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Rasul Shams\*

# Are Trade and Industrial Policies Still Economically Justifiable?

*In recent years new approaches have emerged in the fields of trade and growth theory that seem to provide some justification for interventionist policies. This article presents the arguments derived from the new trade and growth theories and considers their respective validity in the context of developing countries.*

The development policy debate is currently characterised by a broad consensus on economic liberalisation, both domestically and in international relations. Given the failure of import substitution policies in a large number of developing countries in the 1950s and '60s, interventionist policies which rely on differentiated trade and industrial policies have now been totally discredited. By way of contrast, the structural adjustment programmes of more recent times give preference to ensuring neutral incentives and keeping the rules by which economic policy measures are crafted as simple as possible. This "paradigm-shift" in development policy can be seen as a victory for traditional foreign trade theory. Paradoxically, as the acceptance of liberal policies in practical development policy has increased, new approaches have simultaneously emerged in the fields of trade and growth theory that provide some justification for interventionist policies.

In the light of new trade and growth theories, we can now ask to what extent and under what conditions trade and industrial policies could also be employed in developing countries to enhance welfare. Although this would not justify going back to import substitution policies along the old lines, it is nevertheless possible to demonstrate that the current liberalisation approach is in need of realignment to allow for increased use of selective trade-policy and industrial-policy measures adapted to the situation at hand.

## Implications of the New Trade Theory

The upshot of traditional foreign trade theory, based on the assumption of constant returns to scale and perfect competition, is that free world trade is the best strategy for maximising welfare in all participating countries. The ensuing pattern of world

trade is a result of countries specialising in accordance with their comparative costs. The new trade theory, on the other hand, concentrates on analysing foreign trade on the basis of increasing company-specific returns to scale and imperfect competition in the markets they operate in. Besides comparative cost advantages, increasing returns to scale are now also proving to be an autonomous cause of foreign trade between countries with identical factor endowments.

New trade theory delivers two types of argument for government intervention in the fields of trade or industrial policy:

□ If increasing returns to scale are present, historical coincidences and small differences in initial endowments can trigger off cumulative processes which lead to the affected country being "locked into" initial patterns of specialisation. In addition, multiple equilibria are also possible. As a result of small differences in the process or level of industrialisation, differences in growth may arise between trading countries, the rectification of which would call for policy intervention.

□ Given a situation of imperfect competition, there is, in principle, a possibility that state intervention might allow a country to increase its welfare beyond the level it could attain under free trade. International oligopolistic competition thus becomes a further cause of foreign trade. In markets such as these with a small number of competitors, there is a strategic interdependence between the firms involved. Price, investment and production decisions by one firm affect the decisions taken by the others.<sup>1</sup> Companies in markets such as these behave strategically by imposing certain restrictions on their own parameters of action in such a manner that their competitors' options are also constrained in their favour.

Since with increasing returns to scale the first company to establish itself in an international

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oligopolistic market creates an advantage for itself over other, "late-comer" suppliers, conquering a market position before one's competitors become strategically important. Government support might allow a firm in a particular country to induce a systematic weakening of the competitive position of foreign suppliers and thus cause "rent shifting", or indeed it might allow new local industries to be established ("rent creation"). In both cases monopolistic and oligopolistic rents would arise for the domestic companies. By means of a protectionist policy such as subsidising exports and restricting imports, the access of foreign companies to strategically relevant markets could be impeded and an increase in national welfare effected. This assumes that the gains achieved in the companies involved exceed the costs incurred by government policy. Strategically relevant sectors in this sense are those with a high rate of product innovation and a correspondingly high level of research expenditure.

### Objections

The question as to whether the theory of strategic trade policy provides a basis for protectionist policies is quite a controversial one even for industrialised countries. The chief counter-arguments can be summarised as follows:

□ Slight alterations in the premises in the partial-equilibrium models of strategic trade policy fundamentally change the outcome so that it becomes difficult to work out the appropriate strategic measures for individual countries.<sup>2</sup> Under certain conditions a subsidy can reduce production, for example, or an export duty may prove to be the optimum strategy.<sup>3</sup>

□ There are information problems which could lead to measures being completely off target.<sup>4</sup> This is particularly true when estimating how high a subsidy needs to be to oust foreign competitors from a market. Subsidies that are too low will not cause rent shifting, whilst subsidies that are too high favour the development of excess capacity if market entry is possible for other domestic suppliers. Both cases lead to a loss of welfare. A further information problem occurs in trying to assess the welfare losses arising as a result of the resources taken away from other sectors to establish the strategic sector – another factor which has to be taken into account. Inaccuracies can easily creep in, however, and could lead to net losses of welfare.

□ Two further assumptions, relating to the attitude of the foreign country and the size of the market, are also

problematic. If the foreign country takes retaliatory action the welfare of both countries can fall. The size of the market, on the other hand, can grow as a result of strategic production decisions, allowing welfare to increase without the competition having to be crowded out.<sup>5</sup>

□ Strategic trade is also problematic for political reasons.<sup>6</sup> The pressure of organised groups and the demands made by other sectors would encourage "rent-seeking" and replace the market as a guiding mechanism in resource allocation by purely political allocation decisions.

These objections suggest that, from a welfare point of view, free trade is superior to strategic trade policy. In practice, however, politicians resort to strategic trade policies again and again – and often meet with public approval for doing so.<sup>7</sup> Paradoxically this behaviour by policy-makers is understandable in the light of the objections to strategic trade outlined above. As tough as the requirements may be for welfare gains in individual economies through strategic trade, situations which fulfil the conditions specified in the models may nevertheless occur in the real world. Whether it would be appropriate to pursue strategic aims in a particular situation would thus have to be proven in each concrete case. Since information problems make it virtually impossible to calculate the exact benefits and costs of a strategic policy, enough scope remains for controversies over how advantageous the measures might be and how they should be implemented, and the controversies then have to be settled politically rather than economically. Strategic trade thus becomes an important political instrument for winning elections and satisfying political clients. So one can hardly expect politicians to relinquish strategic trade, especially as they can always resort to the argument that, "If we don't do it, somebody else will!"

<sup>1</sup> D. A. Irwin: *Against the Tide, An Intellectual History of Free Trade*, Princeton, N.J., 1996, p. 207.

<sup>2</sup> *Ibid.*, pp. 215-216.

<sup>3</sup> J. Eaton, G. M. Grossman: *Optimal Trade and Industry Policy Under Oligopoly*, in: *Quarterly Journal of Economics*, Vol. 101, 1986, pp. 383-406.

<sup>4</sup> W. Kösters: *Neue Wachstumstheorie und neue Außenhandels-theorie, Frische Argumente für eine staatliche Industriepolitik?*, in: *WiSt*, No. 3, 1994, pp. 117-122, (p. 121).

<sup>5</sup> F. Stewart: *A Note on "Strategic" Trade Theory and the South*, in: *Journal of International Development*, Vol. 3, No. 5, 1991, pp. 467-484, (p. 472).

<sup>6</sup> W. Kösters, *op. cit.*, p. 122.

<sup>7</sup> H. Heinemann: *Neue Außenhandelstheorie – Basis für eine strategische Handelspolitik?* in: R. H. Hasse, W. Schäfer (eds.): *Die Weltwirtschaft vor neuen Herausforderungen, Strategischer Handel, Protektion und Wettbewerb*, Göttingen, 1994, pp. 17-31, (p. 27).

### Applicability to Developing Countries

Thus it is fair to assume that industrialised countries will not readily relinquish strategic policies. The question is whether this kind of policy is feasible and appropriate for developing countries too. These countries are generally granted less scope for strategic trade and the pursuit of strategic goals is considered not to be worthwhile for them, for a number of reasons. The small size of markets in developing countries is often pointed out as a chief impediment to strategic policies.<sup>8</sup> A large domestic market is often a prerequisite for the development of internationally competitive new products. Furthermore, in the case of strategic industries (for example, aircraft construction) the domestic market in developing countries is particularly small and direct production for the world market involves high risks. Apart from which the small size of the domestic market would make the developing countries easy prey to retaliatory measures from industrialised countries on account of their lack of credibility.

The technological and resource requirements in strategic industries present a further problem. The returns to scale in strategic industries are often based on an extremely high R&D input, making production in these sectors very human-capital-intensive. Yet such sectors are one particular area in which developing countries lack any comparative advantage over industrialised countries.

Nevertheless, the larger of the developing countries or newly industrialised countries (NICs) cannot be denied a certain scope for strategic trade. In terms of their market size and technological abilities, countries such as Brazil, India or South Korea display properties which would allow them to pursue strategic aims in certain sectors. In the case of niche products in the high-tech sectors (for example, data-processing software) and a number of products for markets in developing countries these countries could be expected to have a fair chance of successfully pursuing strategic goals.

One way of solving the problem of a smaller-sized domestic market and a low human capital endowment clearly lies in economic integration among the developing countries. Classic integration concepts do not provide any help here if member countries are all at the same stage of development and membership would therefore offer hardly any improvements in the fields under discussion here. However, given the process of differentiation that has been taking place among the developing countries, a form of regional integration the author terms "centric

integration" may provide an opportunity for them. This involves several less-developed countries joining forces with one or a number of advanced NICs to form a regional economic community. The concept<sup>9</sup> is based on the idea that whilst the NICs provide the less-developed member countries with a market, at the same time they can also use the latter as a hinterland for farming out their labour-intensive industries. By attracting capital- and human-capital-intensive direct investment from industrial countries the NICs can accelerate the growth process in their own economies. An integration concept of this kind would enable the regional economic bloc to trade strategically. Thanks to the membership of the NICs, small markets and low human capital would largely cease to be significant barriers to strategic trade.

But the smaller developing countries too can pursue strategic goals in terms of the selection and targeted promotion of products, companies or sectors. Countries in East Asia, particularly South Korea and Taiwan, have in the past systematically and successfully used the strategy of "picking winners" for the purpose of industrialisation. This approach differs from classic strategic trade in as far as new industries are not established in highly oligopolised high-tech sectors for the purpose of rent creation or rent shifting, but in order to conquer world market shares in more traditional areas where the country has a potential comparative advantage.

In Taiwan, for example, the basis for the country's industrialisation was provided by establishing the textile and garment industry while maintaining a flexible attitude towards changing world market conditions.<sup>10</sup> This kind of active export promotion sets off two growth-promoting mechanisms: the pressure to import technology and to innovate, and the participation in world market competition. Whilst strategic trade (rent creation and rent shifting) only makes sense if the owners of the companies promoted are based domestically,<sup>11</sup> it is of particular advantage in the case of active export promotion if joint ventures are pursued with foreign-based firms for

<sup>8</sup> A. Alam: The New Trade Theory and its Relevance to the Trade Policies of Developing Countries, in: *The World Economy*, Vol. 18, No. 3, 1995, pp. 367-385, (p. 380); F. Stewart, op. cit., p. 473.

<sup>9</sup> R. Shams: Regionalisierung der Weltwirtschaft und zentrische Entwicklung, in: *Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik*, (42nd annual ed.), Tübingen 1997, pp. 29-50.

<sup>10</sup> B. Chen: Picking Winners and Industrialization in Taiwan, in: *The Journal of International Trade and Economic Development*, Vol. 5, No. 2, 1996, pp. 137-159.

<sup>11</sup> R. Ramkissoon: Strategic Trade Theory in the Context of Small, Less Developed Countries: Some Considerations, in: *Journal of World Trade*, Vol. 26, No. 3, 1992, pp. 74-83, (p. 78).

the purpose of technology transfer and marketing abroad.

Since markets in developing countries tend to have an oligopolistic structure and many firms are inefficient, particular care has to be taken when selecting companies and products or sectors for export promotion. This not only requires sound economic judgement by politicians but also entrepreneurial skills and the willingness to take risks in order to break out of the status quo to recognise future markets and act decisively.

In this particular form of "strategic" trade policy for developing countries, protectionism serves the purpose of promoting exports, not of import substitution as in the past.<sup>12</sup> Whilst with classic import substitution, trade-policy, industrial-policy and especially macro-economic instruments were used in a way that systematically weakened countries' capacity to export, the protection involved in export promotion aims to reinforce the exporting capability of domestic companies and to expose them directly to competition on foreign markets.

### Implications of the New Growth Theory

In addition to new trade theory, some possible starting points for justifying protectionist measures are also offered by new growth theory. Its key feature is that knowledge is regarded as a factor of production in its own right, alongside capital and labour. Although the numerous models established in the field of new growth theory differ from one another to varying degrees, the crucial point is that they all involve the creation of positive externalities when knowledge is produced, generating increasing returns to scale and counteracting any tendency of the growth process to tail off.<sup>13</sup> In other words, the fact that they have endogenised technological progress places the new theories in contrast with neo-classical growth theory. In the models that incorporate the accumulation of knowledge via human capital formation, apart from the increased productivity of the individuals concerned there is also an improvement in overall educational standards, thus enhancing the productivity of all factors of production. In the models that regard private-sector R&D activity as crucial to

the production of knowledge, it is assumed that firms will not be able to keep all of the results of research to themselves via patents and other intellectual property rights, thus also creating a spin-off of increased productivity in other firms and other sectors.

One implication of immediate producers' inability to claim ownership of all of the fruits of their investment in the production of knowledge is that the level of their investment will remain below what is socially desirable. That is the theoretical justification for an industrial policy on the part of governments. The theory is that by subsidising private-sector R&D activity, for example, the state might be able to ensure the attainment of the socially optimum production of knowledge.

### Objections

The objections to a justification of industrial policy on the basis of new growth theory are similar to those relating to new trade theory. The application of certain instruments, such as subsidies to encourage output of particular technology-intensive sectors, may in some circumstances generate counter-productive effects. One example of this would be the creation of a drain of human capital out of the research sector into those receiving the state subsidies, which would result in a diminished rate of innovation on a macro level. Conversely, in the trading partners purchasing the subsidised industry's products the migration of expert personnel would occur in the opposite direction, towards the research sector, thus enhancing the rate of innovation there.

In addition, in parallel to the case of strategic trade policy, an interventionist growth policy suffers from information problems regarding the nature and magnitude of the losses generated in other areas due to the withdrawal of resources to fund subsidies, and regarding the extent of private-sector R&D activity, thus making it difficult to calculate accurately how high the subsidies ought to be pitched. Another problem that applies in a similar way is the likelihood that interest groups will bring their influence to bear. On top of that, no empirically backed consensus has yet been built up as to whether the positive externalities created by private-sector R&D are great enough to justify the payment of subsidies.

On the other hand, the information problem is frequently exaggerated.<sup>14</sup> In reality, knowing exactly what effects have been triggered off by an intervention is not as important as keeping a close and constant eye on the market processes it has generated, and being prepared to respond flexibly to

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<sup>12</sup> Ibid., p. 80.

<sup>13</sup> R. Shams: Investment, Finance and the New Theories of Economic Growth, in: B. Fischer (ed.): Investment and Financing in Developing Countries, Baden-Baden 1994, pp. 10-29.

<sup>14</sup> B. Herbert-Copley: Capture, Drift and Learning: The State and Industrial Policy in Developing countries, in: Canadian Journal of Development Studies, Vol. XV, No. 3, 1994, pp. 347-368, (p. 352).

them to correct potential adverse developments. In any case, particularly in a developing-country context, one cannot necessarily expect markets to respond more swiftly and more efficiently in all circumstances than a government committed to economic growth. The virtually indisputable successes achieved in East Asia show that the information problem can be regarded as soluble, in principle at least.

Developing the ideas of Coase, Grubel<sup>15</sup> has pointed out that positive externalities can be internalised by efficient institutions (known as "Coase institutions"), thus obviating the need to take any industrial policy measures for this purpose. Industrial federations, high-tech centres, technology parks, information centres, etc. serve as examples of such institutions when it comes to the positive externalities of technology production. However, setting up such institutions itself calls for resources, or else it may involve high transaction costs. In such cases, government support may sometimes be necessary to found the institutions the economy requires. This boils down to a more subtle form of industrial policy than what is normally signified by the term.<sup>16</sup>

#### Applicability to Developing Countries

A general conclusion from these considerations would be that, although new growth theory does provide a justification for industrial policy in principle, once again the preconditions tend to be rather too restricted in practice. As far as the developing countries are concerned, though, this view needs to be modified for a number of reasons. First of all, except in a small number of NICs private-sector R&D activity is often still further below the social optimum than in the industrial countries, largely for institutional reasons. Secondly, seen in terms of the significance of human capital formation for economic growth, the deficiencies are far greater than they are in the industrial countries. To that extent, the necessary conditions to justify government support for technology and human capital formation are better fulfilled in the developing than in the industrial countries.

Another of the reasons put forward to justify industrial policy in developing countries is built around the phenomenon of coordination failure. One of the important findings of recently published research on externalities and increasing returns to scale at the manufacturing stage is the possibility that multiple equilibria may exist.<sup>17</sup> One source of externalities might be the interplay of increasing returns to scale and market-size effects, while another might be

interdependence among different sectors of the economy. When multiple equilibria exist, a country could get stuck at a low level of national income. This might simply be due to historical chance, or else it could have to do with the pattern of expectations. In such cases, a government industrial policy is needed to move the economy up to a higher equilibrium. The most suitable strategic industries are those involving a lot of interlinkages both within the industry and with others, thus allowing firms to succeed on the foundations laid by the success of others.<sup>18</sup>

Coordination failures of the type referred to above can crop up elsewhere, too, and not just on the threshold to industrialisation. If we were to assume that all the goods produced were arranged in a three-stage hierarchy from labour-intensive via capital-intensive to R&D-intensive, either of the two transitions from one stage to another might necessitate industrial or trade-policy measures. Chile is a fitting current example, as this country's present extensive economic growth has so far been largely built around resource-based exports. Whether or not the country succeeds in adapting the growth process to place greater emphasis on industries with a higher value added will crucially depend on factors such as what kind of support is given to that process by way of industrial and trade policy.<sup>19</sup>

The problem is that the use of protectionist measures to promote growth can in fact have negative growth consequences. For example, it may impair the use of knowledge available from abroad, leading to doubling-up of R&D expenditure. That in turn is damaging to growth in all countries engaging in trade with one another. The only situation in which this drawback would not apply would be if the externalities created by human capital formation and

<sup>15</sup> H. G. Grubel: Die neue Wachstumstheorie auf dünnem Eis, in: Neue Zürcher Zeitung, 29/30th November 1992.

<sup>16</sup> F. R. Hahn: Theoriegrundlagen moderner Industriepolitik, WIFO Working Papers No. 60, 1993, p. 26.

<sup>17</sup> P. R. Krugman: History versus Expectations, in: Quarterly Journal of Economics, Vol. 106, 1991, pp. 651-667; P. R. Krugman: The Current Case for Industrial Policy, in: D. Salavatore (ed.): Protectionism and World Welfare, Cambridge, 1993, pp. 160-179; K. Matsuyama: Increasing Returns, Industrialization, and Indeterminacy of Equilibrium, in: Quarterly Journal of Economics, Vol. 106, 1991, pp. 617-650; M. Okuno-Fujiwara: Interdependence of Industries, Coordination Failure and Strategic Promotion of an Industry, in: Journal of International Economics, Vol. 25, 1988, pp. 25-43; D. Rodrik: Coordination Failures and Government Policy; A Model with Applications to East Asia and Eastern Europe, in: Journal of International Economics, Vol. 40, 1996, pp. 1-22.

<sup>18</sup> P. R. Krugman: The Current Case ..., op. cit., pp. 176-177.

<sup>19</sup> D. Messner, I. Scholz: Wirtschaftliche Entwicklungsdynamik und Gesellschaftliche Modernisierungsblockaden in Chile, in: Nord-Süd aktuell, Vol. X, 1st quarter, Hamburg, 1996, pp. 126-138.

the accumulation of knowledge were only effective on a national scale, and were not transferable to other countries. If that were the case, a particular country's lead in the production of knowledge and accumulation of human capital would not be eroded over time, but would actually be enhanced by the nationally specific externalities. In a situation such as this, a strategic industrial policy ought to be pursued with a view to establishing dynamic comparative advantages in fields with an especially rich potential, thus launching the bid to catch up with more developed economies. It is fair to assume that institutional problems associated with the transfer of technological knowledge coupled with the generally low level of technology in many less developed countries mean that they hardly have a chance to make optimum use of the stock of knowledge available internationally.<sup>20</sup> In this situation, a differentiated industrial policy is indeed called for, to improve the conditions under which externalities can be internationally utilised.

The objection to industrial and trade-policy interventions that probably carries most weight is that they are liable to generate an increase in the political clout of interest groups and in the amount of rent-seeking activity in the economy. The two possible responses to this are to treat it as a crushing indictment of growth-oriented protectionist policy or to ask the supplementary question as to how rent-seeking might be avoided or at least minimised in spite of continuing to pursue the policy. Rodrik<sup>21</sup> believes that the key to resolving this issue lies in the fabric of relations between the state and the private sector. His hypothesis, which is backed up by the findings of a formal model, is that interventions initiated in an "autonomous state" work much better than those instituted in a "subordinate state". The former takes its economic policy decisions under its own auspices, and has the capability not only to commit itself to executing those decisions but also to enforce them. A subordinate state, on the other hand, simply follows the private sector's wishes rather than providing leadership to it.

Of course, this distinction between autonomous and subordinate states does not provide us with an insight into why some states possess such autonomy and others do not. As it seeks to maximise its objective function, the autonomous state assesses the likely reactions of private-sector economic actors when choosing its instrument variables. However, if it wishes to prevent rent-seeking the state needs to go one step further and to ensure that its ultimate

objective is based on the welfare of society as a whole and not on the particularised interests of certain of its citizens.

In other words, for rent-seeking to be avoided the state not only needs to have the capability to assert its own policies, but those policies must also be geared to overall welfare. Rodrik believes it is possible to ensure these conditions are met by carrying out institutional improvements.<sup>22</sup> For example, he presumes that the establishment of uniform import tariffs would enable the state to assert its independence against particularised interests. However, there are two main problems with this assumption. Firstly, any state in a position to establish uniform tariffs would already be an autonomous state, rather than one which needed to improve its situation in this respect. Secondly, one of the means of defining the degree of autonomy a state has attained is its very capacity to institute differentiated measures where necessary. As Rodrik himself points out in a further enquiry into the conditions under which exports have been successfully subsidised in six different developing countries, the most successful instances were "... highly complex and selective, differentiated by firm, subject to frequent changes ... On the other hand, the least successful programs ... consisted of simple, across-the-board, and non-selective subsidies."<sup>23</sup>

As it happens, the politico-economic analysis of the preconditions for success in governmental development policy has also provided some more differentiated responses as to how rent-seeking might be avoided.<sup>24</sup> First and foremost, government policy has to be geared to the welfare of society as a whole and not to the satisfaction of politicians' or the bureaucracy's own interests. This is by no means a self-evident state of affairs, and one can only expect it to come about if the state, for want of any other, perhaps traditional, anchor-holds within society, actually needs to be committed to society's welfare in order to secure its political legitimation. This can be

<sup>20</sup> R. Shams: *Investment, Finance ...*, op. cit., p. 19.

<sup>21</sup> D. Rodrik: *Political Economy and Development Policy*, in: *European Economic Review*, Vol. 36, 1992, pp. 329-336.

<sup>22</sup> *Ibid.*, p. 335.

<sup>23</sup> D. Rodrik: *Taking Trade Policy Seriously: Export Subsidization as a Case Study in Policy Effectiveness*, NBER Working Paper No. 4567, 1993, p. 7.

<sup>24</sup> R. Shams: *Hemmnisse der wirtschaftspolitischen Reformpolitik in Entwicklungsländern*, in: H. Sautter (ed.): *Wirtschaftspolitische Reformen in Entwicklungsländern*, Schriften des Vereins für Socialpolitik, new series, Vol. 209, Berlin 1991, pp. 135-154; R. Shams: *IMF, Weltbank und Anpassungskonflikte in Entwicklungsländern*, in: *Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik*, (37th annual ed.), 1992, pp. 245-261.

assumed to have been an essential factor in the primacy attached to growth policy in the first generation of newly industrialised countries in East Asia, particularly in South Korea.<sup>25</sup>

Whether or not the state will be able to stick to and assert its growth objectives depends crucially on the nature of its relations with the other major groups in society. The particular constellation of groups that defines these relations is invariably the product of historical developments. At any one point in time, a certain group constellation may facilitate a form of economic policy which, by way of its cumulative effects over a relatively long period, will in turn alter the structure of the groups involved and hence lead to a new group constellation: so the constellation of groups is subject to fundamental change over time. Favourable conditions for the state to assert its policies often arise at a time when persisting economic crises have engendered a broad consensus among the relevant societal groups that growth policy must take top priority. This consensus permits the enforcement of growth-policy measures even when it is impossible to clearly define the state's power position vis-à-vis other societal groups as autonomous or subordinate. In fact, more recent enquiries have shown that, in countries such as South Korea, private-sector firms tended not simply to take orders from the government, but played a leading role in a good many key government decisions.<sup>26</sup> Once such a consensus has been established, all of the societal groups involved have the opportunity to monitor one another and to work together, and one of the results of this would be to restrain rent-seeking activity.

Not so much for the sake of avoiding rent-seeking but for that of ensuring government interventions are properly implemented, another necessary condition in addition to growth-orientation and consensus is the existence of a capable administrative apparatus. However, once the first two conditions have been met it ought in principle to be possible to set up such an administrative apparatus. The problem is that the organisation and structure of the administrative apparatus also have consequences for the incidence of rent-seeking. Specialised bureaucracies can rapidly turn into inflexible ones that block progress if, partly by virtue of their very suitability to their original tasks, they are no longer capable of adapting to

necessary changes. The pursuit of the bureaucracy's own interests may then easily take the place of the pursuit of the government's objectives.<sup>27</sup> Another danger is that the bureaucracy may soon become over-inflated in size and, with its own internal momentum that it is very difficult to slow down, that it will lay claim to more and more resources, with all the opportunity costs that entails.

Thus growth orientation, consensus and an efficient administrative apparatus can be taken to be the key conditions for successful industrial or trade policy interventions. Structural adjustment policies endeavour to establish such conditions in developing countries. Yet at the same time, liberalisation policies do everything in their power to roll back the influence of the state over the economy, confining its role to one of staking out the framework for economic activity. The paradoxical upshot is that, while this improves the likelihood that industrial or trade-policy interventions might be successful, governments are expected to deliberately refrain from instituting them.

## Conclusions

The new trade and growth theories provide a number of arguments in favour of industrial or trade-policy interventions. However, because of the exacting conditions that need to be met to ensure such interventions are worthwhile, or because they are felt to do more harm than good, this course of action is often rejected. Yet a number of successful instances can be pointed out which are sufficient to call into question any blanket rejection of government intervention. This article has endeavoured to examine how the conditions for applying industrial or trade policy measures might be improved in a developing-country context or, in other words, how the criticisms voiced by opponents might be taken into account by designing such measures more effectively.

As regards new trade theory, the position can be summed up by stating that the pursuit of strategic objectives does appear theoretically justified under very strict conditions, but the scope for applying such measures in the real world is inevitably limited, and the welfare gains obtainable are barely significant. Among the developing countries, only certain newly industrialising countries might, under certain circumstances, be advised to pursue strategic trade objectives. For other developing countries, the chances of engaging in strategic trade would be improved by their participation in "centric" economic integration. Given the relatively constrained pre-conditions, deciding whether to take such a step in

<sup>25</sup> R. Shams: *Regionalisierung*, op. cit.

<sup>26</sup> P. Köllner: *Der Aufstieg und Niedergang des "Entwicklungsstaates" in Südkorea*, in: *Nord-Süd aktuell*, 3rd quarter, Hamburg, 1996, pp. 482-498 (p. 485).

<sup>27</sup> B. Herbert-Copley, op. cit., p. 351.



practice is ultimately a matter of weighing up potential costs and benefits.

For developing countries, a far more important matter than strategic trade is the pursuit of an active export-promotion policy to build up dynamic comparative advantages. A policy of this kind involves selecting the instruments that are appropriate in the particular conditions prevailing, rather than according to any doctrinaire criteria (e.g. do they always strictly conform to market principles or not?). The instruments should be applied determinedly but with a flexible approach, allowing learning effects to take place and improvements to be made. This has been the approach taken by East Asian countries. Experience in these countries has shown that it is misleading to regard the market and government as mutually exclusive alternatives for policy-making purposes. A determined yet flexible interplay between the two institutions is what really brings results in breaking through development barriers and accelerating development processes.

As in the case of new trade theory, the scope for applying the new growth theory via industrial and trade-policy interventions is limited on the whole. Depending on the particular conditions prevailing, using the usual instruments could prove counter-productive. However, a situation in which it does appear appropriate to pursue an active industrial policy is when technology and research clearly offer positive externalities that are not being internalised in some other way. In that sense, the conditions found in most developing countries are such that an active policy on technology and the development of human capital ought to be worthwhile. Coordination failure and the threat of being peripheralised may also justify industrial-policy measures in developing countries. However, it is essential when growth-promoting measures are taken that the danger of a misallocation of resources be minimised. Two possible ways in which that might be done are:

- ☐ by refraining as far as possible from taking direct government measures, and operating instead via Coase institutions,
- ☐ and avoiding rent-seeking by giving appropriate backing to governmental institutions.

By creating Coase institutions, the state only intervenes indirectly in market processes, by removing obstacles to the emergence of such bodies and promoting their establishment. However, because existing Coase institutions are not normally sufficient to completely internalise externalities,<sup>28</sup> a certain amount of scope does indeed remain for implementing direct measures. More detailed studies of East Asian countries, particularly of past industrial and trade policies pursued in Japan, South Korea and Taiwan,<sup>29</sup> do indeed show that direct government intervention was used in combination with the establishment of Coase institutions, especially as regards information-gathering and evaluation, and also technology promotion.

Promoting Coase institutions in itself serves to roll back the amount of rent-seeking occurring. On top of that it is necessary to strengthen government institutions to the same end. The prime, crucial condition is that a general consensus has to be built up on the importance of growth-orientation in government policy. Apart from sending clear signals to the private sector, this also ought to act as a key guiding standard for the activities of governmental institutions. The behaviour of the private-sector if it makes use of government financial assistance needs to be geared to strict performance criteria backed up by possible sanctions, thus ensuring there is a commitment to the growth objective as the strategic export-promotion policy is pursued. The government sector's own endowment of human capital is also crucially significant in this context.

As multilateral trade liberalisation under the auspices of the WTO continues, the scope for individual countries to pursue industrial or trade policies can be expected to grow ever tighter. Yet that is not to say that multilateral liberalisation has rendered growth and development-oriented government intervention obsolete. For an economy to integrate successfully into the world market, the government needs to pursue an active policy of export promotion, technology transfer and human capital formation, while also coping with coordination failures and resisting the threat of peripheralisation. Just as it would be absurd to abandon the market altogether when market failure is found to have occurred, so too government failure cannot be used as a justification for the complete withdrawal of the state from economic affairs. What needs to be done is to strengthen the role of the market with the aid of institutional innovation, while simultaneously ensuring that government bodies function more efficiently in those areas where their activities are indispensable.

<sup>28</sup> F. R. Hahn, *op. cit.*, p. 29.

<sup>29</sup> B. Herbert-Copley, *op. cit.*; UNCTAD: Trade and Development Report, New York, Geneva, 1994; J. Meyer-Stamer: Kompetenter Staat, wettbewerbsfähige Unternehmen: die Schaffung dynamischer komparativer Vorteile in der ostasiatischen Elektroindustrie, in: Nord-Süd aktuell, 4th quarter, Hamburg 1991, pp. 567-577; P. Köllner, *op. cit.*