

IMPORT SUBSTITUTION IN THE CONTEXT OF THEORY AND PRACTICE OF INDUSTRIAL POLICY

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***Abstract:** Since 2015, Russia has initiated a policy of import substitution, which has impact on most industries. The question arises in this regard: which conditions must such a policy satisfy to be considered effective from the economic point of view? Policy of import substitution is a particular case of industrial policy, and therefore the theory of industrial policy can be used to analyze these conditions. In order to improve resource efficiency in the economy, industrial policy should be aimed at reducing the level of certain market failures. They include weak and non-existent markets, static economies of scale, in-house and intra-industry teaching by doing, external effects of investments in research and development, in human capital, information external effects and external effects of coordination, asymmetry in the commodity and financial markets. However, its implementation is inevitably linked with the government failures, in particular, such as distortion of market signals, lobbying and corruption, lack of information and skills of the state apparatus, and strengthening of non-economic criteria. The paper shows that the import substitution policy pursued in Russia does not meet at least two criteria of the efficient industrial policy. Firstly, it is insufficiently selective. Secondly, it does not compel priority firms for the future work for export. Furthermore, the role of non-economic factors is too large.*

***Keywords:** Import substitution, industrial policy, market failures, government failures.*

1. INTRODUCTION

Back 10 years ago, it was not just hard to imagine the massive import substitution programs in Russia, but even the very idea of industrial policy seemed almost absurd. However, the sands are running out. In 2007, state corporations for various purposes were created at an accelerated pace. In particular, the state corporations “Vnesheconombank”, “Rosnano”, “Housing and Utility Reform Foundation”, “State Corporation on Construction of Olympic Venues and Development of Sochi as Mountain Climatic Resort (Olimpstroy)”, “Rostec”, “Rosatom” and “Roskosmos” were created. State corporations received very substantial budget allocations, despite the fact that these organizations in accordance with their legal status were subject of far less control than the state unitary enterprises and JSC with the prevailing state participation. From 2007 to 2014, the state corporations became the main agents of the state industrial policy (Simachev, Kuzyk, Kuznetsov and Pogrebnyak 2014).

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It should be noted that their activity was many times criticized for its weak financial performance and low “transparency” of operation (see Dementiev, 2008).

In spring 2014, in connection with the well-known events in Ukraine, the country faced the need to take emergency measures in the event of termination of the supply of components, products, services and technologies required for the military-industrial complex. Since that time, a new phase of industrial policy has begun, which was marked by a much greater state activity in this area. Back in May 2014, the Russian President clearly stated the need for import substitution and gave instructions to the Government on this issue (Presidential Administration of the Russian Federation (2014)). In particular, the government was required to assess the possibility of implementation of competitive import substitution in industry and agriculture by August 1, 2014; submit the list of goods and services which may be supplied to the federal and regional authorities by suppliers from EAEC countries by September 1, 2014; develop plans for the implementation of import substitution in 2014-15 by October 1, 2014. A year later, on August 4, 2015, the Government commission for import substitution was set up. Two subcommittees were created in its structure: on the issues of the civilian sectors of the economy and on the issues of the military-industrial complex.

This article is review, and its purpose is to analyze the conditions represented in the contemporary scientific literature, in which the import substitution policy could be considered effective to maximize social welfare.

2. RESEARCH METHODS

The impact of industrial policy on the economic development of the countries is difficult to analyze empirically. This is due to several reasons. First, industrial policy tools are very diverse. In fact, they cover the whole range of measures of economic policy of the state applied to selective support of certain sectors of the economy or even individual firms. Secondly, even if the impact of any industrial policy tool is analyzed, it is very difficult to achieve compliance with the “*ceteris paribus*” approach. Therefore, in most cases, case studies method is used, when a certain case of applications of industrial policy is analyzed in detail with an attempt to summarize a number of similar cases. Examples of such case studies include studies of Little, Scitovsky and Scott (1970), Sohal and Ferme (1996), Goldstein (2002). Attempts to assess the role of industrial policy through econometric methods are also made. The authoritative papers in this area include, *inter alia*, Krueger and Tuncer (1982), Harrison (1994), World Bank (1993), Aghion, Dewatripont, Du, Harrison, and Legros (2012). But as pointed out by Dani Rodrik, the key problem of all such econometric studies is that it is not possible to distinguish between two different target functions of the government: “(a) the government uses industrial policy for political or other inappropriate ends, and its support ends up going to

losers rather than winners; (b) the government optimally targets the sectors that are the most deserving of support, and does its job as well as it possibly can in a second-best policy environment” (Rodrik (2008)).

3. RESULTS OF THE STUDY

Import substitution is the case of an explicit (and active) application of industrial policy. Any industrial policy implies the choice of sectoral or technological priorities. At the same time, import substitution implies that the part of imported goods and services are replaced by the domestic ones. In this case, the state somehow determines which sectors should replace imported goods and services. Thus, there is a choice of sectoral priorities, and therefore we are dealing with industrial policy. There are many interpretations of industrial policy, but common is that they all mean to create more favorable conditions for the functioning of the priority sectors (or some manufacturing sectors).

The modern theory of industrial policy justifies the application of this policy in cases where the existence of certain market failures leads to inefficient allocation of resources between various economic activities, which may be technological chains, sectors, sub-sectors, and sometimes individual companies that use certain technologies and resources or produce certain resources (Ermolaev 2005). However, the problem lies in the fact that any government intervention in turn leads to the emergence of the state failures (and this fact is the key target of criticism of industrial policy by its opponents).

These market failures can be classified as follows:

- Weak and non-existent markets: in the early stages of development, markets often do not exist or do not operate properly, so prices may not give good signals for resource allocation;
- High entry costs or the existence of a minimum scale of production with decreasing average costs (both cases are associated with static economies of scale). These “failures” of the market lie in the fact that only a few companies are able to enter the industry (the first case) or to achieve the scale of production, from which they can make a profit (the second case).
- Existence of a distinct learning curve (in-house teaching by doing): firms with production experience in this industry receive performance benefits compared with those that have just started working in it;
- External effects associated with the investment in research and development: the creation of knowledge requires significant investment in research and development, but in this case other companies can gain access to the generated knowledge without significant cost;

- External effects caused by investments in human capital: the firm can lose its trained staff, and therefore does not have sufficiently strong incentives for such investment (if mechanisms for compensation of such costs are provided);
- External effects associated with teaching by doing, which is external to the firm (intra-industry). This is one of the oldest and most popular arguments in favor of protectionism, affirming that the “young” industry with a production capacity of less than optimal is not able to withstand foreign competition in the initial period of its development.
- Information external effects: before entering new markets, firms often require significant investment in order to find out whether the operation on them is profitable. However, competitors can learn it without costs just watching this firm;
- External effects of coordination: if economies of scale are significant and export is limited by transport costs and trade barriers, the entry of the potential producer to the sector may not be possible due to lack of buyers of its products. At the same time, another potential manufacturer will not be able to enter another sector consuming these products, due to the inability to reach a supply of this product at a reasonable price.
- Imperfection of the capital market: asymmetrical access to information from lenders and borrowers. Borrowers know more about the “nature” and the degree of risk and the likely income in a variety of alternative situations and their own ability to “vouch” for the success of the new activity. This asymmetrical access to information would not be important for creditors if the debt contracts ensure loan repayment under all circumstances. But usually there are laws on the limited liability of borrowers who endanger creditors with the borrower declaring bankruptcy.
- Imperfections of the commodity market (in particular, the reputation of their quality as an entry barrier to the sector).

Since the state intervention has its costs, it is necessary that they do not exceed its benefits. The result of this intervention depends on the size of the market failure, the market’s ability to address them, as well as the government’s ability to design and carry out the necessary regulation.

As we believe, the arguments against industrial policy accumulated in science can be classified as follows:

- Industrial policy distorts market signals and leads to inefficient decisions at the micro level. Therefore, it creates more significant imbalance than the one it is designed to neutralize.

- Industrial policy involves unequal “game rules”, creates opportunities for lobbying and corruption (Albertine in 1984, DiLorenzo 1984, McKenzie 1984, Miller III 1984). Even if the government is able to identify “winners” and “laggards”, it faces the problem of redistribution of resources from the latter to the former. Existing industries (more precisely, the employers and the workers in them) have an opportunity to put pressure on the government with the aim of turning industrial policy into protectionist for the protection of these sectors. In addition, representatives of the sectors who consider their activities as promising may also have an impact on the government. Since existing industries have greater political “weight” than emerging or not yet existing, the development of new sectors may be questionable. Moreover, the government may be forced to maintain too many sectors, which will prevent the creation of economies of scale and establishment of comparative advantages in these sectors.

M. Noland and H. Pack believe that even in “showcase” Japan it appeared very difficult to reach concurrence in plans of various ministries, and there is little evidence of their coordination (Noland and Pack 2002). They name competition for budgetary resources one of the reasons. But this fact is not a reason to deny the industrial policy, since competition can occur not only on sectoral, but also on functional basis (e.g., between the representatives of the national defense and social areas). Therefore, we cannot say that the problem is specific during the implementation of industrial policy of the state.

According to M. Noland and H. Pack, provision of subsidies and close corporate-government relations in S. Korea increased the problems of “rent seeking” and corruption. At the same time, it is noted that the increase in transparency in the selection of priorities reduces this problem (Erber 1996).

- Industrial policy implies the selection of priority areas by the state, which even in the absence of corruption inevitably leads to errors and the large-scale inefficient use of public resources. Perhaps, the most controversial aspect of industrial policy is whether the government is better than the market in choosing the sectors that should be developed and whether it is able to reallocate resources to them faster than the market. Disposing of public resources, bureaucracy is not so much interested in the effectiveness of their investments as entrepreneurs are interested in the profitability of their investments. Experience of many countries demonstrates the ineffectiveness of industrial policy tools in the long-term. There are examples of India of the 1960-70s, Korea of late 1990s, France’s rejection of industrial policy in the 1980s. V. Mau (2003) suggests that a discussion of priorities may lead to the fact that sectors having the maximum lobbyist capabilities will be considered as such.

Government that implements industrial policy requires information on technologies, markets, potential of the country and the possibilities of the

existing market institutions. Failures that “hit” the markets at the optimization of resource allocation also may affect the government. For example, it can have no access to better information than the firms do. In fact, it is very unlikely to have the necessary information at the detailed level of products, markets and technologies. At the same time, J. Stiglitz notes that a relatively small number of errors is a positive evidence of the governments’ ability to determine the winners (Stiglitz 1994).

Implementation of industrial policy places very high requirements to the technical and administrative qualification of the state apparatus, which most developing countries lack. At the same time, the need for it is not the same everywhere. In our opinion, it is highly dependent on the level of industrial development and the extent of the policy selectivity. The more complex the industrial base of the country and the chosen strategy, the higher the requirements for the staff qualification. The strategies can be developed much easier in the countries with small and simple activities. The degree of selectivity shall correspond to the capabilities of the state apparatus and the pace with which they can be increased. Qualification of the state apparatus is not set once and for all. The experience of the newly industrialized countries shows that good training, selection and promotion system can improve it. According to many experts, there was no super-bureaucracy in East Asia, and the process of building a competent state apparatus was slow and intermittent (Stiglitz 1996).

- The nature of modern corporate structures (transnational and diversified) does not allow to use the industry as the subject or regulation. For example, one of the difficulties of industrial policy in South Korea has been associated with the use by “chaebols” of capital for priority projects and the cross-subsidization of other projects. The result could be an investment without regard to rates of return, and “weak” corporate balance sheets. For example, the biggest bankruptcy in the world history, the one of Daewoo, the second largest corporation in the country, in the 1990s has become indirect evidence of the “weakness” of the South Korean “chaebols” (Noland and Pack 2002).

Other costs associated with industrial policy are also possible, such as:

- Strengthening of non-economic criteria. Some authors believe that both in S. Korea and Taiwan, the industrial policy was determined more by factors such as the presence of sectoral unemployment and lobbying on the part of large firms, rather than the pursuit of the development of the comparative advantages of the country (Noland and Pack 2002).
- Interests of small businesses are not taken into account. The problem here may lie in the fact that the sectors that mainly compose of small businesses are less able to influence the government.

- Facilitating mergers, it comes into conflict with competition policy. World experience shows that industrial and competition policy objectives may diverge (Japan, South Korea).

In general, in our opinion, it can be assumed that all the considered “failures” of the state increase when forms of the government intervention become more selective. Such a policy requires great skills, information and discipline from the government, because it is very likely that it will strengthen the “rent-seeking” forms of interaction and the emergence of interest groups. Such a policy may be very costly if poorly formulated or applied.

We believe that it is appropriate to consider the model of export promotion or import substitution in light of the broader strategies of developing countries emanating from the orientation outwards or inwards. The policy of outward-oriented development contributes not only to the free movement of capital and labor, but also to multinational business, as well as the opening of the communication system. On the contrary, the policy of inward-oriented development emphasizes the need to develop the own approaches to development. In effect, they are measures that encourage the development of the own manufacturing and the own technologies. There has been an active discussion in the economic literature within the framework of these two broad approaches to development since the early 1950s. During this time, the pendulum of this discussion has been swinging – from the predominance of the point of view of adherents of import substitution in the 1950-60s to the supporters of promoting exports reaching the dominant position in the late 1970s.

The main discrepancy between these strategies is as follows: supporters of import substitution believe that developing countries should first organize their own production to replace previously imported simple consumer goods, implementing it all under the protection of high tariffs and import quotas. In the long term, the followers of import substitution pursue twofold aim: to diversify local industry and expand their exports in the future, after the domestic prices of industrial products become competitive as a result of economies of scale, low labor costs and mastering the production experience.

Supporters of the promotion of export of both primary and secondary industrial goods indicate the importance of a shift from narrow national to capacious world markets, to the distortions in prices and production costs that accompany protectionism.

In the 1950-60s, developing countries faced the restriction of their positions in the global markets of primary products and the increase of balance of payments deficit on current accounts. Faith in the “magical” role of industrialization has led them to implement import substitution strategy. In particular, since the 1950s, developing countries conducted the development of metallurgy and mechanical engineering

due to their positive external effects, to a great extent based on the study of the Soviet experience (Pack, 2000).

Typically, the import substitution strategy includes the establishment of joint ventures with foreign companies attracted by the possibility of production under the protection of customs barriers, along with various tax and investment incentives provided. Potentially, this strategy for many industries is a prerequisite for the transition to an export strategy. Korea and Taiwan are examples of such successful transition.

At the same time, the import substitution policies may have a number of adverse effects in relation to the structure of the economy:

- Many young productions under the shelter of customs barriers never reach maturity, and the government is not inclined to lower rates in order to force them to increase competitiveness, as it can be the owner of these enterprises or be subject to strong lobbying pressure from their side.
- Foreign firms may be the main beneficiaries of import substitution, if domestic manufacturers fail to master certain activities. In addition, the implementation of the import substitution strategy requires imports of investment and intermediate goods, which both foreign and domestic firms can carry out. In case of foreign companies, the situation with the balance of payments of the country may worsen due to the fact that a substantial portion of the profits will be transferred abroad.
- The negative impact on traditional exports of raw materials due to the overvaluation of the exchange rate of the domestic currency (besides, it can encourage capital-intensive methods of production due to depressed prices on the import of capital goods). In the case of the existence of the Dutch disease, it mainly relates to secondary exports.

In our view, the most important factor in determining the success or failure of industrial policy is the mechanism of its implementation. Thus, according to most estimates, the Philippines were in similar initial conditions with the future Asian “tigers”, but the policy of import substitution, like Latin American, turned out fruitless (Noland and Pack 2002).

“Failures” in the conduct of industrial policy of other states, and successes of Japan and “tigers” suggest that the result depends not only on whether the government intervenes, but also on how it conducts intervention. According to this criterion, the strategies used by “tigers” differ from the typical import substitution policy at least with the following:

1. Selectivity, rather than promoting all types of activities. This point, in our opinion, is extremely important. In the absence of specific state priorities, they will be chosen by the government, based on the current considerations;

2. Choice of activities that provide significant positive external effects and have close links with other domestic sectors;
 3. Forcing early entry of processing industries in the world market, using export as a means to “discipline” both government officials and enterprises;
 4. Use of selectivity in attracting foreign direct investment. This helps create the domestic technological base (by setting certain conditions before foreign investors, such as on the direction of investment in the dynamic, high-tech “chains”).
- A very important difference in the conduct of industrial policies in Latin American and East Asian countries was the way they tracked progress of the firms that were recognized as a priority. The weakness of this mechanism in Latin American countries was mainly in the fact that after the protectionist defense had been established for most of the sectors, its level has not decreased until the crisis in the 1980s and later. M. Noland and H. Pack indicate that no single case of reducing protection is known when the sector failed to perform the established conditions (Noland and Pack 2002). In contrast, Japan, South Korea and Taiwan carried out constant monitoring of the progress of firms. The most glaring example is South Korea, where the credit subsidies and protection in the domestic market depended on export sales. It can be said that exports was the numeraire, by which the progress was assessed.

Now it is difficult to say something quite definite about the results of the import substitution policy carried out in Russia. At the same time, as pointed out by the World Bank in its latest report on the Russian economy, “in general, today import substitution, apparently, has not had a significant impact on economic growth and the redistribution of production factors. Partial cyclical recovery of the economy under the influence of rising oil prices is unlikely to be accompanied by a redistribution of resources in favor of the economic activities with higher added value of non-oil industry” (World Bank 2016).

By April 2016, 20 sectoral plans of import substitution in civilian industries had been formed in Russia (Minpromtorg). Approved plans contain 1,553 headings, and during their implementation 1,719 projects are monitored. At the same time, proposals on the inclusion of projects in the list of potential performers of sectoral plans are consistently lodged with the Ministry of Industry and Trade (Minpromtorg) of the Russian Federation from both organizations and the Russian Federation subjects. Minpromtorg of Russia has approved 16 interagency working groups (IWG) to reduce the dependence of industry sectors on the import of equipment, accessories and spare parts, services of foreign companies and use of foreign software. The IWG consists of representatives of Minpromtorg, interested federal executive bodies, development institutions, the Russian Academy of Sciences, RF subjects, as well as producers and consumers of import-substituting products.

4. DISCUSSION OF RESULTS

Given all of the above, the question arises: how the policy of import substitution pursued in Russia meets the criteria for successful industrial policy. Despite the fact that it is not possible to carry out a detailed analysis of this problem in this work, some general conclusions can still be made. Let's consider the criteria for selection of priority sectors mentioned above in the context of the declared policy of import substitution in Russia.

To what extent is it selective? This condition is particularly important in conditions of very limited resources of the Russian budget. However, 20 sectoral plans is already a lot, and in fact they influence most of civilian manufacturing. It can hardly be expected that each of the priority sectors receives adequate resources for its technical re-equipment.

To what extent are the sectors selected as priority ones that generate significant external positive effects and have close links with other domestic sectors? Here the situation is not so clear, as many sectors recognized as priority largely meet this requirement. These external effects can originate from a variety of sources – from investments in research and development, in human capital, as well as created through teaching by doing and overcoming the coordination failures. In addition, support for the manufacturers of the final product launches demand down the entire process chain. However, since no comprehensive studies were carried on which sector meet this requirement to a greater extent (in fact, the Ministry of Industry does not present any grounds), it is difficult to understand how justified the chosen priorities are.

Forcing an early entrance of priority sectors to world markets is also very important, but how will it be complied with in reality? There are many doubts with regard to this, since it is very difficult at such a huge number of priority sectors to expect that all of them are potentially competitive in the global market. Their export is unlikely to be possible, even with significant state incentives. But the main danger lies in the possibility of the implementation of the Latin American scenario of the endless support of inefficient sectors. Provided significant employment in these sectors, they will have considerable lobbying potential to require this support.

With regard to selectivity in attracting foreign investment, it is also difficult to comply with the requirement. In the conditions of so low interest of foreign investors in the Russian economy, it is difficult to set them tough conditions on the transfer of high technology.

5. CONCLUSION

Import substitution is a particular case of industrial policy, or an industrial policy aimed at the replacement of a number of imported goods and services with domestic

ones, to be exact. This means that the efficiency of the import substitution policy can be estimated from the point of view of the industrial policy theory. This theory focuses on the analysis of market failures and state failures (and combinations thereof), which prevent the inflow of resources in the activities in which the country has a potential comparative advantage. The respective market failures include weak and non-existent markets, static economies of scale, in-house and intra-industry teaching by doing, external effects of investments in research and development, in human capital, information external effects and external effects of coordination, asymmetry in the commodity and financial markets. Information external effects and external effects of coordination are considered to be the most significant in the modern theory of industrial policy.

There are also very significant failures of the state associated with implementation of this policy. This policy tends to distort market signals, create opportunities for lobbying and corruption, leads to inefficient use of budget funds at a large scale. The government often may not have the best information about technology and markets than firms themselves. Technical and administrative qualifications of the state apparatus are often insufficient for an industrial policy in developing countries. In addition, the industries are currently difficult to use as a subject of regulation due to the nature of the modern corporate structures, and this policy is often in conflict with competition policy. Perhaps, the most important industrial policy disadvantage in relation to Russia is that non-economic criteria begin to play dominant role in its implementation.

Such a criterion in the ongoing Russian policy of import substitution is called the reduction of dependence on Western countries in technology and supply of a range of goods and services. This largely determines the fact that the criteria required for success in carrying out the import substitution policy in Russia are disregarded. Its most important drawbacks are low degree of selectivity and lack of clear plans to compel the firms for the future work for export.

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