, and Malta is no exception.

The scope of such a future policy may be amended in scope in order to promote greater competitiveness. Thus rather than reviewing the Business Promotion Act in 2008 as the government has promised in line with Malta's commitments following the transitional period subsequent to full accession, it would be more correct to review the entire gamut of policies falling under the industrial policy package, from time to time, rather than individual pieces of legislation.[3]

Additionally by virtue of the EU's own Lisbon Strategy (see Briguglio and Cordina, 2004), the rationale exists for industrial policy interventions, which in the Maltese context, must recognise at which stage the local economy is situated and which must be aligned closer to Porter's broad competitiveness prescriptions than they are presently.

Conclusion

The foregoing discussion has attempted to make clear the rationale for an industrial policy that is necessary for greater levels of competitiveness in the Maltese economy. Several positive competitive-enhancing measures have been adopted thus far, and the August 2004 announcement of the creation of a Ministerial Competitiveness Forum is intrinsically sound (see Naudi, 2004). However, a number of questions need to be urgently addressed namely:

- To what extent do the state authorities recognise that competitive advantage and successful industries are created and sustained by firms and not by the government?
- Could the achievement of a more co-ordinated, complete and integrated framework require the unification of the four main strands of industrial policy referred earlier—namely competition policy, regional policy, innovation policy and trade policy—under one ministerial "roof"? Do we recognise that Malta still suffers from what Porter has described as overlapping authority and inconsistent policies towards industry?
- How committed are we towards serious investment in education and training? Has the time come for the establishment of a specialized Industrial Research Technical Institute?
- How can Malta realistically begin to contemplate adopting the Lisbon Agenda-inspired knowledge-based economy, when it is clear that the domestic economy has still to fully secure the investment-based stage in terms of its national competitive advantage?

[3] It is worth noting that certain provisions of the Business Promotion Act may need to be amended in view of Malta's commitment to the *acquis communautaire*. Although most of the BPA regulations are now in line with the EU's rules, those provisions of the Act allowing for reduced rates of income tax and operating aid will be allowed to continue for the duration of the transitional period as they do not fully comply with EU state aid rules. Additionally SME's eligible for tax exemptions under the said BPA will only be allowed to continue to benefit from this aid until the end of 2011. See http://europa.eu.int/comm/ competition/state aid/scoreboard/2004/profile mt.pdf.

It is important to avoid the pitfall of missing the greater picture provided by the various strands of industrial policy, by excessively focusing narrowly on selective areas relating to national competitive advantage.

While under Malta's present economic realities, there are clear onuses on the government to address its grave budgetary problems, it is the influencing of the Porterian diamond components, described earlier, that will clearly determine how sustainable Malta's competitive advantage will be.

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