Optimal framework for state-business relations

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The relative roles of governments and markets have always been an area of fundamental importance in economic theory and policy. For too long, economists were trapped in the false dichotomy that opposed the market and its 'invisible hand' and its planning and implementation capabilities. From Adam Smith's laissez-faire to Keynesian interventionism, from the old structuralist school to neoclassical economics, the pendulum has swung from one extreme to another, generating many intellectual controversies and many policy failures across the developing world.

With the emergence of new growth theory, new trade theory and new institutional economics, significant advances have been achieved towards a systematic comparison of market and governments (or centrally operated mechanisms – Acemoglu et al., 2008). A broad consensus has emerged in recent years that both states and markets play a key role in the transformation of all economies – especially developing ones. It is now widely accepted that even the most advanced economies need constant and strategic state action to support and regulate private businesses and help generate and disseminate on a large scale the technological progress that sustains economic growth (Aghion, 2009; Romer, 1990). However, despite intellectual progress in building modelling tools for assessing economic performance in various systems, economic theory is still struggling to offer a convincing and practical policy framework to maximise the potential of public and private agents. This note draws on recent work on a new structural approach to economic development and outlines a path towards an optimal framework for state-business relations (SBRs) (Lin, 2009, 2010; Lin and Monga, 2010).

The main theoretical justification for government intervention in economic development is twofold: the need to account for externalities beyond the realm of any individual firm and the need for coordination.

Industrial diversification and upgrading is a process of innovation, in which pioneering firms generate public (non-rival, non-excludable) knowledge for other firms in the economy. That is, consumption of the new knowledge by one firm does not reduce its availability for others, and no-one can effectively be excluded from using it. Adequate public compensation is desirable for the information externality that the pioneer firms generate. Meanwhile, in most cases improvements in infrastructure, both hard (such as transportation) and soft (such as financial and legal institutions), cannot be internalised in an individual firm's investment decision, yet they yield large externalities to other firms' transaction costs. The idea that some business activities exhibit externalities that increase with the size of the industry and that arise through localised industry-level knowledge spillovers, input-output linkages and transportation costs has been well documented (Harrison and Rodriguez-Clare, 2010). This can give rise to geographic concentration and labour pooling among firms in the same industry (Krugman, 1991; Marshall, 1920).

As a country climbs up the industrial and technological ladder, many other changes take place: the technology its firms use becomes more sophisticated and capital requirements increase, as does production scale, Markets grow and transactions increasingly take place at arm's length. A flexible and smooth upgrading process therefore requires simultaneous improvements in educational, financial and legal institutions and hard infrastructure, so that firms in the newly upgraded industries can produce sufficient amounts to reach economies of scale. Clearly, individual firms cannot internalise all these changes cost-effectively, and spontaneous coordination among many firms to meet these new challenges is often impossible. A change in infrastructure requires collective action or at least coordination between the provider of infrastructure services and industrial firms. It falls to government either to introduce such changes itself or to coordinate them proactively. Thus, on top of an effective market mechanism to allocate resources at each stage of economic development, government needs to play an active facilitating role in the industrial diversification and upgrading process and in the improvement of infrastructure.

The general concern with state involvement in economic development is its propensity to create suboptimal business arrangements and practices, inefficiencies and costly

distortions that open the way to rent seeking. In this context, establishing successful SBRs requires an appropriate policy framework which allows the state to support industrial development and technological upgrading but also minimises opportunities for rent seeking.

Countries that succeed in adopting and implementing such frameworks are those where government's industrial development goal is consistent with its comparative advantage, which reflects the accumulation of human and physical capital and the change in its factor endowment structure. When firms choose to enter industries and adopt technologies that are consistent with the comparative advantage determined by the country's factor endowments, they are viable in an open, competitive market and the economy is most competitive. As competitive industries and firms grow, they claim larger market shares and create the greatest possible economic surplus in the form of profits and salaries. Reinvested surpluses earn the highest return possible as well, because the industrial structure is optimal for that endowment structure. Over time, this strategy allows the economy to accumulate physical and human capital, upgrading the factor endowment structure as well as the industrial structure, and making domestic firms more competitive over time in more capital- and skills-intensive products. As new firms in the process are viable, the role of the state in industrial diversification and upgrading is limited to providing information about the new industries, coordinating related investments across different firms, compensating pioneer firms for information externalities and nurturing new industries through incubation and encouragement of foreign direct investment (Lin, 2009; Lin and Chang, 2009). Large subsidies and protection for new firms are not required. Opportunities for rent seeking and other distortions are therefore limited.

Such an approach to SBRs rejects conventional import substitution strategies that rely on the use of fiscal policy or other distortions, in low-income and labour- or resource-abundant economies, to develop high-cost, advanced, capital-intensive industries that are not consistent with the country's comparative advantage, with firms in these priority industries not viable in an open, competitive market.

Following the economy's comparative advantage will also allow developing countries to tap into the potential advantage of backwardness. At each stage in their development, firms can acquire the technologies (and enter into industries) that exist in more advanced countries and that are appropriate for their endowment structure, rather than having to reinvent the wheel (Gerschenkron, 1962; Krugman, 1979). This use of off-the-shelf technology and entering into existing industries has allowed some of the East Asian newly industrialised economies to sustain annual gross domestic product (GDP) growth rates of 8% and even 10% for two or even more decades, and is being emulated successfully by many other countries around the world.

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