The New Structural Economics
A Framework for Rethinking Development and Policy

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Why Do We Need Rethinking?

Economic Theory

Failure to: Failure to:

Explain Observed Economic Phenomena

Guide Economic Policies or Choices

Rethinking
Development Theory is in Need of Rethinking

- Successful **East Asian Tigers**: Export promotion
- **China, Vietnam, and Mauritius**: Dual-track approach to transition

**Market-based economies with proactive role for government**

Structuralist Approach
Focus on Market Failures:
Import Substitution Strategy
*Miserable results*

Washington Consensus
Focus on Government Failures:
Privatization, Marketization & Liberalization
*Lost decades*
World Bank has been in the Process of Rethinking Economic Development

Export Orientation and Market-Friendly Government

No one-size fits all

(i) Openness;
(ii) Macro stability;
(iii) High rates of saving & investment;
(iv) Market mechanism;
(v) Committed, credible & capable government
New Structural Economics

• Application of a neoclassical economic approach to understand the determinates of economic structure and its evolution in development

• Why do I focus on structure?
  – By nature, economic development is a process of continuous change in the structure of technology, industry, and soft and hard infrastructure in the economy

• Why do I call this approach New Structural Economics?
  – By convention, it should be called structural economics
  – Add “new” to distinguish it from structuralism
What Determines Structure and its Change?

• The main hypothesis. Industrial structure is endogenous to endowment structure, which is given at any specific time and changeable over time.

• Initial endowments. Determine the economy’s total budgets and relative factor prices at time t.
  – Comparative advantage
  – Optimal industrial structure (endogenous)

• Dynamics. Income growth depends on:
  – Upgrading industrial structure
  – Upgrading of endowments
  – Improvements in “hard” and “soft” infrastructure

• Following comparative advantage (determined by the endowment structure) to develop industries is the best way to upgrade the endowment structure and to sustain industrial upgrading, income growth, and poverty reduction.
The Market and the State

• Firms maximize profits...choice of technology and industries based on relative factor prices...

Need for a competitive market system

• Industrial upgrading needs to:
  – Address externalities
  – Solve coordination problems

Need for a facilitating state
NSE and the Failure of Structuralism

• Structuralism advised governments to develop industries that were **too far advanced** compared to their countries’ level of development and went **against their comparative advantages**.

• The **firms were non-viable in competitive markets** and required government policy support for their initial investment and continuous operation.

• This led to **rent-seeking, corruption, and political capture**.

<table>
<thead>
<tr>
<th>Country</th>
<th>Industry</th>
<th>Time</th>
<th>Main producer at Time</th>
<th>Real GDP pc Latecomer Country</th>
<th>Real GDP pc Leading Country</th>
<th>Income Ratio Follower versus Leader</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Automobile</td>
<td>1950s</td>
<td>USA</td>
<td>577</td>
<td>10,897</td>
<td>5%</td>
</tr>
<tr>
<td>DRC</td>
<td>Automobile</td>
<td>1970s</td>
<td>USA</td>
<td>761</td>
<td>16,284</td>
<td>5%</td>
</tr>
<tr>
<td>Egypt</td>
<td>Iron, Steel, Chemicals</td>
<td>1950s</td>
<td>USA</td>
<td>885</td>
<td>10,897</td>
<td>8%</td>
</tr>
<tr>
<td>India</td>
<td>Automobile</td>
<td>1950s</td>
<td>USA</td>
<td>676</td>
<td>10,897</td>
<td>6%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Ships</td>
<td>1960s</td>
<td>Netherlands</td>
<td>983</td>
<td>9,798</td>
<td>10%</td>
</tr>
<tr>
<td>Senegal</td>
<td>Trucks</td>
<td>1960s</td>
<td>USA</td>
<td>1,511</td>
<td>13,419</td>
<td>11%</td>
</tr>
<tr>
<td>Turkey</td>
<td>Automobile</td>
<td>1950s</td>
<td>USA</td>
<td>2,093</td>
<td>10,897</td>
<td>19%</td>
</tr>
<tr>
<td>Zambia</td>
<td>Automobile</td>
<td>1970s</td>
<td>USA</td>
<td>1,041</td>
<td>16,284</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: Author's calculations based on data from Maddison (1995).
NSE and the Failure of the Washington Consensus

- All transitional economies started with many nonviable firms in their old priority sectors due to their **comparative advantage-defying development strategy**.

- The Washington Consensus **failed to recognize that the distortions were endogenous** when advocating for the protection of nonviable firms in the priority sectors and advised the government to eliminate all distortions immediately, which caused the **collapse of old priority sectors**.

- The Washington Consensus also **opposed that government play a proactive role in facilitating firm entry** into sectors consistent with the country’s comparative advantages.

- The dynamically growing transitional economies adopted a **dual-track approach**:
  - The government continued to provide transitional support to nonviable firms in the old priority sectors and removed distortions only when firms in those sectors became viable or the sectors became very small.
  - The government facilitated private firms’ entry to sectors that were consistent with the country’s comparative advantage, which were repressed before the transition.
Industrial Policy in a Market Economy

• Industrial policy is desirable.
  – Contents of coordination will be different, depending on industries.
  – The government’s resources and capacity are limited and need to be used strategically.

• To be successful, the targeted industries should be in line with the economy’s latent comparative advantages.
Growth Identification and Facilitation

**Step 1**
Find fast growing countries with similar endowment structures and with about 100% higher per capita income. Identify dynamically growing, tradable industries that have performed well in those countries over the last 20 years.

**Step 2**
See if some private domestic firms are already in those industries (existing or nascent). Identify constraints to quality upgrading or further firm entry. Take action to remove constraints.
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 successful private innovations in new industries.
Growth Identification and Facilitation

Step 5
In countries with poor infrastructure and bad business environments, **special economic zones or industrial parks** may be used to overcome barriers to firm entry, attract FDI, and encourage industrial clusters.

Step 6
The government may **compensate pioneer firms** identified above with:
- Tax incentives for a limited period
- Direct credits for investments
- Access to foreign exchange
Two additional points

• Agricultural development is crucial for developing countries:
  – For poverty reduction, and
  – For providing capital and a market for industrial products.

• A resource-abundant country’s resources will be a blessing if:
  – It has a good management of resources. (E.g., some of it must be saved for future generations, and enclave rent capture avoided.)
  – It uses (part of) the wealth generated from resources to facilitate structural transformation.
Concluding Remarks

• Every developing country has the potential to grow continuously at 8% or more for several decades, and to become a middle-income or even a high-income country in one or two generations...

• As long as the government has the right policy framework to facilitate the development of the private sector along the lines of the country’s comparative advantages and taps into the latecomer advantages.