Comments on "New Structural Economics: A Framework for Rethinking Development" by Justin Yifu Lin

The paper attempts to define a new framework for thinking about economic development following a review of past such attempts which the author finds unsatisfactory. The new framework is put forward to accommodate both theoretical advances and empirical findings on economic development in developing countries. The framework that is proposed is a marriage of two somewhat opposing ideas of the structuralists (1950s-1970s) and what the author calls neo-classical economists. It is an ambitious attempt, given the two different approaches of these contending frameworks.

One would have thought that the ideas of structuralists have been thoroughly reviewed and rejected in the past but their ideas are resurrected in the new framework given the particular way the issues s are posed. Thus from the strucutralist point of view we find, a strong case made for Government intervention on grounds of externalities and coordination issues. From neo-classical economists, the author takes a principal idea for the paper that developing countries have to order their policies according to comparative advantage. And, he posits Government intervention is necessary to lead to allocation of resources based on comparative advantage and to promote competition, as he claims there is limited competition in developing countries. While there is much to admire about the approach, one is left with the idea this marriage of convenience does raises more questions than it answers. Although all papers written by World Bank staff carries with it the qualification that the they do not necessarily reflect the views of the World Bank's Board of Directors or the management, a paper by the Chief Economist is taken as something very close to the official view of the Bank. Already, many outside the mainstream of economics have claimed that the World Bank's attitude has been changed as evidence by the main thrust of the framework giving primacy to intervention by the state.

There is much to agree with the paper. We agree with the first and second key propositions and a part of the third proposition upon which the framework is built: (i) that the optimal economic structures are different at various stages of development that is based on a country's industrial, technological, financial, legal, and other structures (ii) that economic development is a continuous process, not one that can be divided into rigid or specific "stages" or distinctive binary groups, there are a continuum of development ranges and certainly not a dichotomy between two groups ("low-income" countries versus "high-income" countries) and (iii) that at any given stage of development, the market is the fundamental mechanism for efficient resource allocation.

However, we do not agree with the second part of the third proposition that that there is an inexorable need for the state to play a proactive, facilitating role in the move from a lower stage to a higher stage, we believe that this aspect has to be carefully defined because it leaves wide room for the Government to intervene in any sector declaring that there is latent comparative advantage in any sector. We also find that this part of the third proposition does not follow from the first or second propositions. There is, in fact a contradiction with respect to the allocation of resources under comparative advantage. It asserts that only the Government is the agent for discovering latent comparative advantage. Yet, we know from the past experience of developing countries that Government intervention has been the main reason why comparative advantage was not allowed to operate under state led attempt to raise the rate of growth.

Moreover, the main reason that is advanced in the paper that the Government should intervene in the economy is to lead to a the creation of infrastructure (both what are called rigid and soft infrastructure) that is consistent with the desired resource endowment which is defined to include infrastructure. The paper claims that because of externalities and coordination issues it is the Government that has to create infrastructure to make the economy more pass from one stage of development to a higher stage. While we see the point for the need for the creation of additional and appropriate infrastructure consistent with the desired level of growth, we do not believe that such a large latitude should be granted to the Government without sufficient safeguards so that history will not be repeated where Government failure seem the more dominant factor in poor economic performance of developing countries compared to market failure. What success there has been in Government intervention was associated with the East Asian countries, where contrary to the new style structrualists views, the role of Government was well defined, with clear exit policies when there were failures and increasingly left to private sector decision making in expanding existing operations that received Government subsidies and increasing the size of the private sector by letting it an ever increasing role in the economy. The new framework could have written rules that defined exit policies so that dirigiste policies were perpetuated for long periods in the vast majority of developing countries. Even modern day success stories such as China, India, Vietnam among others wasted a resource for four to five decades of widespread intervention in their economies within and beyond the creation of infrastructure.

The framework proposed in the Lin paper departs from the mainstream framework that favors neutral policies towards activities or industries such that the individual entrepreneurs who risk capital and are closer to that activity makes crucial decisions to invest in new activities and expand their existing activities. This risk taking is a part of the market system. It cannot be delegated or taken over by the state to lead to better outcomes, most of the time. Hence a general approach that permits overall intervention by the state across many sectors is not a good approach supported by theory or empirical evidence. To be sure, it is claimed that East Asian countries had taken this approach (Wade, Amsden, Chang et al) . This is not supported by close evidence. That is not the only thing they did but maintained good macroeconomic policies, used competitive exchange rates and limited intervention and exited activities when support proved to unhelpful. This contrasts with countries that the Lin paper sites-India, China, Vietnam and hundreds of other poor countries that continued with widespread state intervention.

The thirteen countries that the paper cites as successes, were not following what the Lin paper calls a “New Structural Framework”. Many in that group, for instance Chile the most successful country in Latin America in the last two decades followed a policy of neutral incentives and the Government did not intervene in the economy anywhere close to what the NSF advocates. Even the East Asian economies it turned out provided neutral incentives through some state intervention only in a limited way. It turns out that countries that intervened through various means from trade protection to domestic subsidies of one type or the other did not lead to success in the industries that were supported by the state. (Bean and Winestein for Japan the cited as the arch-typical country that intervened in the economy in a non-neutral way). What is needed is not industrial policy but a consistent neutral policies toward industry.

By policy towards industry is meant an approach that does not in general target any particular activity as a public policy but maintains a neutral stance towards all activities through uniform incentives. But, neutral policy towards industry does not mean an abdication of the Government’s role. It means that the Government has an onerous role to play in promoting growth but it is done at a more general level and where intervention in any particular activity is the exception, rather than the rule. Under this policy stance, public policy addresses only those distortions that prevent the emergence of a viable long-term industry or activity. Thus the contrast between these two types of policy stances can be described as selective intervention in the economy in contrast to the pursuit of neutral policies in general. For example, the Government provides a trade regime that is neutral among activities and is producing for the domestic market and the foreign market, has stable macroeconomic policies and exchange rates, and legal and regulatory frameworks that will allow easy entry and exit from different sectors or activities. With a few exceptions, it lets the market make the decisions as to where to invest. While NSE also claims that it would lead to allocation of resources to be market based, it leaves wide room for the state to intervene in the economy, that in the past have produced horrendous outcomes for a large majority of developing countries in the last five decades.

The NSE attempts to rehabilitate what was known as the infant industry argument, a term that the Lin paper suppresses, perhaps it does not want to enter into past arguments. The main elements of the infant industry argument can be summarized in four propositions.5 (a) New industries and activities have high costs compared to foreign enterprises and they require some time to become competitive. (b) It is not profitable for any new firm to enter that industry without assistance due to the reason that the firm that is willing to make the investment in technology, labor training and similar learning activities cannot appropriate the benefits of that investment to itself. (c) With assistance from the Government, the firm may be able to become competitive in the future and be able to turn out net profits following initial losses that justify the initial investment. (d) Assistance is required for a temporary period over which costs would fall and it would enable the firm to compete with foreign firms without further public assistance.

Many economists who have supported industrial policy have argued that there is a host of reasons why initial costs of firms would be high. They include many “supply side market failures” in both product and factor markets, the limited ability to create technological capability, the absence of necessary labor and managerial skills, weak backward and forward linkage creation, and the weakness of the institutions that could promote industry.6 Individual entrepreneurs overestimate the costs and risks and underestimate the benefits from their investment in this milieu. These economists cited in this paper see market failures and the absence of markets as leading to a weak industrial performance all around and the country’s inability to duplicate the success of East Asian countries, according to their own interpretation of the ingredients of East Asian countries’ industrial success.

It is necessary to examine the arguments for intervention on infant industry grounds to see what elements support the case for industrial policy. With reference to (a), high costs of new industries would arise from the reasons given by those who advocate industrial policy. But while agreeing that the initial costs of industries may be high for a variety of reasons, industrial policy cannot be the sweeping answer that has been put forward by the majority of Sri Lankan economists. To be sure, developing countries have high costs of capital (given their endowments) , and weak institutions that raise transaction costs and make initial costs of establishment and operation high. The main contention of those who advocate industrial policy is that these deficiencies have to be addressed by targeting these activities for public support on a wide scale as the NSE framework advocates. It would imply a subsidy of some type to the firm or activity either to raise profitability of the industry through raising domestic output prices (through a guaranteed price to the producer or through protection) or reduce costs through a subsidy to the particular factor of production or input, if it is overpriced due to a distortion (such as a monopoly in the supply of the input). It could be a subsidy to capital or to skilled labor or to some intermediate input. However, the optimal intervention theory holds that the intervention has to go to the origin of the distortion directly. It is well known that trade protection is not the answer in the presence of domestic distortions, since it leads to a lower welfare outcome than an optimum subsidy.7 A targeted subsidy to address the high cost is superior to trade protection since the former does not involve a consumption cost. But it could involve costs in terms of the producer surplus in the manner in which the subsidy is financed (e.g. raising taxes on other efficient producers). It is essential that there is a time element involved in the process to give it the required dynamic character, namely that over time costs decline and profitability increases. The initial high costs must fall over time for the industry or activity to become profitable. However, it is important to make the point that the initial cost disadvantage is temporary and not a permanent state of affairs. If the latter were the case, the country has no static or dynamic comparative advantage in the production of the item, so that no amount of subsidy will help to overcome the cost disadvantage. The infants supported then become a geriatric ward needing permanent sustenance.

With respect to (b), the presence of an externality, it is essential that the benefits of investments are not internal to the firm but to the industry. This means that a private entrepreneur would not be able to recover the investment costs in future profits because the benefits of his investment (such as training labor or acquiring technological capability) could not be appropriated by that entrepreneur. If the benefits are internal to the firm, it can make initial losses but recover them over time and in fact become a profitable venture without public support. In this sense these losses are an investment. And, as any investment, it must have a high rate of return compared to other investments.8 Thus it is essential that there is an externality, namely that the firm that makes the investment cannot appropriate the returns to it because other firms (in the industry) that benefit from it (such as a lowering of their supply curves) keep the benefit to themselves.

With respect to (c), it is necessary that industrial policy based assistance leads to the creation of returns over and above that which would be possible if there were no intervention. What is even more important is that the returns to the activity must rise above all other activities for it to be optimal. Otherwise, the resources used to support one activity imply an opportunity cost to other activities. Thus, if manufacturing and export activities are supported for reasons of raising a particular component of GDP, it must be such that there is no reduction in output of other activities beyond a reasonable period of support. In other words, the return to the supported activity must be such to pass a test of returns over and above other activities. The real reason for the promotion is to raise GDP and its growth rate rather than some particular component of GDP. Thus measuring success as equal to an increase in exports due to promotion of exports is not the appropriate way to measure success. The simple test is whether support for an activity raises overall GDP, or in a dynamic sense raises the GDP growth rate.

Finally with respect to (d), the issue of the time period of support needed for an infant to grow up has to be determined. What is the cut off period for support? It should be intuitively clear that all activities requiring support may not have the same period and extent of support, because cost structures, degrees of learning, the extents of market power and technological capabilities differ. This then leads to the issue of how to make the determination as to what activities to support, what form the support must take and for what period support is to be provided. These are intrinsically difficult questions.

The above generic (or could even be described as naïve) requirements for viable industrial policy are more demanding than commonly recognized in the Sri Lankan debate on industrial policy.

Moreover, other considerations not captured above come into play making the advocacy of industrial policy a questionable proposition. These considerations also arise from the received theory of policy intervention. They may sound easy on the surface, but are eminently difficult to implement in fact. These considerations are: (i) the choice of which activities to support in the sense that the activity has long term dynamic comparative advantage which is not as easy to determine. Why would fixed income earning bureaucrats have better knowledge of products and markets than those in the market themselves and whose decisions as to where to invest are subject to their own individual risk evaluations so that they would be careful in choosing the investment in the first place? The exceptions to this rule are few and hard to come by. (ii) What is the optimal form of intervention given that received theory tells us that the policy must be targeted to the particular deficiency or distortion that prevents a country from realizing greater returns to its resources from supporting a particular activity? (iii) For what period is support needed and could it be fixed in advance? (iv) What is the exit policy from support in the absence of a fixed period when a highly political choice is involved in giving or taking away support? The latter is more difficult given that the political processes are not often capable of withdrawing support once it is given; since groups or coalitions are built to preserve the support. (v) It is not the case that bureaucrats and administrators are neutral actors in allocating support; they could be seeking rents themselves as public choice theory tells us through rent and revenue seeking activities.9 (vi) It is also not clear that the firms which receive public support will actually put it to the use for which it is requested. This is a difficult area to monitor due to the principal-agent problem encountered in decision making for optimal outcomes. The public is the principal and the bureaucrats are the agent. It is not the case that their interests coincide even among presumably, the best of the world's bureaucrats as one saw in the case of the East Asian countries. (vii) The firms that receive the support will pursue lobbying to maintain that support. It may also be rational for the firm receiving the support to not make the investment in fact, but window dress in order to satisfy some bureaucratic performance criterion. As Baldwin (1969) has noted, it is even not clear that the firms will make the appropriate investment of the funds it receives in public support.10 Their incentive to maximize profits would prevail over making some uncertain long term investment. If the investment in knowledge that industrial policy has supported is easily duplicable by other firms, then the returns to it will fall, and firms will be reluctant to make the investment even if public funds were to be available. (viii) Finally, private markets can create mechanisms to preserve the knowledge to ensure returns to such investment through technology agreements with foreign firms that have the technology protected by patents. Or alternatively, domestic firms (if there is a small number involved in the industry) can come to an agreement to use technology on a cost-sharing basis. Thus an externality is internalized through the use of the market.11

The past record of the various public enterprises in the developing countries that received huge targeted subsidies is hardly encouraging. They became a veritable geriatric ward rather than infants who grew up to adulthood to fend for themselves. This must have a sobering effect on those who advocate industrial policy for these countries. They must be careful to recognize the difficulties in formulating, implementing and monitoring industrial policies. They would of course argue that the support of public enterprises was wrong because even a prima facie case for infant industry could not be made in those cases. But the fact is that nobody tried. It was a political decision based on ideology at the time when the Governments of the day followed the model of state ownership as a panacea for handling all manner of perceived social evils. These enterprises wasted public resources on a tremendous scale and impacted adversely on both GDP growth and equity. However, the proponents of modern day industrial policy would argue that support for the private sector would be more viable on grounds that private enterprises will have to pass market tests ultimately, even if they were to receive handsome subsidies initially. But this is not addressed in the NSE framework, namely how to administer a system that attempts to identify and implement support for industries. Thus NSE framework has not met the existing argument against industrial targeting, nor has it provided a search procedure and implementation to overcome problems associated with industrial policy in the past.

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