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ADVANCE REPORT ON THE INDUSTRIALIZATION PROJECT CONDUCTED BY THE DEVELOPMENT CENTRE OF THE ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Presented by

The Organization for Economic Co-operation and Development

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We regret that some of the pages in the microfiche copy of this report may not be up to the proper legibility standards, even though the best possible copy was used for preparing the master fiche.

1. The Development Centre of the Organization for Economic Co-operation and Development (OECD) is conducting a research project which will try to appraise as well as compare and draw general conclusions from the post-war course and policies of industrialization in six countries: Argentina, Brazil, the Rpeublic of China, India, Mexico and Pakistan. At the time of writing, not even preliminary drafts of the individual country reports are available; nothing, therefore, can be said here about our findings. But it may be of interest to outline our approach.

2. We hope to present a detailed account of the growth, pattern and changes in the pattern of each country's factor availabilities, output and foreign trade, as well as of its economic policies and the tools of its economic policies. The country reports will consist of two parts, one dealing with the country's over-all performance and policies, the other being a detailed study of a few selected individual plants and industries. An OECD consultant is in charge of collecting data and writing a report in each of the six countries; and one or two additional consultants in each country are visiting and studying the performance and special problems of selected manufacturing plants. On the basis of their reports, as well as of other material published or otherwise available about these countries, we plan to publish an over-all summary and comparative study of their development.

3. The main problems we hope to investigate can also be classified into two groups: first, the allocation of investment funds and establishment of priorities among different industries; second, the efficiency, inefficiency, and causes of inefficiency in individual industries, as well as in the economy as a whole.

4. Concerning the first problem, there are indications that import substitution has been carried too far. Too many industries have been encouraged to develop without much regard to their having, or not having, comparative advantages or enough scope for economies of scale; and few have been encouraged to develop beyond the limits of the domestic market, although this is often

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too small at an early stage of development even in the largest countries. To some extent, such undue reliance on import substitution has been imposed by the developed countries' protectionist policies, and to some extent it has resulted from the developing countries' own mistaken policies, their deliberate planning for self-sufficiency, their indiscriminate extension of protective tariffs, or their mistaken or misguided efforts to save foreign exchange. Self-sufficiency is an advantage; but its cost is very high, much higher than has been realized in the past.

5. There are several signs that the countries we are studying have indeed achieved - or been forced into - an exceptionally high degree of self-sufficiency; and they have done so at a high cost. To begin with, all of the countries under study are much more self-sufficient today than they were in the immediate post-war period; they are also much more self-sufficient than developed countris of comparable economic size. Second, in several of the countries, the cost, in terms of domestic resources, at which import competing industries save foreign exchange is very much higher than the cost at which foreign exchange could be earned through the export of manufactures. We are trying to measure this cost in specific industries in each of the countries studied. This means that, from the point of view of foreign-exchange budgeting, these countries' stress on import substitution and relative neglect of export promotion must be judged a mistake.

6. Yet another sign, which may indicate both excessive import substitution and the development of the wrong industries, is the tremendous range of variation of effective rates of protection enjoyed by different manufacturing industries in several of the countries we are studying. This means that the relative profitability of these industries bears little relation to what their comparative advantages would be in a free market. This would be a good thing if the structure of the rates of protection were designed to correct market prices with a view to encouraging the absorption of unemployed labour and creating external economies and economies of scale. While we hope to investi-

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gate whether this is the case, a preliminary and superficial survey suggests that part of the variance in the rates of protection is explained by the popular, if economically unjustifiable, strategy of giving the highest priority to the domestic production of final consumers' goods; some of it is due to chance, and some to the policy of giving "protection as needed" to industries established on political rather than economic grounds.

7. Only a single example can be given here of the results of such policies. Brazil is a country that has extended very high protection to many industries in its effort to industrialize. This effort has been successful in a sense; but very few of its protected industries have been able to expand beyond the confines of the protected domestic market and compete in world markets. By contrast, Brazil's equipment and machine-tool industry, far from being protected, was discriminated against by the protection accorded to other industries, since this usually comprised every encouragement to import foreign equipment, including of course its duty-free entry. Nevertheless, Brazil's equipment industry experienced fast growth, thanks partly to its ability to export and compete in world markets. Indeed, there are several reasons to believe that Brazil (like developing countries in general) has a comparative advantage in the manufacture of machine tools and equipment other than those that are subject to rapid technical change. Discrimation against this industry, therefore, and the consequent slowing down of its development may well have been a costly error in development policy.

8. We hope to study in detail the various factors that explain the excessive emphasis on import substitution and the tendency to overrule through deliberate policy specialization along lines of comparative advantage. One the one hand, we shall deal with the developing countries' failure, as well as the motivation and consequences of their failure, to exploit their comparative advantages even in the manufacturing sector of their economies. On the other hand, we shall also deal with the protectionist policies of the developed countries, the formal and informal obstacles they put in the way of the developing countries'

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manufactured exports, thereby forcing on them the necessity of aiming at greater self-sufficiency than the developed countries have attained.

9. The market alone would probably lead to unduly great reliance on exports of primary products. The practical question is: what is the best way to correct market prices and market incentive, while still making use of these incentives as a guide and a spur to industrialization? An example will have to suffice here, although we hope in our final report to deal exhaustively with the subject.

10. Developing countries wish to encourage industrialization, and they may face a low elasticity of demand for their traditional primary-product exports. The simplest way of meeting this situation is to levy duties on primary-product exports and maintain exchange rates that will sufficiently discourage imports and encourage manufactured exports to require no or little supplementing with import duties, export subsidies and exchange control. In most practical cases, the reverse policy is followed: the exchange rate is used to maintain the prices and restrict the quantity of primary-product exports; whereas duties, subsidies, import restriction and exchange control are heavily relied on to promote industrialization. Ideally, this could lead to the identical result; in practice, owing to its greater reliance on administrative procedures and to the greater scope it creates for administrative delays, corruption and inefficiencies, it usually leads to much worse results.

11. For example, the stress on import substitution, to the neglect of export promotion, is at least partly explained by such factors. One of these is the limited ability of developing countries to levy and collect income taxes, since this creates a strong bias in favour of relying on tariffs and against granting subsidies. Another factor is that exchange control, though designed to deal with a foreign-exchange shortage, discourages exports almost as much as imports by impartially subjecting both to administrative red tape and delays.

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Again, the foreign-exchange shortage has led to the restriction of unessential luxury imports; an unexpected and unwanted side effect of this has been the increased profitability of the domestic production of substitutes.

12. Concerning the problem of efficiency, much of the inefficiency of manufacturing plants in these countries stems from their uneconomically small size and their serious underutilization even of their relatively small capacity. We hope to investigate and list the causes of this as well as of other forms of inefficiency; in the interim, a few tentative explanations must suffice.

13. The under-utilization of existing capacity and the building of new capacity are largely explained by the many policy measures that always aim at expanding capacity, never at utilizing it more fully. Equipment can often be imported duty-free when new capacity is to be created,but seldom when it would merely help to maintain or utilize better existing capacity. Tax holidays and licence initially to assemble imported components again favour the establishment of new capacity; and so do foreign aid and cheap loans, made available to new projects only. The quantity of imported parts and components licensed to import or allowed in duty-free is usually geared to capacity with one-shift operation and often scaled down even further as a means of saving foreign exchange, thus limiting the utilization of capacity. This contrasts to industries using domestic materials that typically operate on a multi-shift basis.

14. Further likely reasons for the emergence of excess capacity are the extreme variability of government demand in many developing countries and also the system of high tariff protection, combined with encouragement of domestic competition. The effects of the former are obvious. As to the latter, tariffs keep domestic prices near the world price plus the import duty; and if the resulting profits are high and attract several firms to enter the market, competition among them is likely to reduce profits to normal, not by lowering prices, but by raising costs through the creation of too small capacity and

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and the under-utilization of capacity.

15. Other and more general forms of inefficiency have been created by the various administrative controls, such as quantitative import restrictions and investment licensing, that have been introduced by many countries in an attempt to deal with situations in which it is felt that market mechanisms would not work, or would work inefficiently or unjustly. We shall attempt to trace the history of some of these controls to see how they have worked out in practice. It seems that in some cases, there have been undesirable consequences and that some of the hoped-for advantages of controls over market mechanisms have not been realized. For example, excessive profits have been earned by those fortunate enough to receive import licences. Large firms have been favoured over small ones. Excess capacity, as has already been mentioned, has been partly due to the way in which the controls have operated. Administrative delays have slowed down the pace of development and (though this must be, in the nature of the case, difficult to substantiate) corruption has increased. These disadvantages have often grown with the passage of time, partly because many have learned how to manipulate the controls to their own advantage (an unfavourable example of the learning process) and partly because the controls have multiplied. For example, imports are restricted to deal with a shortage of foreign exchange. Various schemes are then introduced to encourage exports, so that the whole burden of adjustment shall not fall on imports. These schemes make exporting more profitable, and even may make it whorth-while to import goods costing X dollars in foreign exchange and to re-export them for less than X dollars of foreign exchange. Special measures are then required to prevent this from happening.

16. Nor are these disadvantages confined to quantitative controls. Discriminating or complex tax systems and multiple exchange rates may lead to similar results. For example, better quality goods may be taxed at higher rates in order to discriminate against the rich. In practice, however, most

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goods may be classified as of lower quality after the tax inspectors have been suitably bribed. Furthermore, so many special tax remissions may be given as incentives of one kind or another that the difficulties of levying sufficient taxes become very serious.

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