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# Comments on “New Structural Economics” by Justin Yifu Lin

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Ever since development economics became a field, there has been a search for “the” key to development. Physical capital accumulation, human capital, industrial development, institutional quality, social capital, and a variety of other factors have been the focus at one time or another. As each became the focal point, there was a parallel explicit or implied role of government.

If I understand Justin Lin correctly, he is saying that the “new structural economics” (NSE) accepts that earlier thought ignored comparative advantage, which should be market determined, but that growth requires improvements in ‘hard’ (tangible) and ‘soft’ (intangible) infrastructure at each stage. Such upgrading and improvements require coordination and inhere with large externalities to firms’ transaction costs and returns to capital investment. Thus, in addition to an effective market mechanism, the government should play an active role in facilitating structural change (p. 206).

He seems also to believe that growth depends almost entirely on industry growth and believes that constant “upgrading” or moving up the value added chain is the central challenge. He says that “the laissez-faire approach . . . missed the importance of the process of continuous, fundamental technological changes and industrial upgrading, which distinguishes modern economic growth from premodern economic growth” (p. 196).

It is questionable whether such changes and upgrading must take place early in the development process. In many countries, unskilled labor has moved to unskilled-labor-intensive industries, with expansion of those industries’ outputs for a period during which more and more workers acquired acquaintance with modern factory techniques, and exports of the unskilled-labor-intensive goods

increased. Only later in the development process did upgrading become a major part of industrial growth once there had been significant absorption of rural labor, and much of it happened in existing firms in response to rising real wages, lower capital costs, and learning through exposure to the international market.

However, in most countries rural labor could be absorbed only as agricultural productivity increased; Lin's NSE seems to equate growth with industrial expansion, ignoring the importance of increased productivity of the large fraction of the labor force (and of land) in rural areas. Failure to invest in agricultural research and development and in rural health and education has been a major weakness of many countries' development strategies. While strides have been made in reducing discrimination against agriculture, the NSE as expounded by Lin would appear to support the industrial and urban bias that has itself constituted a very large distortion in some countries.

It will come as no surprise that I agree that the market should be used to determine comparative advantage, and that governments have responsibilities for insuring an appropriate incentive framework and provision of infrastructure (both hard and, as he terms it, "soft").

But there is nothing new in that. What purports to be the "new" part is the assertion that coordination and upgrading of infrastructure should in some way be related to particular industries. It is at this point where a question arises: most economists would accept the view that cost-benefit analysis should be used in the choice of infrastructure projects. If "externalities" and "coordination" are important, are they important for specific industries or for the entire industrial economy? If the former, how are those industries to be identified, and how would the externalities be estimated in cost-benefit analysis? Or would they? If infrastructure is seen to be industry-specific, it is not clear what it is. As with the possible existence of infant industries, it is one thing to believe that there are such industries (perhaps) and quite another to identify ahead of time which they are. And even if such industries exist and are identified, questions arise as to the incentives that would be appropriate for the government to foster these industries. (Would they be firm-specific treatment? Tariffs? Subsidies to firms or industries? Each has huge problems.) And if it is more "conventional," what is new? If infrastructure is specific to industry (or a group of industries), the same questions must be addressed.

Some hints are given as to what Lin has in mind: "successful industrial upgrading in responding to change in an economy's endowment structure requires that the pioneer firms overcome issues of limited information regarding which new industries are the economy's latent comparative advantages determined by the changing endowment structure. Valuable information externalities arise from the knowledge gained by pioneer firms in both success and failure. Therefore, in addition to playing a proactive role in the improvements of soft and hard

infrastructures, the government in a developing country, like that in a developed country, needs to compensate for the information externalities generated by pioneer firms” (p. 203).

Here, the infant industry concerns arise again. How can these externalities be forecast? As Baldwin (1969) pointed out, there are major difficulties with this argument, quite aside from the identification of such externalities. And firms producing unskilled-labor-intensive goods and exporting them have usually learned of the opportunities provided by the international market and chosen to upgrade as their experience has increased. Learning does not seem to have been a major issue for firms in South Korea, Taiwan, and elsewhere.

Another hint as to what Lin has in mind comes from his advocacy of coordination of infrastructure investments. According to him, “Change in infrastructure requires collective action or at least coordination between the provider of infrastructure services and industrial firms. For this reason, it falls to the government neither to introduce such changes or to coordinate them proactively.”(p. 203) How this would be carried out is unclear; Lin insists that infrastructure must be upgraded with growth as long as it is consistent with the evolving future direction of comparative advantage, but does not elaborate on how that future direction should be identified. Involving individual firms and industries in decisions as to infrastructure investments would appear to offer far too much scope for individual firms’ and industries’ influence over these investments.

Although it is certainly true that not everything can be done at once, focus on selected areas for large investments at the neglect of the rest of the economy is a highly questionable strategy. Why it would be preferable to allocate scarce capital so that some activities have excellent infrastructure while others must manage with seriously deficient infrastructure is not clear: without further evidence, it would appear to be a distortion. Further, questions can also be raised as to why “soft infrastructure,” such as the “business environment” (which consists of such things as the commercial code, the structure of taxes and subsidies, regulations, and so on), cannot be economy wide. And the criteria by which there would be designation of a given area, or the types of industries that would be eligible, as the recipient of special treatment are not discussed. What the hard infrastructure is that does not consist of items such as roads and ports, and is industry specific, is not discussed.

But all of this hinges on the proposition that decisionmakers in the public sector can ascertain the appropriate rate of “upgrading” and the extent of the supposed externalities. This raises a host of issues. There is, first, the consideration that even if one could know which activities would have comparative advantage, that advantage often develops as small firms enter, some of which are successful and grow larger. Any strategy of “upgrading” would inevitably favor larger, established firms, and hence encounter the same sorts of problems as did the older

import-substitution strategy which, as Lin recognizes, failed. “Picking winners” as industries is difficult; it cannot be firm specific or the usual problems of corruption and cronyism arise. And yet supporting an industry or industries as an undifferentiated entity is difficult: are textiles an industry? Or is synthetic fiber an industry? Or is nylon an industry? And, of course, the breakdown could go further. And as capital and skills per person accumulate, how is it to be decided where the industrial park or export processing zone should be? And which firms should be eligible to enter it?

Another strand of Lin’s argument pertains to the role of distortions. He appears to be saying that countries that earlier adopted import-substitution strategies have distorted industrial structures that should affect policy. In particular, he says: “many developing countries start climbing the industrial ladder with the legacy of distortions from old structural strategies of import-substitution. [The new structural economics] would therefore suggest a gradualist approach to trade liberalization. During transition, the state may consider some temporary protection to industries that are not consistent with a country’s comparative advantage, while liberalizing at the same time entry to other more competitive sectors that were controlled and repressed in the past” (p. 212).

Here, as elsewhere, little guidance is given as to how much protection industries would be provided with; how long that protection would last; how industries to be protected would be chosen; and so on. But even more important, one can imagine the political pressures for greater protection for longer periods. Protection of some industries is disprotection of others, as is well known, so reform efforts would clearly be dampened. Even worse, a major challenge for liberalizing reforms is for it to be credible that the altered policies are not reversible. Lin’s prescription would greatly increase the challenge of creating credibility, and a slower transition would be a longer period during which growth was slow and political pressures opposing liberalization at all were mounting.

In all, there is much in Lin’s analysis with which most would agree, but focus on governmentally led identification of industries with “latent comparative advantage” and industry-specific provision of infrastructure is not convincing. Lin calls for much research. A first task should be to show that there are industry (or industry-cluster) externalities, how they could be identified and measured *ex ante*, and what sorts of government support would improve potential welfare and growth prospects without generating the same sorts of rent-seeking opportunities as import substitution policies did.

Until that research is undertaken, the NSE will, it is to be feared, be taken as a license for governments to support specific industries (and worse yet, perhaps even firms), in ways that may be no more conducive to growth than were the old, failed, import-substitution policies.

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## Reference

Baldwin, Robert E. 1969. "The Case against Infant Industry Protection." *Journal of Political Economy* 77(3): 295–305.