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МОКРОГОРСКА ШКОЛА МЕНАЏМЕНТА
MOKRA GORA SCHOOL OF MANAGEMENT

STATE: WHERE ARE THE NEW FRONTIERS OF STATE INTERVENTIONISM – WHAT STATE MAY AND SHOULD DO?

The Role of the State in Industrial Policy

A Framework for Rethinking the Approach

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Industrial Policy

Key Guiding Principles

- Industrial structure is endogenous to endowment structure
- Initial endowments determines the economy’s comparative advantage and optimal industrial structure at time “t”
- But this can dynamically change over time
- Following comparative advantage is the best way to upgrade endowment structure and to sustain industrial upgrading, income growth and poverty reduction.

Failures of Industrial Policy in the Past

- Attempt to develop industries that went against comparative advantage
- The firms in the industrial policy's targeted sectors were non-viable in competitive markets and required government policy supports for their initial investment and continuous operations.
- Types of support:
  - Direct subsidy
  - Preferential tax treatment, trade barrier, and monopoly
  - Interest rate and foreign exchange rate distortions
- The supports were implemented through price distortions. As a result, planning and administrative allocations were required.
- This led to rent-seeking, directly unproductive profit seeking, and soft budget constraints.

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Conditions for dynamic growth

- Market economy: Necessary Condition for efficient resource allocation and following comparative advantage
- Facilitating state: Necessary condition for smooth industrial upgrading and diversification to industries that the economy has comparative advantage
- Historically, all the successful countries were market economies and their governments played the facilitating role in the process of industrial upgrading. The governments in developed countries continue to play that role.
- However, the governments in developing countries all attempted to play the facilitating role but most failed.
- **The key issue is how to help them play the role right?**

Existing practices

- Business environment:
  - The goal is to introduce a whole set of the first-best institutions
  - but the issues are:
    - The government may not have the capacity to introduce all those changes
    - The first-best institutions may be different at different stage of development
    - No identification of industries with latent comparative advantages and no compensation for the "first movers"
- Growth Diagnostics:
  - The goal is to remove binding constraints
  - but the issues are:
    - Binding constraints are endogenous to industries
    - It relies on survey of existing firms. Many of them may be in industries where the country has no comparative advantages.
    - No firms may be in the new industries that the countries have latent comparative advantage

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New Approach:

Growth Identification and Facilitation

- Step 1:
  - Find dynamic growing countries with a similar endowment structure and with about 100% higher per capita income. Identify tradable industries that have grown well in those countries for the last 20 years. References for Lao may include Vietnam, Thailand, Indonesia, and China now and Finlandin the 1950s.
- Step 2:
  - See if some private domestic firms are already in those industries (of which may be existing or nascent). Identify constraints to quality upgrading or further firm entry. Take action to remove constraints

New Approach:

Growth Identification and Facilitation

- Step 3:
  - In industries where no domestic firms are currently present, seek FDI from countries examined in step 1, or organize new firm incubation programs.

- Step 4:
  - In addition to the industries identified in step 1, the government should also pay attention to spontaneous self discovery by private enterprises and give support to scale up the successful private innovations in new industries

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New Approach:

Growth Identification and Facilitation

- Step 5
  - In countries with poor infrastructure and bad business environment, special economic zones or industrial parks may be used to overcome these barriers to firm entry and FDI and encourage industrial clusters.
- Step 6:
  - The government may compensate pioneer firms in the listed identified above with:
    - Tax incentives for a limited period,
    - Direct credits for investments,
    - Access to foreign exchanges