OPINION PIECE

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Industrial policy revisited

The best-kept secret of economic policy may be the fact that every single economy in the world, either intentionally or not, pursues industrial policy. This is true not only for the usual suspects, such as Brazil, China, France and Singapore, but also for Chile, Germany, Great Britain and the United States. The news is only surprising if one forgets that industrial policy broadly refers to any government decision, regulation or law that encourages the ongoing operation or development of a particular industry. After all, economic development and sustained growth are simply the results of continuous industrial and technological upgrading, a process that requires public-private collaboration.

While industrial policy has had a bad reputation in economics for a long time, historical evidence shows that all countries that have successfully transformed from agrarian economies to modern advanced economies – the old industrial powers in Western Europe and North America as well as the newly industrialized economies in East Asia – had governments that played a proactive role in assisting individual firms in overcoming the coordination and externality problems that arose during the process of their structural transformation.

However, the sad fact is that while almost every government in the developing world has attempted, at some point in its development process, to play that facilitating role, most have failed. The economic history of the economies of the former Soviet Union, Latin America, Africa and even Asia have been marked by inefficient public investment and misguided government interventions that have resulted in many "white elephants" and costly distortions.

Looking carefully at these pervasive failures in developing economies, it appears that they are mostly due to the inability of governments to come up with good criteria for identifying industries that are appropriate for a given country's level of development. In fact, the propensity of governments to target industries that are too ambitious and are not aligned with a country's comparative advantage largely explains why their attempts to "pick winners" have often resulted in "picking losers." In contrast, as I argued in "New Structural Economics" (Lin, 2010), governments in successful developing countries have typically targeted mature industries which have succeeded in countries with an endowment structure similar to theirs and with a level of development not much more advanced than theirs. The main reason is straightforward: government interventions aiming at facilitating industrial upgrading and diversification must be anchored in industries with latent comparative advantage determined by their endowment structure, so that they enjoy low factor costs of production. In this way, once a government uses targeted policy to improve the hard and soft infrastructure needed to lower transaction costs, private firms in the new industries can quickly become competitive, both domestically and internationally.

In the case of advanced countries, most industries tend to be on the global frontier (i.e. having adopted the most recent innovations), which means upgrading requires an original innovation. In addition to *ex post* measures such as giving a patent to a successful innovation or supporting a new product through procurement, the government may also use *ex ante* measures such as supporting basic research needed for new product/technology development or impose a mandate for using a new product like the case of ethanol.