TOWARDS A RETURN OF INDUSTRIAL POLICY?
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Middle-income developing countries and industrial policy

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Development economics repeats itself, first as tragedy, second as farce

[paraphrase of opening sentences of Karl Marx's "The Eighteenth Brumaire of Louis Bonaparte" (1852)]

- First Wave: Part of movement to replace neoclassical economics – Keynesian macroeconomics for the First World, and Development Economics for the Third World
- Second Wave: Subsumed both as applications of neoclassical economics – Monetarist and New Classical counter-revolutions in macro, and Washington Consensus in development economics

Latin America vs East Asia: IS vs EP

- Little-Scott-Scitovsky: *Import Subtituting (IS) vs Export-Promoting (EP)*; or Balassa: *Inward-oriented versus Outward-oriented*
- World Bank: Export-Promoting is "neutral incentives" → **get your prices right**
- Cooper-Corden-Little-Rajapatirana: profligacy vs prudence -> **get your macro-balances right**
- John Williamson combined above to arrive at **Washington Consensus** (WC)
- **There have been two incarnations of WC: WC Mark 2 (WC2) emerged in mid-1990s**

Understanding Why the World Bank Interpreted the Industrial Policies in the Republic of Korea (ROK) and in Taiwan Province of China (TPC) as Having Zero Net Effect on Resource Allocation

The secrets in “The More Things Change, the More They Remain the Same”

Neutral incentives? (1/2): Link between domestic prices and world prices

$(P_I/P_X) = PW_I(1+t) / PW_X(1+s)$

- P_I = domestic price of imports
- P_X = domestic price of exports
- t = effective tariff rate
- s = effective subsidy rate
- PW_I = world price of imports
- PW_X = domestic price of exports

- $(P_I/P_X) = PW_I(1+t) / PW_X(1+s)$

  $> PW_I / PW_X$ when $t > s > 0$
- Import-substitution is when $t > s > 0$

Neutral incentives? (2/2): Link between domestic prices and world prices

- **Export-promotion is when t = s with t > 0, which is the case for ROK and TPC**
- Free trade is when t = s = 0
- $(P_I/P_X) = PW_I / PW_X$ under EP and free trade
- World Bank: EP is neutral incentive regime
- Don’t bother with the administrative burden of EP, just go for free trade (e.g. Deepak Lal)
- ROK and TaC policymakers were lucky in that their import tariffs and export subsidies fortuitously offset each other.

Washington Consensus Mark 1 (1/2)

Washington Consensus I (emerged in mid-1960s, comparative studies on trade regimes e.g. Krueger): **Get the prices right and get the macro-balances correct**

1. Fiscal discipline.
2. A redirection of public expenditure priorities toward fields offering both high economic reforms and the potential to improve income distribution, such as primary health care, primary education, and infrastructure.
3. Tax reform (to lower marginal rates and broaden the tax base)

Washington Consensus Mark 1 (2/2)

4. Interest rate liberalization.
5. A competitive exchange rate.
6. Trade liberalization.
7. Liberalization of inflows of direct foreign investment
8. Privatization.
9. Deregulation (to abolish barriers to entry and exit)
10. Secure property rights.

WC1 = Market Fundamentalism
WC2 = Institutional Fundamentalism

- Phenomena like (a) Good bye financial repression, hello financial crash; (b) public monopolies replaced by private monopolies; (c) more inequality without efficiency gains => so **Washington Consensus Mark 1 got dethroned**
- Washington Consensus Mark 2 emerged in mid-1980s, e.g. new institutional economics: **Get the institutions right by bringing the state back in** to ensure transparent rule of law; adequate prudential regulations and monitoring; effective competition policy; protection of property rights
- ***"institutions trump all other factors" (Dani Rodrik, 2004) is the present mantra of the World Bank***

African governance unusually bad?

- Good governance requires resources, e.g. computerisation of records, technical training, adequate compensation for civil service
- In competitiveness scoring, Singapore ranks high in governance index. Singapore has highest-paid cabinet in the world
- After controlling for income level, is African governance unusually bad? NO

Table 1. Governance Quality and Income[a]

	(I)	(II)	(III)	(IV)
Dependent variable	Corruption Perceptions Index, 2003[b]	Index of Economic Freedom, 2001[c]	Average Kaufmann, Kraay, Zoido-Lobaton indicators, 2000[d]	Average ICRG indicators, 1982-1997[e]
Independent variable				
log(GDP pc PPP 2001)	**1.05**	**-0.48**	**0.4**	**0.45**
	(5.31)	**(-4.75)**	**(5.20)**	**(4.00)**
Dummy variable for tropical	0.58	-0.27	-0.05	0.15
sub-Saharan Africa[f]	(1.57)	(-1.58)	(-0.33)	(0.71)
R-squared	0.4	0.27	0.42	0.29
N	67	82	92	73

Sources: Authors' regressions using data from Transparency International (2004); Miles Feulner, and O'Grady (2004); Kaufmann, Kraay, and Zoido-Lobaton (2002); PRS Group (2004); World Bank (2003).

a. The sample consists of ninety-two countries worldwide, excluding high-income countries and former republics of the Soviet Union. All regressions are ordinary least squares and include a constant term (not reported). Numbers in parentheses are t statistics; coefficients within statistical significance at the 5 percent level are in bold.

b. From Transparency International, this index relates to the degree of corruption in the country as perceived by business people, academics, and risk analysts and ranges between 10 (highly clean) and 0 (highly corrupt).

c. The index is published by the Heritage Foundation and the Wall Street Journal and ranges from 1 to 5, where 5 indicates the greatest government interference in the economy and the least economic freedom.

d. Average of six World Bank governance indicators measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governacne outcomes.

e. Average of six governance indicators from the International Country Risk Guide, with values ranging from 1 to 6, with higher values reflecting better governance.

f. Refers to sample of 33 countries defined in Sachs et al. (2004)

Institutional fundamentalism: one-variable primacy is ahistorical

Which is correct equation for growth rate, Y?

a. $Y = (X_0 + aX_1 + bX_2) \times d(\text{Institution Variable})$

b. $Y = (X_0 + aX_1 + bX_2) + d(\text{Institution Variable})$

- China and Vietnam grew despite primitive institutions – because at their initial stage of development, getting the prices right was sufficient to begin industrialization process
- Regressions show statistical significance of tropical African dummy despite presence of various proxies of institutions

Table 2: Regressions Explaining Economic Growth in Tropical sub-Saharan Africa with Governance Indicators[a]

	(I)	(II)	(III)	(IV)	(V)
Independent variables					
Tropical Sub-Saharan Africa dummy[b]	-3.28 (-6.56)	-3.06 (-6.50)	-2.68 (-6.11)	-3.43 (-7.05)	-3.40 (-6.46)
Corruption Perception Index 2003, Transparency International[c]	0.83 (5.23)				
2001 Index of Economic Freedom[d]		-0.96 (-2.75)			
2000 Average Kaufman, Kraay, Zoido-Lobaton indicators[e]			1.89 (5.91)		
1982-1997 Average ICRG Indicators[f]				1.56 (5.29)	
1982 Average ICRG Indicators[f]					0.68 (3.78)
log(GDP pc PPP in 1980)	-2.07 (-7.02)	-1.65 (-6.06)	-1.75 (-7.07)	-2.00 (-7.01)	-1.82 (-5.84)
R-squared	0.58	0.46	0.59	0.59	0.54
N	60	71	78	65	52

Sources: This table from Sachs et al. (2004). Regressions use data from Transparency International (2004); Miles Feulner, and O'Grady (2004); Kaufmann, Kraay, and Zoido-Lobaton (2002); PRS Group (2004); World Bank (2003).

a. The dependent variable is average annual growth of GDP per capita, 1980-2000. The sample consists of ninety-two countries worldwide, excluding high-income countries and former republics of the Soviet Union. All regressions are ordinary least squares and include a constant term (not reported). Numbers in parentheses are t statistics; all coefficients reach statistical significance at the 1 percent level.

b. Refers to sample of 33 countries defined in Sachs et al. (2004)

c. From Transparency International, this index relates to the degree of corruption in the country as perceived by business people, academics, and risk analysts and ranges between 10 (highly clean) and 0 (highly corrupt).

d. The index is published by the Heritage Foundation and the Wall Street Journal and ranges from 1 to 5, where 5 indicates the greatest government interference in the economy and the least economic freedom.

e. Average of six World Bank governance indicators measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governacne outcomes.

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Three Blind Spots in Wash-Consensus

- No acknowledgment that “neutral-incentive policies” had resource allocation effects (Just implausible that interventionist policies in ROK and TPC just offset each other)
- No acknowledgment of state-initiated scientific innovations as engine of growth
  - trade-led growth? (but Africa is more trade-oriented than Latin America)
- No acknowledgement of poverty traps (no recognition that there are limits to self-help) or middle-income traps (doing more the same stops working)

1st blindspot: Woo (1990): EP has no resource allocation effects only if no nontradables

- P_T = domestic price of tradables
  $= aP_I + (1\text{-}a)P_X$
- P_N = domestic price of non-tradables
- PW_T = world price of tradables
  $= aPW_I + (1\text{-}a)PW_X$
- For EPI, $P_T = (1+t)PW_T$
- (P_T/P_N) under EPI $= (1+t)PW_T / P_N$
- (P_T/P_N) under free trade $= PW_T / P_N$
- Rodrik (2008) confirms Woo's (1990) thesis that discrimination against nontradable sector promotes growth. Key: Promote development of industrial sector in market-compatible ways

Fixing 2nd blind spot: Science policy not just market forces

- Primacy of culture of excellence
- University-state-business coalition
- Different funding mechanisms for basic research, and for applied research: public funding and private funding respectively (e.g. NSF and venture capital)
- New industrial policy: more human capital, less physical capital.

Fixing the 3rd blind spot for low-income countries: MDGs

- Natural mechanism? In US development, labor flowed from poor to rich areas, and capital flowed from rich to poor
- Capital that flowed was public capital for infrastructure: interstate, rural electrification, land grant universities [manpower training and research on ecology-specific problems]
- Rich provinces subsidizing backward provinces (US previously, China presently).
- Rich countries must inject sufficient aid into poorest countries to achieve the Millennium Development Goals before growth begins

Selected References

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