Economic Diversification in Developing Countries
Lessons from Country Experiences with Broad-Based and Industrial Policies

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Contents

Acronyms and Abbreviations ........................................................................................................ iv

Executive Summary ........................................................................................................................ v

1. Introduction ................................................................................................................................ 1

2. Selected Literature Review and Conceptual Framework .............................................................. 3
   A. Benefits of Diversification ........................................................................................................... 3
   B. Drivers of Diversification and the Role of Government .............................................................. 4

3. Country Case Studies ................................................................................................................... 7
   A. Six Country Experiences ............................................................................................................ 7
   B. Lessons for Peer Countries ........................................................................................................ 18

4. IMF Work on Diversification and Staff Engagement with Authorities ....................................... 21
   A. IMF Work on Diversification ..................................................................................................... 21
   B. IMF Staff Engagement with Authorities on Diversification ..................................................... 24

5. Conclusions ................................................................................................................................ 27

Annex 1. Countries and Analytical Outputs Covered in the Stocktaking ............................................. 28

Annex 2. Survey of Country Teams on Traction with Authorities ....................................................... 38


References ....................................................................................................................................... 43

BOXES
Box 1. Export Diversification and Export Quality Data Toolkits ..................................................... 22

FIGURES
Figure 1. Costa Rica: Government Spending .................................................................................... 8
Figure 2. Gabon: Real GDP Growth and Oil Production ................................................................. 9
Figure 3. Gabon: Contributions to Real GDP and Foreign Direct Investment .................................. 10
Figure 4. Georgia: Growth Accounting, 2000–15 ....................................................................... 11
Figure 5. India: Real GDP Growth .................................................................................................. 13
Figure 6. Senegal: Change in Real Exports, 2000–17 ................................................................. 16
Figure 7. Vietnam: Number of Schools and Teachers ................................................................. 18
Figure 8. Vietnam and Comparators: School Completion Rate .................................................... 18
Figure 9. Survey of Vertical Policies (58 Countries) .................................................................... 25
Box Figure 1.1. Export Diversification and Export Quality in Case Study Countries ...................... 23

TABLES
Table 1. Summary of Country Case Studies .................................................................................. 20
Acronyms and Abbreviations

FDI foreign direct investment
FTZ free-trade zone
PSE Plan Sénégal Émergent
SEZ special economic zone
Executive Summary

This paper explores the importance and impact of both broad-based and industrial policies on economic diversification in developing economies, drawing on the literature, a range of case studies, and IMF analysis.

Diversification is defined as the transition from a dependency on traditional sectors, such as agriculture and mining, to a variety of sectors and high-quality services. Economic diversification is critical for industrialization or for transitioning toward a high-productivity, service-oriented economy. Further, it helps create an economic structure adaptable to global market fluctuations and resilient to global challenges. Economic diversification is therefore essential in promoting sustainable growth and improving living standards in developing economies. A literature review, including many IMF contributions, underscores a strong correlation between economic diversification and improved macroeconomic performance in developing countries, including enhanced stability, faster economic growth, and higher incomes per capita.

Various factors influence economic diversification, including macroeconomic stability, the quality of infrastructure, workforce skills, access to credit, the regulatory environment, and income equality. The recent surge in industrial policy in advanced economies has also increased interest across developing countries in the potential diversification benefits of such policies, making it critical to assess carefully what conditions are needed for such policies to prove cost-effective.

Six case studies illustrate various countries’ diversification experiences and highlight that successful diversification strategies require a long-term commitment and effective broad-based (horizontal) policies. Well-designed and effectively implemented industrial (vertical) policies can play an important supporting role by helping address market failures, but the bar to get such policies right is high. Common lessons are that maintaining macroeconomic stability, investing in human capital, and fostering competition are critical. Sector-specific mechanisms such as special economic zones should be used carefully, with an emphasis on tackling underlying bottlenecks and minimizing fiscal costs. Such measures must be backed by a focus on enhancing governance, including by strengthening administrative capacity, promoting transparency (also through the publication of tax expenditures), and ensuring accountability and value for money. Country-specific highlights include the following:

- Costa Rica: Demonstrates the power of a strategic policy shift toward export orientation and trade liberalization, a focus on human capital development, and establishing specialized institutions to overcome market failures and attract foreign investment.
- Gabon: Some success in reducing dependence on oil, including by attracting foreign direct investment, but a failure to broaden the revenue base has created fiscal challenges.
- Georgia: Illustrates the potential payoff to market-friendly policies and to improving public governance, but also the need to maintain the momentum of structural reform.
- India: Solid diversification results owing to the availability of skilled labor, improvements in the business environment, and the promotion of software clusters, including through investment incentives.
- Senegal: Highlights the importance of policy efforts to address infrastructure gaps, improve the business environment, and increase value addition, but also the fiscal cost of tax incentives.
Vietnam: A successful shift from an agrarian to an industrial economy through broad-based policies, including investment in education, backed by macroeconomic stability. However, the government’s strategies, including the relatively large role played by state-owned enterprises, and the occasional emphasis on specific sectors and products, were not consistently successful.

The paper also offers an overview of the IMF’s engagement on diversification. It takes stock of IMF work on the topic and presents the results of surveys of the engagement between IMF teams and national authorities on diversification. The IMF’s advice has mainly focused on improving human capital and infrastructure, reducing trade barriers, promoting international trade integration, and moving up value chains. IMF teams noted strong interest by the authorities in both horizontal and vertical policies to promote diversification.

Researchers, international organizations such as the IMF, and policymakers have all put increasing emphasis on the importance of economic diversification in developing countries. Diversification is a critical pathway toward resilient, sustainable, and inclusive growth. But it requires careful, nuanced policy interventions that consider each country’s context, production structure, capabilities, and institutions.
1. Introduction

Both policymakers and researchers increasingly acknowledge that economic diversification is critical to the performance of developing economies and view it as a policy priority. Diversification, which entails broadening the range of economic activities within a country, is an essential mechanism for fostering sustainable economic growth and improving standards of living (IMF 2014). For developing economies, this shift is especially pertinent because it increases their capacity to absorb economic shocks, while also creating new opportunities for innovation, investment, and job creation.

This paper studies the intricacies of this process by assessing different strategies, analyzing significant challenges, and identifying effective practices for successful economic diversification. The examination is rooted in the analysis of country-specific case studies and an exploration of the relevant academic and policy literature. By doing so, the paper seeks to offer a nuanced understanding of the diversification process across different developmental contexts.

Our analysis reveals that strategic policy shifts and targeted investments play a central role in facilitating diversification. For instance, developing human capital, attracting foreign direct investment (FDI), and building institutional capacity can significantly enhance the diversification process. Such measures are instrumental in constructing a robust and diverse economic structure. However, these elements do not operate in isolation: rather, their efficacy relies on their interaction and on the creation of a supportive broader policy environment.

Diversification strategies often involve a mix of both broad-based (“horizontal”) and sector- or industry-specific (“vertical” or “targeted”) approaches. Horizontal strategies aim at improving conditions that support all sectors. Vertical strategies, often referred to as “industrial policy,” focus on supporting specific activities or technologies. Recently, there has been a global resurgence in industrial policy as countries seek to navigate complex challenges, including climate change, technological change, and geoeconomic fragmentation, while striving to foster innovation, secure a competitive advantage in strategic industries, and ensure supply-chain resilience (Evenett and others 2024).

Our analysis underscores the importance of horizontal policies, focused on ensuring macroeconomic stability, fiscal sustainability, and a favorable general business environment, as foundational preconditions for successful diversification efforts. Industrial policy can potentially help address market failures, but the bar to get it right is high. The effectiveness of targeted measures depends critically on the quality of their design and implementation. It is also context-specific, contingent upon the unique circumstances and developmental stage of each economy. Striking the right balance between all these considerations forms a challenging task for policymakers, who will need to simultaneously consider overarching economic conditions and sector-specific needs.

This paper seeks to build on the current body of literature that identifies the central role of economic diversification in fostering sustainable and inclusive growth in developing economies. By investigating the economic pathways of six different economies—Costa Rica, Gabon, Georgia, India, Senegal, and Vietnam—we
aim to extend the existing conversation surrounding economic diversification. While each of these countries presents unique sets of strategies and experiences, they also offer some common lessons that offer valuable insights for other developing nations embarking on their economic diversification journeys.

Our analysis also leverages research from the IMF to present the evolving perspectives and strategies toward economic diversification in low- and middle-income countries and emerging markets. We delve into the complexities of the IMF’s advice on horizontal and vertical policies, investigate the relationship between diversification deficits and macroeconomic volatility, and uncover specific challenges faced by different types of economies.

The rest of this paper is organized as follows. The second section presents a literature review to establish the theoretical and empirical underpinnings of economic diversification, including its impact on macroeconomic performance and the key factors driving it; it is partly based on the conceptual framework outlined in the companion piece of Cherif and others (2022). This section underscores the pivotal role of diversification in bolstering economic resilience and supporting broader development, and highlights the need for effective policy interventions to remove barriers to diversification. The third section presents case studies of Costa Rica, Gabon, Georgia, India, Senegal, and Vietnam. These studies offer a rich array of insights into the realities on the ground, the challenges encountered, and the outcomes achieved through various diversification strategies. The fourth section offers an overview of the IMF’s engagement on economic diversification in developing countries. It both takes stock of IMF work on the topic and presents the results of surveys of the engagement between IMF teams and national authorities on diversification.

In an era characterized by escalating economic volatility and mounting global challenges, being able to assess the costs and benefits of various economic diversification strategies, and to overcome implementation challenges, is ever more critical. This paper contributes to furthering the debate and aims to serve as a resource for policymakers, practitioners, and researchers navigating the complexities of economic diversification.
2. Selected Literature Review and Conceptual Framework

As economies evolve and global landscapes change, countries’ economic structures must adapt. One key facet of this adaptation is economic diversification, the process by which a nation broadens its economy beyond its traditional sectors. This review draws upon multiple strands of literature to delve into the various ways in which economic diversification impacts developing economies and some key factors driving it.

A. Benefits of Diversification

Economic diversification denotes a shift from a dependence on traditional sectors, such as agriculture and extractives (oil and mining), toward a broader array of sectors and high-quality services. Diversification is intimately related to the process of structural transformation, that is, the dynamic shift of resources from less productive to more productive sectors, including knowledge-based industries. This process, which involves both capitalizing on a country’s current comparative advantage and building the capabilities required to create new comparative advantages, is essential to economic development (Papageorgiou, Spatafora, and Wang 2015; McIntyre and others 2018). Diversification therefore serves as an essential pillar for fostering sustainable growth and improving living standards, particularly in developing economies (IMF 2014). Recent global challenges, including climate change (IMF 2020), technological change, and geoeconomic fragmentation (IMF 2023a), have highlighted the critical role of economic diversification in ensuring sustained growth (Cherif and Hasanov 2019; Cherif, Hasanov, and Zhu 2016).

Specifically, diversification’s numerous economic benefits have been widely documented:

1. Diversifying domestic production, exports, and imports enhances resilience to external shocks (IMF 2014; Cerdeiro and Plotnikov 2017; UNCTAD 2018; Koren and Tenreyro 2013).

2. Diversification can also stimulate faster economic growth, especially in countries at early stages of development (Papageorgiou, Spatafora, and Wang 2015; IMF 2014). Indeed, a large empirical and theoretical literature has investigated the often-negative relationship between the extent to which countries, and in particular developing economies, are specialized in producing exhaustible resources and their subsequent economic performance—the “Dutch disease” and the “resource curse.” That said, the link between diversification and long-term growth is not always straightforward. For instance, the Latin American and Caribbean region has failed to leverage diversification for long-term growth owing to macroeconomic instability (IMF 2015).

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2 There are several ways to measure and assess economic diversification, including examining the distribution of output across different sectors, analyzing export concentration and the complexity of export baskets, and evaluating changes in employment patterns across industries. The IMF’s export product diversification index reflects a country’s range of exports and concentration in certain products, with lower values indicating higher diversification. This index is based on the Theil index, capturing both extensive (range of goods) and intensive (concentration of exports) diversification margins (IMF 2014; Cadot, Carrere, and Strauss-Kahn 2011). The export product quality index measures the relative quality of a country’s exports, considering price markups adjusted for production costs and trading distance, providing a yearly global ranking of export quality (Henn, Papageorgiou, and Spatafora 2013).

3. Successful diversification can lead to reductions in poverty and inequality, as it often involves the emergence of new industries requiring labor, thereby generating jobs and boosting income levels. Diversification into technologically advanced sectors may result in higher wages and improved job opportunities (Acemoglu and Autor 2011).

4. Economic diversification becomes even more salient in the context of climate change. As certain sectors, especially in agriculture, become less viable owing to shifting environmental conditions, diversifying into other sectors can help economies stay resilient. Incorporating green technologies and sustainable industries into diversification strategies is therefore critical.

Despite its many benefits, diversification is a complex process. It requires countries to acquire new capabilities and expertise, which can be a challenging endeavor (Hidalgo and Hausmann 2009). In this regard, Hausmann and others (2013) introduced the concept of “economic complexity,” referring to the knowledge incorporated within an economy. They contend that economies with greater complexity (that is, more diverse and sophisticated production structures) are likely to grow faster. In this context, diversification can be viewed as a route to enhancing economic complexity, thereby driving sustainable growth.

Historically, developing economies have largely relied on a limited range of primary products, often involving exhaustible resources, and a small number of export markets. Yet, over the past two decades, these countries have increasingly diversified into new products and trading partners (IMF 2014). Despite this growth, there is still considerable potential for further diversification, especially by enhancing the quality of existing products and introducing new, higher-value goods. Importantly, diversification extends beyond manufacturing to encompass agriculture, often the least productive sector in low-income countries.

Patterns of diversification vary across regions and countries. Developing Asia has seen significant success in diversifying its exports, often through entry into entirely new products and quality upgrading (Papageorgiou, Spatafora, and Wang 2015). This contrasts markedly with the more limited progress toward diversification observed in sub-Saharan Africa (IMF 2014). At the same time, an analysis of goods trade in Latin America and the Caribbean indicates that human capital and infrastructure development were crucial to increasing the region’s export share in high-skill products (Ding and Hadzi-Vaskov 2017). This highlights that strategies to structurally transform or diversify economies should be tailored to each country’s unique regional and sectoral dynamics.

B. Drivers of Diversification and the Role of Government

We now outline a conceptual framework, drawing on Cherif and others (2022) and IMF (2014; 2024a), which can be used to help interpret the subsequent case studies, survey results, and recommendations. The extent of a country’s economic diversification is influenced by multiple factors. Most relevant for our purposes, potential drivers include various aspects of a country’s policy and institutional environment. Put differently, what governments do, or fail to do, can create barriers to diversification—or, conversely, help mitigate the impact of such barriers.

In particular, key factors potentially constraining the observed level of diversification include government failures to provide macroeconomic stability, including through appropriate monetary, fiscal, and macroprudential policy frameworks; support the development of quality infrastructure, a skilled workforce, and access to financial services; foster effective, transparent, and accountable governance, including an appropriate
regulatory environment; and, ultimately, ensure broad-based opportunities for the entire population, including through gender-responsive policies to help reduce disparities in human capital accumulation and resource allocation.⁴

At the same time, private markets may themselves be the source of distortions that hamper prospects for diversification. In particular, different sectors and actors in the economy may be subject to “coordination failures,” and overcoming these will be essential for diversification (Hausmann and Rodrik 2003). For instance, the development of new sectors may involve the coordinated creation of an entire ecosystem of producers, specialized suppliers, and workers with specialized skills. Likewise, coordinated investments may be required to adapt technology, establish the size of potential markets, reach potential customers, and create verifiable quality standards.

As a corollary, the future of economic diversification in developing economies is likely to rely on the effectiveness of policy interventions of two broad types, typically categorized as horizontal and vertical strategies (IMF 2016a; 2017). Horizontal policies are broad-based and aim to improve the general business environment across all sectors of an economy, for instance, by developing infrastructure and human capital, increasing the ease of doing business, and strengthening governance. Vertical policies, also called industrial policy, are more targeted and focus on supporting specific sectors, industries, or technologies considered to have high growth potential or strategic importance, but where private incentives may prove inadequate to support the activity. Vertical policies may, for instance, include subsidies, tax incentives, directed lending programs, and tailored regulatory regimes, generally with the goal of promoting investment, skills development, and innovation in the target areas. Rodrik (2014) emphasizes the pivotal role of the state in facilitating diversification along such lines.

The selection and implementation of diversification strategies comes with a large set of challenges. The state must maintain a close relationship with the private sector to understand the specific constraints and bottlenecks the latter faces and how these can be resolved. Yet the state must also retain sufficient autonomy to enforce discipline and prevent capture (Cherif and Hasanov 2019). More specifically, potential industrial policies should be evaluated using four criteria (IMF 2024a). They must have a solid justification: what is the underlying market failure, and could other policies tackle it? They must be well designed: what are the best policy instruments, and what complementary policies are needed to ensure effectiveness? Industrial policies must pass a rigorous (ex ante and ex post) cost-benefit assessment, including fiscal and administrative costs, as well as indirect costs due to potential resource misallocation and trading partner retaliation. And industrial policies must be well implemented. They must be consistent with a country’s institutional and administrative capacity. They must preserve domestic macroeconomic stability, as well as fiscal and external sustainability. And they must be consistent with World Trade Organization commitments. In general, successful implementation requires robust administrative capacity; comprehensive reforms to address underlying institutional weaknesses, boost transparency, and strengthen governance, so as to deter corruption and rent-seeking; and an emphasis on maintaining openness to foreign firms and vigorous competition throughout the economy (IMF 2024c; Cherif and others 2022).⁵

To sum up, economic diversification is a complex process with the potential to yield significant rewards for developing economies. It can facilitate sustainable and inclusive growth, enhance resilience to external shocks, and foster industrialization and productivity enhancement. However, diversification may necessitate

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⁴ See IMF (2012; 2014; 2017) for broad cross-country analyses of the drivers of diversification; Salinas (2021) for a similar analysis, employing a gravity equation framework and disaggregated export data; Callen and others (2014) for the impact of policy-related macroeconomic volatility; and Kazandjian and others (2016) for the role of gender inequality.

⁵ To illustrate potential pitfalls, even research and development subsidies, with their strong theoretical justification, may encourage the survival and expansion of low-productivity firms (Acemoglu and others 2018); may oversubsidize applied research (Akcigit, Hanley, and Serrano-Velarde 2021); may crowd out business research and development investment (Boeing 2016); in Germany, may not boost innovation among young firms (Schneider and Veugelers 2010); in China, may yield a sharply negative return (Wei and others 2023) and may serve mainly to signal political connections (Guo, Guo, and Jiang 2022); and, in smaller countries, may reduce productivity growth (Davis and Hashimoto 2015).
significant broad-based reforms, with potentially important support from judiciously designed, effectively implemented industrial policies that consider the specific context of a country, including its existing economic structure, its capabilities, and the state of its institutions. These nuances will be discussed in the next section with the help of country case studies.
3. Country Case Studies

This section explores diversification successes and challenges in six different countries: Costa Rica, Gabon, Georgia, India, Senegal, and Vietnam. These countries were chosen because, on the one hand, their governments were all concerned with promoting economic development through diversification, and, on the other hand, the countries represent a wide range of geographical regions and income levels. Each country therefore presents a unique set of economic conditions, circumstances, and practices that shaped their strategies for development and diversification. Data and methodological limitations prevent a comprehensive assessment of their diversification policies (for instance, impact evaluations or cost-benefit analyses). Nevertheless, by analyzing these case studies, we can draw some useful common lessons and gain a greater understanding of what works, what does not, and why.

A. Six Country Experiences

Costa Rica

Costa Rica underwent an extensive transformation following the economic crisis in the early 1980s. The country transitioned from an import-substitution model to an export-oriented model, embracing trade liberalization and attracting high-tech FDI. This case study delves into the major policy decisions, institutional measures, and strategies that Costa Rica implemented between 1980 and 2018 to spur economic diversification and growth.

Costa Rica faced a severe economic crisis in the early 1980s, characterized by a GDP contraction of 9.4 percent between 1980 and 1982, inflation reaching about 90 percent in 1982, large fiscal deficits (with public spending equating to 54 percent of GDP), and rapidly increasing external debt. This crisis was a result of several factors, including an overreliance on the import-substitution model, fluctuating international trade conditions, and imprudent fiscal policy responses. In response, Costa Rica transitioned toward an export-oriented model through multiple significant measures:

- Introduction of a crawling peg exchange rate regime, which replaced a fixed exchange rate regime, enhancing export competitiveness and stimulating the tourism sector.\(^7\)

- Start of trade liberalization through accession to the World Trade Organization and the signing of numerous preferential trade agreements, covering over 80 percent of Costa Rica’s trade. The average applied tariff rate has fallen from over 11 percent in 1985–89 to around 1 percent, promoting international competitiveness.

- Implementation of inward processing regimes that facilitated the transition from an import-substitution to an export-oriented model.

- Establishment of free-trade zones (FTZs) to attract export-oriented foreign firms in strategic sectors, including high tech. Over time, FTZs have come to account for a dominant share of total exports and inward FDI.\(^8\)

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\(^6\) This section is based on a note prepared by Nan Geng.

\(^7\) The introduction of a crawling peg allowed exchange rate depreciation to offset positive inflation differentials relative to key trading partners. This stabilized the real exchange rate and provided more certainty to exporters for their investments.

\(^8\) While the FTZs have been catalytic in supporting exports, job creation within the FTZs, and growth, this has led to a dual economy; the rest of the productive sector, which is taxed under the standard corporate tax regime, lags in terms of growth.
Three key institutions played vital roles in this economic transition, their effectiveness boosted by Costa Rica’s strong governance frameworks:

- The Costa Rican Investment Promotion Agency, founded initially with support from the US Agency for International Development in 1984 to help train and encourage small agricultural exporters of new products, promoted inward high-tech FDI, attracting over 280 high-tech companies by 2017.
- The Trade Promotion Agency fosters the quantitative and qualitative growth of exports by simplifying and facilitating export procedures and varied activities and facilitated export procedures and provided training and advisory services to businesses.
- The Ministry of Foreign Trade aimed to create a competitive business climate for export promotion in coordination with the Costa Rican Investment Promotion Agency, the Trade Promotion Agency, and the government.

Additionally, Costa Rica made substantial investments in education and health to develop a high-quality labor force (Figure 1). This human capital foundation became a crucial asset in attracting FDI and in transitioning toward an export-oriented economy.

The policy and institutional changes implemented by Costa Rica resulted in significant economic growth and diversification. The country evolved from a primary commodity exporter to an exporter of high-value, knowledge-intensive goods and services: the share of primary commodities in total exports declined from 65 percent in 1980 to 26 percent in 2018. This transition led to diversified exports and improved export quality, stable economic growth over the past three decades, an improved standing in the Economic Complexity rankings (Hausmann and others 2013), a doubling of GDP per capita, and a dramatic reduction in growth volatility.

Costa Rica’s experience offers valuable insights for other economies. It underscores the significance of:

- A strategic shift toward broad-based trade liberalization and export orientation.
- Investing in human capital.
- Establishing specialized institutions to overcome market failures and attract foreign investment, including in high tech.

In conclusion, Costa Rica’s experience underscores the potential for economic transformation through a comprehensive approach involving policy shifts, institutional innovations, and human capital development.

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9 In particular, semiconductors, computer accessories, medical devices, and information technology and consulting services.
10 See Trejos (2013) and Gokmenoglu, Sehnaz, and Taspinar (2015) for more detailed analyses.
This case study analyzes how Gabon’s government has been seeking to break the economy’s dependence on oil through industrial policies, while boosting fiscal space through non-oil revenue mobilization, with a focus on the period between the mid-1990s and 2021. Gabon became a large oil producer in the 1950s, and oil initially turned it into one of the wealthiest countries in sub-Saharan Africa, with progress in human development and living conditions. However, the lack of structural transformation or of investment in human capital led to continued heavy dependence on oil. Indeed, in a classic manifestation of the Dutch disease, oil production and exports suppressed those of the non-oil tradable sectors, such as manufacturing and agriculture.

As a result, when oil production and exports began to decline in the mid-1990s (Figure 2), owing to dwindling reserves, there was a significant negative impact on economic activity through the 2000s. Activity recovered in the 2010s, but real per capita incomes have nevertheless declined since 1990 by more than 20 percent (see also IMF, forthcoming).

To boost economic diversification and promote foreign investment, the Gabonese government launched in 2012 the first of three ambitious development plans, called Plan Stratégique Gabon Émergent (PSGE, or the Emerging Gabon Strategic Plan). Aiming to transform Gabon into an emerging and diversified economy by 2025, the PSGE initially envisaged an investment of US$12 billion over seven years. The plan comprised three strategic axes: (1) diversification via vertical policies, which included sectoral plans for to nurture sectors like agri-business, mining, and forestry; (2) competitiveness via horizontal policies, focusing on human capital, governance, doing business, and infrastructure; and (3) shared prosperity, redistributing more effectively the country’s wealth coming from natural resource revenues. To attract investors through that plan, the government promoted tax exemptions, special economic zones (SEZs), and public-private partnerships.

The 2014 negative oil price shock, however, exacerbated some of the vulnerabilities inherent in Gabon’s oil-dependent economy. The 50 percent drop in oil export prices led to cutbacks in the oil sector, lower production volumes and export earnings, reduced investment and local employment, and smaller purchases from domestic service providers. Since oil revenues constituted over half of the total government revenues, the administration had to reduce current and capital expenditure and resort to borrowing to offset their decline. At the same time, the already low-performing non-oil tax revenues were further undermined through several interrelated channels (IMF 2019). The first channel was the impact of the protracted oil shock on non-oil economic activity and hence revenues, both directly through lower domestic input purchases by the oil sector and indirectly through the decline in government expenditure. The second channel was weaknesses in tax and customs administration, related to factors such as low operational capacity, limited success in identifying and classifying distinct taxpayer groups (for instance, small versus medium-sized

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11 This section is based on a note prepared by Toomas Orav and Marcos Poplawski-Ribeiro. See IMF (2024d) for more details on economic diversification in Gabon.

12 See also Melina and Poplawski-Ribeiro (2021) for the macroeconomic effects of the (lack of) non-oil revenue mobilization in the Central African Economic and Monetary Community region.
versus large enterprises) and developing customized approaches to meet the needs of each group, and fragile political and financial support. The third channel was weaknesses in tax policy, with non-oil revenues still relatively reliant on the taxation of international trade. Both non-oil corporate income taxes and indirect taxes (including excises and value-added taxes) proved highly volatile, magnifying the spillovers from the oil sector.

In that context, the government had to review the initial PSGE, complementing it in 2017 with the Plan of Economic Recovery, which became also one of the pillars of the Extended Arrangement under the Extended Fund Facility with the IMF. The recalibration of the PSGE for the period 2017–19 had five main objectives: (1) maximize revenues and economic financing, (2) control public spending, (3) reinforce sectoral competitiveness, (4) improve business climate to boost private investment, and (5) improve the quality of public services to the population.

The PSGE had to be recalibrated once more in light of the COVID-19 pandemic and its impact on the country and on sub-Saharan Africa as a whole (Loko, Nembot, and Poplawski-Ribeiro 2022). In 2021, the administration made a significant review of its development plan, launching the Transformation Acceleration Plan. While the initial objectives of the previous plans were maintained, they were reoriented to reflect the deteriorated outlook of the Gabonese economy after the pandemic: (1) accelerate the structural transformation of the economy; (2) boost inclusive growth and employment creation, reducing income inequality; (3) continue the fiscal adjustment to open fiscal space; and (4) reinforce external stability.

The three development plans led to a significant diversification of the economy, with progress in developing new sectors such as manganese, wood, palm oil, and rubber, and to a substantial increase in FDI in these new sectors (Figure 3). Each of the development plans proved important in supporting this diversification. The PSGE established the vision and launched the horizontal, vertical, and social policies that were maintained through the other two development plans. For instance, the PSGE allowed the completion of the wood industrial zone (Zone Nkok), the construction of a mineral port, and the creation of skill-based professional courses. As mentioned, the second plan (the Plan of Economic Recovery) combined this focus on development with policies to enhance macroeconomic fundamentals, a necessary precondition for sustainable growth. For instance, the Plan of Economic Recovery enabled a fiscal consolidation that created fiscal space and reduced central government debt (from 64.2 percent of GDP at the end of 2016 to 60 percent of GDP in 2019, just before the COVID-19 pandemic). Finally, the third plan (the Transformation Acceleration Plan)

![Figure 3. Gabon: Contributions to Real GDP and Foreign Direct Investment (Constant 2001 CFA franc, billions; percent of GDP, right scale)](image-url)
recalibrated policies to respond to the sizable negative effects of the pandemic on Gabon. It supported continued diversification, investment, and economic growth between 2021 and 2023, despite the significant external and domestic shocks which the country faced during this period.

Yet the implementation of the plans also created new challenges. Tax exemptions caused the loss of an estimated 4 to 5 percent of GDP in revenues, causing a reconsideration of the cost-benefit balance of these policies (IMF 2019). In addition, SEZs and public-private partnerships have not substantially contributed to the domestic economy, despite the creation of some infrastructure and jobs.

In sum, Gabon’s case shows commendable efforts and initial successes in diversifying its economy and reducing oil dependency. However, the overall effectiveness of its strategy remains uncertain. In particular, Gabon’s experience highlights the need to balance the pursuit of foreign investment with long-term fiscal sustainability. Tax exemptions can lead to significant revenue losses. And, if economic diversification is sought without simultaneously broadening the revenue base beyond resource-rich sectors, unsustainable fiscal policy and macroeconomic instability may follow. At the same time, investors often prioritize stability, institutional quality, and the availability of essential inputs over tax incentives, including in sub-Saharan Africa (Naudé and Krugell 2007).

Georgia

Following independence in 1991, Georgia faced severe political and economic instability characterized by large public deficits, unprecedented hyperinflation, and deindustrialization. A sharp fall in industrial production marked the initial phase of this tumultuous period. During this time, the economy was chiefly concentrated in subsistence agriculture and low value-added services.

This case study focuses on the period between the 2003 Rose Revolution and 2014, when the transition to better public governance and market-friendly policies allowed services to expand and productivity to increase (Figure 4). Key measures during this reform period which supported Georgia’s economic transformation included:

- Implementation of prudent fiscal policies and a transition to an inflation-targeting framework.
- Improvement of public governance and efficiency of public institutions while drastically reducing corruption.
- Infrastructure development, including the extension of the East-West highway and the completion of the Baku-Tbilisi-Kars railway.
- Securing trade agreements with multiple partners to increase global integration and diversify export markets.
- Implementation of a framework for establishing investment funds and primary dealers, expanding financial instruments, and promoting financing for small and medium enterprises.

Figure 4. Georgia: Growth Accounting, 2000–15 (Percent)

Sources: Georgia authorities; and IMF staff estimates.

13 This section is based on a note prepared by Majdi Debbich.
• A comprehensive reform of education curricula and continuing training for teachers to mitigate skills mismatches in the labor market.\textsuperscript{14}

This reform strategy led to diversification and faster total factor productivity growth, boosting employment and real GDP per capita growth (Gvindadze 2017; Khodunov 2022). Key trends in this phase included the following:

• Growth averaged 5.6 percent of GDP in 2000–18, although it leveled down after the global financial crisis to around 4 percent.

• The country’s production base started diversifying, with services rising to two-thirds of total output. Service exports diversified and grew rapidly, while merchandise exports remained relatively concentrated.

• Despite this diversification, growth was not sufficiently inclusive, with unemployment and inequality remaining elevated; the economy remained vulnerable to external shocks.

Overall, in Georgia’s case diversification resulted from broad-based policies and structural reforms, rather than sector-specific policies. The policies were built upon free-market principles, despite the country’s history as part of a planned economy. The core objective of the authorities was to develop transport and energy infrastructure, improve labor force quality, streamline regulations, and create a business-friendly environment to attract foreign investment.

Despite strong productivity gains within sectors over 2004–14, the extent of the economy’s diversification and structural transformation proved insufficient to prevent a slowdown in total factor productivity growth over time. To address this, a second wave of reforms aimed at further improving the business environment and facilitating access to finance was launched. The “Produce in Georgia” program, launched in 2014, aimed to support domestic production, promote small and medium enterprises, foster exports, and attract FDI. Additionally, the country established three FTZs to provide companies with tax incentives and simplified procedures. Power purchase agreements were also put in place to attract private investment for the construction of hydropower plants (the use of traditional public-private partnerships was more limited). While these policies contributed to raising contingent liabilities and fiscal risks, there is limited evidence that the second wave of reform significantly increased diversification and total factor productivity growth.

The IMF has supported Georgia’s strategy through policy advice and technical assistance, aligning with the market-based approach to foster higher and more inclusive growth led by the private sector. Georgia’s experience suggests the importance of deep, continued structural reforms to ensure ongoing diversification and sustainable, inclusive growth, while highlighting the need to contain fiscal risks.

India\textsuperscript{15}

This case study focuses on India’s transformation between the early 1990s and 2018 from a state-controlled model, with an industrial strategy focused on import substitution, toward policies promoting competition. Beginning in the early 1990s, India initiated significant reforms aimed at stimulating economic growth (Figure 5):  

• Removal of exchange controls
• Trade liberalization
• Foreign investment promotion
• Dissolution of entry barriers for new firms

\textsuperscript{14} OECD (2019) discusses progress and remaining challenges in the education sector.
\textsuperscript{15} This section is based on a note prepared by Jarkko Turunen.
The more recent focus has been on maintaining macroeconomic stability and promoting ongoing liberalization, which have positively impacted growth (Goretti and others 2019). At the same time, the transformation from an import-substitution model to one based on competition remains incomplete, particularly in the manufacturing sector.

Related, results with regard to the diversification of goods exports are mixed. Manufacturing exports as a share of GDP remain less robust than those of regional peers. India’s production complexity lags peers such as China and more advanced economies; much production remains labor-intensive and low-tech (Atlas of Economic Complexity, Harvard University). Yet India has also demonstrated a trend toward producing and exporting more sophisticated, capital-intensive goods such as car parts, capital goods, and pharmaceutical products. This shift has bolstered export diversification in goods to levels comparable to regional counterparts (Sodsriwiboon 2019). India’s portfolio of exports points to a potential for continued diversification into a broader range of more complex goods, a goal of the current manufacturing and export promotion schemes.

That said, India’s growth trajectory diverges from traditional development paths reliant on manufacturing exports. Instead, the focus has shifted more toward modern services exports. From 1990 to 2018, the value-added share of the services sector increased nearly 20 percentage points (World Bank, World Development Indicators). This growth has been marked by a significant expansion in modern information and telecommunication and business services. Two key drivers of this rise in service exports were:

- Reforms aimed at improving the business environment, together with a relative lack of state controls on service activities; and
- Investments in education (where spending is around 5 percent of GDP).

The emphasis on tertiary education specifically led to the availability of a pool of high-skilled, English-speaking workers who could meet the demands of the services export sector (Sahoo, Dash, and Mishra 2013). The growth of India’s service exports is also linked to the establishment of software technology parks and SEZs. Such initiatives, termed knowledge clusters, can play a crucial role in addressing both market and government failures. These clusters offer several benefits, including:

- Mitigating coordination difficulties among private firms,
- Facilitating knowledge spillovers across businesses, and
- Providing necessary infrastructure and regulatory support.

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16 See https://atlas.cid.harvard.edu/.

17 Recent developments in India include the amendment of the Special Economic Zones Act, 2005, to broaden the focus of SEZs beyond exports and the implementation of the Production Linked Incentive Scheme across 14 key sectors, aimed at boosting manufacturing and exports. As of March 2024, the Production Linked Incentive Scheme has catalyzed investments and job creation across sectors including electronics, pharmaceuticals, and telecom.

18 The observed increase in the value-added share of the services sector also reflects the growing "servicification" of manufacturing exports, where services enhance the value of manufactured exports. Organisation for Economic Co-operation and Development Trade in Value Added data shows India’s domestic services value added in manufacturing exports grew from 13.4 percent in 2011 to 17.7 percent in 2020, emphasizing the integral role of services in manufacturing.
The first software technology park, an export zone dedicated to the software industry, was set up in Bangalore in 1990 (Saxenian 2001). Firms operating within these knowledge clusters could capitalize on new goods and technologies, moving from basic services to modern ones. Export-oriented firms in these clusters enjoyed several fiscal incentives:

- Tax exemptions
- Import duty exemptions
- Free repatriation of capital investment, royalties, and dividends
- Permission for full foreign ownership in exchange for an export obligation

In addition to fiscal incentives, SEZs provided critical infrastructure and administrative support, such as a streamlined, single-window clearance mechanism for potential investors (Rao and Balasubrahmanya 2017).

The growth of firms originating from knowledge clusters contributed significantly to the expansion of modern services exports. This is demonstrated by the rapid development of Indian information and telecommunications multinationals such as Infosys and Wipro, both based in Bangalore (Saxenian 2001). Similarly, global capabilities centers, which enable large foreign firms to establish their back-office functions (including human resources, finance, and information and telecommunications) in India, are becoming increasingly common.

While service exports have bolstered economic growth, their impact on job creation is limited due to the relatively low employment elasticity in services compared to manufacturing (Sodsriwiboon 2019). Consequently, broader structural reforms are needed to address constraints to further diversification and growth. For instance, the quality of education often remains low, particularly in rural and poorer areas, and many graduates do not have skills that match market demands, even though a relatively small group of Indians are very well educated (Tilak 2023). Tackling this challenge also holds promise for reducing poverty and inequality.

In summary, India’s pivot toward modern services exports has benefited from several key factors:

- Availability of skilled labor and (ongoing) educational reforms
- Improvements in the business environment
- The promotion of software clusters, including through investment incentives

In the post-COVID-19 era, India experienced a noteworthy increase in digital services exports, accelerated by the push for digitalization that occurred during pandemic (Alonso and others 2023; Gajbhiye and others 2024). The government’s Digital India initiative played an important role in this transformation, enhancing India’s capabilities in high-value services exports, particularly through global capability centers.

**Senegal**

Senegal’s pursuit of economic diversification, with the objective of becoming an emerging market economy by 2035, is an ambitious endeavor summarized in its comprehensive development strategy, the Plan Senegal Emergent (PSE), launched in 2014 (Kireyev 2018). This case study examines the PSE’s objectives, its strategies for diversification, and its outcomes thus far, contributing to an understanding of Senegal’s experience with economic diversification.

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19 To tackle skills shortages, the Government of India launched in 2015 a campaign, Skill India Mission, dedicated to empowering youth with future-ready and industry-relevant skills. This mission is operationalized via a vast network of skill development centers and institutes under key schemes such as the Pradhan Mantri Kaushal Vikas Yojana, the Jan Sikhshan Sansthan, the National Apprenticeship Promotion Scheme, and the Craftsman Training Scheme facilitated through industrial training institutes.

20 This section is based on a note prepared by Mesmin Koulet-Vickot and David Stenzel.
The PSE, building upon Senegal’s earlier strategic frameworks, envisages structural changes in the economy and increased exports through a wide array of sectoral policies, priority projects, and a specified investment program. Focus areas include:

- Modernization of agriculture and promotion of food processing industries,
- Utilization of SEZs for export promotion,
- Promotion of tourism,
- Maximizing domestic value from oil and gas discoveries,
- Digitalization, and
- Enhanced access to financing.

The PSE has effectively coordinated and monitored key projects and reforms across sectors such as energy, infrastructure, services, mining, agriculture, and social areas, leading to substantial achievements.\(^{21}\)

Senegal had experienced a downward shift in its economic growth trajectory after 1995, largely due to structural reforms and the devaluation of the CAF franc in 1994 (World Bank 2018). With the contribution of the PSE, the country returned to strong per capita growth from 2014 onward,\(^{22}\) suggesting a potential turning point in its economic history.

Despite this, the Senegalese economy remains dominated by the service sector, which grew from 48 percent (2000–07) to 52 percent (2014–18) of GDP. The predominance of the services sector in Senegal’s economy, while providing numerous employment opportunities, raises concerns regarding long-term sustainable development, especially given the prevalence of low-productivity, informal employment within the services sector. Other sectors like mining and construction grew during the high growth period of 2014–18, but the GDP share of agricultural processing and other manufactured products declined.

Investments have played a significant role in the growth spurt during 2014–18. Private investment increased significantly after 2010, reaching almost 20 percent of GDP in 2017. FDI, however, remained around 2 percent of GDP, far below the PSE’s objective of 6–8 percent.

Exports also increased, with an average annual growth of 8 percent since 2010 (Figure 6). Despite the overall growth, traditional export products such as cotton and groundnut have become less critical. As of 2017, exports of goods and services amounted to 21.9 percent of GDP.

To strengthen the growth foundations, several “horizontal” reforms were initiated to improve the business environment, tackle high input costs, and establish an even playing field. These included:

- Establishment of a new commercial justice system,
- Introduction of a new land management system,
- Revisions to the investment law,
- Investments in education (where spending exceeds 5 percent of GDP) and health services, and

\(^{21}\) For instance, a quadrupling of installed electrical capacity, increased rural electrification rates, major infrastructure projects including the Regional Express Train and Blaise Diagne International Airport, and significant improvements in agricultural productivity and public health.

\(^{22}\) Average annual growth of 6 percent during 2014–18 and 4.4 percent during 2019–22. This growth was instrumental in reducing Senegal’s poverty rate by 5 percent between 2011 and 2018, to the lowest levels in the West African Economic and Monetary Union region.
Initiatives to help small and medium enterprises and improve access to financing.

The PSE also acknowledges sector-specific policies as critical to the country’s economic growth. Several policies addressed low agricultural productivity, including tax incentives and targeted policies for subsectors such as groundnuts and sugar. There was also a focus on sectors including agro-processing, information and communications technology, tourism, textiles, aquaculture, mining, and construction. In addition, the PSE involved infrastructure development initiatives such as the Dakar Regional Campus, Dakar Medical City, and regional business hubs.

Senegal has employed SEZs to attract manufacturing investment, offering generous tax benefits to companies. However, multilateral institutions including the IMF and World Bank have recommended reducing such tax benefits and instead improving the business environment and logistics.

Looking ahead, the third phase of the PSE, focusing on the period 2024–28, aims to boost economic, social, and environmental development through structural transformation, increases in human capital, and improvements in governance. Tourism, despite its potential, has been on the decline due to inconsistent political support and external shocks. The PSE aims to turn this around and make Senegal a major tourist destination by building new tourism hubs and upgrading existing sites.

In sum, the PSE represents Senegal’s robust effort to reshape its economic trajectory. While some positive effects have been noted, greater transparency, competitive practices, and a reduction in public subsidies are needed to foster efficient and sustainable growth. Recommendations from the IMF and World Bank, such as fostering competition, liberalizing prices in regulated markets, reducing tax benefits, and focusing on the business climate and logistics, could guide the way forward.

Vietnam

Vietnam’s economic journey over the past three decades presents a compelling story of transformation. Since the launch of economic and political reforms in 1986, Vietnam successfully transitioned from a centralized economy into a socialist-oriented market economy. This transition turned Vietnam from one of the poorest countries into one of Asia’s fastest-growing economies, boasting robust domestic demand and export-oriented manufacturing. This case study explores Vietnam’s experience with economic diversification, with a focus on the period 1986–2015, highlighting lessons that can guide policymaking in other developing economies.

The cornerstone of Vietnam’s success was the continuous reforms initiated during the Doi Moi process in 1986. These reforms, aimed at adapting to changing conditions, reduced barriers to entry and expansion, liberalized domestic prices and external trade, significantly curbed inflation, and privatized collective assets in agriculture. The government also invited foreign investors into the Vietnamese economy, which laid the foundation for the country’s modernization and growth. These reforms led to a substantial structural shift from a primarily agrarian economy to one increasingly dominated by industry and construction.

23 This section is based on a note prepared by Yuanyan Sophia Zhang.
From 1986 to 2005, sectoral policies played a pivotal role in Vietnam’s economic diversification. During this period, Vietnam prioritized the development of specific sectors such as heavy industry, natural resource-based industries, and light export-oriented industries. A variety of instruments supported these sectors, including:

- Protective measures such as tariffs, quotas, and export subsidies;
- Legislation to encourage private businesses and foreign-owned enterprises;
- Investment in public infrastructure; and
- Restructuring of state-owned enterprises to enhance their competitiveness in the industry.

Despite these efforts, challenges persisted, including a dualistic structure of the industrial sector, low industrial labor productivity, and a large, inefficient state-owned enterprise sector.

Vietnam’s entry into the World Trade Organization in 2007 ushered in a new era of industrialization. The government initiated strategies to boost structural change, industrialization, and modernization, and further promote export-oriented industries. Measures included a reduction in trade distortions, including export taxes, and efforts to boost FDI and associated technology transfers. This period also marked the government’s pivot toward high-tech industries that can generate higher domestic value, create quality jobs, and stimulate the economy. However, lack of growth among import-competing firms and negligible spillover impacts from FDI signaled ongoing challenges. Also, domestic revenue collection fell sharply, by as much as 8 percentage points of GDP in the following years. This reflected partly tariff reductions and the maturing of Vietnam’s oil industry, but also the provision of a wide range of tax incentives for foreign investment, not just by the national government but also by local governments competing with each other—ineffective incentives which may have been of questionable value.

An analysis of Vietnam’s experience offers several key lessons:

- **Broad-based policies**: The policies that significantly impacted Vietnam’s industrial development were those that provided a comprehensive framework of incentives for individual enterprises, irrespective of ownership. These included enterprise laws and rules related to Vietnam’s World Trade Organization membership.

- **Education and stability**: Expanding and upgrading the quality of the education system (Boman 2022; Figures 7 and 8), and maintaining macroeconomic and political stability, contributed significantly to Vietnam’s economic success. Of note, Vietnam spends relatively little on education (3 percent of GDP in 2022), but the efficiency of this spending is high.

- **Weaknesses in sectoral policy**: Past sectoral policies did little to improve Vietnam’s competitiveness, and the absence of local suppliers and supporting industries led to overreliance on imports. Desired spillover impacts from FDI, particularly via technology transfer and linkages with domestic enterprises, were rare.

- **Overemphasis on specific sectors**: Policies that focused too heavily on specific sectors and products failed to improve the overall competitiveness of enterprises. A shift in focus toward improving overall business competitiveness could yield more substantial results.

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24 We focus here on the period 1986–2005 because it was a time of relatively intensive reform, including the preparations required for the 2007 World Trade Organization accession. However, important reforms also occurred afterwards, as discussed later.

25 At the start of the transition, the state was responsible for about half of total output in industry and services. Especially before the reforms of the 2010s, state-owned enterprises continued to account for a large share of the economy, dominated in key business areas, and received preferential treatment from the government (OECD 2022).

B. Lessons for Peer Countries

Overall, the six country case studies, despite their heterogeneity, highlight important lessons for policy engagement with country authorities on diversification strategies and targeted interventions. Diversification takes time, macroeconomic stability is a key prerequisite for successful diversification strategies, and promising strategies generally include both horizontal and well-designed vertical elements. On the horizontal side, policies often put human capital development at the center of the diversification effort: this can both support growth and help mitigate inequality. Infrastructure development typically also plays an important role. On the vertical side, targeting broad sectors, including in particular exports, rather than picking national champions can help foster competition and avoid rent-seeking. Related, measures focused on tackling directly the underlying market failures may be more successful and raise fewer fiscal and
governance challenges than less targeted fiscal incentives. In this context, experience with SEZs has shown mixed results: sometimes succeeding in addressing obstacles in the overall business environment, but often creating a fiscal burden from possibly ill-targeted tax exemptions.

Specifically, Table 1 summarizes countries’ main horizontal and vertical interventions. All country cases show that, while quick wins are possible, big strides in diversification take time, often two to three decades, to succeed. They also show that successful diversification starts from a position of macroeconomic stability. For instance, Vietnam’s success since the early 1990s in achieving macroeconomic stability, and the maintenance of stability in its political and economic relations with the rest of the world, was a key foundation that other policies were built on. And, in all countries studied, governments chose a combination of horizontal and vertical policies, with human capital development often at the center of the effort.

“Soft” industrial policy, focused on developing processes whereby government and industry can collaborate to tackle the underlying structural bottlenecks and coordination problems that depress sectoral productivity (including red tape, sector-specific gaps in skills and infrastructure, and constraints on foreign investment), often represents a promising approach (Harrison and Rodríguez-Clare 2010). In contrast, “hard” industrial policy, focused on changing relative prices through tax exemptions and subsidies, can become entrenched, be subject to manipulation, and create significant fiscal risks. Hence, in Costa Rica, the government applied soft instruments to specific industries; for instance, selecting activities for which to train labor, choosing areas in which to conduct research, and contacting companies to highlight the country’s merits as an investment destination. In contrast, Latin American governments traditionally intervened strongly in selected industries through hard tax incentives and subsidies (Cornick and Trejos 2009), which tended to introduce distortions. In Vietnam, the provision of an overall framework of incentives for enterprises irrespective of ownership has had the largest impact, while policies that overemphasized specific sectors and products came at the expense of improving overall competitiveness.

Strengthening the export sector, including by encouraging private sector collaboration, has had a generally positive impact. In the 1990s, Costa Rica started attracting export-oriented foreign firms in the electronic, medical equipment, and service sectors in FTZs that allowed for income tax exemptions and duty-free imports of raw materials and intermediate goods, with limits on production for domestic sale. Increased manufacturing and service exports have been the engine of growth in the country. Georgia has set up three FTZs where companies benefit from tax incentives and simplified procedures to attract foreign investment and support technology transfers.

SEZs can help overcome complex bureaucracy, difficult land access, and poor infrastructure, but there are risks from high fiscal costs related to broad tax exemptions. In India, the establishment of software technology parks supported the increase in service exports. Software firms received fiscal incentives such as tax exemptions (for five years); exemption from import duties and licenses for equipment; free repatriation of capital investment, royalties, and dividends; and permission for 100 percent foreign ownership, in exchange for an export obligation (Saxenian 2001). However, in Senegal, where tax incentives were a main tool for sectoral development, revenue losses from tax exemptions proved significant. This is a particular concern since it is often unclear that tax burdens are in fact a major constraint to the development of a specific sector, and the opportunity cost of foregone revenue is easily ignored.27

27 In addition, the introduction in 2024 of the global minimum tax could render many tax incentives irrelevant or redundant.
### Table 1. Summary of Country Case Studies

<table>
<thead>
<tr>
<th>Country</th>
<th>Horizontal Policies</th>
<th>Vertical Policies</th>
<th>Diversified Exports?</th>
<th>Structural Transformation?</th>
</tr>
</thead>
</table>
| Costa Rica | • Health and education  
• Trade liberalization and free trade agreements  
• Export and foreign direct investment promotion | • FTZs  
• Investment and trade promotion agencies (following rather than promoting industry winners)  
• FTZs supported by tax exemptions | Yes | Yes |
| Gabon | • Transport infrastructure | • SEZs to develop industrial clusters and increase sophistication of natural resources  
• Tax incentives around SEZs and public-private partnerships | Limited diversification (too early to tell) | Too early to tell |
| Georgia | • Addressing infrastructure gaps  
• Market liberalization and free trade agreements  
• Improving public institutions’ efficiency and governance  
• Financial stability | • Small and medium enterprise promotion  
• FTZs supported by tax exemptions | Limited goods diversification, expansion in services but limits to services-driven growth | Yes, albeit limited |
| India | • Improvements in the business environment  
• Investment in tertiary education  
• Availability of skilled labor and (unfinished) educational reforms | • Promotion of knowledge clusters, including software technology parks  
• Investment incentives  
• Production-linked financial incentives to domestic manufacturing | Yes | Yes |
| Senegal | • Addressing infrastructure gaps  
• Improvements in business environment (labor laws, justice, land) | • Agriculture value-added promotion (agropoles, groundnut value chain) subsidies  
• SEZs to attract investment in manufacturing, tax incentives  
• Tourism development plans | Limited diversification (too early to tell) | Too early to tell |
| Vietnam | • Trade liberalization around World Trade Organization accession  
• Legal framework for investment and foreign direct investment promotion  
• Education reforms | • Industrialization policy dominated by state-owned enterprises  
• SEZs and high-tech parks  
• Information and communication technology promotion | Limited goods diversification, expansion in services but limits to services-driven growth | Yes, albeit limited |

Source: IMF staff.  
Note: FTZ = free trade zone; SEZ = special economic zone.
4. IMF Work on Diversification and Staff Engagement with Authorities

This section takes stock of IMF work on economic diversification and presents the results of surveys of the engagement between IMF teams and national authorities on diversification. In response to members’ demands, the IMF has over time substantially intensified its focus on the issue of diversification in developing countries. Seminal documents included a staff discussion note and a subsequent board paper discussing trends in diversification in developing countries, the type of policy reform that could help remove barriers to diversification, and how the removal of such barriers was associated with lower volatility and faster growth (Papageorgiou and Spatafora 2012; IMF 2014). More recent work has analyzed the issue in the context of the renewed global interest in industrial policy. IMF documents have proposed conceptual frameworks to analyze industrial policies and discussed the rationale and pitfalls behind commonly employed policy tools (Cherif and others 2022). They have outlined the broad considerations to be taken into account when deploying industrial policies, including the need for measures to be well targeted, time-bound, cost-effective, transparent, designed to mitigate incentives for rent seeking and corruption, and consistent with macroeconomic, fiscal, and external sustainability (IMF 2024a). And they have discussed whether specific such policies are consistent with countries’ international commitments under the World Trade Organization (IMF 2024b). Related work has analyzed macrostructural reforms to accelerate growth in developing economies (for instance, measures dealing with labor markets, the credit sector, business deregulation, the external sector, and governance), with a focus on the appropriate prioritization, packaging, and sequencing of reforms, including in the context of the green transition (IMF 2023b).

A. IMF Work on Diversification

A stocktaking exercise analyzed 138 pieces of comprehensive IMF assessment of diversification in low- and middle-income countries and select emerging markets. A total of 59 countries were investigated, including 30 low-income developing countries, 10 low- and middle-income countries, and 19 emerging markets (see Annex Table 1.1 for a detailed country list). This body of work also includes a representative sample of fuel exporters and small states, for whom diversification represents a significant component of their development strategies. This process resulted in 114 single-country and 32 cross-country pieces of analysis (see Annex Tables 1.2, 1.3, and 1.4).

Approximately half of the single-country outputs were selected issue papers. The remainder comprised of substantive paragraphs in staff reports, boxes, annexes, and working papers. More than a third of these outputs were focused on countries in fragile situations, demonstrating the importance of diversification in these contexts. Regarding the distribution of outputs, the Asia and Pacific Department and the African Department had the largest number, in line with the significant representation of low-income developing countries in these regions. The proportion of country teams handling diversification issues ranged from 35 percent in the African Department to 70 percent in the Middle East and Central Asia Department.

Most of the analyses were centered on countries dependent on commodity exports, considering their vulnerability to economic shocks due to their relatively undiversified export bases. However, the interest in diversification extended to diversified exporters, aiming to expand the range or quality of their exports. Approximately 40 percent of the outputs incorporated data from the IMF’s toolkits on export diversification and export quality (Box 1), which is based on an updated version of the United Nations-National Bureau of Economic Research data set. Three overarching themes characterize these outputs:
1. **Diversification deficits causes macroeconomic volatility**: Analyses highlight how dependence on a few exports, or slow diversification, result in volatility in export proceeds, output, and fiscal revenues, and can destabilize economies in the presence of negative trade shocks. These effects are especially significant in sub-Saharan Africa.

2. **Necessity for diversification**: Policymakers in low-income developing countries prioritize diversification for better growth. Factors prompting diversification include commodity dominance or depletion, dependence on few trade partners, and demographic pressures. Other reasons include competition (Central America, Caribbean) and weather-related challenges (Africa).

3. **Causes of diversification deficits**: Infrastructure deficiency, limited capital investment, weak business environments, and opportunity inequality are often mentioned. Other reasons include regional security concerns (Middle East), overvalued currencies, labor issues (Asia and Pacific), and inadequate financial markets (sub-Saharan Africa).

The IMF advised in favor of horizontal policies for diversification, in line with the 2014 board paper, such as improving human capital, institutions, infrastructure, and access to finance; reducing trade barriers; and promoting international integration. In some cases, sector-specific (vertical) policies have been recommended, including developing new sectors, improving product quality in competitive sectors, or promoting sectors with comparative advantages (for example, Tanzania and Vanuatu).

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**Box 1. Export Diversification and Export Quality Data Toolkits**

This box summarizes the main indices presented within the IMF’s Export Diversification and Export Quality Data Toolkits:

- The export product diversification index reflects the number of products a country exports and the extent to which the export structure is concentrated in a few products. By construction, lower index values indicate higher levels of export diversification. Mathematically, this is the Theil index of export diversification (IMF 2014, following Cadot, Carrere, and Strauss-Kahn 2011), which consists of a “between” and a “within” subindex. In this equation, \( i \) is the product index and \( N \) the total number of products. The “between” Theil index captures the extensive margin of diversification, that is, how many goods a country exports. The “within” Theil dimension captures the intensive margin, that is, how concentrated a country’s export base is.

\[
\text{Theil Index} = \frac{1}{N} \sum_{i=1}^{N} \frac{\text{Export Value}_i}{\text{Average Exp. Value}} \cdot \ln \left( \frac{\text{Export Value}_i}{\text{Average Exp. Value}} \right) = \text{Theil}_{between} + \text{Theil}_{within}
\]

The export product quality index proxies the quality of a country’s export products by the markup they command. Mathematically, the index is measured by the export’s unit value adjusted for differences in production costs and the relative distance to the trading partner (Henn, Papageorgiou, and Spatafora 2013). The higher the cost a country can charge for its exports, adjusted for these factors, the higher the export quality according to this index. The index is normalized for each year to show export quality relative to the rest of the world, thus giving a relative ranking of each country for each year.

Box Figure 1.1 illustrates the different measures of diversification for the six country case studies (Costa Rica, Gabon, Georgia, India, Senegal, Vietnam).
IMF research on diversification informs policies promoting FDI, aid, remittances, and gender equality. IMF staff warn against distortionary incentives like tax holidays and exemptions, which often cause fiscal revenue loss and fail to assist diversification.

Further, the IMF provided the following country-specific advice:

- **Small states**: Given small populations and financing limitations, diversification is suggested within competitive sectors, advocating international/regional integration, focusing on niche products, and diversifying tourism.

- **Countries in fragile situations**: Diversification is hard due to weak security, limited resources, skill deficits, low institutional capacity, and governance issues. Suggestions include improving domestic security, law, reducing corruption.
Fuel exporters: Price volatility, depleting fields, and global climate mitigation trends call for diversification, as well as FDI in non-hydrocarbon sectors, flexible exchange rates, and countercyclical fiscal frameworks.

Other commodity exporters: Environmental degradation and export concentration challenges have been addressed by suggesting industrializing or improving commodity exports quality.

Diversified exporters: IMF staff advise increasing production quality and implementing structural reforms and prudent macroeconomic policies to maintain stability.

In conclusion, the IMF, responding to member demands, has amplified its analysis and policy advice on diversification in developing countries. It has recommended enabling (horizontal) policies and, in specific cases, sector-specific (vertical) policies.

B. IMF Staff Engagement with Authorities on Diversification

Two surveys have explored the engagement between IMF teams and national authorities on diversification. The findings suggest strong stakeholder interest in diversification; in most cases, the discussions were jointly initiated. The authorities’ focus ranged from enabling environments to sector-specific policies, indicating the need for a broad-based approach to economic diversification. Increased analytical work and enhanced policy advice, including by incorporating best practice examples, could further strengthen this engagement.

Survey of IMF Staff Engagement with Authorities on Diversification

A survey conducted across four departments with low-income developing country representation sought to evaluate the engagement on diversification between IMF teams and authorities (Annex 2). A total of 124 country teams, inclusive of several emerging markets, shared insights on their discussions on diversification. Country teams noted strong stakeholder interest in diversification. More than half recognized the government’s strong interest in diversification, and approximately 75 percent saw at least some interest in the issue, indicating the importance of addressing economic diversification in the IMF’s interactions with authorities. Diversification discussions were jointly initiated by teams and authorities in 55 percent of the cases, and the teams’ advice was generally well received. Most teams reported that authorities focused on both (horizontal) policies for creating an enabling environment and (vertical) sectoral policies. About 84 country teams noted existing policies facilitating diversification. Teams, however, primarily concentrated on horizontal policies in their recommendations.

IMF staff emphasized that policy advice traction could be enhanced through more granular policy advice, best practice examples, and increased analytical work. Teams identified internal and external factors affecting their discussions on diversification, including political, security, and economic environment; capacity constraints; and data quality issues. Teams found collaboration with experts, including from other international financial institutions, very supportive of their policy advice.

Zooming In on Engagement on Vertical Policies

A subsequent survey (Annex 3; Figure 9 panels 1 and 2) aimed to deepen understanding of vertical policies and the interaction between IMF country teams and authorities. This survey of 58 country teams revealed that most countries implemented both horizontal and vertical policies, with enabling business environment and physical infrastructure improvement as key horizontal policies. Vertical policies often included promoting FDI, developing SEZs, and targeted investment promotion.
Figure 9. Survey of Vertical Policies (58 Countries)

1. Ratio of Respondents per Each Department
   (Percent)

2. Share of Respondents Among DWG Countries
   (Percent)

3. Does Your Team Consider Vertical Industrial Policies to be Macrocritical for Your Country?
   (Ratio of yes versus total)

4. Has Your Team Discussed Vertical Industrial Policies with the Country Authorities in the Past 24 Months?
   (Ratio of yes versus total)

5. Has the Country Put in Place Industrial Policies in the Past Five Years?
   (Ratio of yes versus total)

6. Do You Plan to Discuss Vertical Industrial Policies in Your Forthcoming Dialogue with the Country Authorities?
   (Ratio of yes versus total)

7. Please Characterize the Vertical (for example, Target Specific Sectors or Industries) Policies.
   (Share of respondents in total, percent)

Targeted/directed lending for specific sectors or industries
Selective industry development plans
Selective public support in infrastructure, skills, and technology development for specific industries (e.g., for tourism)
Targeted investment/production promotion via fiscal and/or financial incentives
Selective protection (trade restrictions; market access rules)
Providing support to specific industries for exports and participation in Global Value Chains (GVCs)
Developing special economic zones for specific industries
Promoting FDI in specific sectors

Source: IMF staff.
Note: AFR = African Department; APD = Asia and Pacific Department; DWG = IMF Diversification Working Group sample; FDI = foreign direct investment; MCD = Middle East and Central Asia Department; WHD = Western Hemisphere Department.
Industrial policy interventions were diverse, including targeted small and medium enterprise lending, fiscal incentives, import tariffs, and infrastructure investment through public-private partnerships. Authorities frequently targeted sectors based on local conditions, export potential, and employment share. Interest in industrial policy was reported as strong among authorities and the private sector.

Approximately 60 percent of respondents identified vertical policy as macro-critical for their countries (Figure 9, panel 3). However, less than half of the respondent teams discussed vertical policies with authorities in the past 24 months preceding the survey (Figure 9, panel 4), three to five teams had discussed it in the past 5 years preceding the survey, and 62 percent of countries had implemented some form of industrial policy (Figure 9, panel 5). Less than half of the teams expected to discuss the topic in their forthcoming dialogue (Figure 9, panel 6). Teams advising on policies primarily focused on reducing market distortions; recommending policy changes in areas such as imports, tax exemptions, and subsidies; and improving business environments. Their advice was generally well received and often implemented. IMF teams suggested that more granular guidance and resources, including case studies, assessment tools, and expert collaboration, could strengthen the IMF’s advice.

IMF teams also pointed to the usefulness of sectoral advice in areas such as tourism, agriculture, mining, textiles, electricity, and fisheries. They proposed that “peer-to-peer” symposiums, guidance grounded in best practice, and deeper partnerships with fellow international financial institutions could be advantageous. Given the IMF’s limited resources, leveraging the expertise of other institutions with regard to vertical policies could prove critical. The survey unveiled that approximately half of the country teams identified development partners contributing advice on vertical policies, although collaboration was sporadic. These partners encompassed global establishments such as the World Bank, International Finance Corporation, UN Development Programme, and the Organisation for Economic Co-operation and Development, as well as regional entities including the European Bank for Reconstruction and Development, European Investment Bank, and African Development Bank. The frequency and nature of these collaborations varied, ranging from recurring policy dialogues to straightforward exchanges of information.

In sum, the survey reflects the proactive engagement of IMF teams with country authorities, focusing on economic diversification. There is a clear and strong interest from stakeholders in diversification, making it a pivotal aspect of the IMF’s interactions with authorities. However, the findings also highlight opportunities for enhancing these engagements through more granular policy advice, examples of best practices, increased analytical work, and improved collaboration with other international financial institutions. Overall, these insights underscore the significance of the IMF’s continuing focus on supporting and advising member countries in their pursuit of diversified economic growth.
5. Conclusions

This paper delved into the rising consensus among policymakers and researchers on the critical role of economic diversification in promoting economic development. Its findings underscored the importance of diversification as a steppingstone toward a resilient, adaptable, and inclusive economy. Removing barriers to diversification can stimulate faster economic growth, contribute to higher per capita incomes, and foster greater resilience to global challenges including climate change, technological change, and geoeconomic fragmentation.

The pathway to effective diversification requires comprehensive, context-specific strategies and nuanced policy interventions. It will generally include broad-based (horizontal) policies with economy-wide impacts, such as fostering macroeconomic stability, improving human capital and infrastructure, reducing trade barriers, and promoting international integration. Effective strategies may also include targeted industrial (vertical) policies that help address market failures, often with the goal of developing new sectors or improving product quality in competitive sectors. Such industrial policies have experienced a global revival as nations grapple with challenges including climate change, technological change, and geoeconomic fragmentation, while striving to foster innovation, secure a competitive advantage in strategic industries, and ensure supply-chain resilience.

The six case studies presented—Costa Rica, Gabon, Georgia, India, Senegal, and Vietnam—share commonalities, but also indicate that economic diversification strategies must be tailored to fit each country’s unique circumstances. In all cases, diversification strategies were adopted as means to foster resilience and sustainable growth. While these countries have experienced varying degrees of success, the common lessons from their experiences contribute to a broader understanding of the potential and the complexities of economic diversification. Macroeconomic stability and effective broad-based policies, often with an emphasis on human capital development, come across as fundamental prerequisites for the success of diversification strategies. Well-designed industrial policies can play an important supporting role. They are most likely to prove effective when they target the bottlenecks constraining specific sectors, particularly export sectors, rather than pick national champions, so as to avert rent-seeking and support competition. SEZs have demonstrated mixed outcomes, at times effectively addressing barriers in the overall business environment. But tax incentives can cause significant revenue loss, with little to show in return—a particular concern for fiscally strapped developing economies with substantial development needs. And all such measures must be backed by a focus on enhancing governance, including by strengthening administrative capacity, promoting transparency (also through the publication of tax expenditures), and ensuring accountability and value for money.
Annex 1. Countries and Analytical Outputs Covered in the Stocktaking

Annex Table 1.1. Countries Covered in the Stocktaking of Analytical Work

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Source: IMF staff.
Note: AFR = African Department; APD = Asia and Pacific Department; EM = emerging markets; LIDC = low-income developing countries; LMIC = lower-middle-income countries; MCD = Middle East and Central Asia Department; WHD = Western Hemisphere Department.
Annex Table 1.2. Single-Country Outputs

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Source: IMF staff.
Note: AFR = African Department; APD = Asia and Pacific Department; EM = emerging markets; LIDC = low-income developing countries; LMIC = lower-middle-income countries; MCD = Middle East and Central Asia Department; N/A = not applicable; SIP = Selected Issues Paper; WHD = Western Hemisphere Department.
### Annex Table 1.3. Regional Outputs

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### Annex Table 1.4. Other IMF Research Papers

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Source: IMF Staff.
Annex 2. Survey of Country Teams on Traction with Authorities

1. Department
2. Country
3. Has your team discussed issues of economic diversification with the country authorities in the past 24 months? (yes/no)
   ▪ If yes, my team discussed issues of diversification with the authorities in the past 24 months:
4. Were the discussions first initiated by:
   a. Authorities
   b. The team
   c. Jointly
   d. Unsure
5. Did your dialogue focus on
   a. Diagnostics
   b. Impact of diversification on macroeconomic outcomes
   c. Policy advice
   d. All of the above
   e. Other
6. If other, please specify.
7. Do the authorities have set of policies to facilitate diversification? (yes/no)
8. If yes, please characterize these policies as:
   a. Horizontal (do not target specific sectors or industries; instead, improve general business environment, education, research and development)
   b. Vertical (target specific sectors or industries)
   c. Mix of horizontal and vertical
   d. Unsure
9. Has the team proposed a set of policies to facilitate diversification? (yes/no)
10. If yes, please characterize these policies as:
    a. Horizontal (do not target specific sectors or industries; instead, improve general business environment, education, research and development)
    b. Vertical (target specific sectors or industries)
    c. Mix of horizontal and vertical
    d. Unsure
11. How were your analysis and recommendations received?
    a. Very negative response
    b. Not well received
    c. Indifferent
    d. Well received
    e. Very well received
12. Please elaborate on the responses or reactions received.
13. What could have made your policy dialogue more effective?
14. Please quantify the time commitment by your team to work on economic diversification on average over the past 24 months (full-time equivalent/year):
   ▪ If no, my team did not discuss issues of diversification with the authorities in the past 24 months:
15. What was the main reason for not focusing on the issue?
   a. Not relevant/other priorities
   b. No interest from authorities
   c. Resource constraints
   d. No expertise within the team
   e. Other
16. If other, please specify.
17. Do you plan to discuss economic diversification in your forthcoming dialogue with the country authorities? (yes/no)
18. How would you judge the general interest of the government in economic diversification?
   a. Very weak
   b. Weak
   c. Some interest
   d. Strong interest
   e. Very strong interest
19. How would you judge the general interest of the private sector, including civil society organizations/nongovernmental organizations, in economic diversification?
   a. Very weak
   b. Weak
   c. Some interest
   d. Strong interest
   e. Very strong interest
   f. Do not know
20. Is your team aware of the IMF Diversification Toolkit?
21. What resource would be most helpful in supporting discussions on diversification in future work (seminars, collaboration with an expert on the matter, etc.)?
22. Other comments or suggestions?

This survey was carried out in November 2018.

1. Department
2. Country
3. Name and email address (person filling in the survey)
4. Has your team discussed vertical industrial policies (see definition in introduction) with the country authorities in the past 24 months? (yes/no)
   ▪ If no (that is, team did not discuss vertical industrial policies with the authorities), then:
5. What was the main reason (choose all that applies)?
   a. Not relevant/other priorities
   b. No interest from authorities
   c. Resource constraints
   d. Limited IMF guidance
   e. No expertise within the team
   f. Other (please specify)
   ▪ If yes (that is, team discussed vertical industrial policies with the authorities), then:
6. Were the discussions first initiated by:
   a. Authorities
   b. The team
   c. Jointly
   d. Unsure
7. Did your dialogue focus on:
   a. Diagnostics
   b. Impact of industrial policies on macroeconomic outcomes
   c. Policy advice
   d. Other (please specify)
8. Please describe any specific output the team has prepared on vertical industrial policies (for example, Selected Issues Paper, box, annex). Independent of all the previous answers:
9. Does your team consider vertical industrial policies to be macro-critical for your country? (yes/no)
10. Has the country put in place industrial policies in the past five years?
11. If yes, please characterize these policies as (choose all that applies):
   a. Horizontal (do not target specific sectors or industries; instead, seek to improve operational conditions and capabilities across several sectors)
      i. Enabling business environment
      ii. Improving physical infrastructure
      iii. Developing information and communications technology and digital economy (general)
      iv. Promoting FDI (general)
      v. Implementing support schemes for small and medium enterprises
      vi. Developing skills and education (general)
      vii. Other (please specify)
b. Vertical (target specific sectors or industries)
   i. Promoting FDI in specific sectors
   ii. Developing special economic zones for specific industries
   iii. Providing support to specific industries for exports and participation in global value chains
   iv. Selective protection (trade restrictions; market access rules)
   v. Targeted investment/production promotion via fiscal and/or financial incentives
   vi. Selective public support in infrastructure, skills, and technology development for specific industries (for example, for tourism)
   vii. Selective industry development plans
   viii. Targeted/directed lending for specific sectors or industries
   ix. Other (please specify)

12. Please provide more detail on vertical policies implemented by the authorities such as specific sectors targeted, design of the measure (a brief description), etc.

13. Has the country team provided advice on vertical industrial policies to the authorities? (yes/no)

14. If yes, please specify which industry you provided advice on and briefly describe the advice provided.

15. How were your analysis and recommendations received?
   a. Very negative response
   b. Not well received
   c. Indifferent
   d. Well received
   e. Very well received

16. Please elaborate on the responses or reactions received.

17. What could have made your policy dialogue more effective?

18. To your knowledge, which other institutions (international financial institutions, development agencies, regional development banks, etc.) have provided advice on vertical industrial policies in your country?

19. How do you assess the collaboration between the country team and representatives of those institutions regarding advising authorities on vertical industrial policies?
   a. No collaboration
   b. Some collaboration
   c. Close collaboration

20. If you answered b. or c. above, please elaborate on the modalities of collaboration. Independent of all the previous answers:

21. Do you plan to discuss vertical industrial policies in your forthcoming dialogue with the country authorities? (yes/no)

22. How would you judge the general interest of the government in vertical industrial policies?
   a. Very weak
   b. Weak
   c. Some interest
   d. Strong interest
   e. Very strong interest
23. How would you judge the general interest of the private sector, including civil society organizations/ nongovernmental organizations, in vertical industrial policies adoption and implementation in general?
   a. Very weak
   b. Weak
   c. Some interest
   d. Strong interest
   e. Very strong interest
   f. Do not know

24. What resource would be most helpful in supporting discussions on vertical industrial policies in future work (seminars, collaboration with an expert on the matter, country case studies, etc.)?

25. Please specify areas of focus for such additional resources that are of interest to your country team (for example, special economic/industrial zones, tax incentives, exports and global value chain participation, etc.)

26. Other comments or suggestions?

This survey was carried out during 2019.
References


