

7 The Political Economy of Policies for Structural Change: A Cautionary Note

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Virtually all developed societies are now adopting or contemplating government policies to encourage structural change. Such measures, once called “industrial policy” (often with scorn), are now widely promoted as attempts to encourage transition toward a more climate-friendly economy, rebuild an industrial base, enhance national security, and perhaps combat the growth of populist sentiment.

Whatever the welfare goals and implications of such policies in principle—and here I take no position on their desirability—in practice their impact will depend on the political economy within which they are devised and applied. These policies will be devised and implemented in the cauldron of national and international politics, subject to the same political pressures as other policies. They can be blocked or captured by powerful special interests, and policies as implemented may diverge from what was intended, or expressed, by their designers. Politicians charged with adopting and implementing policies to effect structural transformation face the same incentives as politicians in other policy areas.

Structural economic change creates winners and losers and thus provokes political conflict. Government policies to speed, reinforce, alter, or impede the path of structural transformation are likely to be just as rife with conflict. Those who want to understand such transformations, and those who want to play a role in the policy processes that affect them, need a clear sense of the political forces at work, and of the political institutions through which those forces operate.

Analyzing Policies for Structural Transformation

One of the more striking structural economic changes of recent times occurred when inexpensive products from rapidly developing countries flooded into developed countries. The imports wreaked havoc with leading sectors of these economies, displacing tens of millions of working people and creating a powerful political backlash that was felt for decades.

This onslaught of cheap farm products from rapidly developing regions to Europe in the late nineteenth and early twentieth centuries prompted 50 million Europeans to move into Europe's cities and another 50 million to emigrate to the western hemisphere and elsewhere. As Charles Kindleberger (1951) noted, European governments chose one of four paths for the farm sector: liquidate it, protect it, encourage farmers to emigrate, or facilitate the sector's modernization. Only Denmark chose the last option, even though it was a model of how to encourage structural change. These choices, Kindleberger argued, reflected the preferences and degree of organization of relevant interest groups, and the social and political institutions of the countries in question.¹ Although he focused on structural transformation driven by exogenous events, the general method of political economy analysis helps us think about today's focus—policies for structural change undertaken purposefully by national governments.

All policies are developed and implemented by politicians subject to political and political-economic pressures. This is true even of policies for which there is some consensus, as there are often disagreements about the details—and even about the overall direction—of policy and implementation. Policies to promote structural change are no exception, and we can reliably expect that powerful economic interests will attempt to mold policies in their favor, politicians will be alert to the implications of policies for their own futures, and the character of political institutions will color the policies that emerge from the policymaking process. Powerful actors, political incentives, and political institutions all affect the ways in which structural policies are designed and put into effect.

Recent government policies to encourage reindustrialization, spur the use of artificial intelligence (AI), or catalyze a transition toward a green economy—again, broadly grouped under the rubric of industrial policy—merit close attention, viewed through the lens of political economy. This analysis is at least as important as the purely economic nature of the design

of such programs, especially for those interested in understanding whether these policies will achieve their goals—as well as for those who promote the policies with these goals in mind.

Actors and Their Interests

First-best policies based on some welfare criterion may be politically infeasible. To explain policies that are *actually* adopted—and, perhaps, why they deviate from a notional first best—we need to pay close attention to political conditions. This is true for outside observers, especially for those engaged in policy debates with the goal of achieving their most desirable, *politically obtainable* outcomes.

Political-economy constraints on structural policies start with the most important actors and their preferences, especially interest groups and politicians. Political economists tend to be cynical—or realistic—in expecting that if special interest groups can capture economic policies, they will do so. This is true even of policies to provide public goods. Indeed, while the *consumption* of public goods is public, their *production* is often private—and the private producers often stand to benefit handily (Aranson and Orde-shook 1985 is a classic statement). After all, there are many possible ways to deliver a public good, such as a transportation network. Some ways benefit automobile firms more, others locomotive producers more, and still others highway construction companies more. It is common lore in American political economy that construction contractors are a powerful force behind infrastructure development. Public goods can have differential benefits, and those who enjoy disproportionate benefits are more likely to mobilize in support of providing the public good than do the general public.

Powerful interests can capture the policymaking process, but interests vary in terms of the degree to which they care about policies and the extent to which they can influence them. Incumbents—industries, workers, or other groups comfortable with current conditions—typically find structural change a threat. After all, most structural transformations replace incumbents with new entrants—farmers with industry, industry with services—and incumbents do not want to be replaced.

Incumbent interests differ in terms of the extent to which structural change represents a challenge or an opportunity. Producers and heavy users of fossil fuels have a major stake in policies to address climate change: There

are substantial stranded assets in coal, oil, and natural gas. It seems clear that the green transition will devalue many of these assets significantly; their owners are likely to resist these structural policies and try to slow their impact. But some interests typically associated with major carbon emissions may be able to incorporate new policies and industrial structures into their plans: Much of the automobile industry, for example, has committed massive investments to hybrid vehicles and electric vehicles (EVs). Economic interests that can incorporate the new structural policies are less likely to oppose them and may try to mold policy to their advantage. At the limit, incumbent industries that can adapt to new climate policies may be willing and able to capture them and push them in directions most favorable to themselves (Frieden and Silve 2023).

Proponents of structural change often express the hope that new entrants will support policies to encourage the transformation. But in many—perhaps most—instances, those who might be new entrants do not know in advance that they will benefit from enabling policies. The common expectation that potential exporters will support trade liberalization, for example, often fails because it's not clear in advance exactly who the exporting winners will be. In climate policy, there are entrepreneurs already active in renewable energy, to be sure, but as the green transition progresses, there are likely to be many more, and the transition will undoubtedly create opportunities not yet fully understood or imagined.²

The experience of Import-Substituting Industrialization (ISI) in developing countries is instructive. In many instances, ISI was favored by industrialists whose activities had grown as the result of conditions outside their control. For example, the dislocations of two world wars and a great depression led many countries in Latin America to experience natural import substitution. When the world economy started opening again in the 1950s, the industries built up in the previous forty years often wanted and received protection. However, in the 1950s and 1960s, there were plenty of other instances, both in Latin America and in newly independent former colonies, of governments that undertook policies of import substitution in an attempt to stimulate the creation of industries that had not previously existed in their economies. Accordingly, the role of real or potential new entrants in supporting structural policies will vary in line with starting conditions, available information, and the reliability of projections about the future.

Changing the nature of economic activity affects specific interests, and it also affects the broad population. Although organized interests are more likely to affect policy than the mass public is, there may well be issues and instances when broad public opinion matters. There is little question that generalized dissatisfaction with economic performance helped bring down the Soviet Union; there are striking differences in national attitudes toward nuclear power. Policymakers—especially those who have to be elected, but even those who need at least some level of popular support—may not be able to ignore broad public attitudes.³

Some combination of special interests and public opinion is easily seen in the design of many of the policies currently being implemented or considered. Mass popular hostility toward taxation has meant that climate policy in most countries has made little use of carbon taxes despite overwhelming support from economists. Emissions trading systems also gain support from economic analysts as roughly as efficient as carbon taxes; but where they have been put in place, they have often been biased toward powerful and politically sensitive industrial interests (for some examples, see Dorsch et al. 2019; Patnaik 2020; and Melnick 2024).

One important issue in the politics of structural change is compensation. It is an established principle of public economics and political economy that if policies improve aggregate social welfare but create both winners and losers—as almost all do—the appropriate measure is to tax some of the winners to compensate the losers, allowing for a Pareto improvement. However, taxing winners is politically difficult, so those most negatively affected by structural change may be left behind. This reality is a major reason for the recent upsurge in what has been called a “backlash” against globalization (Broz et al. 2021; Frieden 2019). Where groups facing potential losses with structural transformation do not believe in government commitments to compensate them, opposition to these changes will be stronger—and vice versa.

The preferences of powerful economic interests may not be consistent with the goals of policymakers and others seeking to promote the broad economic purposes of structural policies. But serious analysis of the possibilities for policies to spur structural transformation, and policy proposals that hope to be adopted and implemented, must take the realities of distributional politics into account.

Political Organization and Political Institutions

Political-economy pessimism about the deviation of public policy from a normative welfare baseline is often explained by the fact that concentrated interests typically prevail over diffuse interests. Producers are concentrated; they can get valuable rents from protection or support, at the expense of disorganized consumers. This is certainly an accurate depiction of much of economic policymaking: Organized interests prevail over the disorganized.

The picture may not be so bleak in reality. Plenty of organized groups stand to lose from the rent-seeking policies of others. Downstream industries have an interest in keeping upstream suppliers from artificially raising prices, whether due to collusion or government policy. Political coalitions form all the time to bring together those with otherwise disparate interests: housing advocates, developers, and construction unions can all agree on the desirability of more expansive zoning regulations. Mass organizations somehow overcome problems of collective action to act as powerful lobbies, such as the AARP and the National Rifle Association (NRA) in the United States.

Another complaint about politicians, of particular relevance to thinking about structural policies, is that they focus too much on the short term. There is certainly plenty of evidence that policymakers fashion policies in the shadow of the next election—and there is always a next election (e.g., see Conconi et al. 2014). Certainly, politicians are central to the policymaking process, and their interests in getting elected and reelected can shorten their time horizons. A related concern is that policymakers are willing to adopt policies that benefit their constituents but that impose negative externalities on other constituencies. This may be regional: Politicians from one region may have little reason to worry if a job-creating industry at home is pollution-creating for the region next door. It may be functional: The representative of a steel-manufacturing region may support prohibitive tariffs without concern for their impact on the steel-using auto industry.

Short-term thinking and negative externalities are common in politics, but they can be counterbalanced by political institutions (Rickard 2015). Individual politicians may have limited lifespans—and limited time horizons—but political parties are often long-lived. While single politicians may have incentives to care only about their own future—and thus only about themselves, the next election, and their constituents—political

parties normally need more encompassing and long-lasting reputations. Political parties, especially in political systems with a stable party structure, can temper the particularistic interests of specific politicians in the interest of the party. Of course, many of the socioeconomic and political trends that have sparked interest in policies for structural change are also associated with the collapse of traditional parties and party systems, which may affect the design, adoption, and implementation of such policies.

Legislatures can also serve to both lengthen politicians' time horizons and address externalities. For legislation to pass, it requires broad support, and this can counteract the tendency of provincial legislators to be concerned narrowly, only for their constituents. By the same token, legislators and legislatures develop reputations, and a reputation for ignoring the common good and longer-term concerns can hurt all incumbent legislators.

Political institutions that encompass broader regional, economic, or other interests, and that lead policymakers to care about their longer-run reputations, can increase the likelihood of more socially desirable structural policies. Political economists typically argue that more encompassing or inclusive political institutions conduce to policies that are more attuned to the broader social welfare.⁴ Many would associate such institutions with the apparent success of northern European societies, with such inclusive and encompassing social and political organizations.

Political and social institutions less susceptible to capture might help check particularistic interests. Official agencies that have formal—better yet, real—independence from politicians can be insulated to some degree: Central banks and some regulatory agencies are well-known examples. Independent media outlets can also play a role in restricting the impact of special interests. Senior civil servants who enjoy a measure of independence from direct political pressure, and a similarly independent judiciary, may also be better able to resist special-interest pressures than politicians with directly political incentives.

On the other hand, political institutions that encourage short-term thinking and narrow policymaking are more likely to see structural policies captured by particularistic interest groups and self-interested politicians. There is no shortage of examples of political systems in which policies alleged to be enacted for the purpose of structural transformation have in fact been biased to benefit a small host of rent-seeking interests. In the post-World War II era, for example, most developing nations adopted ISI policies

with the stated intention of spurring economic modernization. However, in many postcolonial countries in sub-Saharan Africa, the laudable goal of encouraging industrial development and urbanization often degenerated into policies that punished the rural majority of the population in favor of a thin stratum in the military, public employment, and urban middle class (Bates 1981). This was possible because the political institutions of these societies excluded the voices of the rural majority in favor of bases of support drawn from the privileged urban elite. While ISI in Latin America was not so extreme, and its results less disastrous, structural policies in the region often tended to increase or reinforce divisions between more privileged formal-sector workers and the mass of less fortunate informal workers. Again, it is almost certainly the case that the limited democracies of the region—and, in many cases, their turn toward authoritarianism—were responsible for these outcomes.

Features of both the existing economic structure and the existing political system will affect the extent to which policies to promote structural change avoid capture and approach some notional welfare baseline. Can incumbent sectors, firms, and workers be incorporated into the structural transformation without distorting it? Can real and potential new entrants be mobilized? Can broad political organizations and coalitions be marshaled to spread the benefits widely and compensate those who lose out? The answers to all these questions will affect the nature of the structural changes toward which policy is directed.

Inoculation Against Populism?

At least some of the current interest in structural policies seems motivated by a desire to address the political challenges represented by the upsurge of populist sentiment hostile to international economic and political integration. This backlash against prevailing integrationist trends—whether it takes the form of skepticism about globalization, about European integration, or about international organizations—has spread throughout the developed world. It is concentrated, as study after study has shown, in economically distressed regions, especially those that have experienced a substantial decline in manufacturing employment (see, e.g., Colantone and Stanig 2018).

The economic distress associated with the populist upsurge is closely related to the long-term decline in manufacturing employment due to

technological change, international trade and investment, and structural trends. The broad trend was exacerbated by the Global Financial Crisis (GFC) of 2007–2009 and its aftermath. Mainstream policymakers interested in countering populist rejection of existing political institutions and international integration typically propose to address the long-term developments associated with the rise of populism. This includes supporting policies to encourage structural changes that might reverse some of the trends of the past decades, such as reindustrialization. This has been proposed in many contexts, from the “green transition” to the reallocation of supply chains for reasons of economic and military security. Certainly, it makes sense to address structural problems like the decline of well-paying manufacturing jobs with structural policies, although like all policies, they risk being diverted from their original purpose by political realities.

Policies to promote long-term structural transformation may be desirable on their own, even with the possibility of capture, but they are unlikely to help combat populism in contemporary politics. Populist voters both need and want, quite legitimately, short-term solutions to the problems that they face. And there are plenty of populist politicians ready, willing, and able to offer short-term solutions. Populists of both the left and right have been quick to promise to increase spending on programs to alleviate the pain felt in depressed and distressed regions, including those hard hit by deindustrialization.⁵ If populist politicians are the only ones to offer short-term policies to address economic distress, other political parties and politicians will be giving up on attempting to address the real, legitimate, and immediate demands of many voters. Policies for structural transformation are not a realistic response to populist pressures in the short run. In recognition of this, perhaps, there is increasing interest in place-based policies that aim to address both the more immediate concerns of distressed regions and their longer-term future (for a summary, see Venables 2024).

Conclusion

The next twenty-five years seem certain to be marked by major government interventions to channel investment and economic activity to address the demands of climate policy, industrial restructuring, and national security. Governments everywhere are rushing to adopt policies to speed or guide structural transformation, for they are favored by powerful political

actors—and often by society as a whole. Attempts to capture and distort these policies in the interests of particularistic groups in society are inevitable. There are important reasons to try to understand the course of both structural economic changes and policies adopted in service of these changes.

Those interested in effecting structural transformation, and in affecting the manner of the transformation, need to understand the socioeconomic and political forces brought to bear on the policymaking process. This understanding should include a clear sense of the principal actors in place, as well as of the political institutions within which they interact. The political realities reinforce the fact that first-best policies that are not politically feasible are hardly worth pursuing, and realism suggests pursuing the best *feasible* policies—which in turn requires a clear sense of what indeed is feasible.⁶

Those interested in working toward the most desirable process of structural economic transformation—however that may be defined—would do well to think long and hard about the incentives that this transformation presents to private agents, to politicians, and to voters. The goal should be to put in place economic policies that are broadly desirable on socioeconomic grounds. But economic desirability on welfare principles is not enough; such policies must also obtain political support from powerful actors, politicians, and voters. Political realities can turn a noble endeavor into a morass of special-interest venality. It is no simple matter to devise and put in place policies for structural economic transformation that are both socially desirable and politically feasible. Yet governments everywhere face that challenge, and how they address it will define the world economy for at least a generation.

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Notes

1. Kindeleberger's study has been followed in the seventy-five years since by hundreds of papers (most directly Gourevitch 1986).

2. There are clear parallels to the political economy of transition and economic reform; for a summary, see Roland (2002).
3. This is the fundamental point of the Stigler-Peltzman model, and of its descendant, the Grossman-Helpman model; in both cases, the policymaker weighs special-interest concerns against broad benefits.
4. Canonical examples are Olson (1971, 1982) and Acemoglu and Robinson (2012).
5. President Donald Trump's trade policies in his first term are an obvious example; their economic and political impact is evaluated in Autor et al. (2024). The recent French parliamentary election featured such promises from both the right and the left (see Hall and Johnston, 2024).
6. For an example from the climate-policy realm, see Meckling and Karplus (2023).

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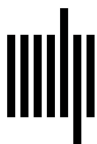
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