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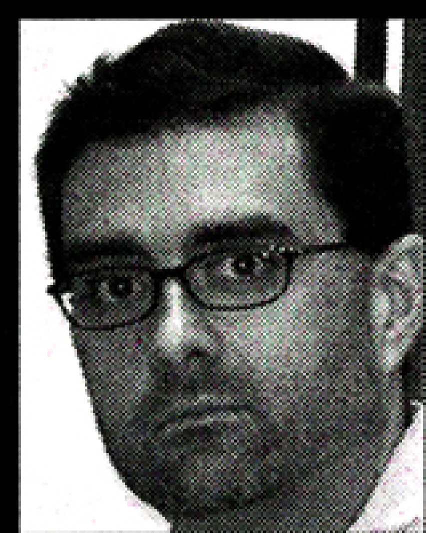
The current state of industrial policy in P.R.



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Commentary

Industrial policy is defined as any government initiative that (I) stimulates specific economic activities, (II) promotes structural change from low productivity to higher productivity activities, and (III) foments the change from traditional activities to more dynamic activities, regardless of whether those activities are located within industry or manufacturing per se.

Therefore, policies targeted at non-traditional agriculture or services qualify as much as incentives for manufacturing. Industrial policies became popular in the early post WWII years and this is, to a large extent, Fomento's mindset today.

The traditional case for industrial policy is based on the fact that the world is full of market failures and strong government intervention is necessary to overcome poverty traps.

In general, there are two principal forms of market failure. The first type of market failure regards coordination failures, which occur when the return on one investment depends on whether some other investment is made. For example, building a hotel near a beautiful beach may be profitable if somebody builds an airport. Thus, coordination failures are traditionally solved through direct government investments or guarantees.

The other typical kind of market failure regards information spillovers. This occurs because the process of finding out the cost structure for the production of new goods is fraught with uncertainty.

The first mover will find out whether something is profitable or not, if it is he is copied by other entrants, if he fails he bears the whole loss. Thus, private returns are lower than the social benefits and the market incentives for these activities are inefficiently low. Information failures usually require government subsidies to promote investment in new industries.

Industrial policies traditionally have been subject to a number of critiques. First, government failure is worse than market failure. Governments usually put in place expensive programs and unwieldy bureaucracies that are very difficult to modify or eliminate later on.

In addition, governments are not good at picking winners because market imperfections are rarely observed directly, and industrial policies are usually implemented by bureaucrats who have little capacity to identify where the imperfections are or how large they may be. Finally, bureaucrats are supervised by politicians who are prone to corruption and rent-seeking by powerful groups and lobbies.

Proponents of these critiques argue that governments should limit themselves to ensuring property rights, enforcing contracts, and providing macroeconomic stability. The market would take care of the rest.

Reality has not been kind to either set of expectations. On the one hand, import substitution, planning and state ownership did produce some successes but where they got entrenched and ossified over time they led to colossal failures and crises.

On the other hand, economic liberalization, deregulation, and opening up benefited export activities, financial interests, and skilled workers but produced growth rates far short of what was expected.

Currently, industrial policy in Puerto Rico is an anachronistic, top-down process where government believes it can pick and choose winners successfully and is still based on the old model of government intervention as the first-best solution for everything.

Our economic institutions simply have become entrenched and ossified over time. The policy process also lacks transparency.

The current process for designing the new industrial incentives law is dominated by a small group of private sector interests working behind closed doors. This is the opposite of what is needed: large representation of private sector groups participating in an open, transparent process.

The new thinking on industrial policy today is that it is critical to get institutions "right" before thinking of specific policies. According to Harvard professor, Dani Rodrik, a first-best policy in the wrong institutional setting will do considerably less good than a second-best policy in an appropriate institutional setting.

It is necessary to think of industrial policy as an interactive process of strategic cooperation between the private sector and government; which on the one hand, serves to elicit information on business opportunities and constraints and, on the other hand, generates policy initiatives in response. The challenge is to find a middle ground between full autonomy and full embeddedness for bureaucrats. Too much autonomy for the bureaucrats and you minimize corruption but fail to provide what the private sector really needs. But if bureaucrats become too embedded, then they may end up in the pocket of business interests.

Given the current state of thinking about industrial policy we suggest the following principles to guide the new policy in Puerto Rico. First, any incentives should be provided only to new activities. New refers to both products that are new to the local economy and to new technologies for producing an existing product. Second, there should be clear criteria for determining success or failure. The important thing for the government is not to pick winners, but to know when it has a loser. Third, it is important that the new law have a built-in sunset clause. Sunset clauses ensure that resources are not tied up for a long time in activities that are not paying off. Finally, it is necessary to establish open, permanent, transparent channels of communication between the government and the private sector.

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