Comments on "New Structural Economics" by Justin Yifu Lin

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Justin Lin wants to make structuralist economics respectable again, and I applaud him for that. He wants to marry structuralism with neoclassical economic reasoning, and I applaud this idea too. So he has two cheers from me. I withhold my third cheer so I can quibble with some of what he writes.

The central insight of structuralism is that developing countries are qualitatively different from developed ones. They are not just radially shrunk versions of rich countries. In order to understand the challenges of under-development, you have to understand how the structure of employment and production—in particular the large gaps between the social marginal products of labor in traditional versus modern activities—is determined and how the obstacles that block structural transformation can be overcome.

The central insight of neoclassical economics is that people respond to incentives. We need to understand the incentives of, say, teachers to show up for work and impart valuable skills to their students or of entrepreneurs to invest in new economic activities if we are going to have useful things to say to governments about what they ought to do. (And of course, let's not forget that government officials must have the incentive to do the economically "correct" things too.)

If we put these two sets of ideas together, we can have a useful development economics, one that does not dismiss the tools of contemporary economic analysis and yet is sensitive to the specific circumstances of developing economies. This is the kind of development economics that is appropriately nuanced in its take on government intervention. It doesn't presume omniscience or altruism on the part of governments. It has a healthy respect for the power and effectiveness of markets. But it does not blithely assume that development is an automatic process that takes care of itself as long as government stays out of the picture.

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So as Lin rightly emphasizes, the state has a useful role to play in promoting industrial diversification and upgrading. He lists among desirable functions the provision of information about new industries, the coordination of investments across firms and industries, the internalization of informational externalities, and the incubation of new industries through the encouragement of foreign direct investment. Policies of this kind may be unnecessary or superfluous in advanced economies, but they are essential if poor countries are to progress.

To distinguish his brand of structuralist development economics from old-style structuralism Lin writes that a key difference is that the old school advocated policies that go against an economy's comparative advantage. The new approach, by contrast, "stresses the central role of the market . . . and advises the state to play a facilitating role to assist firms in the process of industrial upgrading by addressing externality and coordination issues." Lin argues that government policies should "follow" comparative advantage, rather than "defy" it.

Here is where I quibble with Lin's argument. It seems to me that Lin wants to argue both for and against comparative advantage at the same time, and I cannot quite see how this can be done. If one believes that externality and coordination problems need to be addressed, as Lin apparently does, one must believe that such problems are preventing firms from investing appropriately. One must believe that markets are sending entrepreneurs the wrong signals—invest here, not there—and that allocating resources according to comparative advantage, as revealed by market prices, would be socially suboptimal. Comparative advantage has practical meaning for firms only insofar as it gets reflected in prices.

So when Lin asks governments to step in to address market failures and recommends the type of policies I have listed above—the coordination of investments, the incubation of new industries, etc.—he too is asking them to defy comparative advantage as revealed in market prices. In this respect, there is less difference between what the old school said and what the new school is saying.

Lin doesn't want governments to employ "conventional" import substitution strategies to build capital-intensive industries which "are not consistent with the country's comparative advantage." But isn't building industries that defy comparative advantage what Japan and South Korea did, in their time? Isn't it what China has been doing, and quite successfully, for some time now? According to my calculations, the export bundle of China is that of a country between three and six times richer. If China, with its huge surplus of agricultural labor, were to specialize in the type of products that its factor endowments recommend, would it now be exporting the advanced products that it is?

Some people draw a distinction between static and dynamic comparative advantage in this context, but I don't think that is the relevant distinction. Market failures drive a wedge between market prices and social marginal valuations, and distort the relative costs that signal comparative advantage. Whether these distortions are introduced into intertemporal relative prices or today's relative prices is largely secondary. The policies that Lin recommends are meant to offset such market distortions, and their intended effect is to induce firms to make choices that defy comparative advantage.

I suspect that my difference with Lin is mainly methodological—and perhaps even just terminological—and may have little practical import. What Lin probably has in mind is that today's industrial policies need to have a softer touch than that which structuralists of old tended to recommend. They must be more respectful of markets and incentives; they must show greater awareness of the potential of government failures; and they must focus specifically on market failures rather than vague shortcomings of the private sector. I would agree with all this.

But a deeper question relates to the policy implications one draws from all this. In principle, market failures need to be addressed with appropriately targeted policies. So if the problem is one of information spillovers, the first-best is to subsidize the information generating process. If the problem is lack of coordination, the first-best is for the government to bring the parties together and coordinate their investments. In practice, though, the relevant market failures cannot be always closely identified and the directly targeted remedies may not be available. The practical reality is that the type of policies structuralism calls for—whether of the traditional or the contemporary type—have to be applied in a second-best setting. And in such a setting, nothing is all that straightforward anymore.

Presumably this is the reason why Lin recommends, for example, a gradual approach to trade liberalization. Such an approach is, at best, a second-best remedy to some loosely specified market failures that either cannot be precisely identified ex ante or cannot be fully treated with first-best Pigovian interventions. But how different is this from the old structuralist approach? Didn't most structuralists also view protection as a temporary expedient, to be done away with once the requisite industrial capabilities were built?

To repeat, my differences with Justin Lin are second order, and they are swamped by our areas of agreement. My quibbles are a bit like the internal doctrinal debates waged among communists—does the revolution require the intensification of the class struggle, or can that stage be skipped?—when much of the rest of the world is on a different wavelength altogether.

As a fellow traveler, I am greatly encouraged by what Justin Lin is trying to do. It is high time that the common sense exhibited in his approach reclaimed its mantle in development economics.

Note

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