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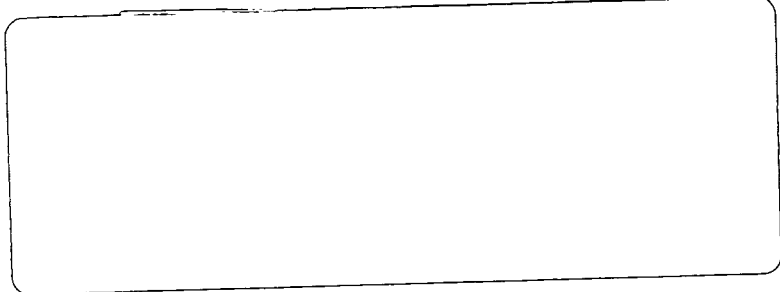
Trade Policy for Developing Countries

SWP353

INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20433

World Bank Staff Working Paper No. 353

August 1979



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TRADE POLICY FOR DEVELOPING COUNTRIES

A Background Study for World Development Report, 1979

Although some issues remain unsettled, expert opinion and lessons of experience have begun to converge in recent years on trade policy measures that make sense for an individual developing country. This paper presents in a readable form what is now recommended and why, together with puzzles that remain. Suggestions are also put forward that go beyond the emerging consensus, not only to take into account a country's special circumstances, but also as part of an exploration of important issues beyond the edges of what is now generally agreed. Trade policy must be made on three levels, all of which are treated here -- strategic choices, economy-wide management including exchange rate policy, and detailed setting of incentives in relation to particular products and industries. Along with the underlying relationships at each level, attention is focused on practical lessons of experience concerning the policy instruments available, their proper design and use, and complications that arise in a world of harsh realities. Social repercussions of trade policy are also considered.

Part I is concerned mainly with trade policy for purposes of industrial development, e.g., how to expand manufactured exports along with production for the home market. Part II examines relationships of trade policy with social and political systems and goals, for example, its effects on poverty, and how it interacts with repression or redistribution. Part III looks at how to achieve a successful transition from an unsatisfactory to a desirable trade policy regime.

This paper has greatly benefitted from comments on an earlier version by a large number of colleagues, including especially Shankar Acharya, Bela Balassa, Joel Bergsman, Armeane Choksi, Kemal Dervis, John Holsen, Helen Hughes, Paul Isenman, Garry Pursell, Paul Streeten, Larry Westphal and Adrian Wood. While their help has been immensely valuable they are in no way responsible for remaining (or subsequently added) shortcomings.

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PREFACE

Experience in the second half of the twentieth century confirms what economists already saw clearly in the eighteenth century, that policies toward international trade play an enormously important role in what is now called economic growth and development. With more nations striving to increase their wealth today than ever before, many valuable lessons have been learned on how to do this effectively in countries that start out industrially and economically behind. As a result, much can be said today about what does and what does not work successfully for a developing country, not least in the crucial area of trade policy.

This does not mean that the answers are easy, least of all in their practical application, nor does it mean that recent experience leaves little room for argument. Trade policy issues are inherently complex, embracing as they do foreign exchange transactions and overall "macro" balances of the economy, as well as the setting of incentives in a vast range of activities and industries. At the same time, government intervention in trade and foreign exchange markets remains only one influence among many in a richly complex process of growth and development, in which much of what ultimately counts depends on changes in people, and the pace of change depends partly on their motivation. Trade itself interacts with, and is shaped by, practically everything else going on in this development process. However, given these complexities and -- let us face it -- the poor record of modern economics and its practitioners in dealing with many other complex policy issues at an economy-wide level, it is something of a miracle that enough is known to prescribe trade policy to promote development with the confidence

and success that can be done today, particularly for countries in the middle and later phases of the development process (as opposed to the early phases for which advice today is less confident).

The task of documenting the successes and failures in actual policy that lie behind this growing confidence will not be attempted here: a systematic review of trade policy experience is beyond the scope of this paper. By now, however, most officials of developing countries, as well as practically all specialists in economic development, are aware that one can indeed document startling histories of success, for example, in South Korea (Republic of Korea), Taiwan (Republic of China) and Singapore, and one can also find many other cases of partial success and of failure which either reinforce the same lessons, or teach useful supplementary ones. Perhaps even more important, application in new settings of the combination of what is now known and recommended -- particularly in countries well along in the process of development -- gives very encouraging results, even if it does not usually turn other countries into success stories on the same scale as Korea. The World Bank and its staff, among others, have already published many pages on these subjects, so that hopefully there is no need here to review the evidence from the ground up. For that matter, this paper will not try to sketch out a history of the analytical discoveries that have helped to unuddle trade policy issues that, twenty years ago, were fraught with confusion and controversy, though this too is a very interesting story. Trade policy seems to be one of those rare areas in which theoretical analysis has been of considerable relevance in relation to economic policy at a national level. This paper also does not look at the international actions open to developing countries to improve their trade situation by acting together, though this is certainly an important

subject.

Instead, this paper is addressed to policy recommendations and, at the same time, to the underlying relationships that policymakers need to understand, in order to choose intelligent trade policies in an individual country. This paper is concerned above all with what a developing country ought to do -- particularly one in which existing policy falls far short of the best practice, or a country just beginning to decide its policy. The focus is thus on the lessons themselves. While trying to distill, in a readable form, what is known about policies that work best, an attempt is made to include practical complications and less obvious points that tend to be glossed over in most discussions of the subject. At the same time, an effort is made to push the discussion beyond the frontiers of what is known or agreed among experts, in regard to issues that, though not yet settled, bear on policy decisions that must be made now, today, in many developing countries without waiting for the experts to reach better answers.

The longest section of this paper, Part I, looks at the relationships between trade and development, and the trade policy measures needed to promote industrial success, including manufactured exports. Part II is concerned with effects and corollaries of trade policies and their human impact in selected areas ranging from employment and income distribution to political dimensions, including relationships with repression and social revolution. Part III is devoted to the challenge of how to effect a successful transition from an undesirable, unsuccessful trade policy regime to a desirable, effective one.

In many ways this paper is an experiment; it is far from definitive. Limitations of time in writing it, and the author's limited knowledge

to begin with, have made impossible a thorough study and documentation of the existing literature on these subjects. No doubt the paper also has many flaws in content and organization, but it is offered all the same in the expectation that such a paper is needed and that much can be learned from an experiment if it is aimed in appropriate directions.

Part I

TRADE POLICY AND INDUSTRIAL DEVELOPMENT

A. Strategic Considerations Based on Underlying Relationships

1. Perspective

As the preface suggests, among international and development economists strongly concerned with trade policy questions, one now finds considerable convergence of views on what trade policy regimes should ideally be like and which changes would constitute improvements in any particular case. One finds even more agreement on what are the intellectually valid arguments for what are sometimes called "departures from unified exchange rates," that is, special favorable or unfavorable treatment of particular products in trade or production, including protection and subsidies.^{1/} Unlike the situation twenty years ago, recently there has been very little intellectually argued opposition to the dominant view on these matters, even from people who stand apart from the mainstream of economics and view its findings with suspicion. What were once coherent contrary views have been either partly assimilated or intellectually destroyed, while many one-time proponents of other views have been converted by experience.

Disagreements in detail continue, but those that remain have not yet been well mapped or clearly argued. Above all, one finds disagreements among experts in matters of application -- for example, how much protection would be justified and for how long in a particular case or how to make a

^{1/} The consensus among experts in these areas is well reflected in the writings of Corden (especially 1974 and 1971) and Bhagwati (especially 1969 and 1978), and in Little, Scitovsky and Scott (1970).

transition from inferior policies under given conditions -- where as yet there is no decisive analysis or "hard" evidence available for resolving the questions. Meanwhile, especially outside the circle of people who have studied these issues most, one finds a great many people who are intuitively eager to throw over the recommendations now being made, on grounds that the world is changing, and that rising protectionism in industrialized countries, or some other influence such as transactions within multinational enterprises, must surely justify a new and different body of advice. Those who have thought the subject through, however, have come to recognize that the policy answers come out the same in a world of powerful protectionist foreign governments and powerful, grasping foreign businesses. Perhaps this should not come as a surprise. After all, protection abroad and powerful business empires are hardly new. International economists and national policy makers have been struggling with these challenges for generations, and if the past successful trade policy measures of countries such as Japan, Korea, and Singapore did not take these realities into account, they would surely have failed.

Before going further into the analysis of policy issues, however, an examination of some basic relationships is in order. Starting with the role of trade in development, this first section of the paper treats not only key relationships, but also strategic considerations and a few of the objectives that must be understood clearly in designing trade policy.

2. The Role of International Trade

International trade contributes to growth and development in a developing country in a number of ways.

It expands output and provides additions to incomes through demand for local natural resources which, as the old phrase "vent for surplus" suggests, might otherwise go practically unused. More generally, it permits a developing economy to specialize, based on its relatively abundant resources, while importing goods and services that would be very expensive or impossible to produce locally. Thus, through trade, the country can potentially obtain more of each type of output than it could produce for itself.^{1/}

Benefits from trade are also based on economies of scale, i.e., advantages from large-scale production. The extent of the division of labor, and hence the output attainable per worker in any economy, are limited by the size of the market. Poor countries offer only tiny markets for most industrial products, so that a developing country will be impoverished by the high unit costs if it tries to produce a little of each product for its inadequate home market. Such a country stands to gain enormously by importing many or most of the goods that can be produced cheaply only on a large scale, and by building its manufacturing industries partly around exports, so that a larger scale of production can be attained.

By sharply raising incomes, trade expands demand, enlarging opportunities for learning, scale economies and a productive division of labor. At the same time it greatly expands the resources available for processes of savings, investment and accumulation that play a central role in development, including not only investment in physical capital, but also investment

^{1/} This is the basic point of the theory of comparative advantage. Putting the point differently, the country has the opportunity of choosing among a much more attractive set of options than it would have without trade.

in intangible assets such as "human capital."^{1/}

Then, too, trade helps to create and demonstrate the existence of markets -- initially for imports -- that can eventually be made the basis for import substitution and industrialization around the domestic market.

It provides through imports, a supply of capital equipment, technical assistance, raw materials and other key inputs essential for industrial development, augmenting local supply capabilities where they are weakest or nonexistent.

It also brings with it new products, new technology, new standards and new ideas, and assistance in mastering them. Indeed, trade goes hand in hand with travel by businessmen and technical specialists, such as industrial engineers, through which a flow of information is set up and technology is transferred across international boundaries. Economists are just beginning to realize to what extent efforts, for example, to export manufactures bring forth advice and technical assistance from foreign buyers on matters ranging all the way from product design and production techniques to cost accounting. In any case, technology transfer seems to depend on having people travel abroad, study foreign plants, and engage in direct personal interchanges with specialists from other countries. To some extent this happens in industrial projects set up with imported equipment and advice, but it happens much more with a lot of trade than with little or none.

In addition, trade is a source of stimulus and pressures from international competition, which can be a major source of motivation for actually

^{1/} Meaning education, labor skills, health, etc. -- investments that raise the productivity of people.

mastering the techniques and meeting the standards of foreign competitors. Learning to export and even trying to export manufactures is valuable partly for this reason. Competition from imports, too, can potentially motivate improved performance, especially since, in a developing country, many industries consist of only one or two or a very few enterprises, as a reflection of the small size of the local market. Unless subjected to foreign competition, these firms are more likely to collude than compete, and they will tend to raise prices, neglect quality, and perform poorly in terms of technology and efficiency. Import competition helps to weed out hopelessly inefficient local firms while driving others to greater efforts and higher performance standards.

Even though trade is valuable for all these reasons, this does not mean that more trade is desirable in all situations. Trade policy must not only pursue these advantages but also balance them against the gains from learning to produce goods and services that could be imported. There is also a need to limit disruptions and pains in the growth process as a result of the vicissitudes of trade and capital movements, and to tailor trade to the needs of growth and development. Trade policy is partly a matter of selecting and implementing a strategy and overall approach, to take full advantage of the potential benefits, limit the disruptions, and cultivate the learning opportunities, taking into account a country's particular situation and resources.

3. The Goal of Industrial Development and Its Relation to Economic Growth

This paper is concerned especially with the use of trade policy to promote industrial development, defined here as the mastery and expansion

of modern manufacturing industries.^{1/} This in turn can be viewed as part of a wider process of economic growth and development having two sides: one is economic growth, raising earnings and income levels; while the other is economic development, transforming and expanding supply capabilities so that a wide range of output can be produced up to what might be called "high modern standards." Industrial development is part of this second process involving a transformation of supply capabilities in manufacturing industries. This involves:

- creating modern manufacturing industries;
- expanding their production and capacity;
- improving their technology and organization and efficiency;
- raising the quality of their output;
- widening their range and flexibility;
- building up their marketing and design and product-development capabilities;
- augmenting their capability for borrowing and adapting technology from abroad;
- shifting the mix and "structure" (eventually if not immediately) in directions deemed desirable in the long run;
- making locally owned industrial enterprises strong and competitive by the "best" international standards.

The wider task of economic development, of which industrial development is an important part, involves an analogous transformation of supply capabilities in the economy as a whole, not only in manufacturing but also in

^{1/} Mining, construction, electric power and water supply are often grouped with manufacturing as industrial activities. In this paper, however, inclusion of primary production and major "non-tradeable" subsectors with industry would complicate the exposition to no advantage.

agriculture, construction, mining, transport and communications, finance, distribution of goods to consumers, foreign and wholesale trade, education, health and medical services, power and water supply, sewerage and sanitation, public administration, national defense, engineering and research, other service and professional activities, and cultural facilities and recreation, along with the mix of activities.

Successful development on practically all these fronts, and particularly in manufacturing is required to turn a country into an "industrialized" or "developed" nation, able to generate a high level of income per person based on its human resources and organizations and physical facilities, without having to rely on rents from natural resources or earnings from investment abroad, or from a narrow and vulnerable specialization at home. Of course, no national economy produces everything for itself, and a very small economy -- one with less than, say, five million people -- cannot expect to master the same wide range of modern industries and other activities as a larger economy; instead it must expect to remain somewhat specialized as part of a wider industrialized economy. But it can still reach for high standards in everything it does undertake, and it can strive for flexibility based on the quality of its human resources and infrastructure. In this light, development is concerned with earnings potential and vulnerability in the long run, while growth is concerned with actual output, earnings, living standards, and effective demand.

Economic growth has a huge impact on industrial (and overall) development, since effective demand on an adequate scale is required before an industry (or other economic activity) can be launched and mastered. Successful growth leads to a rising demand for consumer goods and indirectly for producer and investment goods. Systematic development efforts alongside

this growth help to widen demand to include a broad range of producer goods that would not necessarily be needed in a narrowly-based process of economic growth. As part of this process of demand creation, government programs often play a large role in areas such as road building, electrification, irrigation, mass education, defense and many others, not to mention the impact of the public authorities in shaping incentives, financing major investments, and initiating specific projects. In some eras developing countries such as Turkey, Mexico and Brazil seem to owe much of their industrial vigor to government initiatives creating demand through public development programs.

In industry as in many areas, the objectives of growth and development sometimes conflict -- raising output rapidly conflicts with learning skills essential to build a modern nation, which sometimes must be learned at the cost of sacrifices in efficiency, or in programs with only very slow returns. But these objectives do not conflict much because growth is so essential to industrial development. Any development program that does not contribute to growth, or detracts seriously from growth, becomes self-defeating. A country can foster industrial development at a modest cost in growth, on highly selected fronts, but except perhaps if it is enormously rich in oil revenue, it cannot afford a massive concentration on development without carefully weighing growth effects of each measure and each investment. Lessons on this score abound in the past history of such different countries as India, Ghana, Chile, Argentina, Algeria and socialist Cuba, to mention only a few that have undertaken ambitious development programs with too little attention to growth. This point is fundamental in choosing trade policy in developing countries bent on industrial development.

4. Imports, Import Substitution and Industrial Development

Imports and import substitution play central roles in industrial and overall development under any sort of trade regime. Autarkic development is hardly feasible, even in the largest of economies: even China and the Soviet Union rely on strategically chosen imports of equipment, technology, raw materials and food. Smaller economies are even more dependent on imports at every stage in their development.

Industrial development, in particular, is highly dependent on imports, which supply some or all of the following:

- capital equipment to start production;
- spare parts and repair services required to keep production going;
- some of the construction materials required;
- fuel and raw materials;
- intermediate manufactured inputs (for example, special steels or parts for assembly) required in production;
- technical assistance and engineering, design and other services required to launch production;
- technology, which frequently must be paid for in one way or another (royalties, foreign enterprise profits or fees, search costs, etc.);
- consumer goods not locally produced which may be required as incentive goods or as inputs into health of the labor force;
- financial, insurance, transportation and other services indirectly required.

Over the course of time, successful development leads to mastery of production of many of these requisite goods and services that are at first imported. As a result, as a country's own output becomes more diversified and technically "sophisticated," the composition of imports shifts systematically

toward goods, services, and technologies that are increasingly complex and require a larger and larger scale of production, along with raw materials that cannot be found locally.

By some broad definitions, within manufacturing, import substitution is nearly synonymous with industrial development--the exceptions would involve processing or labor-intensive manufacturing for export where the product was not first imported. After all, in any economy that starts out industrially behind the leaders, practically all modern industrial goods are at one stage only produced abroad in more advanced economies, and are imported before being produced locally. Usually the existence of a market for imports helps to show the feasibility of (and precedes) local production on an adequate scale. However, in a growing economy, local production soon exceeds the scale attained previously by imports. Eventually, restrictions against imports can be relaxed. By a narrow definition, import substitution is only the initial production replacing imports, while the subsequent expansion is a product of domestic demand growth coupled with expanding supply capabilities. (When import constraints are relaxed, there may be more imports alongside local production than there ever were, before the local industry got started!)^{1/} Depending on which definition is used, industrial growth over a long span of development consists in any fairly large economy mainly of import substitution (based on a broad definition) or mainly of domestic demand and supply growth (where import substitution is defined narrowly).

^{1/} This is sometimes viewed, perhaps misleadingly, as negative import substitution. For a discussion of definitions, see, for example, Desai (1969).

By either a narrow or a broad definition, however, the amount of import substitution that takes place, and how fast, may depend on export success and overall growth even more than on direct efforts to accelerate and promote import substitution. This is because total purchases, including imports, are limited by effective demand, while import growth (paving the way to import substitution) is limited by import capacity, which is increased by export success. Exports and economic growth lead to increased imports and foster a "natural" process of import substitution, based on a combination of transport cost protection (most industries tend to locate near markets or raw material supplies for reasons of transport costs), scale economies, improved infrastructure, and growing capabilities of the labor force, making new industries profitable. This natural process can sometimes be hastened through protection, subsidies, or other incentives, and governments can sometimes improve the results through direct attention to the quality, scale and timing of the resulting industrial expansion. But by itself, such attention may be misplaced without major efforts to promote exports and growth at the same time.

Reliance on careful analysis and evaluation of projects and selection among alternatives through cost-benefit calculations (and, also, where industries are highly interdependent, through appropriate modeling), can help to avoid premature import substitution projects. These all too often turn out to have a negative value added at world prices--implying a negative effect on the balance of payments--and burden the growth of other industries and depress real incomes by the high prices they must charge, in order to make even a low rate of return. Often, too, the capital investment must be publicly

subsidized, while the output is inferior compared to imports.^{1/}

Sequences of import substitution, and instruments for promoting it, will be discussed in greater detail in subsequent sections: the difficulties change somewhat as the process moves forward and shifts from consumer goods to intermediate and capital goods. Details apart, however, even a small developing country requires successful import substitution in a wide range of products, in order to emerge as a fully developed country. One of the challenges in trade policy is how to achieve this success.

5. The Importance of Expanding Exports

Export expansion, too, is an important feature of the growth and development process, to the point where a large expansion of exports is very nearly a necessary condition for sustained rapid growth and development over any lengthy period, at least in a market economy. (In regard to qualitative results this may well be true in any but the largest command economy as well.)

Exports make possible the benefits from trade, discussed already. They are required to pay for the imports required in development, both directly and by adding to the country's borrowing and debt-servicing capacity; they allow the country to gain the benefits of specialization, including economies of scale, and so on down the list.

Inter-country comparisons show strong positive associations between export growth and overall economic growth, beyond what can be explained by the fact that production for export is a part of output. This is almost

^{1/} Theoretically such a project might be justified if it served in effect as a training school. But this effect if weighed properly will seldom be sufficient to outweigh the negative features.

certainly a reflection of the economic benefits from specialization, along with favorable effects associated with international competition and the other benefits already touched.

Alternatively, the relationship between exports and economic growth can show itself instead in a negative direction. When, for whatever reason, exports fail to expand, and especially when they decline, some of the links between trade and growth begin to operate in reverse, with the result that development tends to be slowed down by a lack of stimulus and dynamism, as well as by lack of imported inputs and market demand. These negative effects are likely to be especially acute in manufacturing, since it is highly dependent on trade in ways already mentioned.

As a result of these links, exports and import substitution are, on the whole, complementary. If exports do not grow and overall growth is sluggish, the process of import substitution is slowed sharply through difficulties on both the demand and supply sides. Feasible opportunities become exhausted because markets are too small to make new industries profitable, while the "import intensity of import substitution"^{1/}--its heavy requirements for imports of equipment, intermediate inputs, fuel, etc.--adds to the obstacles.

Paradoxically, import substitution turns out to have been exceptionally rapid and successful in economies that have given unusually strong attention and incentives to industrial exports, such as Japan, Korea and Taiwan; in the period 1960-76 industrial growth rates averaged over 17 percent

^{1/} In Carlos Díaz-Alejandro's phrase.

per year in Korea and over 15 percent in Taiwan, considerably higher than in any other developing country.^{1/} By the early 1970's, despite their spectacular growth, exports only accounted for about 10 percent of the demand for manufactured goods in Japan, 24 percent in Korea and 28 percent in Taiwan.^{2/} In the last two, some of the industries set up to substitute for imports have been sufficiently large and efficient from the start so that they have quickly been able to compete in export markets as well.

One of the least widely understood points about trade policy is that the need for exports, and the associated need for incentives to maintain or increase them, are not diminished, but may even increase when international conditions make exports difficult to achieve, for example, as a result of adverse trends in the world economy or increasing protection abroad. Of course, exports themselves are likely to decline, and investments in export-oriented capacity may have to be cut back, but paradoxically the value to the economy from successfully exporting becomes greater than ever, since exports are still needed just as much and are harder to get. This means that protection or poor demand conditions abroad do not change the need to pursue export promotion alongside import substitution as a central part of trade and industrial policy.

As noted already, however, there can be too much of a good thing: an export bonanza involving a high degree of specialization based on one or two natural-resource products brings major problems in its wake. In

^{1/} World Bank (1978), Annex Table 2, pp. 78-79; see also World Development Report, 1979, Table 2.

^{2/} See Keesing (1979).

particular, there is a danger here that both industry and agriculture will be held back by import competition. In this case, development may well be promoted by policies that tax (in one way or another) leading export products, while giving special assistance to other sectors. However, in practice, superabundance of export earnings is rarely a problem except in economies rich in mineral exports, or in periods of exceptionally high primary product prices. Even in these cases it is exceptional for a developing country to be able to plan around a sustained growth of its primary export earnings. Much of the difficulty in trade policy comes from the need to expand exports without neglecting other objectives such as gaining valuable learning experience.

6. Protection and Export Taxes

Among its advantages, the existence and growth of trade opens the possibility of using administratively easy-to-apply instruments for stimulating local production of products that start out being imported. Protection can be given through tariffs--taxing particular imports but not locally produced versions of the same products--or through quantitative restrictions on imports, such as quotas or outright embargoes, limiting the imported supply; or through both together. In each case, provided that protection can be enforced (despite smuggling, cheating and corruption), the effect will be to raise the prices and profits received by local producers of the product, while afflicting with higher prices the people who use or consume the product.

Protection is very nearly equivalent to a tax on all the unprotected industries, and particularly the export industries, as well as the users of the product, in order to help the protected industry. How much the protection

is worth, to the industry protected, depends not only on the dimensions of its protection (e.g., the height of the tariff) but also on how many other industries are protected at the same time. If every industry is protected equally, the effect is simply a tax on all trade, and therefore on all exports, without favoring one import-competing industry over another. Because user industries are hurt, protection for an industry's final product can be cancelled out, wholly or in part, by protection of the industries that supply it with capital goods.

This point lies behind the notion of "effective protection," which in principle is a measure of the net effect of the system of protection on the value of a firm's (or industry's) "value added" after paying for inputs purchased from other firms or industries. Another point behind the notion of effective protection is that the effect of a tariff in raising value added depends on the share of the product's price that represents inputs purchased from other industries. Suppose, for example, that only two industries receive protection, each in the form of a 50 percent nominal tariff, while there continues to be no tariff at all on their inputs. In the first of these industries, before the tariff is imposed, inputs imported or purchased from other industries comprise 50 percent of the final price, while 50 percent represents value added ("in world prices"). In the second, these purchased inputs account for 90 percent of the product price and value added is only 10 percent. The effective tariff will be 100 percent in the first case but 500 percent in the second, meaning that the 50 percent nominal tariff doubles value added from 50 to 100 percent of the world price in the first case, but raises it to six times what it was (a 150 percent final price, minus the same

90 percent for input costs, raises value added from 10 to 60 percent of the world price) in the second.

A major disadvantage of widespread use of protection is that it discourages and decreases trade, thereby destroying or giving up many of the advantages from trade that were described in a previous section. Of course, for a developing country it may be extremely important to encourage the growth of new industries that could not initially compete with imports; but once these industries are well started their continued protection acts as a disincentive to other industries, and the existence of widespread protection acts as a disincentive to the growth and diversification of exports, including exports from the new industries initially created through protection.

In face of this dilemma it is important to keep in mind that export taxes have many of the same effects as tariffs (import taxes) and they also discourage trade, but with essential differences. Export taxes fall specifically on the particular exports taxed--which can be chosen to be the primary exports that can bear taxation most--while they indirectly encourage, to some extent, all forms of import substitution and all the exports that are not taxed. This sort of effect may be superior, for a developing country, to the effect of protection which is to discourage indirectly all exports however desirable, as well as all unprotected import-competing industries. By choosing which exports to tax, and how much, and by applying protection only selectively and temporarily, a developing country can achieve a trade regime that is equivalent to much higher ongoing protection both for industry and for other new and diversified economic activities, coupled with large export subsidies for all these new industries and other new ventures. The

selective use of protection then becomes equivalent to picking out a few industries for extra-high protection above all the rest.

A highly simplified arithmetical example may help to illustrate what is involved. Suppose that a primarily agricultural developing country wants to promote manufacturing and, secondarily, diversification of its agriculture and its exports. For this purpose it wants to discriminate against its traditional export agriculture, giving its manufacturing industries incentives at least twice as attractive. It also would like to give special incentives, not quite as strong, to new export crops, and exceptionally high incentives at least temporarily, to a carefully chosen group of high-priority industries. To implement this strategy, suppose that on a numerical scale, if one sets arbitrarily equal to 100 the incentive to be given to the traditional export crops, what is needed is incentives in the order of 160 for new export crops, 200 for most manufacturing, and 300 for the high-priority industries. If the complications caused by input-output relationships could be ignored, this structure of incentives could be achieved by setting the exchange rate to give 200 as the ordinary yield for foreign exchange saved or earned, and placing a 50 percent tax on traditional agricultural exports, a 20 percent tax on others, and a protective tariff of up to 50 percent in the special high-priority industries.^{1/} By contrast, with no export tax at all, and an exchange rate of 100, not only very high protection (100 - 200 percent in manufacturing) but also very high export subsidies would be needed

^{1/} Taking input-output relationships into account, of course, such a structure of export taxes and tariffs would cause some high incentives for manufacturing based on exportable raw materials. However, the basic principle remains generally valid even if details must be adjusted.

to achieve anything like the same structure of incentives, if it were feasible at all.

Achieving such a result mainly through export taxes has some practical advantages. First, there will be a large tax revenue easily collected that can then be applied in part to development expenditures, including infrastructure and subsidies to new industries. Second, the tax on exports can be modulated and adjusted each year to take into account export performance and the need for foreign exchange earnings. If the more heavily taxed exports cease to grow, and lack of trade growth and import capacity begins to hold back the country's development, the taxes on principal exports can be reduced to speed up export growth; but if temporarily high prices of the product threaten to cause too strong a growth of imports and purchasing power, hurting local industries while causing price inflation, the tax can be raised higher and some of the proceeds can be set aside to be spent in years of low prices. (Of course, depending on the product this effect may be achievable through public-sector purchasing and marketing schemes or through some other special institutional arrangement, which amounts to export taxation.) Not least important is the administrative feasibility of this approach. Export subsidies are practically impossible and massive protection is very difficult to implement well in a developing country, while a large tax on a country's main export products is relatively easy to administer. Finally, trading partners frown on export subsidies and may retaliate against them with countervailing duties or other pressures, but without these subsidies each new industry will be discouraged from exporting, despite the small size of the domestic market.

Another set of influences is also centrally important: the real value of protection depends on local cost levels and on actual competing imports. The degree of import competition, and the cost inflation, experienced by local industries (and agriculture and services) will depend on how the government spends the proceeds of the export tax, and indeed on the whole government budget along with aid and borrowing from abroad. To the extent that public spending goes for debt-service abroad or sophisticated equipment built abroad, this will have little effect in bidding up local prices or in generating competing imports. If the spending goes for local construction or government salaries, however, the added local demand will be likely to raise prices and spill over into imports, with or without protection.

Low levels of protection in a developing country, supplemented by export taxes and conservative government spending, tend to mean low local prices and costs--including wage costs, which are likely to reflect the cost of living--making industries competitive both in exporting and in competing against imports. An extreme case of export taxes holding down local wages and prices comes when, as in Thailand, these taxes fall mainly on the local food staple (in this case rice), since its low price reduces the cost of living. By contrast, high levels of protection characteristically result in high local prices and wages, as translated through the exchange rate, so that protection appears essential in order for local industries to compete against imports, and exporting nontraditional products without subsidies appears practically impossible.

A related point is that regardless of the degree and structure of protection in a country, or even its price level, the real intensity of competition from imports will be determined in a fundamental sense by the

level and composition of imports; and in shaping this structure, protection is only one influence among many. The value of exports and other sources of foreign exchange is a more basic influence. Another powerful influence affecting the composition, if not the level, is the pattern of government expenditure, and in particular the public sector's foreign exchange expenditures; one study shows that 52 percent of U.S. exports to developing countries in 1976 went to governments and public sector agencies or enterprises.^{1/}

Massive reductions in the capacity to import have occurred historically in times of war, depression and export disasters. In some instances, notably in India and Latin America in World War I, the Great Depression, and World War II, local industrial production has received a major stimulus as a result. However, historical experience suggests that exposure to imports can also be very good for development, particularly in sharpening the competitive edge of the industries that survive. In this regard it is instructive that Hong Kong and Singapore share a background as free ports, subject to some of the most vigorous import competition on earth, while Korea and Taiwan spent several decades as colonies exposed to severe (sometimes unfair) Japanese competition, and then received a flood of U.S. aid followed by rising imports when exports expanded and foreign capital came in. Many of the best results in development are achieved, as already noted, in times of rapidly rising trade, perhaps not only because industries have access to means of production and growing markets, but also because they are subject to a process of losing their protection.

^{1/} In developed market economies this share was only 17 percent. See Dreyer (1978).

In any case, since protection and export taxes alike are powerless to achieve a growth in trade--they ordinarily have the opposite result, at least until the "infant industries" grow up and begin to export--they tend to work best where trade growth is ample and especially when it is so substantial as to cause difficulties from too much import competition and an excessive, narrow export specialization.

Export taxes have a special value, too, in the case where a developing country enjoys a degree of monopoly power at a worldwide level in the supply of a particular export commodity, since in this situation an export tax can help to improve the country's terms of trade, so that the foreign customer will actually pay part of the tax. In practice, this is an exceptional situation and is not likely to last long, if the country applies strong export taxes (and for that matter high protection, which has a general effect of raising local prices) to raise its price. Other suppliers will soon cut into its share of the world market.^{1/}

7. Central Role of the Exchange Rate

Quite apart from the use of protection, subsidies, export taxes, or other special measures at an industry level, a developing country has a powerful and simple instrument for promoting industrialization around the home market, and through exports at the same time, in the form of exchange rate policy.

^{1/} Unless all act as a cartel to raise their prices (by export taxes or other means such as export limits for each supplier), in which case there is still an incentive to cheat by cutting prices and exporting a larger share. This is one of the international actions by developing countries that lie outside the scope of this study.

On the export side, the extent to which exports of all kinds are promoted depends above all on the relationship between the exchange rate effectively applied to exports, and domestic prices and costs.^{1/} If, in real terms, people are well rewarded for producing exports, they will be encouraged to produce more; if not, they will turn their attention in other directions.

The exchange rate, as it relates to domestic prices and costs, also determines the rewards for saving foreign exchange by producing import-competing goods and services. Here, as in exporting, there is often a choice between, on the one hand, saving or earning foreign exchange, and on the other, using the same local resources in alternative ways--for example, producing nontradeable goods and services, working less hard, seeking government favors, or holding factors of production idle. Import substitution is rewarded, side by side with exports, when the real rate of exchange is shifted so that imports are made expensive. Local production is discouraged, apart from special measures of government intervention, when imports are made cheap.

Of course, maintaining a favorable real exchange rate is no simple matter--the export incentive and price effects of protection and export taxes have already been touched, but in addition, pursuing this objective involves macro-level management of the economy, with difficulties and complications that will not be discussed until later, in connection with measures to foster exports. A developing nation's price level in terms of internationally used currencies is also determined to some extent by its geography and

^{1/} For a simplified, yet relevant, theoretical model, see Nelson (1970).

resources.^{1/} Nonetheless, exchange rate policy is a central tool of trade policy, with far-reaching effects, which are often underrated.

Note, however, that the relationship between exchange rate incentives for earning or saving foreign exchange is not wholly symmetrical, because if exports are poorly rewarded through the exchange rate system, with the result that export earnings dwindle, ways must be found for reducing imports even when, on its face, the official exchange rate continues to encourage them. Thus, an overvalued exchange rate, one by which the price of foreign exchange is set too low so that exports and (seemingly) import substitution are discouraged, is likely to have to be roughly compensated by a massive use of quantitative import restrictions, exchange controls, tariffs and subsidies. Compared to the effects of maintaining an equilibrium or undervalued exchange rate, however, there will be costs and inefficiencies. For example, local industries will get a (probably false) impression that they are hopelessly incompetent and inefficient, compared to their foreign competition. Some import substitution activities will be overlooked and discouraged, others will not be started for lack of foreign exchange, some will be badly designed because the "wrong" prices are used, some will get undeserved windfall profits, etc. So the stimulus for import substitution will be very uneven.

In practice, the celebrated success of so-called "outward-looking" or "export-promoting" strategies of development is built largely around the use of "realistically" valued exchange rates. The leading purpose in most cases has been export expansion, but the success of this approach also comes

^{1/} See Usher (1968).

in part from their use of superior means for promoting import substitution and production for the domestic market. Correcting the exchange rate shows local industries where and when they are efficient and how their costs really compare with those of foreign competition. Meanwhile, no import-competing activity is neglected, nor is special attention generally required. Everyone concerned is led automatically by the price system to achieve import substitution as well as exports. However, these positive effects cannot easily be disentangled from those of more exports and more capacity to import at the same time.

Use of exchange rates in this way can even be viewed as a development strategy--in extreme form, a "mercantilistic" one. Richard Cooper (1964) has argued that Japan, Italy, West Germany and a few other developed countries succeeded in accelerating industrialization, starting in the 1950's, by tipping their exchange rates in the direction of undervaluing their currencies. This generated a very heavy demand for their manufactured goods at home as well as abroad. Japan depreciated repeatedly in the 1930's for a similar effect. Obviously, not all countries can do this at once, and it may only work well in a relatively small economy with a strong potential for exporting manufactures; but there are ample precedents for the use of such a strategy.^{1/}

^{1/} However, as will be discussed in connection with exchange rate policy, it is not easy to achieve real depreciation side by side with large-scale public development expenditures since these will push up prices. Unless otherwise underutilized resources can be put to work producing tradeable goods, devaluation is likely to be cancelled out by price increases.

8. Primary Exports, Foreign Aid and Borrowing

Natural resource advantages are invariably the main basis of a developing country's exports through much of the development process. Early in development there is not much else to export. As long as primary exports prove reasonably adequate, they tend to continue to be the country's main export specialty until late in the development process, when industry attains quite an advanced level of development. Of course, natural resources are often used to earn foreign exchange through tourism. And the other major resource of backward regions--unskilled labor--is often used together with natural resources, in mines and plantations and logging camps, as an added basis for primary exports.

The shortcomings of primary exports at a global level have been widely discussed. Most are held back by slow growth of demand. Many are characterized by unstable prices and others by severe competition from synthetics or other substitutes. Agricultural exports are not only buffeted by forces outside the country's control, but are subject to the vagaries of the weather and of pests and diseases. Minerals are depleted and even forests are difficult to renew. However, for most developing countries there is not much else to export, so there is reason to be thankful for this distant demand. Most of the exportable products and resources would be almost worthless if the local economy were isolated.

A sense of the difficulties in exporting primary products, for the developing countries as a group, can be gleaned from numbers in the World Bank's World Development Report, 1979. From 1960-76 developing countries' exports of primary products other than fuel increased in volume at only 3.7

percent per year, while for 1976-90 these exports are projected to grow at an annual rate of 3.3 percent, with fuel exports projected to expand at 3.2 percent.^{1/} By comparison, gross domestic product in developing countries grew at about 5.7 percent per year from 1960-76 and is projected to increase at 5.3 percent per year in 1976-1990.^{2/} Consequently, although some individual countries may have better-than-average prospects, the predominant pattern has been a decline in primary export earnings relative to GDP, and this is expected to continue. These export difficulties are not all caused from outside--more on that in a moment--but in part they reflect such fundamental influences as slow-growing world demand for food and fibers as incomes rise, technological progress in reducing raw material input requirements per unit of output, and trends toward use of synthetic materials in place of natural ones.

For purposes of a coherent development program, an equally basic problem with exports based on natural resources is that the rhythm of their discovery and exploitation is likely to be erratic and imperfectly suited to the needs of development. A sudden upswing as new resources are brought into production is usually followed by slow or zero export growth along with irregular ups and downs caused by price and production instability. More often than not, the initial increase comes very early in development when few imports are yet needed for investment or production purposes outside the primary export sector itself. This upswing helps to trigger a sequence of

^{1/} Table 3, p. 5.

^{2/} The historical growth rate is from Table 1, p. 3. The projection is from unpublished background material for the World Development Report, 1979.

economic growth and import substitution along with conscious development efforts. From this point on, if steady economic growth could be sustained, the imports required and "essential" for development would probably grow in very nearly an exponential curve and so would the local output of goods that once were imported. But unless exports are exceptionally large, the rising curve of "essential" imports soon bumps against the country's import capacity, and the development process is slowed or choked by foreign exchange shortages. Even before this point is reached, slow and erratic economic growth associated with erratic export performance tends to exert a drag on industrial development, until new exportable natural resources are discovered and brought into production, or episodes occur when prices of the local primary exports shoot up and stay high for a sustained period. In some times and places primary exports are too large, but more often they are too small to suit the needs of development; and seldom can a country count on their steady growth.

Of course, in addition to exports of goods and services, foreign exchange to pay for imports is available to a newly developing, resource-poor country from other sources. Foreign aid raises the import ceiling while helping to provide technical assistance as well. Since there is almost no systematic worldwide uptrend in foreign aid, the effect on average is much like another fairly steady source of primary export earnings, except to the extent that aid is being shifted to poorer recipients. However, hardly any resources are required to "produce" the aid, and there may be extra funds where and when they are most needed. Along with official lending, private foreign lending helps to give developing countries an ability to vary the time profile of their imports according to their development needs.

Earnings stabilization schemes help to smooth out the ups and downs. Private foreign investment provides an added potential source of funds as well as managerial skills, technology, training and other ingredients required in development. However, except for outright aid grants, all these sources of foreign exchange are ultimately dependent on repayment, which hinges on exports. Thus, a swift or at least dependable growth of exports remains essential to increase import capacity to the extent required over the long run.

In addition to their benefits in expanding imports and overall demand growth, primary export activities usually provide direct stimuli for industrial development. Processing industries are built up to export the product in less raw form--for example, sugar mills, cotton gins, sawmills, ore concentrating plants, or copper smelters. Local metalworking industries are set up to produce or at least repair mining, agricultural and/or transport equipment used in producing and shipping primary exports. Chemicals, packing materials, fuels and construction materials are examples of other inputs that may be needed. In each case the stimulus is stronger as a result of transport-cost protection. However, the growth of processing industries is limited by the growth of the associated primary production.

One of the major needs of world development is for developing countries to accelerate the increases already taking place in their output and exports of primary commodities. Of course, in some products they cannot collectively do this at once for lack of sufficient world markets--greater supplies would only drive down the world price. But in many products this is not the case. Developing countries even as a group are often only minor suppliers of their primary exports, all the more so, taking into account the supplies of closely related natural or synthetic substitutes, which largely determine the price.

Individually, most of these countries are price-takers in international trade; their export levels have almost no effect on the prices they receive. Consequently primary exports for most of them are limited principally by their ability to increase their exportable supply in exchange for the prevailing world price.

In many instances, developing countries fail to realize their potential as exporters for lack of sufficient incentives and investments in export-oriented production. Obviously limits exist in what can be achieved-- agricultural exports compete with the food demand of growing populations, difficulties exist in creating a favorable environment for investment and mineral exploration, not enough is known about how to increase yields in many types of tropical agriculture, and so on--and in some cases international action may be required to reduce the difficulties. But in many developing countries, export increases could be achieved unilaterally through improved trade policy, coupled with needed attention to agricultural and mineral production.

In agriculture at least, poor performance in both output and exports of primary products seems to have been partly self-inflicted. In the period 1960-76 industrialized countries increased their agricultural exports at an average rate of about 5.5 percent a year, but developing countries only achieved a rate of 3.5 percent, while shifting on balance from being net exporters to being heavy net importers of grain. Even more worrisome, in the same sixteen years, agricultural output per capita in the developing countries increased on average at only 0.3 percent a year, not nearly enough to meet their demand increases caused by increasing per capita income (at

3.3 percent per year) as well as their export needs.^{1/} The most impressive per capita agricultural output increases took place in the Middle Income countries of East Asia and Southern Europe (at annual rates of 1.7 and 1.6 percent respectively). In these regions a majority of the countries maintained reasonably realistic exchange rates and stayed export-oriented in their policies. Conversely, per capita agricultural output declined over time at average annual rates of 1.1 percent in Low Income Africa, 0.7 percent in Middle Income Sub-Saharan Africa, and at 0.1 percent in Low Income Asia, while annual rates of increase were only 0.2 percent in the Middle East and North Africa, and 0.3 percent in Latin America. All these regions witnessed a widespread anti-export bias in trade policy and a heavy burden on agriculture as a result of protection, overvalued exchange rates, and interventionist policies favoring (perhaps unduly) the urban and industrial sectors.

9. Manufactured Exports

Manufactured exports, apart from those based on processing of local natural resources, are generally not feasible on any significant scale until industrial development reaches a fairly advanced level. By way of exception, where local natural resources per head are unusually small and inadequate, this will reflect itself in an unusually low wage level and exchange rate, which will begin to foster labor-intensive manufacturing for export at a somewhat earlier stage in development. However, the competition is fierce in export-oriented manufacturing and standards are rigorous so that low wages must normally be combined with a disciplined, well schooled and

^{1/} Numbers quoted in this paragraph are all taken from unpublished background materials for World Development Report, 1979.

urbanized work force, good infrastructure facilities (notably transport, communications and power), a convertible currency and an administration, police force, legal system and political situation sufficient to insure political stability, protection of private property, few labor troubles, and an ability to take profits out. These conditions are not created quickly in a developing country. Export "miracles" are built on decades of ground-laying effort.

The main negative feature of manufactured exports is that they are difficult to achieve, partly for reasons just given. This also means that in its early stages, industrial development is straitjacketed by the small domestic market and is forced to focus on "make-or-buy" decisions for that market. It generally means, too, that when first achieved, manufactured exports tend to involve slender profit margins and, indeed, narrow margins of value added, even including local wages. This is a very competitive business in which the resources that developing countries can best supply, including most of the labor and (financial) capital, are not well paid compared to the managerial and marketing know-how, the technology and design capabilities supplied by partners or cooperating firms from more developed countries. Unlike primary exports, there is no significant rent from natural resources. However, these exports do make use of unskilled labor, notably female urban labor, that would produce much less output in alternative activities; and over time there is a substantial scope for increasing the wage and other income accruing to the local economy.

Apart from these difficulties, manufactured exports have practically all the advantages of other exports and more besides. Like other exports, they are intrinsically desirable to help pay for imports, provided they add

to the supply of foreign exchange available. This may not be the case if they are based on processing of natural resources which would otherwise be exported in cruder forms, where processing is encouraged by taxing or restricting the alternative export (and/or by subsidizing investments or output in processing). It may not even be the case in "offshore assembly" industries if a high price must be paid in subsidies to attract foreign firms.^{1/} But it is normally the case, so manufactured exports normally contribute to growth as well.

For purposes of industrial development, of course, manufactured exports are valuable in that they directly involve industrial expansion and learning of industrial skills. But the actual learning and development benefits will depend on the details of the export industry and how it is operated. If it is an enclave apart from the local economy, under foreign direction, there may be only a limited fallout of desirable learning and training that can be applied in local manufacturing.

Particularly where they are integrated with local industrial development, industrial exports are especially useful in freeing development from the constraints imposed by the small size of the home market, since manufacturing is especially affected by the scale of production. Scale economies can be achieved through international specialization within manufacturing, without either waiting for the market to grow to the proper dimensions, or paying the penalties of producing on a less-than-optimal scale. Specialization can be built, too, around locally abundant factors.

^{1/} Such subsidies and losses of foreign exchange may be justified in some cases by the learning or side effects.

Developing countries with low natural resources per head, after they have begun to develop, typically became rich in trainable and willing unskilled labor and usually in people with some manual and clerical skills as well, ready to work at low wage rates. But without industrial exports, industries especially suited for such labor are held to small dimensions for lack of demand, while other industries struggle with high costs and flounder because they depend on skills and resources that are locally expensive or poorly supplied. Export-oriented manufacturing makes intensive use of factors of production, including labor, that are relatively cheap and abundant while using little of the factors that are scarce. Once incentives for exporting are made adequate, too, any local industry or firm that has achieved competitiveness for whatever reason (such as good management) can expand by exporting.

Manufactured exports can usually be expanded over time based on the requirements of development. Indeed, unless they are based on limited local natural resources, they have a built-in potential for continuing expansion throughout the rest of the development process. However, this is not an easy expansion since it frequently involves moving into one product or market after another.

Collectively developing countries have achieved a very remarkable growth in their manufactured exports over the last two decades. In the 1960-76 period this growth averaged at least 12.7 percent a year. The World Bank now projects a further growth at an average rate of about 10.9 percent through 1990.^{1/} This growth appears to be continuing in practice at a brisk pace--for the year 1978 compared to 1977, for example, Taiwan reported a volume

^{1/} World Development Report, 1979, Table 3, p. 5.

increase of fully 24 percent in its merchandise exports and Korea 14 percent.^{1/}

This does not mean, of course, that international markets for manufactures are unlimited or that all countries can hope to achieve simultaneously results comparable to those of Taiwan and Korea. Rather, there is every reason to believe that the results now being achieved are straining world markets' capacity to absorb and adjust to these exports, at least in the simpler labor-intensive industries that are now on the defensive in industrialized countries. Korea, Taiwan, Hong Kóng, and other leading suppliers would have smaller exports if other developing countries such as India had been more vigorous in joining the competition in earlier years. As it is, export expansion is having to be achieved in the face of frequent threats of new import restrictions. And while industrialized countries' protection in most products has had little evident effect in stemming the tide, the very important exception has come in the textile and clothing industries, in which almost all developing countries are now threatened to some degree with effective quotas as soon as they achieve substantial exports.

The fact remains, however, that in most manufactured products markets are still wide open and developing countries are still only minor suppliers. Moreover, the most successful suppliers are now diversifying into new, more technically challenging export products, while most of the developing countries that now export manufactures on a smaller scale--and there are many of them--are still too small and not far enough down the "learning curve" to be viewed as a serious threat to their industrialized country

^{1/} IMF, International Financial Statistics, June 1977.

competitors, outside the more sensitive textile products, in which mechanisms have been carefully set up to trigger new quotas. Footwear in several industrialized countries ranks up with textiles and clothing in sensitivity, but in most manufactured goods developing countries are at least partly defended against new protective measures by domestic interests in favor of imports, as well as by procedural and legal obstacles, including international agreements, impeding the erection of new barriers. Besides, markets can frequently be found in another country if they are restricted in any particular one.

In short, despite the seeming obstacles on the demand side, even more than in primary products the main difficulties are found on the supply side; export expansion has to await successful development of the industries and skills required.

However, in facing up to the difficulties it is important to emphasize that an average developing country does not need export success on the scale of a Korea or Taiwan. A very large country such as India or Brazil with its own large market and diversified resources will never require more than a tiny fraction of the per capita exports achieved by the leading success stories. And most of the smaller, less successful developing countries would benefit quite significantly from even a modest fractional increase in their exports, especially if the earnings from manufactures could be increased steadily, year after year. Given the large role of learning and experience in these exports this is by no means an unrealistic hope, if conditions are at all propitious.

Moreover, and this is very important, there appear to be benefits from an export-oriented policy in regard to manufactures for other reasons besides the exports actually achieved. Exporting manufactures--and, indeed,

even trying to export manufactures--is believed as a rule to have favorable learning and side effects, involving the quality of the product, the efficiency with which resources are used, the quality of the learning that takes place, the acquisition of methods and technology from abroad, and the standards applied. This is especially true compared to protection-sheltered production for the home market, where it is easy to fall into poor performance based on stagnant, inefficient methods, while losing touch with the best methods and standards abroad. Efforts to export put pressure not only on the industry itself, but also on its suppliers and surrounding institutions and infrastructure, to meet the best international standards.

There are also beneficial learning and side effects through which skills are created so that exporting of manufactures is itself mastered and made easier in the future. Industrial firms learn many of the "ins and outs" of getting their exports sold and tested and labeled and packaged and shipped and cleared through customs, and how to adjust to foreign laws and specifications and sizes. Marketing connections, if not networks, are built up, while potential customers are made aware of the country as a source of supply.

Exporting manufactures is also linked to learning special skills such as industrial management, technology acquisition, marketing, design and product development, that are enormously valuable assets once mastered.

Because of the link to these difficult-to-master activities, however, exporting manufactures usually depends, in its early stages, on the initiative of foreign multinational manufacturing corporations, and/or importer-wholesalers, trading firms, department stores, retail chains and other major buyers from developed countries, who help to organize exports and

provide much needed technical and marketing assistance. The subsequent process of expanding manufactured exports is partly a matter of attracting more and more attention and orders and export-oriented investments from these foreign firms, but it also involves a learning process in which local firms build up connections and marketing know-how and exporting experience, so that the initiative (and associated profit) shifts to them. In this process the highly profitable skills involved are gradually mastered. Mastering them helps the local firms in their ability to compete with foreign firms on an equal basis, at home as well as abroad.

In the long run, learning to export manufactures is crucial for development. Any nation that can export a diversified range of manufactures, as well as produce most goods and services for itself, frees itself from a vulnerable reliance on a few natural resources. A nation that cannot export manufactures can hardly be considered fully developed since its supply capabilities will be very narrow, while once this skill is well mastered over a considerable range of goods, becoming a fully developed country is only a matter of time and continued effort.^{1/} Besides, natural resources can be exhausted or diverted to local use in the course of development.

B. Protection and Closely Related Measures

1. The Subject

Trade policy is concerned with three interconnected levels of policy-making. The strategic level concerns broad choices of trade strategy. These hinge on basic considerations already discussed, together with the way

^{1/} Provided the country stays independent and avoids catastrophe. This is no small matter in Taiwan, South Korea or Singapore today, let alone Hong Kong.

trade policy interacts with overall political-economic systems and social goals--subjects explored in Part II. Next, there is a level of economy-wide management involving exchange rate policy and the relationship between domestic and foreign costs. What is required at this second level will be discussed in section C of Part I, together with specific measures to promote exports. Finally, there is a level of setting incentives in detail by product and industry. This third level will now be discussed. More precisely, this section is concerned with the design of protection and closely related measures that discriminate among products and industries, making some more profitable than others, particularly in relation to production for the home market.

Incentives are set, of course, through an interaction of the measures to be discussed here, with the economy-wide and exchange rate measures and the export promotion measures to be discussed afterwards. By themselves, measures of protection and subsidy only set relative incentives. What these relative incentives mean in absolute terms is only determined when their structure is anchored in relation to prices abroad and export incentives. As has already been pointed out, in many ways the most powerful measures of protection for import-competing industries are those set up through a realistic or undervalued exchange rate and the economy-wide cost-price effects from "macro" level management to match. However, the instruments of trade and industrial policy include a battery of specific measures such as tariffs, quantitative import restrictions (QRs), export taxes and subsidies that apply usually at a product level. These and similar measures can be used directly to discriminate in favor of particular industries or products, as against the rest; and in practice they are used very heavily by developing countries

as a means of fostering particular manufacturing industries and other favored activities. Consequently, today, as in the past, to a great extent trade policy is concerned with when and where to apply these instruments, how to choose among them, and how to design them.

Setting incentives at a product and industry level--including incentives affecting the profitability of tradeable as against nontradeable goods and services--cannot really be avoided in any developing country. These incentives may be designed through a conscious strategy, or by piecemeal decisions, or drifted or blundered into by allowing a situation to occur, for example, by letting the exchange rate become undervalued, which means that rewards become unrealistically small for exports and also (except where imports are prevented or very highly taxed) for import substitution. Unfortunately, in developing countries it is very common for only a part of the incentive structure--such as tariffs and export taxes but only some of the quantitative import restrictions (QRs) and subsidies--to be designed deliberately to promote a particular set of development objectives. Too often much of the rest, including the "real" exchange rate, becomes the result of unplanned and poorly controlled influences. As a result even the deliberately designed part does not have the effect originally intended, since help to particular sectors through tariff protection is undermined and redistributed through these other influences.

In treating protection and related policy measures, and indeed in drawing lines around trade policy throughout this paper, it becomes somewhat arbitrary to draw lines around what is and is not trade policy. For example, subsidies including tax advantages to manufacturing (or other) industries

are usually, strictly speaking, not measures of trade policy at all, but they are so enormously important as substitutes or complements of protective measures, and they have such a huge effect on trade, that there is really no choice but to treat them as major instruments along with tariffs and QRs.

At the same time, however, it is practically essential to draw the line somewhere. In practice, governments are always influencing relative prices "all over the place" by actions that are not directly connected with trade policy, for example, government purchases, indirect and also direct taxes, public-sector pricing decisions, interest rate and price controls, credit policies, wage and labor policies, laws, regulations and police pressures. Except when these measures enter the discussion "naturally" because they are directly linked to either subsidies and trade incentives policies or to overall management of the economy in order to obtain specific trade effects, it will be useful to simplify the presentation by leaving them out; but one should not entirely forget their importance as supplementary and complementary measures. Potentially they can either reinforce or undermine the effects of incentive measures taken in trade policy. Successful development policy requires that they be made consistent with the trade policy measures discussed here, in pursuit of a coherent set of objectives.

2. "Theoretical" and Revenue Arguments for Unequal Incentives and their Practical Implications

In the theoretical, as well as the practical, literature on trade and development, much has been written about the valid reasons for giving unequal treatment to particular products, in production and trade.

According to the "mainstream" view of the subject, the main reason for giving unequal treatment to particular products, in trade and production,

is the existence of side effects--known as "externalities" in the economic literature, though they are sometimes called spillover effects--from production and/or trade, involving one product as against another. Many types of side effects can be identified. For example, there may be a side effect of more production by each individual firm in lowering the price received by all the country's export producers together--if so, this may call for export taxes to improve the terms of trade. One also finds other negative side effects, too, such as pollution, adverse effects on the social system or on consumers' values or psychological well-being, weakening of military defense capabilities, or vulnerability to a decline in world demand for the export specialty, all of which can be made the basis for discriminating against particular exports, imports, or levels of trade. One also finds favorable side effects--benefits that spill over to benefit other firms and industries as a result of production, or trade, within a decentralized market economy. For example, a pioneer enterprise can serve as a training center training people, and accumulating technical know-how, that can then be applied in other industries without their having to pay the same learning costs. Side effects also come about through input-output links by which one industry's output is another's input, so that the cost and quality of the product affect the user industry. Side effects are important, too, in exporting manufactures. For example, the initial exports of the first few firms that begin to sell in foreign markets, if their products are of good quality and attractively priced, become a magnet for foreign buyers and a source of acceptance for other manufactured exports from the same country, while bad experiences with one export supplier could hurt others. In most areas, depending on the circumstances, side effects can

operate in either direction; for example, while particular imports in some instances might lead to harmful social or psychological consequences, other imports may have positive side effects, for example, in spreading desirable new ideas, helping people learn new skills, or triggering an impulse to imitate foreign achievements.

According to "mainstream" economics, to the extent that side effects are understood and can be correctly valued, a case exists for changing the incentive system to take them into account. Correcting prices to reflect the true social benefits of each activity--taking into account its side effects--would lead to a superior outcome for the economy and society as a whole, since prices are a guide for decentralized decision-making throughout the economy. Through taxes and subsidies, private profitability can at least theoretically be brought in line with social profitability. Of course, in some cases the desirable action may take the form of prohibiting the harmful trade, regulating quality testing of exports, or taking some other direct action that is not in the form of taxation or subsidy. And again, where public investments are being made there will be a need to make investment choices based on "shadow prices" deemed to be socially "correct," as another part of the same process of correcting prices to reflect true social costs.

Besides a need to correct private prices to bring them in line with "social" considerations, at least two other rather different and distinctive arguments can be theoretically accepted as a basis for discriminatory treatment of one product or subsector as against another. One is that protection or some other tax may be justified as a revenue measure, where the social value of getting the revenue is deemed to outweigh the negative effects in distorting incentives. Revenue implications of trade policy

will be discussed shortly. The other is that protection or some similar action may be justified as a "second best" measure. This refers to any case in which there are known to be social imperfections and distortions in the price incentives that actually prevail, due to perverse government policies or lamentable realities that cannot be directly corrected. In this case, if the distortion cannot be corrected by "first best" means--for example, if unjustified protection cannot be removed for political reasons, or if an overvalued exchange rate cannot be directly remedied--there may be a "second best" argument for an expedient policy measure--such as export subsidies or disguised administrative favors in exchange for exports--that themselves have negative side effects in distorting incentive systems, and that would not be needed or used under "first best" policies.

Much of the discussion of trade policy in the economic literature centers around the practical implications of "externalities" and "second best" arguments. In particular, when and where do these effects justify direct intervention in trade through tariffs, QRs, and the like? What do these effects imply in regard to the issues of when, how, and how much to protect or subsidize manufacturing industries, or other new activities, in a developing country?

In the literature analyzing these subjects, the most important findings appear to be the following:

--Favorable externalities--side benefits that spill over to benefit other firms and industries--as a result of production within a decentralized market economy, are only likely to be very large in the early years of a new production activity. The early years of a new industry

are usually marked by much technical progress, learning, training, "debugging" of production processes, demonstration of the feasibility of the activity, and formation of skills and new ideas that can then be applied profitably in other industries or other firms in the same industry. Thus, there is a justification for giving strong special incentives to a new activity for its first few years; and this may be essential to get it started. But these benefits diminish sharply once the new industry has been around for a few years. Thus, much less special help ought to be given to latecomers and survivors, ten years after the industry has been started, than to the "pioneers" who first launched it.

--Once activities are well established, as a rule, there are likely to be only modest differences in their economic side effects. Favorable ongoing "externalities" from production are quite likely greater in most manufacturing industries than in most primary production, relative to the value of output. This is because technical progress, learning and training effects that are of value to (but are not compensated by payments from) other firms in the same or different industries, seem likely to be greater in manufacturing than, for example, in agriculture. After all, relative to the value of output, more technical progress comes about in manufacturing through private firms' experiments, and more managers and trained workers shift from one firm to another, taking with them valuable special skills and know-how acquired on the job. However, these differences in side benefits are almost certainly not large in most cases as a percent of the price of the finished output; and some other activities--in finance, commerce, services, and even in particular types of agriculture--also surely have positive spillovers of

a similar nature. Moreover, given all the many contributions that agriculture makes to successful development, and its importance as a source of employment, developing countries may be ill-advised to burden and tax it to build up industry.

--Some of the side effects sometimes cited in the past as arguments for protection clearly are not, but very obviously call for other types of intervention instead. For example, protection cannot generally be justified on the basis of inter-industry input-output links, even though these are a source of externalities. Starting one industry may help to start others as emphasized by Hirschman (1959), and this may sometimes reinforce the case for giving temporary special help to strategically chosen industries for a few years, but forcing other industries to use the output of a high-cost, low quality or unreliable local supplier in place of imports will certainly hurt their development. This influence calls for, if anything, subsidies keeping costs down, instead of tariffs that would raise user costs. Again, special financial help may be required for firms in manufacturing, and other fast-growing activities requiring large investments, when they have little creditworthiness (if only for lack of established collateral and income streams), but this, too, is obviously not a "first best" argument for protection, but rather for direct measures of subsidized credit, government financing or guarantees, financial institution-building and the like. Again, as already

1/ Some economists would go so far as to contend that agriculture merits special favorable treatment at least as much as industry does. Everyone would agree at a minimum that a strong argument exists for subsidizing any crucial aspect of agriculture, such as research and extension services with favorable externalities, that would otherwise be neglected.

noted, diversification away from a vulnerable specialization in one or two export products would ideally be handled by export taxes on these products.

--Most of the positive economic side effects already cited, when looked at closely--including the benefits flowing from a pioneer industry in its first few years, and the ongoing side benefits from industries that provide proven technology and skilled workers to other firms without being able to recover the costs--turn out to be equally great whether production is for the home market or for exports. To the extent that this is true, it means that government intervention should ideally take the form of taxes or subsidies on production, or if the effects have to do with the social desirability of consuming the product, on consumption, and not on trade at all. Incentives should ideally be neutral between production for export and production for the domestic market. And indeed, this is the central principle of trade policy as recommended for developing countries these days: favor one industry, product or subsector against another, where there appears to be a strong reason for doing so, but keep incentives neutral between import substitution and exports except in special cases where there is a strong reason to deviate from this principle. Of course, if in the first few years an industry is not going to export anyway there may be no practical objection to using temporary protection to get it launched.

--Manufacturing for export, and perhaps launching of new exports in other sectors as well, may well be among the economic activities that have the greatest positive side benefits, given the learning effects and the carryover of the experience from pioneer firms to those that come afterwards. Thus it would not be unreasonable on economic grounds to give special incentives at times to "infant" export activities, actually favoring sales

abroad, in view of their positive side effects. (In practice this may be politically difficult to achieve in light of international rules against export subsidies.)

--Continuation beyond the first few years of measures that discriminate very strongly for or against traded products would appear most justified in special cases involving strong noneconomic considerations, such as military security, pollution, or harmful social repercussions. Here, however, the discrimination will in some cases be justified against, rather than in favor of manufacturing industries. For example, some manufacturing industries cause unusual degrees of pollution, and others lead to luxury consumption that may be deemed to cause negative social side effects. As for military security, a paramount national need may be near self-sufficiency in food in event of war, calling for incentives in favor of import-substitution in agriculture.

--"Second best" considerations may call for protection in some cases where a correct exchange rate, subsidies, and/or neutral incentives would be theoretically superior, but in the same conditions they usually argue strongly for export promotion as well, by whatever practical means may be available.

--Finally, quantification and measurement of most of the side benefits under discussion here have never progressed far enough to provide reliable guidance in setting incentives: this remains a matter of guesswork.

As already noted, another major reason for unequal treatment of exports and imports in different sectors is simply to raise revenues. In practice, even the poorest governments require tax revenues equal to a

substantial fraction--typically 15 percent or more--of GNP; and they cannot afford subsidies unless taxes can be raised to match. Revenue arguments for taxes on trade are relevant mainly in the early and middle phases of development, since in later phases it becomes feasible to raise revenue in large amounts through alternative measures more like those of industrialized countries.

Taxes on foreign trade and on primary export sectors are among the only taxes that are administratively feasible and convenient in very poor countries. Typically such an economy is only partly monetized and can afford only a small public administration (officials' salaries being high compared to per capita income). Cash transactions in the economy are concentrated in trade, while elsewhere they are scattered and small. The income generated from local natural resources is the most obvious target for taxation, along with imports. Other taxes are likely to be at least equally crude and expedient (e.g., indirect taxes or government monopolies on a few consumer goods supplemented by crude direct taxes based on numbers of population or dwelling units, or land if it is scarce, or wealth in cattle or output in grain). "Modern" tax systems can be and should be introduced as development progresses so that eventually taxes on trade (like other crude taxes) lose importance; but this does not happen before their effects have been fully explored and recognized and battled over politically by those most concerned.

Attempts to tax trade lead to a recognition that some trade can bear taxation without production and commerce being eliminated or severely curtailed as a result, while other trade cannot. As a result, taxes are set higher on some exports and imports than others. What economists call "rents" from natural resources, by definition, can be taxed without eliminating the

export activity, so that on the export or export production side, taxes become concentrated in products where the rent element is greatest, while taxes tend to be small on exports that are only marginally profitable, prior to taxation.

Imports are typically able to bear taxation since at early stages of development the foreign article is likely to be much superior in quality and price to any available local substitutes; but even here, duties will be concentrated on imports for which demand is inelastic. Taxation of imports leads, too, to a demand for exemptions. Some imports are required by the government itself, and others are likely to be exempted by governments on grounds that they contribute to development. Machinery, scientific instruments and books have often been exempted from import duties for this reason not only in this century but in past centuries.

Import-competing industries are quick to recognize the value to them of tariffs on imports. Frequently such tariffs, applied to consumer goods, serve to "kill two birds with one stone" by taxing luxury consumption and at the same time giving a subsidy to producers out of the pockets of consumers, without any tax having to be collected or subsidy distributed, beyond customs surveillance of a few ports that is essential for revenue purposes anyway.^{1/}

In the case of producer goods of practically all kinds, and also consumer goods whose use is deemed desirable--for example, medicine, or powdered milk for school children, or grain needed to feed industrial workers--import duties may have to be foregone, in order to promote use of the good,

^{1/} The tax on luxury consumption will only persist to the extent that local production remains expensive: it may be necessary to supplement this by an excise tax as local production costs fall.

particularly in the case of imports destined for use in publicly approved projects and purposes. In any case, some producers (those competing with the imports) will be in favor of protection and others (the users) will be opposed and may have valid, development-related arguments for being exempted.

Even for tax-revenue purposes, these are not easy decisions. In the case of consumer goods, setting protection high enough to replace imports by local production extinguishes a source of revenue, which might have to be offset by an indirect tax on consumption of the product. In the case of producer goods, taxing imports carries a danger of discouraging local production or investment that could eventually provide a new source of revenue.

In summary, theoretical and tax considerations provide a number of reasons for departures from unified and equal treatment of different sectors, in trade and production, but there is little or no intellectual support for high protection and large price distortions such as those often found in developing countries, except perhaps on a transitory basis in the first years of a new industry. Even in this case, there are strong reasons for using subsidies or similar instruments rather than protection in the case of producer goods industries, to avoid damage to other industries.

3. The Declining Case for Protection as Development Proceeds and Producer Goods Industries Become Important

In recommending levels of protection, export taxation and related government intervention, despite what has already been said, a considerable range of disagreement could almost certainly be found among experts over how much protection or other special help ought to be used in building up manufacturing industries--such as consumer goods and simple construction materials industries--in early stages of development, in countries that find

themselves enormously far behind the rest of the world and are eager to get started in industrialization. Some experts would be sympathetic to giving substantial initial levels of protection to industry in such a country, while others would be very concerned that once started, high protection becomes very hard to stop through the rest of the development process. A very conservative view would also argue that getting industries started artificially behind protective barriers is likely to divert skilled manpower and government attention from more fundamental tasks of building up education, infrastructure, and basic functions of government, and that if progress can be made on fronts such as these and in agriculture and other key sectors, industries will soon come into being anyway. An intermediate view would call for temporary and/or moderate protection of industries.

Lack of agreement on this subject is based in part on a lack of research and of persuasive evidence, one way or another. Much careful, partly quantitative analysis has been carried out on the trade policy regimes of countries in middle and later stages of development, and much has been written about the implications of their experience, leading to a considerable convergence of views among experts. But very little has been done by comparison to study industrial and trade policy choices in the early stages. Another part of the problem is that the evidence is not easy to interpret in these stages: other influences are likely to be more immediately central in shaping the economic results being attained, and it is difficult to weigh in advance the long-run significance of the factories that already exist. If, as seems to have been found in the World Bank's research on several countries of West Africa,^{1/} almost none of the local industries is particularly

^{1/} This study under the direction of Bela Balassa has not yet been published, but findings are presented in unpublished form in Pearson, Nelson and Stryker (1979), Pursell, Monson and Stryker (1975), Horton, Pursell and Stryker (1975) and Shepherd and Stryker (1975).

efficient and promising as yet by international standards, this is not a clear piece of evidence against the protection given since the gains are presumably slow to materialize. Historical experience has also been less than decisive on this subject, either because the evidence is too mixed, or because it has not been arranged in a sufficiently persuasive fashion, or because the countries that have already made decisive breakthroughs in their development are and were quite different, particularly in their human resource situation, from those now in the early stages.

Expert views begin to converge, however, on the point that whatever may be the justification of protection early in development, the case for protection becomes weaker and the case for shifting policy away from protection gains in strength as development moves forward.

A number of reasons for this have already been touched upon. Superior alternative policy instruments such as subsidies and tax credits become increasingly available as revenue systems improve; the industries already established need a healthy economic environment in which to grow and learn to compete without being seriously handicapped by either protection or discrimination against them (including their export possibilities); and so on.

Perhaps the most important reason is that the new industries being started will increasingly be producer goods industries turning out either intermediate inputs such as chemicals, steel, refined petroleum, or motor vehicle parts, or capital goods in the form of machinery and equipment.

Sustained protection is not an ideal way of promoting these industries. In the first place, the slow-to-be started producer goods industries almost always involve large economies of scale based either on the scale of the plant

(as in typical processing industries) or the size of the production run (in the case of batch or assembly-line production typical in capital goods and parts production). This means that exports will help the industries to attain adequate scale economies, and taxing users through higher prices will hurt by reducing the level of home market demand. Thus, protection will reduce the scale of operations, increasing unit costs. Then, too, protection of producer goods industries will hurt other industries, by forcing them to pay higher prices and/or accept a lower quality (and/or narrower range) of inputs. This will reduce the country's international competitiveness in export and domestic markets alike, forcing continued protection of all manufacturing, while reducing the supply of imports to the manufacturing sector and the rest of the economy as well, since manufactured exports will be made infeasible. More generally, at later stages of its development, a developing country must be heavily concerned with the quality of its infrastructure and organization and training and human resources, and the competitiveness of its manufacturing industries with those in richer countries. After all, the basic objective is successful growth and development. Producer goods industries so inefficient that they need substantial ongoing protection do not provide a solid foundation for a drive toward industrial parity with advanced countries.

These considerations will not always be decisive, since the alternatives, such as relying on subsidies or continuing to import, have their disadvantages in denting the available supply of public revenues and capital and foreign exchange. The evaluation of alternative methods for promoting new industries may have to be done on a case-by-case basis. Even high protection may be acceptable if it is done for only a very few years with

reasonable assurances to all concerned that it will be removed. However, as an ongoing system, high protection is not appealing at this later stage of development, and it may lead industrial development to a "dead end" if there is no provision for promoting manufactured (and primary) exports side by side with production for the home market. Even such one-time advocates of protection as Raúl Prébisch and the U.N. Economic Commission for Latin America have become highly critical of "industrialization in water-tight compartments," and in favor of manufactured exports at this stage.

4. What Can be Learned from Historical Experience?

This paper is meant to serve as a distillation of lessons from experience, without attempting to array the case-by-case evidence. In keeping with this approach, very little will be said here about the evidence of history, but this subject is too important to leave wholly aside, all the more so since the expert views already cited contain a considerable range of ambiguity as to just how much protection (etc.) should be applied, and when and where.

On the whole, historical evidence seems generally consistent with the converging "mainstream" expert views and recommendations of recent years. In particular, one finds ample evidence in the experience of recent decades that a continual use of high and very uneven protection, based heavily on quantitative import restrictions (QRs), combined with a neglect of exports and a ubiquitous use of exchange controls--required in such a regime to restrict foreign exchange transactions in face of a balance-of-payments disequilibrium--results regularly in inferior and unsatisfactory results in industrial development as well as in economic growth. The "horrible

examples" most cited are probably those of India and Chile, but the experience of dozens of other countries can also be brought to bear on this point.

Beyond this, however, the historical evidence is not very decisive, offering no resolution to most of the ambiguities and conflicts in expert advice. This is partly because the policies pursued in different countries and eras have been largely dictated by changing fashions in policy, with fashions themselves partly dictated by the size and resource situation of the countries involved. This means that one finds only a narrow range of policy contrasts among countries with similar resources. The evidence is also indecisive, of course, because trade policy in each case has been only one of many influences. While one can conclude, from what actually happened, that successful industrialization was consistent with the pattern of trade policy actually followed, it is difficult to reject the possibility that results would have been better with a different policy. Even so, a brief look at these changing policy fashions will be useful, along with a few speculative comments on the implications in terms of development results.

For at least a century up to 1930's, tariffs were the main instrument of protection in westernized countries. Import licensing and QRs came into widespread use starting in the Great Depression, at first as temporary expedient measures required in combination with exchange controls, in face of currency inconvertibility and foreign exchange shortages. Their use soon became widely favored in poor countries as an instrument of protection and industrial development policy as well, so that many developing countries expanded and elaborated them while they were being dismantled in Europe and Japan in the

1950's. More recently their defects have been widely recognized, and they have been at least partly dismantled in many developing countries, in favor of a return to tariff protection.^{1/}

In each era, some countries have favored high protection and others have departed only slightly from a basically free-trade orientation. In the nineteenth century, for instance, Mexico followed the examples of the United States, France, and Russia in opting for what was then considered high protection: Mexico's tariff collections generally averaged over 50% of the value of officially reported imports, starting only a few years after independence.^{2/} Almost all the major Latin American countries became quite protectionist by the early twentieth century, while by 1902 Spain and Portugal each had tariffs averaging over 70% (weighted by British manufactured exports).^{3/} India adopted tariff protection once it was allowed to, after 1921. But some smaller countries such as the Netherlands, Norway and Switzerland have never embraced high protective tariffs. Many of today's developing countries were not given a choice but were treated as captive markets under colonial regimes, and allowed almost no protection against goods from the colonial power. Japan was restricted by treaty to only low revenue tariffs up to 1900 and did not

^{1/} This has taken place in several different parts of the world -- particularly the Mediterranean Region (Spain, Yugoslavia, Greece, Israel); East Asia (Taiwan, Korea, Philippines); and Latin America (Mexico, Argentina, Chile, Colombia, Brazil) -- with incipient changes elsewhere (e.g., India and Sri Lanka). However, the shift is not nearly as widespread as the increased promotion of manufactured exports.

^{2/} See Keesing (1972).

^{3/} So did Russia and the United States. See Little, Scitovsky and Scott (1970), p. 162.

begin to use strong measures of protection until after World War I. Even after that, while it has used QRs as well as tariffs, its exchange rate and monetary policies and its industrial strategy have remained export oriented, compared for example with those of Britain or the United States.

Since the 1940's practically all the larger semi-industrial developing countries have gone through heavy doses of QRs and exchange control backstopped by tariff protection.^{1/} Since their independence this has also occurred in a number of African countries, for example, Ghana, Mali, and Tanzania. A few developing countries -- notably oil countries such as Venezuela, and most countries of the Central American Common Market -- have maintained convertible currencies while relying mainly on tariffs; but few of the developing countries have resisted protectionism in some form. The important exceptions have been Malaysia and Singapore, which have kept tariffs low and eschewed QRs, and Hong Kong, which has remained a colony and (practically) free port.

Closely related to these changes in protection have been changing fashions in economic management and exchange rate policy, and in the emphasis given to exports, particularly manufactured exports. In the era when tariffs were the norm, exchange rates were based, where feasible, on full convertibility into major currencies and also (until World War I) into gold or silver. This approach was coupled with conservative monetary and fiscal management restricting local demand and monetary expansion to

^{1/} Here there is the evidence of two or major studies each, leaving no room for doubt, in such important cases as Argentina, Brazil, Chile, Colombia, Egypt, India, Korea, Mexico, Pakistan, Philippines and Turkey.

what the balance of payments would bear. At the same time, exports were widely fostered as an "engine of growth," but only exceptionally (as in Japan) did this imply development around manufactured exports. The era of enthusiasm for QRs in and around the 1950's corresponded to a period when expansionist demand management was lauded (in the spirit of Keynesian economics) in the interests of growth and full employment. If this strained the balance of payments and led to overvalued exchange rates, the effect in discouraging exports was not considered important -- export pessimism was widespread, and development was expected to be built around the home market. Starting in the 1960's, however, it became recognized that undervalued exchange rates, by fostering a rapid growth of exports along with import substitution, had been providing a powerful impetus for growth in some of the industrialized countries; that world trade was growing rapidly and providing a source of growth, particularly in manufacturing for export; and that countries which promoted manufactured exports were developing much more successfully than those that did not, which soon found themselves in an impasse. Fashions (and expert advice) shifted in favor of "realistic" exchange rates along with other powerful incentives to promote manufactured exports. However, this shift has not been easy to achieve in economies already built around QRs and high rates of effective protection, so that developing countries are now spread out across a wide spectrum of policy regimes.

Looking at the historical evidence from a somewhat different angle, in practice, since mineral exporting sectors are generally taxed (or their exports are taxed) in special ways, the question, how much protection

should manufacturing be given, very nearly amounts to asking, how much should agriculture be "unprotected" and discouraged by indirect taxation in order to promote manufacturing?

In striking a balance between the two, policy fashions have been quite different depending on a country's population, resources, and other characteristics. Today it is practically impossible to find a large country, with a population now over, say, 20 million, which has not engaged in very considerable protection of manufacturing, for better or worse, over a substantial span of its industrial development. Of course, there have been differences of degree -- Russia even before the Bolshevik Revolution used more protection than the United States, which had higher tariffs than Germany or Italy; and in a few countries, notably Germany, agriculture was protected at the same time, to an extent that may have offset most of the effects. Most of the larger of today's developing countries, such as Brazil, India, Pakistan, Mexico, and Turkey, have also made heavy use of protection; even Korea has done so, making heavy use of QRs even in recent years, though after a few years the net policy bias was shifted away from import substitution toward equally strong incentives for exports. As a rule, protective tariffs have been continued beyond the initial learning period of each new industry, if only because the vested interests created insisted on them.

It is interesting to observe, further, that in many, if not most, of the larger industrialized countries, including Japan and France, as well as Germany and the United States, once industry has become strongly competitive it has proved politically necessary to protect and subsidize

agriculture more, so that the balance with manufacturing has been reversed.

By contrast, countries that have stayed with low protection, such as Switzerland, Denmark, the Netherlands and Malaysia, are relatively small with a flourishing, high-technology, high quality agricultural sector that does not need protection to compete successfully. Each of these countries valued its agriculture highly and sought to apply scientific methods in it, even before industrialization made great headway. The "city states" of Hong Kong and Singapore, of course, had no possibility of building industry at the expense of agriculture, which is pursued in each place as an import-competing quasi-industrial activity, for lack of land.

Where farmland has been abundant relative to population, as in Canada, New Zealand, Australia or Argentina, a rather defensive high protectionism has been typical, aimed at maintaining employment in manufacturing rather than competing internationally. These economies have suffered in industrial competitiveness as a result, and employment has become precarious.

Obviously there is room to argue that low protection of manufacturing would have been better, at least once industrial development got well started, in large or land-rich countries, leaving them fewer problems today. Japan, for example, would not have its problem of high-cost, inefficient agriculture, politically difficult to change, and Australia would not have such defensive and uncompetitive industries. But at least in the larger countries it is difficult to find historical examples of a non-protectionist approach. The possibilities of industrial progress, without greatly favoring industry over agriculture, would have to be supported based on German experience, which is complex, and early periods of low or moderate

tariffs in such varied nations as Japan, India, China, Korea and Taiwan as colonies, and (for the land-rich countries) Canada, Australia and Argentina. This evidence is suggestive but not conclusive. Conversely, however, there is very little historical argument in favor of high protection of manufacturing, particularly by the standards of the developing countries that have QR-based, import substitution oriented trade regimes. Perhaps the most that can be said is that a few of them, such as Brazil and Turkey, have gone a fairly long way in their industrial development, achieving at least moderately high rates of growth before they have found themselves stopped by exchange rate difficulties.^{1/}

Differential treatment among subsectors of manufacturing and agriculture is also very common in large countries. Here the usual fashion is to favor consumer industrial goods, selected intermediate goods, and import-competing, grain-producing subsectors of agriculture, while indirectly penalizing not only agriculture for export, and most of the rest of the economy, but also capital goods industries and assorted other manufacturing. Here, again not much can be concluded, although even Korea and Malaysia give high incentives to import-competing rice production. Perhaps it may be noted that most of the small countries with low or moderate tariff histories have emerged as specialized exporters of capital goods despite the scale economies involved (witness Sweden, Norway, Denmark, Switzerland, and now Singapore and Taiwan, if not Malaysia). But this helps to point up the rather high level of skills and "human resources" in these low-tariff countries that has helped them do without high protection. Practically no "captive" colonial economy has put together a substantial capital goods

^{1/} The reference here is to Brazil prior to 1964 when its policies became more export-oriented.

industry although a few have laid useful groundwork for industrialization. A few of the successful engineering industries in developing countries, such as Brazil's machine-tool industry, do seem to have grown up in face of negative effective protection.

Perhaps the most intriguing point to be learned from economic history is that Japan and Korea, among others, have successfully used nearly infinite, QR-based temporary protection of new manufacturing industries in order to get them started, within economic systems that are aggressively oriented toward export success and international competitiveness, and in some cases have then managed to make the industries internationally competitive in an impressively short time period, sometimes only a few years. Obviously there is no tenable rule against transitory, very high protection in such a system, provided the government judges correctly the country's ability to compete successfully.

One puzzle is why some countries are able to do this while others fail, creating floundering "white elephants." Here, some provisional hypotheses can usefully be put forward. First, industries started successfully must be suitable to a country's human resources, infrastructure, market demand, and other surrounding conditions. In many developing countries these conditions are barely conducive to launching the simpler manufacturing industries on a struggling, import-competing basis, but in Korea, as in Japan earlier, the stage has been reached where a wide range of manufacturing industries are now or can soon be competitive as exporters. Second, the conditions for success depend not only on objective circumstances and incentives, but also on implicit pressures for internationally competitive

performance in the country's trade regime and industrial policies. Third, how well a government can intervene on a discretionary basis, using QR protection or keeping industries afloat with subsidies and other special help, depends heavily on the quality of the government's managers and other personnel, as well as those of the country's industries. Japan's success may have been built on its tradition of selecting some of its finest university graduates into economic ministries, and some others into major industrial firms which have then spearheaded the creation of new industries. Korea has sought to emulate Japan's example here. With poorer personnel, the same degree of intervention might have been a disaster.

In summary, the historical evidence on protection is not conclusive, but it does not contradict the main findings of theoretical analysis. Beyond any doubt, high protection of the QR variety is not necessary or desirable, based on the historical record. But initial high protection of new industries and a subsequent period of substantial protection may well be useful, provided the effects on "unprotected" manufacturing sectors can be greatly reduced in the long run. Countries that have not taken this last step (such as Australia and New Zealand with their high tariffs and the more industrialized countries of Eastern Europe, with what amounts to be a perpetual regime of severe QRs)^{1/} seem to have suffered a long-term erosion of competitiveness and are having trouble keeping up, particularly in capital goods and consumer goods -- only their standardized intermediate goods match world standards.

^{1/} The strong parallels between trade policies and their effects, in centrally planned economies such as Hungary and Czechoslovakia, and in QR-ridden developing market economies such as Argentina and Chile in the 1960s, are well pointed out in Balassa (1970).

5. Uses and Special Difficulties of Quantitative Import Restrictions Compared to Tariffs

Where protection does take place, rather than subsidy or some other form of government intervention, a leading practical issue is when and how much to use tariffs and when and how much to use quantitative import restrictions (QRs).

Most "mainstream" advisers on this point are very negative about the use of QRs, for a number of reasons. One is that any widespread use of QRs quickly leads to a situation in which economists and officials do not know or understand the incentives being applied, in contrast to tariffs where the structure of incentives is more straightforward. Second, as numerous studies of particular regimes at particular times have helped to show, the usual effect is to set up very high and uneven protection in different activities, more than the theoretical arguments already cited can justify. Third, the structure of incentives is subject to strong, sudden changes in reflection of shifts in the details of the protection applied, and in the surrounding circumstances -- there is no stability in the protection given. Fourth, the internal dynamics of the resulting economic system, by discouraging exports strongly and leading to a search for general rules as to who will get QR protection, tend to lead to a situation in which many industries receive virtually unlimited protection, which in turn causes them to stagnate, neglect quality and customer needs, and waste resources for lack of competition. Excessive wages are another common indirect result as labor unions press for a share of the profits. Fifth, the administrative complexities of trying to keep out goods or

maintain quotas on whole categories of imports almost inevitably lead to delays and bureaucratic obstacles to legitimate imports, since it becomes difficult for customs officials to know which ones are allowed; and these delays carry a cost in holding back the economy. Sixth, while tariff revenues go to the government, when QRs are used the scarcity value of the imported product -- when importation is allowed -- goes as a rule to the businessman who gets the import license, so that the government loses potential revenues. Still other shortcomings will be mentioned shortly.

So much has been written in recent years about what goes wrong under a regime of QRs, that it is important to note, nonetheless, that they have some advantages over tariffs, as a means of stimulating manufacturing in the early stages of industrial development. To be sure, these advantages may be completely outweighed by their faults, particularly in capital goods industries and those producing all but the most standardized intermediate goods. Here, regulation by QRs all too easily turns into a nightmare where local industries cannot get the particular pump or valve they need, because some local firm is being protected by QRs in producing a different pump or valve with a vaguely similar description. But for consumer goods that can be counted, such as shoes, and for a standardized type of steel or a chemical that can be measured in tons, QRs are a potentially valid option for purposes of protection, at least for a short time period while a new industry is started, despite the disfavor into which they have now fallen as a result of careful field studies. Even more, QRs have special uses in emergencies, when the balance of payments falls into trouble. Partly for this last reason, even if efforts are made to avoid their use, it is still important to worry

about how they had best be designed if they must be used at all.

The main advantage of a QR is simply that it is quantitative so that it provides assurance as to the quantity of imports that will be forthcoming. In an emergency this can be valuable, and as a regular instrument of protection, a QR allows local investments and production to go forward with fewer uncertainties than would be the case with protection by tariffs alone. With all the uncertainties that surround prices, wages, exchange rates, international competition, and the local availability of inputs, in many developing countries, even a high tariff may not provide much assurance over a multi-year horizon.

Most of the uncertainties that give QRs their special value in protecting industry, and also in managing the balance of payments (where exchange controls are generally used to complement quantitative import restrictions), are of minor importance under conditions of political, monetary-financial, and exchange rate stability, such as generally prevailed in the West before World War I and in the richer countries from the early 1950's to the early 1970's. Under these favorable conditions, much industrial growth has taken place with no more than tariff protection. But in developing countries which cannot achieve such stability, QRs supply a partial substitute. However, to the extent that their use is extended into differentiated and complex producer goods, and/or their administration becomes hard to predict, arbitrary and capricious, they can easily contribute more uncertainty than they dispel. In addition, they can lead to misallocation of resources and bottlenecking of development on a very large scale.

In any case, learning to live with the "normal" uncertainties may be an important part of the learning process.

One might argue, in the abstract, that, as instruments of protection, QRs should never be pushed to the point of complete embargoes against competing imports (i.e., zero quotas), to avoid giving blanket unconditional protection to local industries, and to keep consumers (and local producers) in touch with world standards of quality. After all, there is a clear danger -- amply confirmed by studies in Chile, Turkey, Ghana and various other countries^{1/} -- that elimination of all competition from abroad (except smuggling) will lead to deteriorating standards of efficiency, technical progress, customer service, product quality, and learning-by-doing in the protected industry, leaving it stagnant, incompetent, cartelized, and all too ready to pay high wages for inferior work (not to mention bribes for profitable import licenses). This sort of QR system becomes a spreading cancer with negative effects throughout the industrial sector. In practice, however, it would seem very difficult politically to avoid having import quotas pushed to this zero point, except where the supply of foreign exchange is not a serious constraint.

Where foreign exchange is relatively abundant, non-zero quotas may be preannounced years in advance as an exceptional measure of promotion. Another situation in which QRs can be made to work is when an export-promoting, toughly administered regime sets them, but ties them to achievement

^{1/} As shown, for example, by the N.B.E.R. volumes by Behrman (1975), Krueger (1974), Leith (1974) and others.

of competitiveness, high technical standards, and strong export performance. This has been done in the past in Korea and Taiwan.

In any case, the negative view of QRs springs partly from the difficulties in limiting their use and making wise decisions on them. This is partly a matter of politics, where the danger comes not only from the fact that industrialists want them very badly if they think they can get them, but also from the circumstance that government officials are eager to administer them -- they are a source of great power and, potentially, of valuable bribes and favors. Thus, vested interests are swiftly created that perpetuate and spread their use. Still another danger is that, to maintain "fairness" and avoid favoritism, QR protection and the accompanying import licenses (which are needed to implement non-zero QRs) will be given out on the basis of mechanical rules (historical shares of a market, or whatever) that have no relationship to efficiency or management ability. Indeed, incentives may all too easily be distorted by these rules.^{1/} Sustained use of QRs also leads to much clandestine capital movement -- usually out of the country -- through over- and under-invoicing; and depending on geography and the corruptibility of officials, there may be much smuggling as well.^{2/}

Bhagwati (1978) has spelled out in considerable detail the range of variation and the central tendencies, in the actual administration of QRs, in the ten or more developing countries that have been most carefully studied

^{1/} In India, for example, producers got licenses to import inputs in proportion to their installed capacity, and thus were led to expand capacity for no other reason, in industries already suffering from excess capacity. See Bhagwati (1978).

^{2/} These are also problems in a system of high tariffs.

in this regard. There is considerable variation in who gets import licenses, on what rules or basis, with how much delay and uncertainty, whether they can legally be sold or transferred, etc. It turns out that the details of how the QR system is designed can make a large difference in its impact. The pitfalls are too numerous to mention here. Characteristics that appear desirable include saleability and transferability of licenses; rapid, reliable action to license imports of producer goods to the extent that the balance of payments permits, and to keep up the flow of current production in any case; stable but not-too-mechanical rules, and licensing in the hands of a government agency responsible for industrial development, which uses this instrument to promote positive performance.

A related practical lesson of experience is that it is generally desirable to back QRs with substantial tariffs on the same product, for two reasons. First, an import license, permitting the holder to import a restricted product, under a QR regime, is worth money: if the license is fully transferable, this premium varies with the tariff equivalent of the QR. By making the license recipient pay a tariff, this premium is taxed so that much, if not most, of this premium goes to the government. "Mopping up" premia in this fashion reduces the excess demand, corruption, and favoritism associated with the import licensing system. It also helps to ration import licenses to those who need them enough to pay the tariff. Second, existence of the tariff provides another type of protection and offsets uncertainty otherwise aroused under a QR system, because of the possibility that quotas will be liberalized by administrative fiat.

Tariffs also have their practical shortcomings, of course. Two are especially worthy of note. First, in most countries tariffs are imposed or

must be confirmed by legislative action, so that they tend to be rather inflexible, in the short run. Moreover, amending them often involves public politics complete with behind-the-scenes trading or "logrolling," that tends to make them protectionistic. In this respect, the industrialized countries are now largely spared the need to legislate tariffs anew by successive rounds of multilateral trade negotiations in which tariffs are lowered based on international commitments. But developing countries have few such commitments (except in regional common markets, where protection is traded among countries).

A second shortcoming arises from input-output relationships among industries (one's output is another's input). It turns out to be technically difficult to construct a "rational" tariff structure and to avoid giving some processes very high effective protection while other processes get negative effective protection. Even a seemingly innocuous set of nominal tariffs can lead to distorted results at a "micro" level; conversely, a "rational" tariff structure may have a strange appearance. Of course, even greater distortions are typically created under a QR regime than under a poorly designed system of tariffs.

QRs and tariffs share the further shortcoming that both are hard to eliminate in practice -- the cost for them is usually based at first on a temporary need, but once in place they become "needed" forever by a special interest.

6. Use of Other Trade-Related Policy Instruments

In examining technical alternatives in the promotion of industries around the home market, it may be instructive to go beyond a consideration of tariffs and QRs to consider the uses and shortcomings of other policy instruments as well, without getting into minor details of what are clearly

inferior measures, such as prior import deposits or covert administrative obstacles to imports.

In addition to tariffs and quotas, several other trade-related instruments are widely used that have roughly equivalent effects in promoting industrial development. These include (1) export taxes (and restrictions on primary products, (2) government procurement policies favoring local over foreign suppliers, (3) domestic-content requirements, and most important of all, (4) subsidies of various kinds that are essentially equivalent to protection. All of these have proved legitimate instruments, up to a point, or so it can be argued; but they all have pitfalls and raise difficult questions.

Uses and pros and cons of export taxes have already been discussed. One aspect has been omitted, however. Export taxes and quantitative restrictions on primary exports are often used, not only to favor the manufacturing sector in a relative way by reducing the profitability of primary production, but also to favor processing industries by providing local inputs at a lower (depressed) cost. A common case would be that because of taxes on exports of raw cotton, the local cotton textile industry pays less than the world price and is thus assisted in competing against foreign textile mills at home as well as abroad. Or again, Mexican export duties on strawberries make them cheap for the local industry that produces strawberry jam. These effects are often achieved through local price-setting by government marketing boards or by government purchasing and sales at state-controlled prices; in some cases, this takes place at more than the world price with opposite effects.

As has been already pointed out, there is a serious danger that as a result of marketing boards, export taxes, etc., exports will be made directly and indirectly unprofitable and will shrink, depressing imports and industrial

development. Another problem is that the effective protection in the strawberry jam industry and many others may be pushed to absurd levels, creating high profits for undeserving industrialists but very little useful learning.

Turning next to government procurement, many governments have rules and procedures by which local suppliers are favored. This has been a major instrument for promoting industrial development, for example in Japan, especially in the years up to 1900 when only very low tariffs were allowed as a result of unequal treaties. However, all too often developing countries are inconsistent in these matters for no well-considered reason, with different rules on different parts of the public sector; and many fail to give preferences to local firms. For example, in Mexico, at least until very recently, no tariff has been paid on imports and no preference has been given to local suppliers, not only by central government agencies but also by the public sector monopoly enterprises in petroleum, electric power, etc.

Policies in this area deserve more attention and analysis than they have been given. Some of the lurking questions are quite difficult; for example, if preferences are to be systematically given, what should be done about differences in product quality? Should treatment be the same if there is foreign ownership and control of local output? Is it politically feasible to discriminate against foreign firms? Are the procurement rules of major lenders (including the World Bank) reasonable in this area, apart from tying of bilateral aid?

One useful piece of advice may be that a developing country should make its procurement rules logically consistent with its other measures of protection and subsidy.

A recent change in the ground rules occurred in 1979, in the Tokyo Round multilateral trade negotiations, when an international code was adopted

on government procurement. By this code industrialized countries, and other signatories, agree to open their procurement to one another's firms on an equal basis, at least for designated agencies and purposes. A developing country now has to weigh the advantages and disadvantages of signing this code in setting its policies in the area.

Of the instruments discussed here, the most dubious, and the ones most difficult to manage well, are probably domestic-content requirements. These originated in, and are mainly found in, the motor vehicles industry, where they are used to force local production of parts and vertical integration in what started out as local assembly of knock-down parts by large multinational automobile companies. For this purpose, the valuation of domestic content should ideally be done at world prices; but because of oligopolistic price-setting and intra-firm transfer prices, host governments have to estimate these prices and set their own rules. Since economies of scale are so important in parts of production, the resulting operations can easily be very costly in negative value added at world prices, so that rules for exporting parts in order to import parts become necessary to reduce this cost. Even if this is done, there is a danger that the costs cannot be well balanced against the benefits. For example, the passenger car industry generally involves learning at a very high cost: unless success comes rather easily for special reasons, as in Brazil, or there is a clear export payoff in sight, this whole approach (and the content requirements) may not be worthwhile.

As for subsidies to industry, many subsidies are at least roughly equivalent to protection in their effects on production and trade (though not in their incidence on consumption and use). However, unlike protection, subsidies are often tied to the use of particular factors of production such

as financial capital, capital equipment, foreign exchange, or particular inputs into current production (more likely to be energy or raw materials than labor, whose use is hard to subsidize). This may indirectly lead to distorted choices of technology leading to wasted resources, unemployment and/or depressed incomes of labor.

Probably the most important type of subsidy, in terms of the sheer value of subsidies given in developed and developing countries alike, is public sector participation, ownership, and/or "bailing out" of industrial enterprises covering their losses as well as their startup costs out of the public budget. Next most important may be the broad class of tax holidays, tax reduction, and sharing of risks and losses through the tax system. Within this class, a noteworthy form of subsidization is to permit industrial firms to import raw materials, intermediate inputs, and/or capital goods free of tariff duties. Under a system of QRs, the equivalent effect is achieved by giving firms valuable import licenses. Other common subsidies include:

- Provision of infrastructure investment, industrial sites, and the like.
- Provision of financial credit (and access to credit) at artificially low interest rates.
- Supplying energy or other current inputs at subsidized prices.

In most cases, apart from affecting use of the input subsidized relative to other inputs, the effect is not greatly different from protection: there the firm collects the "tax" itself by charging high prices to consumers and users of the product, while in the case of subsidies, the government collects the tax, perhaps by indirect taxation or profits of state enterprises (charging artificially high prices) in other products, and transfers it to the firm in one form or another. As a result, the firm is enabled to compete against foreign firms, at least on the domestic market.

Of course, the use of subsidies competes directly with, and reduces, investment by the public sector, as well as other alternative uses of public funds. The end result may be a very high budget cost.

Subsidies and tax credits, even more than protection, are important instruments of industrial policy in any developing country. Nevertheless, while all the various types of subsidies have their uses, many are, like protection, a means of disguising the real cost of industrial production and forcing this cost on the local population. Because such a large battery of measures can be brought to bear at once, without international protest, as long as production is being aimed at the domestic market, there is little built-in check against disastrously uneconomical undertakings.

7. Fostering Industrial Development in Face of Foreign Exchange Abundance

Having examined the principal instruments of trade policy, for purposes of fostering industrialization around the domestic market, it will now be instructive to consider trade policy questions that involve interactions between strategy and the choice of particular instruments. The first of these questions is what to do in the face of an abundance of foreign exchange, combined with pressures for specialization in trade.

While many developing countries suffer from too little foreign exchange, and must be glad for any export opportunity, some are faced with problems from foreign exchange abundance, usually as a result of exceptional mineral wealth.

The biggest concern here must be that the exchange rate and supply of imports made possible by an export bonanza could doom the economy to not getting experience in a wide range of potential import competing and eventual export

activities, notably in industry, but also in agriculture and tradeable services. If the funds are "well spent" in investment programs, the labor force may get much experience in construction and supporting services, but not in sectors producing tradeable goods, unless special measures are taken to foster these sectors.

Since the mineral wealth will eventually be depleted, there are strong reasons for building up industries (and other ongoing production activities) that can eventually be successful and sustain the country.

An export bonanza provides a potential for a rapid buildup of physical capital facilities and infrastructure with much help from foreign skilled personnel, as has occurred recently in the Persian Gulf and other oil-exporting countries. As part of this buildup, capital-intensive agricultural and industrial projects can usefully be initiated alongside improvements in transportation, communications, and service facilities. In short, public investments are a natural outlet for the mineral wealth, and they can usefully be extended to selected subsectors producing tradeable goods. The government can also afford to hire foreign personnel as teachers and technical advisers, and to send students abroad, in an effort to increase quickly the skills and education of the population. It may be good strategy to concentrate on a basic buildup of skills and infrastructure, since this could provide a foundation for success in tradeable goods production.

In practice, however, there seems to be a serious danger that any country rich in foreign exchange will not really cultivate high standards in its human resources and competitive performance -- managerial jobs and production subsidies become too easy to get, and the population is not subjected to intense pressures to perform up to demanding standards in order to survive,

as it would be in an opposite situation. In economic policy, too, protection and subsidies and investments may be thrown around without sufficient standards. In this situation, one essential in trade policy may be to look at where the country wants to get to in the next thirty or fifty years.

What starts as a resource-rich country should probably aim to emerge, eventually, as an exporter of skill-intensive and capital-intensive goods and services, not directly tied to its natural resources. This has been the pattern of specialization, for example, in Canada, Sweden and the United States. Given this long-run objective, there may be little point in trying to foster unskilled labor-intensive industries such as clothing and footwear, which will never be internationally competitive in a country with high unskilled wages. Conversely, however, there is every reason to undertake strong programs in education, on-the-job training, strengthening of financial institutions, and infrastructure buildup, and to foster skill-intensive and capital-intensive industries, for example, some of the chemical and engineering industries, as well as those with natural transport-cost protection.

Where importing becomes "too easy," special incentive measures become appealing to promote import-competing industries. The main instruments here -- in addition to buildup of institutions to supply easy credit and trained manpower -- are likely to be subsidies, tariff protection, 1/ and what amounts to a dual exchange rate or its equivalent -- one rate for the principal export product(s) and another for everything else.

1/ There is no use in paying for the distortionary and bottleneck-creating effects of quantitative import restrictions, with so many alternative instruments available.

Given the negative side effects of protection in distorting social choices, and the dangers of fostering poor management and low standards by either protection or subsidies, careful attention must be paid to the possibilities of using the exchange rate to foster import competing industries. Here it may be feasible to use export or direct taxation and/or public ownership rights to tax heavily the main exports, while sustaining a seemingly unified exchange rate that is favorable to exports and import substitution in other sectors. Part of the key here may be to set the exchange rate to generate a surplus in the balance of payments on current account, and to let foreign exchange reserves and/or foreign portfolio assets accumulate without corresponding increases in the money supply. This will build up financial resources against future needs, and/or as a supplemental source of income and wealth; and it will hold down inflationary pressures and import demand based on local spending. Venezuela, among others, took an intelligent course of action in this regard, in the first years of the oil boom after 1973, setting resources aside in a special national investment fund. Politically it may prove impossible to hold back public spending for long when money is available, but at least spending should be delayed until investment plans have been well worked out. If feasible, smoothly rising "real" outlays on investment, over a long time period, are likely to result in more real resources created, with better results than a sudden upsurge.

Similarly, where one can expect large swings in export earnings as prices change, prudent economic management may well call for an accumulation of foreign exchange reserves in years of high export earnings, and a "smoothing out" of public investment expenditures, over the long run, not only to keep the

economy moving forward steadily despite the ups and downs of export earnings, but also to maintain a relatively steady "real" exchange rate to promote import-competing and nontraditional export industries. This may be much superior to the use of QRs to foster these industries, since they will grow up internationally competitive. Tariffs alone will not insure steady protection if the supply of competing imports fluctuates sharply.

It may be worth emphasizing, in these contexts, that there is more than one definition of an "equilibrium" or socially optimal exchange rate. One could argue that whatever may be the balance-of-payments effect, the exchange rate is not optimal unless it makes a sufficiently wide part of the economy competitive, over a long period. How to do this is the central challenge in a resource-rich economy.

8. Building Up National Capabilities in "Problem" Areas: Management, Technology Acquisition, Marketing, Design and Capital Goods

Another applied policy question applies, sooner or later, in at least some degree in any developing economy. Within industrial development there seem to be areas in which developing countries are particularly weak and have most to gain, since highly profitable skills are involved and mastery is a key to successful development in the long run. These areas include management skills and techniques, skills in technology acquisition, skills in marketing and design (notably in engineering and consumer goods), and skills in producing capital goods. In promoting industrial growth, how can a developing country acquire these skills?

Here the usual instruments of protection, and even most kinds of subsidies, are not especially helpful. High protection can easily lead to strong negative incentives for capital goods production, which must compete

with imported investment goods that are often available at artificially low prices, while at the same time paying artificially high prices for inputs such as iron and steel. Protection can easily have negative effects on the quality of learning in the other "problem" areas as well. After all, a manager dependent on protection who spends his time searching for government licenses and favors is not learning the kinds of skills that are needed in an internationally competitive modern economy; and comfortably protected firms have little incentive to become expert in marketing, design, or the acquisition and adaptation of technology from abroad. Subsidies, depending on which industries get them, when and for what, may well have similar negative effects on incentives.

What are the government's strongest instruments for the purpose of fostering these crucial skills?

One would seem to be its direct involvement in the industrial sector as a customer, as a shaper of investment demand, and as an instigator and institution-builder.

Another would be its ability to stimulate the industrial sector with judiciously applied doses of competition from abroad.

A third would be its role in promoting industrial exports, to be discussed in the next section.

Finally, despite what has been said, the government can aim subsidies specifically at activities, such as capital goods production and engineering design, that foster these skills and also foster schools and courses that help to teach them.

In subsidizing these activities, however, care must be taken not to overestimate the likely benefits from bringing in and subsidizing foreign "multi-national" corporations (MNCs). It is almost certainly true that the strength of

MNCs lies precisely in their command of these highly profitable skills. As a result, in some situations, MNCs will have to be brought in, one way or another. In these cases they must be encouraged to undertake appropriate training, and used as best possible as a source of instruction and example and technology transfer. However, given MNCs' reluctance to build up potential competitors and to pass on valuable disembodied "capital," except at stiff prices, this is a difficult game and not necessarily a satisfactory solution for the dilemma. Some (not all) multinationals will "unpackage" their various contributions and enter joint ventures, but usually they will drive a tough bargain and the resulting undertakings will be plagued with problems since the multinationals' interest is quite different from the nation's.

Here it may be that one reason for the success of an export-oriented strategy of industrial development is that it puts at least some foreign firms on the "same side." In particular, large foreign retail firms and trading companies, if not manufacturing firms, are induced to transfer know-how and instruct suppliers in matters related to management, marketing, designs and technology.^{1/}

Perhaps without wholly neglecting the foreign actors in this process, it would be more fruitful to pay special attention to the domestic actors. One

^{1/} This raises an intriguing question. Is there any gain to be achieved by bringing foreign companies to organize trade and distribution of manufactured products in the domestic economy in a strategically chosen way, making Sears Roebuck rather than General Motors a firm to be courted? Perhaps commerce can serve to "mother" manufacturing. The links here may be more important than economists now recognize: witness Hong Kong, Singapore and many a business history. But this does not mean that there is necessarily a development strategy here.

key to success in all these crucial areas may be to favor domestic firms and local citizens over foreign firms, at least in the long run, to insure that the nation's own skills and capabilities are built up. Tactically, of course, this may call for joint ventures and a temporary major role for foreign firms. But licensing and local participation or, better yet, local control can be sought systematically as part of this process. Of course, this is much easier in a large economy than in a small one. Japan has been the model success story of doing well while keeping foreigners out; while Brazil or Mexico seem to be effective in bargaining with them in a way that the Ivory Coast or Costa Rica can hardly hope to match.

Perhaps the model for a small developing country should instead be Singapore, which offers an attractive environment for multinationals, but, now that it is successful as a center for some types of manufacturing for export, requires them to build their local branches around technologically advanced and skill-intensive activities, both in manufacturing and in management, finance, marketing, and related functions. Interviews show that multinationals are strongly attracted to move to Singapore their skill-intensive processes and even their headquarters. But, of course, Singapore can attract them because it has such a highly educated labor force, excellent communications and transportation facilities, and a strong infrastructure already in public administration, banking, commerce and the like. A small and backward developing country might be well advised to concentrate on building itself up in areas such as these, as a foundation for industry, particularly if manufacturing under present conditions is bound to be profitable mainly to foreign enterprises which will not transfer much learning in exchange. It "takes something to get something" from foreign enterprises!

In any case, a major key to success in these "problem" areas, particularly capital goods and engineering design, would seem to be to foster learning-by-doing over a long period, in a business environment that is just well enough cushioned to keep the learners going and to maintain continuity of experience while exposing them to as much pressure of competition and high standards as they can bear, while still surviving and expanding. This would be done with the aim of fostering high quality learning and strict attention to international standards.

Since management quality and marketing and technology acquisition depend on skills learned throughout a broad range of manufacturing, the need for a not-too-supportive, fairly competitive environment may extend throughout most of the manufacturing sector, in which case the entire industrialization strategy may have to be designed with this in mind. This is another important reason for keeping protection modest in the middle and later phases of development.

Continuing dependable, buoyant growth combined with a smooth buildup of imports and local demand for capital goods, within an export-oriented and relatively open economy, would also seem to be highly desirable for these purposes. It may be important, too, for businesses to be able to count on sympathetic help from the government in any serious emergency.

If a government has sufficient interventionary capability for these purposes, and can expect to make reasonably reliable judgments in areas such as capital goods, technology transfer and engineering design, it will be well advised to try to determine directly what are the promising enterprises and teams and branches of industry and technology that must be fostered. Then

government procurement, demand creation, and subsidies (or protection) can be given to them, enough to keep enterprises going and learning without ever allowing them an easy or assured existence. (When they fail to meet reasonable expectations and show disappointingly poor management, the weaker enterprises can be allowed to fail, and the resources freed can then be absorbed into the others or into new ones.) Japan has been particularly successful over long periods in fostering growth in strategically chosen subsectors deemed crucial for making its industries fully competitive in the long run. The government has, in effect, stepped in to bail out enterprises and whole subsectors, often by placing orders when a world recession has threatened to put them out of business, then has withdrawn the subsidies when business conditions improved. Of course, in such a large economy there is a built-in level of competition which makes this easier than it would be in a smaller economy. Korea and Taiwan have been trying to emulate Japan's success in this regard, but have had to rely on exports as a source and outlet for competition more than Japan did.

Building up an appropriate set of institutions is also clearly important. This would include banks and development lending institutions, plus special organizations concerned with promoting technology advance, marketing, design and quality standards, and the like, and also institutions to train people and create professional pride in the skills involved, even though these skills can only be fully mastered on the job within an appropriate environment.

C. Measures to Foster Exports

1. The Importance of the Exchange Rate Given the Limited Availability of Alternative Instruments

Turning next to the subject of how to promote exports, what has already been said earlier deserves to be repeated. The central relationship in determining the extent to which exports are promoted is the one between the exchange rate effectively applied to exports, and domestic prices and costs. To the extent that exports are well paid they are likely to expand. Of course, the relationship is the result of many instruments working together. Exchange rate policy is central, but macro-level management of the economy, and measures that affect prices and costs--notably of inputs into exports--are extremely important at the same time.

The main reason why the real exchange rate is such a crucial influence is that there exist no alternative, comparably powerful instruments for promoting exports, unlike the case in promoting import substitution. This absence of alternatives reflects limits to a country's political and economic power in markets abroad compared to those at home. There is no equivalent of QRs and import licensing that can possibly have a similar impact, since markets abroad are not subject to a country's power to restrict trade. A country cannot force its foreign competitors to buy its exports while limiting the quantity of their sales in their own or third-country markets. Similarly there is no equivalent of tariffs, since a country cannot tax other countries' goods (while keeping its own from being taxed) abroad.

The only measure that exists in anything like a symmetrical fashion is subsidies; but here international rules are asymmetrical, limiting subsidies that can be given to exports. Direct export subsidies (including exemptions

of direct taxes on export earnings) are against GATT rules and, though not unknown, are subject to assorted pressures and retaliatory measures. Countervailing duties are allowed, and have been prominently used by the United States.^{1/} Anti-dumping action may be taken. The European Community, though it has been slow to use countervailing duties, threatens to withdraw its favorable tariff treatment of associated developing countries or those with special trade agreements when they use export subsidies of impermissible types. Moreover, in the United States and Europe alike, suspicious use of state-controlled pricing, in exports from publicly owned firms, easily becomes a pretext for discriminatory quantitative import restrictions. No doubt other behind-the-scenes pressures are also applied.

By international rules, the use of subsidies to promote exports is generally limited to subsidized credit, provision of infrastructure, manipulation of input prices, and temporary tax holidays and other tax "breaks" given symmetrically to non-exporting enterprises as well. At the same time, rebates of local indirect taxes (such as import duties, sales or excise taxes, and value added taxes) are not considered to be subsidies. Ways in which these rules can be bent ("where there's a will there's a way") will be discussed later, but there is no easy way to pour public tax revenues directly into export subsidization without triggering retaliation.

^{1/} A new (1979) international code calls for their use, against countries signing the code, only in cases where injury is caused to competing industries as a result of the export subsidies; but no injury test is required in the United States against non-signatory countries, and many developing countries have been reluctant to sign, especially since this would commit them to giving up export subsidies almost as soon as their payments situation allows.

Since most major exporting countries use most of the permitted subsidy-like measures, the range of offsetting instruments is simply too narrow to overcome the effects of an overvalued exchange rate.

Thus, promoting exports is largely a matter of tipping the effective exchange rate, if possible, in the direction of being undervalued or at least not overvalued, while having at the same time a battery of complementary measures similar to those of other countries that are serious about promoting their exports. Of these measures, the most important for manufactured exports appear to be measures to give easy access to imported inputs into exports, and more generally, freedom from indirect taxes on exports and inputs into them. These and other necessary measures will be discussed shortly, but first a closer look needs to be taken at exchange rate policy as it relates to economy-wide management.

2. Exchange Rate Equilibrium and Economic Growth

What constitutes an equilibrium or desirable exchange rate is a crucial question for development policy. On this point the old answers may be out of date. Instead an important point needs to be recognized concerning the relationship between exchange rates and growth.

Traditionally, an equilibrium exchange rate is taken to be one at which the balance of payments generates neither a surplus nor a deficit over a period of several years--sufficiently long for prices and demand abroad to go through any cyclical fluctuations without any otherwise unwanted policy actions being required to correct this balance.

What needs to be recognized in a developing country, however, is that in practice under given conditions an equilibrium exchange rate cannot be defined without at the same time specifying roughly how fast the economy

is to grow. As a general rule, a low price of foreign exchange (in domestic currency) corresponds to a slow growth rate. A high price of foreign exchange corresponds to a higher growth rate.^{1/} Higher and higher real rates of exchange--which would amount to undervaluing the currency for low-growth purposes--will be needed to generate the foreign exchange earnings and savings required to achieve equilibrium in the balance of payments at higher and higher growth rates, subject to qualifications and limits to be noted.

One reason is that more inputs, including more foreign exchange, are required to make an economy grow fast than to make it grow slowly. Another is that crucial growth-related activities are intensive in the use of foreign exchange, compared to the activities required to keep an economy moving at a slow pace. This is not true of all investments and growth-linked activities, of course, but it is true of investment in capital equipment and technology transfer. In addition, particularly in industry, much learning-by-doing depends on imported inputs. Finally, foreign exchange plays a special role in overcoming bottlenecks and resource shortages, not only in energy, food or construction, but also in skilled manpower or technical know-how. Bottlenecks and shortages are most likely to occur amidst rapid growth.

To be sure, if foreign exchange is in short supply it can be economized, and investment can be shifted in directions that take advantage of the resources locally available. Having lots of export earnings will not assure

^{1/} This principle also means that an equilibrium exchange rate under "do nothing" development policies, as in many a colonial or "neo-colonial" regime, may provide less rewards for exports, than a mildly too low, disequilibrium exchange rate under more active policies.

rapid growth, and having too little does not rule out a full use of the resources at hand.

On balance, however, a high growth-rate path of development, if it is feasible, will normally generate a higher requirement for imports than a low-growth path. And other things equal, raising the target growth rate will raise the "shadow price" (opportunity cost) of foreign exchange relative to domestic output. Thus, "getting prices right" depends on changing the exchange rate to match the desired growth rate.

Strict limits exist, of course, on how far the real exchange rate as well as the growth rate can be pushed. As these limits are approached, upward adjustments in the exchange rate, not matched by price rises, are only likely to be feasible to the extent that there are still underutilized factors of production that can be brought into the production of tradeable goods--for example, underemployed labor, idle natural resources, or capital equipment that is not being fully utilized. Once these limits are reached, any attempt at further real devaluation will lead only to further inflation, which is likely to have a negative effect in one way or another, exacerbating political strains and conflicts as well as economic inefficiency.

Upper limits to the growth performance that is feasible are set domestically by real resource constraints, limitations of existing institutions, and the tools, energy, skills, and capabilities of the country's managers. It is misleading to think of these limits only in terms of a "savings constraint" since savings can come from public revenues, and growth performance is linked to the quality, as well as the quantity, of investments.

Anyway, upper limits to savings and investment are set not only by what people will be able to bear, but by the circumstances that current production and consumption contribute to growth, in many cases, as much as or more than what is labeled investment. Generating law and order, and providing electricity and transportation are indispensable for growth. Food, suitably distributed, becomes a key input into production in the present and future. Public administration, schools, and health services cannot be neglected; factories and commercial enterprises serve as training centers; some consumer goods serve as incentive goods and others (such as minimum clothing and housing) serve to sustain the work force. Nevertheless, high savings rates make export success and exchange rate adjustment easier, since they reduce domestic competition for resources and exportable goods.

Beyond some point, adjusting the real exchange rate will not be consistent with more growth, not only because of the resource constraints, but also because growth-linked activities must be forgone to export and to hold down domestic prices relative to those abroad. Indeed, there is clearly an upper limit in the real exchange rate that is desirable because if too much effort is put into producing exports and import substitutes, resources will be diverted away from essential needs in other directions: added foreign exchange may be less needed for growth than added construction or services or nontraded foodstuffs or training programs. This balance is usually struck in part through the government budget and its efforts to promote investment, education, training, health services, etc., along with exports and price stability.

There is also another important influence setting limits on the extent to which exchange rate devaluation can be used to promote faster growth. Real devaluation usually leads, in some exports of goods and services, to at least some deterioration in the country's terms of trade. This means in turn that more exports cannot be equated with more real income from these exports; the positive income effect will be eroded by a negative terms-of-trade effect. Fortunately, in a developing country the price of many primary exports is usually determined by the world price regardless of local cost reductions. However, in unstandardized products and those in which sales depend heavily on particular marketing connections, this is seldom true. Thus, declining terms of trade are likely to occur in tourism and most other services, in handicraft products, in fruits or vegetables sold in particular markets, and in most types of manufacturing for export -- those in which is no standardized market for the product so that sales are based on particular arrangements; in these products declining prices, as perceived abroad, are likely to be required at least in the short run, in order to attract added buyers and thus sell larger quantities.

If the elasticity of demand is low enough (less than one), unless counteraction is taken by either the government (for example, through a tax) or through joint action by producers, increased export volume will not have any positive income effect. However, even in this case a real devaluation will lead to greater employment, along with more learning and other associated benefits. And usually both demand and supply become increasingly elastic in the course of time -- if costs in the country are "a bargain" buyers will increasingly come to place orders, tourists will come for vacations, and the country will be able to expand its output to match. This expansion of real export earnings over the long run is central to growth strategies built around devaluation and favorable exchange rates.

3. Exchange Rates and Economy-Wide Management

Much could be written on economy-wide management in a developing economy as it relates to exports and the exchange rate. Here only a few selected parts of this subject will be treated. Some aspects of the dynamics of the subject will be left to be discussed in Part III in connection with how to carry out a successful shift in trade policy in desirable directions, starting from a situation of balance-of-payments disequilibrium.

What has already been said under the last heading provides a useful introduction to the central challenge in economy-wide management. This is to achieve, in a suitable balance with one another, all the programs, investments and other measures simultaneously required to keep growth and development moving briskly forward, in ways that make reasonably full and wise use of the country's resources, but at the same time, to stop short of doing too much in too much of a hurry, so as to avoid creating excess demand that would drive up costs, hold down exports, and spill over into excessive demand for imports, leading to payments disequilibrium.

Among the instruments that are especially useful in meeting this challenge successfully are a powerful tax system, an efficient public sector making excellent use of its budgetary resources, strong savings incentives combined with high rates of private savings, a well-developed system of financial intermediation oriented to development needs, monetary authorities (usually the central bank) with ample powers to limit inflationary credit creation, and a set of institutions and pressures that, together with trade policy, foster wage and price restraint without seriously distorting resource allocation.

The public sector budget is particularly important in striking an appropriate balance. If the government cannot live within its tax revenues with only moderate borrowing, its budget deficit is likely to spill over

into inflation and a payments deficit, while eroding the real exchange rate. A powerful tax system is required to balance the budget and allow the government to play an active role at the same time on the many fronts where public investment and services are required. In many countries, a heavy use of QRs and exchange controls can be traced mainly to an inability of the government to raise revenue and restrain public spending.

As part of the public sector budgeting process, it is highly advisable to maintain a foreign exchange budget for the government and the public sector as a whole. Frugal use of foreign exchange by the public sector leaves more room for imports that contribute to economic growth in the rest of the economy. The public sector can also shift the directions of its spending to use more or less foreign exchange according to fluctuations in the country's import capacity, thus cushioning the private sector from a sudden flood of new competing imports or a sudden foreign-exchange famine. Borrowing and indebtedness abroad, too, can be better managed with a clear view of the overall foreign exchange requirements of the public sector -- too often decentralized agencies and public enterprises engage in uncoordinated borrowing and spending, without any clear government overview or control of what is happening.

Borrowing abroad allows a country to pursue development with additional resources beyond what it can supply for itself. If the added resources can be well invested so as to more than cover the costs of debt service and ultimate repayment, going into debt is likely to make excellent sense. Depending on how and where the proceeds are spent, however, capital inflows can potentially shift local prices relative to those abroad, with possible adverse effects on exports and at least some of the import-competing industries. Inflows of foreign aid can also have the same effect. Thus, debt and aid management must take into account the real effects on exports, manufacturing,

and agriculture, taking into account the danger that desirable trends and adjustments will be held back.

Monetary and credit restraint is, of course, also important in holding down prices to promote exports, all the more so if the government finds itself overspending its income or printing money to pay for its deficits. But in this case there is a danger that too many financial resources will be diverted to the use of the public sector, leading to imbalances and gaps in the mix of public and private investments, with some private-sector economic activities neglected. Any major bottleneck or shortage can soon become an obstacle to continued growth amidst exchange rate stability.

Wage and price restraint are essential, too, if the country is to achieve a full use of its resources without inflation and payments imbalance. Here effectively fostered competition, patriotic self-denial, and far-sighted attitudes have helped to breed success; but there is no denying that political repression, direct measures to reshape the powers and leadership of institutions such as labor unions and producer groups, and cultural influences leading to docile, hard-working populations have also contributed to various success stories around the world. An important rule here is that success breeds success. If self-denial, hard work and far sighted attitudes pay off in a high growth rate, people will recognize that the standard of living is advancing. Their far-sighted behavior will be reinforced; and many of their hopes and aspirations will be met, so that their demands will not outrun the possibilities for meeting them. Conversely, however, when growth performance is poor, price and wage restraint goes unrewarded and people may react by taking a short-run, self-concerned view leading to a scramble for immediate price and wage increases. Other influences also

operate. For example, a grave disaster such as wartime destruction or the threat of foreign takeover may foster cooperation and restraint, while a sudden bonanza, perceived as such, may lead to a short-sighted scramble for advantages.

A crucial relationship at the economy-wide level is the national balance between aggregate demand ("absorption") and aggregate supply, including savings as against investment, in the public and private sectors combined. Unless private as well as public savings are very substantial, rising demand for investment together with consumption is likely to spill over into excess demand, resulting in a payments deficit and an inflation in domestic costs compared to the exchange rate. Consequently there is a need for positive private savings incentives, in interest rates and the tax system alike. Restraint in public consumption expenditures, along with credit controls limiting both public and private deficit spending, and a powerful tax bite, help to hold "absorption" of goods and services within the limits of the supply available. Poor supply performance and the emergence of bottlenecks and shortages can be just as bad for this balance as excessive demand.

As part of this balance, exports are only feasible to the extent that the nation's output is greater than its absorption out of its own production. If aggregate demand gets out of hand, imports will be sucked in to correct the imbalance and potential exports will be diverted into domestic use.

The underlying problem of adjusting demand and aspirations to what is possible goes far beyond exchange rate policy. This is as much of a problem in a centrally planned economy as in a decentralized one coordinated by market prices. The Hungarian economist, János Kornai, traces many of the

worst features of the East European economies (such as queuing and goods shortages, shabby quality of output, and poor technical progress) to a chronic excess of aggregate demand over aggregate supply, and suggests that better performance depends on shifting this balance. In some past years the People's Republic of China has stood out among "socialist" economies in its adherence to conservative financial management, and has restricted aggregate demand, not to mention wages, in ways consistent with Kornai's on the one hand, and the requirements for holding down domestic prices relative to the exchange rate, on the other. Yugoslavia is another more-or-less socialist economy that has pursued a somewhat similar course. In each case the results have been favorable in getting away from some of the chronic problems of the Eastern European economies, which are all too often shared by developing countries operating under intensive QR protection and exchange controls. Goods shortages, queuing, poor output quality, hoarding and misallocation of scarce inputs, excessive bureaucratic red tape, technological stagnation, production of the "wrong" output mix, corruption and exchanges of favors to get scarce goods, and most of the other ills of planned socialist economies are all too familiar in developing countries when market-price allocation breaks down in the face of excess demand and widespread use of controls.

A danger in promoting financial stability, an equilibrium exchange rate, and conservative aggregate-level economic management, is that the economy will suffer a recession, stagnation and incomplete use of its capacity for lack of sufficient effective demand. The trick is to keep demand growing on all fronts at a brisk pace but in reasonable balance. Here, once the exchange rate becomes properly adjusted, it may be feasible to use the balance of payments (or more precisely, what is happening to foreign exchange

reserves) as one indicator of when the economy has too much or too little stimulus. Leaving aside certain types of capital-account transactions, the balance of payments helps to show the balance between aggregate demand and aggregate supply: a buildup of foreign exchange reserves is likely to mean that the country can do more. A deficit, signalled by diminishing reserves, means that it is doing too much.

Unfortunately for economy-wide management, however, the balance between aggregate demand and supply, and the balance of payments, are frequently shifted by unforeseen events and by influences originating abroad, such as sudden large oil price increases, inflation in the prices of imported goods and services, large swings in the prices of the country's primary commodity exports, or falling demand due to an international recession. Disturbances can also be caused by political events and reactions to them, such as a nervous flight of capital or, for that matter, a stepped up inflow of investment. All these sudden changes make economy-wide management much harder.

Most of these changes affect the aggregate balance between supply and demand in either one direction or the opposite, with clearcut implications for exchange rate and demand management. A sudden oil price rise, any other substantial rise in import costs compared to export earnings, a decline in export earnings or prospects, or a need to compensate for a transfer of capital abroad or a decline in capital inflows, all must be met through some combination of reduced development expenditures, increased taxes and savings, and a shift in the real exchange rate making exports and import substitution more profitable. Note in this last connection that the reduced export demand and/or reduced development and consumption expenditures, associated with all these deflationary and income-reducing changes are likely

to lead to an increase in the labor and natural resources not fully employed and the capital not fully utilized in the economy; consequently added resources are potentially available for production of exports and import substitutes that were not previously economical. Distasteful as this might seem, this is also the direction of domestic policy adjustment required in face of new nontariff barriers in the industrialized countries hurting the country's manufactured exports. Of course, in this case as in others, actions may also be desirable through international negotiations, but actions on these fronts are outside the scope of this paper.

In the opposite situation -- expanded capital inflows, an export bonanza, better export prospects abroad, or the like--there will be some tendency for domestic prices and costs to rise, and new sources of employment and demand to be created, curtailing both the incentives and the resources available for otherwise marginally economical exports and import substitution. The extreme case has already been discussed where it may be useful to neutralize part of the effect, even if necessary by running a balance of payments surplus and investing the proceeds abroad, and also (it can be added) by running a government budget surplus and restricting domestic credit expansion, in order to foster and preserve the country's industries, its agriculture, and other branches of the economy producing tradeable goods.

Along with all these fluctuations originating abroad, and often undetected amidst a welter of short-run influences, a developing country must often adjust over time to a systematic trend in its balance of payments and its equilibrium exchange rate, as a result, for example, of a systematic tendency for its import requirements to increase faster than its exports, or vice versa, as long as it maintains the same real exchange rate. In the case where import requirements would otherwise expand faster than the supply of foreign exchange

available to pay for imports, the exchange rate may have to be raised higher and higher, making foreign goods more expensive compared to domestic goods, in order to keep growth from slowing down more than necessary for lack of exports, imports and import substitution. In the opposite case, in which exports are rising faster than essential import needs, there will also be management and adjustment problems, as wages and the internal price level rise compared to prices abroad, and some industries begin to lose their competitiveness or are made to suffer from import competition.

In choosing an exchange rate regime there are further choices, which will not be discussed in this paper, between alternative types of exchange rate systems, such as "pegging" to one or another major currency, pegging to a basket of currencies, a managed "float," or a regular series of mini-devaluations. As a general rule, poor countries are peggers rather than floaters, even if they vary the peg often.^{1/} Lack of internationally-traded assets denominated in the currency makes it difficult to achieve a smooth float based on international speculation, changing interest rates, and asset movements, as is common in richer countries. One advantage of pegging a currency temporarily, often as part of a series of mini-devaluations, is that it allows the national authorities to gauge the forces affecting the balance of payments (and the need for expanded or contracted economic activity and/or devaluation) through the behavior of foreign exchange reserves.

4. Treatment of Imported and Import-Competing Inputs into Manufactured Exports

Together with an attractive real exchange rate, the other principal measure required to promote manufactured exports is automatic, easy, duty-free access to imported inputs. Without this, manufactured exports are almost

^{1/} See for example Branson and Katseli-Papaefstratiou (1978).

wholly confined to products based on local raw materials, for example, cotton textiles in a cotton-exporting country. In what might be called "footloose" export industries such as clothing or electronics assembly, and many others, nearly all of the developing countries' exports come from places where imported inputs are given what amounts to a free-trade regime. Duty-free access to imported inputs, together with rebates of all indirect taxes, are in fact nearly universal in countries, whatever their income levels, that are successful in exporting manufactures.

Because developing countries' manufactured exports generally involve modest capital investments, low-wage labor, and low profit margins, typically the bulk of the cost of the final product -- in the order of 60 or 70 percent at world prices -- goes for raw materials and intermediate inputs. Any significant tax on these inputs, or even unusually high transport and handling costs, can knock a country out of the running as a source for these goods. Quality defects in raw materials or parts are equally fatal.

Two points deserve emphasis here. First, the competition has access to high-quality inputs at world prices. Second, the buyer is sensitive to the quality, packaging, materials, and accessories of any exported product as well as its price. In fact, it is normally impossible to sell any manufactured export beyond the simplest of standardized intermediate goods, without providing (1) reliable on-time delivery, (2) materials, parts and accessories as well as design to the buyer's specifications, (3) quality control or testing to meet all standards in the importing country, and (4) printed labels, packaging and assortment essentially identical to what the user would get from an alternative source in a developed country, for example, ready

for sale in a department store. (Sales of capital goods and some others generally require technical advice with the sale and follow-up services for repairs and parts supply as well.) Eventually, at least in the simpler goods, people in a developing country become proficient at making most of the necessary inputs up to world standards and at putting together the whole package as required; but this is very difficult at first, and it is learned in part from having easy access to everything required so that the buyer can come in and show the local producer what inputs to use and how to put everything together just right.

To put the same point slightly differently, in exporting manufactures, a developing country is typically providing cheap production capacity; but this has to be of good quality with all the requisite inputs available, or the buyer will go elsewhere. In taxing exports or inputs into them, the question must be asked, what will this do to the country's total income and foreign exchange earnings? Generally it will reduce and squeeze them, with the taxes coming straight out of the pockets of the local industry and its employees, even if the export industry does not shift to another country.

The story is told, perhaps apocryphally, that in India, after striving for over a year to get a license to import zippers needed to make trousers up to export standards, a manufacturer was finally given a license to import one zipper for every two pairs of trousers exported! This is not the way to promote manufactured goods.

It is relatively easy to give a manufacturing enterprise duty-free access to imported inputs when it is wholly specialized in exports, or when

it is involved in the first step in a local chain of production based on imported inputs. It is much more difficult administratively to provide the same treatment to a plant that is producing a product partly for export and partly for the home market, using inputs of types produced locally under protection.

If there is no competing local supplier of the inputs, the firm can easily be given unlimited permission to import its inputs with a zero tariff or a tariff waiver.^{1/} If the firm is producing wholly for export it can either be located in an export processing zone, or it can be given easy access to imported inputs through a bonded warehouse system. If this is done, however, the country will find it important to set up special officials with facilitating power to get shipments of inputs and outputs through customs on schedule and an efficient system for clearing the goods in and out; otherwise unusual inventory costs and/or unreliability of delivery will tend to destroy the ability to compete in export markets.

Experience around the world suggests that creation of export processing (free trade) zones is often useful as a means of cutting through the giant barriers of red tape and taxation too often associated with inward-looking industrialization efforts, but it is only suitable for attracting a small range of footloose export processing activities that are then set up in an enclave apart from the rest of the economy. The work force must generally be transported in; and along with the quality and powers of the zone's managing authorities, the geographical and transport advantages of the location play a

^{1/} This measure discriminates against a potential producer, so that it is not wholly free of the problems of the case where there is an actual producer.

large role in determining whether the scheme is successful. Once red tape is reduced and a reasonable system of bonded warehouses is established, export industries tend to disperse away from the zone.

The difficulties are much greater in the case of goods produced simultaneously for export and domestic markets, using inputs potentially bought locally, at prices higher and/or quality lower than those of imports.

One solution is to allow the producer to import all such products to the extent he chooses, and to pay the local tariff and other indirect taxes on the portion sold domestically, while waiving them on the portion exported. This can be done either by a prompt and reliable system of rebates at the point and time of exporting, as is generally available in European countries, as part of a value-added tax system, or by allowing duties to be waived on the imports up to the share expected to be exported when the imports arrive, subject to subsequent proof of export. Of course, long delays of many months or serious uncertainties in the approval of rebates act much like taxes to discourage the imports and exports involved.

The solution just sketched may prove administratively complex. It is also not easily compatible with QRs unless they are limited to imports for domestic purposes. More importantly, it does not do anything positive for the producer of the local import-competing good to encourage him to supply inputs into exports. This problem can be met potentially by providing subsidies of one kind or another to the producer of import-competing inputs, for example, by giving him a rebate-like subsidy when his inputs are used in exports, or to the extent feasible, giving him the same treatment as is given to exporters. This is apparently done in Korea and Taiwan, but these are

economies rich in low-cost clerical and administrative labor where literacy and numeracy are so common that rather complex schemes can be successfully implemented. In less educated societies, their rebate systems might be a heavy burden, on industrialists and government alike.

Another part of the solution is to subsidize production of requisite intermediate inputs, and bring their quality up to world standards by setting up plants of high quality and adequate scale, with capital investment subsidized to the extent required. This is easiest to do in a rapid growth situation where import substitution has not been pushed ahead prematurely -- it works well in Korea but not, for example, in India, where production capacity is already in place, but on too small a scale, with several plants in different regions for political reasons, underutilized capacity, and little upward trend in demand. There, a typical approach is to introduce a two-price system, in which no more than the world price is charged for inputs used to produce exports. Where plants are state-owned this is fairly easy to implement, but it is not an adequate substitute for free access to imported inputs since quality, range of choice, availability and delivery time may be below world standards.

In countries such as Brazil that make use of QRs and also have complicated systems of indirect taxes, a preferred approach has been to offer an assured, swiftly-given ad valorem export subsidy that is viewed in principle as a rebate of indirect taxes -- 38 percent on one product, 27 percent on the next, and so on, based on some estimate of the average indirect tax on the product. Of course, skeptical trading partners may view this as setting whatever subsidy is necessary to export the product.

Particularly if the subsidy is higher than taxes actually paid, such a scheme is internationally suspect and subject to retaliation. Brazil is now phasing out these subsidies partly because of trading partners' objections. Some other leading Latin American countries employ variations of this scheme, for example, giving exporters certificates that can be used to pay taxes, as rebates for exports. Such schemes are more readily tolerated by trading partners when they are used by developing countries with relatively high wages and domestic prices or only small exports, than they would be in a low-wage, low cost, successfully exporting country.

By and large, the special offsetting schemes used in QR-ridden countries such as Brazil and India are not extremely effective in promoting manufactured exports.^{1/} The vast majority of these exports come instead from countries willing to put aside QRs on imported producer goods, at least when they are used as inputs into exports. Indeed, methods to give attractive rebates on exports can usefully be made a central part of any system of indirect taxation -- a value added tax, a turnover tax, a sales tax or a tariff system.

In countries that neglect to do this, a common excuse for not trying harder to promote manufactured exports based on imported inputs is to argue that the net social benefits would be very low because of international competition in the provision of hidden subsidies and low taxation as well as narrow margins of value added. While this is sometimes true, as recognized by some of the "success story" governments which have cut back their efforts to attract multinational plants designed purely for export, this is a very shortsighted view. The basic question is whether the country

^{1/} Brazil and India each had manufactured exports valued at about \$3 billion in 1977 compared to about \$8 billion each in Hong Kong, Taiwan and Korea.

can hope to emerge as a successful exporter of industrial products, and achieve full parity in industry with advanced industrialized countries, if it refuses to give its industries access to foreign-made intermediate inputs. Possibly this could be achieved in an economy as large as that of the Soviet Union, or China, or even India or Brazil, if they concentrate on imports of technology and equipment instead, and shape their institutions to promote high standards. But for any economy, and especially a small or medium-sized one, this looks like a very inefficient approach and one certain to hold back export growth.

A related point not often recognized is that exports based on domestically supplied raw materials often involve zero or negative value added at world prices, taking into account the opportunity costs of the raw materials, many of which could alternatively be exported directly, and the payments on capital equipment. In this connection, it is the author's impression, based on field interviews and research in Mexico, that the "maquila" border assembly industries there, based on processing of U.S.-supplied inputs, involve on average considerably more value added at world prices per dollar worth of exports than the manufactured exports that come from interior Mexico, most of which are based on artificial linking of exports and imports, "forcing" exports even at a loss, artificially reduced costs of local natural resources which could otherwise be exported directly, artificial exchanges of high protection under LAFTA accords with Brazil and Argentina, or other special measures that make manufactured exports artificially profitable.

A related point of some practical importance is that indirect taxes on manufactured exports are likely to be costly in lost exports and jobs. No one has computed how many jobs Mexico has lost in its border-assembly industries by maintaining until very recently a four percent indirect tax on the value of sales even though the output is exported; but it has been losing business to East Asian competitors for years, and the cost in jobs may have been in the tens of thousands.

5. Other Measures for Promoting Manufactured Exports

A number of additional measures for promoting manufactured exports have been touched on and can be briefly noted here.

-- Direct subsidies and tax exemptions of manufactured exports may make perfectly good economic sense, either as a "second best" offset for protection or exchange rate overvaluation that cannot be directly eliminated, or as a means of fostering an "infant" activity, learning-by-exporting, that provides positive externalities through an assortment of effects already discussed. However, export subsidization may not be a feasible instrument as a result of trading partners' objections and retaliatory threats.^{1/} Generally, direct subsidies must be abandoned for these reasons once a country achieves some export success and a "high profile." Collective action to change the international rule against their use makes sense economically, but perhaps not politically or psychologically. A sense of

^{1/} Excellent examples of practical advice to individual countries in regard to subsidies and alternative instruments can be found in Balassa (1978).

"fairness" in competition with foreign producers may be essential to assure survival of a liberal, open international trading system; and direct export subsidies violate this sense in major importing countries.

- Provision of infrastructure, such as roads, port facilities, harbors, electric power and water supplies, oriented toward exports and exporters' needs, is an essential part of an export promoting strategy of development.
- It is common to provide industrial estates (industrial parks) complete with access roads, floor space, and utilities, at an artificially low cost, and to subsidize the costs of local railroad, air transport and electric power systems. Like five-year (or longer) tax holidays and favorable tax writeoffs of equipment and subsidized credit for investments, these subsidy-like measures can be supplied in principle for all industrial firms but provided especially frequently to exporting firms.

As in the case of protection, excessive use of subsidies for export promotion as well as import substitution in industry can be expected to result in negative effects on the rest of the economy, especially agriculture. Compared to the situation in import-competing industries, however, there are much greater checks from international rules and surveillance, in the case of export subsidies.

Immediate mention could also usefully be made of measures to make it easy for businessmen and their technical experts to travel internationally outside the country as well as for foreign businessmen and experts to visit

the country. Ease of travel in and out is often cited as a major advantage of location in Singapore, Hong Kong and other favored locations for export production.

Less obvious perhaps but also very important are measures to allow businessmen to shift financial capital in and out of the country in connection with exports. Obstacles to capital transfers out are not only a negative incentive for multinational businesses, but also--and perhaps even more important in the long run--they impede the creation of subsidiaries, offices, branches and joint ventures abroad concerned with marketing, technical servicing or assembly of exports by the country's own firms. Recent research by Helleiner and Lavergne (1979) shows that a majority of United States imports from the industrialized countries of the European Community and Japan, are brought in by the exporting firms through sales to their own branches or subsidiaries in the United States. Usually these turn out to be subsidiaries concerned with wholesale trade and marketing, distribution and servicing of the product. By contrast, this sort of trade is rare and unimportant in U.S. imports from developing countries.^{1/} In future, however, as developing countries shift to the exportation of capital goods and their own brand-name goods, and as their nationals become entrepreneurs abroad, the ability to transfer capital out for these purposes becomes

^{1/} Among other findings, Helleiner and Lavergne found that 61 percent of U.S. imports of manufactured goods from other industrialized countries and 37 percent of those from developing countries were "related-party" transactions, meaning in most cases intra-firm transactions. For all products (not just manufactures), "Whereas only 4 percent of total related-party imports from less developed countries are undertaken by affiliates of non-U.S. firms in the wholesale trade sector . . . the equivalent figure . . . is 89 percent for Japan and 63 percent for the EEC."

essential. Even some of the most successful exporting countries such as Korea may need to make policy adjustments in this regard.

Even liberal treatment of imports for home consumption can indirectly benefit exports, by strengthening the exporting industries' awareness of designs, styles, marketing methods and the like in major industrial countries. Some of the exporting strength of the Taiwan economy, for example, seems to come from competition with imported consumer goods in areas such as color television sets, audio hi-fi equipment and assorted other products in which local producers have had to learn how to market and design an internationally competitive product, in order to compete with imports at home. Hong Kong clothing firms are gradually building up design skills in an economy in which the latest in fashions and prestigious designs can often be seen in local stores and on people in the streets; and it may be partly a reflection of the Westernized customer-oriented economy that in other industries as well--toys, computerized electronic games, hand calculators, watches, and the like--Hong Kong firms are exceptionally quick to seize the business opportunities created by changing fashions. However, these benefits are obviously lost on an economy that is not nearly ready to compete in exporting manufactured consumer products.

In addition to all these measures, four other means of promoting manufactured exports deserve careful attention. The first is measures to hold down labor costs, the second is hidden cross-subsidies connected with the system of protection, and the third is subsidized financing of exports.

The fourth, which merits a special discussion apart, is institutional export promotion.^{1/}

Most manufactured exports from developing countries are made possible by low labor costs, relative to the quality and productivity of the labor when it is properly trained and managed. Labor costs are only low, however, if real wages and associated payments are low. This depends on minimum wage levels, if any; compulsory fringe benefits and payroll taxes that must be paid; whether workers can be freely dismissed, or what compensation, if any, they must be paid; absenteeism and work habits and rhythms as well as qualifications of the work force; labor legislation in force; labor union powers and opportunities to bargain collectively, raise wages, strike, and disrupt production; and prevailing wage patterns and expectations in the country.

Many developing countries, particularly in Latin America and in cultural proximity to Europe, have been deeply influenced by ideas of labor rights and social welfare benefits and have tried to legislate a rise in income levels. As a result, workers in larger enterprises in the "formal" part of the urban economy enjoy wages, privileges, and security wholly inappropriate to the country's development level and industrial needs. The rest of the labor force pays for their high incomes and security through opposite conditions and through the high costs, small employment, slow

^{1/} In addition, but not discussed in this paper--since they are outside its scope--there exist measures that involve international multi-lateral agreements and negotiations, such as regional common markets, negotiated exchanges of tariff cuts, special tariff preferences for developing countries, and the like.

growth and international non-competitiveness of the country's industries. Naturally these countries lose out on opportunities for manufactured exports.

The hard realities of competing in exporting manufactures, and in displacing imports based on low-cost production, call for low labor costs, even if all these relevant policy measures must be adjusted for this purpose. The social and distributive issues raised will be deferred until Part II. As a sheer matter of promoting international competitiveness in general and industrial exports in particular, however, minimum wages should be set low or not at all; labor unions should be weakened and made docile, if they are allowed to exist at all; the balance of bargaining power should generally be tipped against them by one means or another at least in cases where their power to raise wages would otherwise be especially strong; payroll taxes and fringe benefits should be kept very low; and employers should be allowed to dismiss workers freely. Government wages and salaries should be held to dimensions that will not raise private labor costs by example, or by unnecessary competition. Obviously, precepts such as these can be used to condone unsavory repression, long working hours, and sweatshop conditions, beyond what may be justified by the country's level of development. A balance must be struck among competing objectives, taking into account the full implications of the measures involved, including their effects on employment and on the labor force not covered by the fringe benefits, minimum wages, or collective bargaining arrangements in question: indirect effects of high wages in the "formal" sector may include unpleasant, sweatshop conditions in small-scale and "informal" enterprises, with no relief in sight from expanding demand for labor.

In practice, most manufactured exports from developing countries come from countries where labor unions are weak and workers have only modest guaranteed benefits or protections. Countries with opposite conditions supply only a very small and declining share of the export total. Contrasts in labor and wage policies are one of the reasons why most of Latin America is losing out in manufactured exports in competition with East Asia. Meanwhile, some of the Latin American countries such as Brazil and Chile have tipped the balance against labor and are beginning to hold their ground in this competition. As a political matter, one should add, it is much easier to hold the line against labor unions and wage demands if industrialists are being subjected to pressures limiting profits and especially consumption from profits at the same time. These may be pressures to invest and plow back profits, pressures to export, pressures to reduce costs and prices, and/or pressures caused by increased foreign competition at home as a result of liberalization of imports.

The next area of manufactured export promotion to be considered is the promotion of these exports through links with protection, import licenses and exchange restrictions.

A wide variety of measures have been used in this connection to promote manufactured exports both in "success story" countries such as Korea and Taiwan, and in others such as Mexico, Colombia, India and Pakistan that have had much to offset, as a result of intervention designed to promote production for the domestic market.

In each case what is involved, roughly speaking, is that the government controls powerful instruments of protection along with the

allocation of valuable import licenses. Thus it can make a firm's domestic sales profitable or not, or give it windfall gains, based in each case on linking this beneficial treatment to its export performance. In effect, profits from sales (and windfalls or low-cost inputs) in the domestic market are used to cross-subsidize exports so as to make them privately profitable. Usually, these are not thought of as cross-subsidies, and they may not be, in terms of legal definitions, but this is their economic effect. (Strictly speaking, cross-subsidies are against the rules of international trade, but in these promotion measures the effect is so indirect this rule is not confronted.) The same sort of linking with protection is used to induce privately unprofitable (but perhaps socially profitable) investments in new import substitution industries, or whatever other industry the government decides to promote. If a firm does not meet the expectations of the government, it loses some of its protection and does not get licenses.

An illustrative list of measures that fit this general pattern would include the following:

- Export "targetting" in Korea. Targets are set, by product category, for each firm, through a sort of bargaining process and exchange of information with government officials. Firms that consistently fail to meet these targets, or are uncooperative in this planning process, may lose out in the allocation of protection, credit, import licenses and/or other hidden instruments that help to assure their profitability.
- Tying import licenses to exports. This is extremely common, either through mechanical rules, as in the Mexican automobile industry where the number of passenger cars allowed to be

assembled by each firm is determined largely on the basis of exports of cars or parts, or through informal administration of the license system, as may be the case at times (for example) in Colombia, where the industrial development authorities control the distribution of import licenses. Elsewhere, a formula is sometimes used to link licenses for imported raw materials or equipment to the value of exports. (Rights to sell or transfer licenses can make them a reliable source of value.)

- Export voucher or entitlement schemes. In India and Pakistan, among other places, within a system of exchange controls and licensing, exporters at times have been entitled to keep a share of their foreign exchange earnings for direct use outside the usual licensing system.^{1/}
- "Wastage" allowances, used in the past in Korea. Imported inputs into exports are given duty-free treatment based on formulas that foresee a large wastage of materials in the manufacturing process. To the extent that this wastage does not occur, the firm can use the inputs in its domestic production, making this more profitable in proportion to the amounts exported.
- Adjustment or threatened adjustment of protection based on export performance. Governments sometimes make strong protection conditional on strong export performance. Though hard to prove, this may have been done at times in Korea, Taiwan and Brazil, among other countries.

^{1/} This may alternatively be classified as a multiple exchange rate system.

Related to all of the above is simply:

- Monopolistic discriminatory pricing by markets. Since large firms in developing countries frequently enjoy monopoly power (some are publicly owned quasi-monopolies), they are almost certainly drawn in many cases into discriminatory pricing, charging high prices in protected domestic markets and low prices, sufficient to cover variable but not fixed costs, in export markets.

An interesting question here is, to what extent does fairly high protection in Korea or Brazil contribute positively to their export performance in manufactures, in association with measures such as those described? Obviously, this depends to some extent on the alternative considered.

If the protection did not exist, a similar structure of price incentives could almost certainly be achieved through a combination of a different exchange rate, indirect taxes, and domestic subsidies. Indeed, the structure of incentives could almost certainly be improved in terms of their resource allocation effects, especially in Brazil where the net bias is now strongly against exporting.^{1/} But at least in Korea it might be difficult to duplicate the extent of quantitative government direction of exports and investment, even if this is sometimes exaggerated in descriptions given of the system. (Authorities on Korea seem to be divided on two crucial points, bearing on the benefits: whether the targetting and direct intervention have much effect in shifting what businesses actually do; and

^{1/} Based on recent unpublished studies by Balassa, Tyler and others.

whether the net effect of the detailed intervention is positive or negative for income and economic growth, since exports may be excessive and sometimes poorly chosen based on considerations of economic efficiency, even allowing for learning and externalities.)

The limitations of cross subsidization would seem most evident in industries that furnish producer goods for other industries. There, a high domestic price becomes a burden on the competitiveness of the rest of the economy (except to the extent that it is feasible to insulate exporters from the effects and protect everyone else). On this basis, it could be argued that hidden cross-subsidies of exports only make consistent sense in the case of consumer goods. Yet the whole approach may be administratively infeasible until development becomes quite advanced, by which point high protection is no longer needed in consumer goods.

A feature that may make these cross-subsidies effective in Korea, compared to most other developing countries, is that several of the larger industrial firms are involved in several industries at once, with branches producing consumer goods that are made more profitable by protection, and others intermediate or capital goods. Still other branches at the same time may be engaged in trading or construction. In this situation (as in the pre-war Japanese zaibatsu industrial giants), losses in some exports and capital goods and intermediate goods may be cross-subsidized to some extent by profits in consumer goods.

On the whole, the case for hidden cross-subsidy measures is not very persuasive if the alternative is to build industrialization around appropriate exchange rates, export taxes on traditional primary products,

and only modest tariffs. However, a full use of these instruments may make good practical sense at some stage in switching to export promotion from high protection.

Turning to subsidized financing of manufactured exports,^{1/} here there is an international code on the interest rates and practices allowed, based on rules of the Berne Union^{2/} and the practices of the developed countries. If a developing country does not "ante up" and match the usual terms, at least for short-term financing of working capital, its firms are likely to lose export business.

Such export financing is not strictly necessary to get started in exporting manufactures, since more often than not, the buyer can provide financing easily enough, borrowing in industrial countries as required. The advantage comes mainly in allowing the country's own firms to compete with well-financed rivals abroad, not least in selling manufactures to other developing countries. The roster of developing country members of the Berne Union -- Argentina, Hong Kong, India, Israel, Korea, Pakistan, Portugal, Singapore and Spain -- and countries that will shortly join -- Mexico and Cyprus -- can be considered an incomplete list of those that have set up export credit agencies.^{3/}

1/ Financing of exports themselves, which is what is discussed here, must be distinguished from subsidization of exports or investments that produce exports; these measures have already been discussed.

2/ This is an intergovernmental organization focused on the members' export credit and insurance schemes. Most developed countries belong.

3/ Information from Albert C. Cizauskas.

Because lenders' unsubsidized interest rates for industrial working capital are usually higher in poor countries than in rich ones, the developing countries usually have to put in more of a subsidy to bring the rate down to the permissible minimum, and they are allowed to do this.

An illustration of how this can be done, based on Mexico as an example, can be briefly described as follows. The central bank sets up a special export financing agency under its auspices. This agency then rediscounts commercial loans that qualify as export financing, on condition that the financing has been accepted at regular commercial terms by a commercial bank: in effect the export bank pays the difference between, say, a loan in U.S. dollars at 15 percent (or whatever the unsubsidized rate may be) given by the commercial bank and (say) 6 percent permitted under the Berne Union. The loan is given for long enough (perhaps six months) to provide working capital to produce exports under terms of a contract, which is used along with collateral to secure the loan.

Variations are possible, of course. Among other problems, the system just described makes it difficult for a small or financially weak local firm to obtain export financing, since it may not have sufficient collateral to secure the necessary commercial loan. An alternative is for the export credit agency to deal directly with exporters, but obviously this carries a high risk of losses and unjustified subsidies, depending on the management and priority objectives of the agency.

In situations where working capital is being badly squeezed by a recession at home, and/or where inflation drives a large wedge between commercial lending rates and subsidized lending rates for exports, export

subsidies of this general type can become a dominant incentive for manufactured exports, as experience in Argentina has helped to show. Obviously, severe distortions of this type are not desirable, although it is natural to turn to exports as one way to overcome a squeeze on working capital, even in the absence of subsidized financing.

In addition to subsidized export credit systems, various governments have set up specialized publicly owned commercial banks specializing in exports and foreign trade, and, of course, this is a major specialty of commercial banks in any case.

The more difficult problems of export financing come in connection with medium- and longer-term suppliers' credits used to promote exports of capital goods. Largely for this purpose, Korea has recently (1976) set up its own Export-Import Bank, which has taken over export credit and insurance services previously delegated to other publicly owned financial institutions, including suppliers' credits, which were already subsidized earlier. Suppliers' credits have been made primarily for exports of ships, but some have gone for overseas plant construction, and other exports of capital goods and parts, with loan maturities ranging up to ten years.^{1/} Berne Union agreements determine the lowest interest rates that can be given.

6. Institutional Export Promotion

Recognizing that marketing and nonprice considerations may sometimes play a major role in successful exports of manufactures, many developing countries are keenly interested in finding institutional ways

^{1/} Information from Albert Cizauskas.

of promoting these exports. Research is now under way in the World Bank to illuminate the nonprice influences and to learn what can usefully be done to promote exports, taking them into account. Pending completion of this research what is said on this subject here must be considered very tentative.

Official export promotion agencies, intended largely for the purpose of promoting manufactured exports, are now found in one form or another in many developing countries, often with branches in leading cities abroad. In some cases, for example, the Brazilian Government Trade Bureau, this agency is staffed by and reports to a leading government department (in this case Brazil's Ministry of Foreign Affairs) while in others, for example, the Korean Trade Promotion Agency (KOTRA), it is a separate organization. These agencies and their counterparts elsewhere, such as PROEXPO in Colombia, the Hong Kong Trade Promotion Center, and the China Export Trade Development Council in Taiwan (to mention only three of the most effective) try to fulfill at least some of the following functions, along with related informational roles:^{1/}

- Providing information and assistance to potential foreign buyers on request, for example, providing lists of exporting firms and their lines of business.
- Generating trade inquiries by advertising in specialized publications, or through direct mailings or calls to potential importers, then processing the ensuing inquiries by putting inquirers in

^{1/} This list is based on unpublished research findings in interviews by Lawrence H. Wortzel.

touch with suitable manufacturers and (in some organizations) by following up to see whether further help is wanted, and what may have gone wrong.

- Organizing and promoting their own trade shows while arranging participation in trade shows abroad.
- Undertaking market research and related activities. These take a variety of forms from reports describing and analyzing markets, to actively obtaining foreign firms' product and price lists or buying samples of the latest designs being sold in leading cities abroad, at the request of exporting enterprises.

In each function what is basically happening is that the government is subsidizing the provision of information, supplementing what is already available or potentially available in the private sector; but three weaknesses in this approach are rather obvious. First, whether there is any payoff depends on whether, and to what extent, the country's exports are in fact attractively priced and otherwise desirable. Second, the value of information provided also depends on how good this information is, and how good the agency is at doing its job, both absolutely and in comparison with other sources of information and market research. Third, even if the subsidized information service succeeds in generating more exports, the gains to the country as a result must be balanced against the costs of running the organization.

On the whole, a realistic weighting of these limitations, together with actual experience with these organizations in practice, suggests that under unfavorable conditions, in combination with weak export incentives or

under indifferent management, they are a waste of public funds. Well aimed and well run, when other conditions are favorable, they may be a useful complement to other measures used to promote manufactured exports. But while some of them almost certainly pay for themselves, it is by no means certain that they are a really important source of increased exports for the countries involved. Some of the more successful exporting countries appear, in practice, to have only marginally effective export promotion organizations, and in any case, as exports grow, the need for these agencies may well fade away.

This is partly because only exceptionally do they command expertise in skills that are valuable and well paid in the business world. Only in rare cases, as in Taiwan, do these organizations even see themselves as playing a significant role, for example, in identifying new export products and markets for the country's industries, or in directly soliciting orders, or in giving advice to the country's manufacturers on corrective steps needed to export successfully. Obviously, a country does not require its own separately staffed agency to mount a public relations campaign or to hand out lists of exporting firms.

In any case, research findings on non-price aspects of exporting suggest that the central difficulty is not just marketing but getting together a whole combination of stringent requirements on time, reliably, and at low cost.^{1/} Any carelessness in regard to details of production, labeling, testing, packing, quality control and the like, or any inferior feature of the product due to poor quality inputs, can easily carry a high

^{1/} This section draws on research by David Morawetz and Lawrence H. Wortzel.

price in making the package unacceptable and/or causing the buyer to go elsewhere. These difficulties, however, do not arise randomly. Almost always they reflect some combination of three basic influences--first, poor judgment or inadequate competence on the part of the managers and firms trying to export, usually as a result of too little experience in an export-oriented and international-style environment; second, a lack of sufficient incentives to concentrate management efforts on high performance in exporting, usually as a result of strong incentives favoring instead production for the domestic market; and third, difficulties in the trade policy regime, usually in regard to access to inputs, causing delays and poor quality of output. In Latin America the second and third problems appear fundamental. Export orders are not delivered on time with all specifications met because it is not profitable to do this, if it means losing sales on the home market, even though managers already know enough to do the job in exporting if they gave it undivided attention and highest priority. And, of course, when firms fail to deliver and have costs too high as well, buyers close down their buying offices and requisite institutional and marketing networks are never built up.

In short, research to date suggests that the influences shaping the nonprice and marketing performance of developing countries' exports are much the same as those underlying their cost competitiveness. Without a suitable trade regime these nonprice dimensions are likely to add to, rather than offset the cost problems.

This helps to show that institutionalized export promotion is not a substitute for measures designed to reduce the costs and increase the profitability of manufacturing for export. In any case, private business firms

are not likely to be misled and lured into unprofitable business ventures by government propaganda. And there is little use in subsidizing information flows, and helping potential buyers to contact potential sellers and vice versa, if no business deal will result due to defects in the country's policies (or for that matter, a lack of immediate economic potential) in relation to the goal of exporting manufactures.

Another problem with the notion that direct export promotion will be effective and needed, is that this idea almost certainly underrates what is already done and known by businessmen and buyers, assisted by other information sources and specialists such as consultants, journalists, banks, trade associations, and others.^{1/}

The information missing or difficult to obtain today is almost certainly different from and less crucial than what was missing years ago when developing countries first began to emerge as major suppliers of manufactured exports. One early instance of successful export promotion was Hong Kong's efforts involving participation in trade fairs and shows, among other steps, starting in the late 1940's. Another example was Puerto Rico's advertising campaigns to attract mainland manufacturing firms in the early 1950's. In each of these cases, policies and cost conditions were favorable, while there existed a need to overcome a negative image of low-wage economies as a location for export-oriented manufacturing plants.

^{1/} One international agency serves as a source of advice on actual marketing prospects in particular cases and on how to carry on government export promotion and marketing. This is the GATT/UNCTAD International Trade Centre in Geneva.

Today there may be little need for this sort of promotion aimed at potential buyers and multinational manufacturers, except in the rare cases where they have a mistaken and prejudiced picture of the real situation. This is hardly the case in most of Asia, Latin America and the Mediterranean basin. There, developing countries with any reasonable potential for exporting manufactures are being systematically searched and criss-crossed all the time by potential buyers in search of potential suppliers with low-cost production capacity, coupled with sufficient management skill to translate a product design into a set of manufacturing processes, and get an order met and delivered on time. Finding such a supplier and setting up a long-term supply connection can be a profitable business for all concerned, so that there is much private effort on both sides to make these connections. Countries where officials feel they have conditions conducive to successful exports, but not enough exports are materializing, may be misled by not understanding the competitive standards in this business in which it is not nearly enough to have prices a little lower than those in industrial countries.

Apart from the information and market research functions, there appear to be at least two other, very distinctive roles in which institutionalized public export-promoting efforts can be extremely helpful, perhaps more helpful than the usual export promotion agency.

One role that deserves high priority is that of expediter, in seeing that exporters get not only information but prompt service and good treatment from government agencies concerned, including customs officials, licensing authorities, credit agencies and investment promotion agencies.

However, this role can only be filled by an agency that has "clout," at least in the sense of influence at high levels, as well as connections; and this is not likely to be true of an ordinary information agency. Often this expediting role is played by a powerful agency, such as the Board of Investments in the Philippines, as part of a national export-creation effort that enjoys support at the highest levels of government.

Another role through which exports can potentially be promoted, is by teaching and training local managers and industrialists on the subject of how to export, for example, how to present themselves to prospective buyers and what skills and know-how they need to be successful in fulfilling export orders. Here general managerial skills, and the ability to translate specifications or a particular design into a production process, are not easy to teach, but there may be some advantage to be gained in teaching people with these skills what buyers are looking for, the importance of on-time delivery and quality control, and the way their goods will be ultimately packaged and sold and will fit into buyers' and retailers' business strategies in the country of destination. As in other vocational or management training, however, unless targetted to reach people likely to use the information in the near future in their businesses and jobs, and well done, training programs are likely to have only a low return.

Beyond specific roles such as these, there is a possibility that export promotion officials will become useful inside critics of government policies affecting exports, if they have the ears of high officials.

Few, if any, of these potential roles are likely to be well filled by the creation of "one more agency" with no special powers or connections. It may be better to assign the roles to special divisions of powerful

government agencies that will then hire consulting, public relations or advertising firms as required, and delegate special tasks to other agencies.

7. Policies Toward "Multinational" Manufacturing Corporations

One other set of policies can be quite important in their impact on manufactured exports. These are policies toward foreign investors, especially those toward multinational corporations (MNCs) of the manufacturing variety. In some industries, at least, countries that discourage and dislike foreign investment may be required to pay a substantial price in manufactured exports forgone.

Most labor-intensive consumer goods and many of the simpler and more standardized producer goods from developing countries--for example, clothing, shoes and textile fabrics--are produced, in developing countries and almost everywhere else, mainly in locally owned rather than foreign-owned firms. Subsidiaries of MNCs play quite a significant role in some of the developing countries that are relatively small scale exporters of these products, but not in the major supplier countries.^{1/} Instead, trade in these products is largely organized by major foreign buyers and trading companies, whose role is often crucial. Any developing country that makes it difficult for these foreign firms to come in and organize trade in their usual fashion suffers a loss of exports as a result. However, what is required for this purpose has already been discussed. There is also scope for a country to organize its own trading enterprises to sell standardized goods.

^{1/} See, For example, Nayyar (1978), Hone (1974), and Cohen (1975).

In what can be broadly described as engineering industries, however--that is, electronics, machinery, transport equipment, fabricated metal products, instruments, and the like--manufacturing MNCs play a more central role, and direct foreign ownership of export-oriented manufacturing plants is very common.

In these industries, taken as a single group, the bulk of the developing countries' exports are built around labor-intensive processes, within larger sequences of production and marketing dominated by MNCs. Often MNCs control the technology, the product specifications, the marketing connections and know-how, and the other, more difficult, steps of the production process. In some cases, MNCs are willing to subcontract to firms in developing countries for parts or processing; but in many instances, they show a strong preference for production in wholly owned subsidiaries.

MNC dominance of exports within this broad group of industries is very uneven. It is greatest in electronics industries and a few others, and much smaller in industries producing most types of finished capital goods ranging from ships to "turnkey" plants. However, in most of the industries with low MNC ownership participation, developing countries have only relatively small (and difficult to achieve) exports, while larger exports come from industries in which MNC ownership is typical, probably because the MNCs organize the process.

In view of this pattern, countries that are extremely reluctant to allow foreign ownership and control of their manufacturing industries, even for purposes of export expansion, are almost certain to rule themselves out of the export competition in some of the engineering industries, and

place themselves at a disadvantage in some of the others. This is a trade-off to be faced in developing countries just as it is faced in Eastern Europe and elsewhere.

8. Special Measures to Promote Primary Exports

Now that the main measures for promoting manufactured exports have been reviewed, a few words may be useful on policies required to expand primary exports, beyond what has already been said.

Expanding primary exports is partly a matter of adequate incentives, through the exchange rate and primary sector procurement, price and tax policies. However, while in both agriculture and mining, favorable price incentives contribute positively, they are not sufficient to insure an optimal strong growth of output up to the country's full potential, over the long run.

In agriculture the principal reason is that a great many socially desirable programs and investments are too big and involve too many scale economies and "externalities," to be undertaken by individual farmers. Collective action is the key to success here, and is usually organized by the state. Along with favorable prices, the keys are institution-building and public expenditures. Institutions of suitable quality must be built up in research and extension work, and can usefully be built up to promote other forms of collective action, such as purchasing, marketing, coordinating cultivation, sharing equipment, making local investments, and directly constructing useful infrastructure and public works. Public expenditures are needed for large-scale investments such as irrigation and water conservancy schemes, feeder roads, soil conservation and reclamation schemes, and the

like, and also carry on services such as experimentation, breeding of plants and livestock, dissemination of information and advice, and organizing agricultural cooperation. Governments can also facilitate the supply of crucial inputs such as credit, fertilizer, pesticides, seeds, pumps and equipment. All of these influences can contribute to the supply of exportable agricultural products.

In mining even more than agriculture, scale economies tend to be enormous, calling for large-scale operations and state-organized undertakings to such a degree that there will ordinarily be a one-on-one relationship between the government and the mining enterprise. Under these conditions, today's price incentives can never be taken as a reliable guide to long-run returns, in contrast to the situation in agriculture where it may be feasible to reassure farmers on this score. The discovery of minerals and the setting up of mining operations take several years and involve substantial technical know-how together with large outlays of capital. When these discoveries and investments take place they shift the bargaining power relationship in favor of the host government, which needs the mining enterprise's technical contributions, however, to get to this point. With this prospect in mind on both sides, policies must address themselves to subsequent price, tax and ownership relationships, and governments must find ways to reassure and reward the mining enterprises without giving away too much. In practice, it is difficult to provide reassurances since agreements have often been broken, once the power relationship shifts.

To the extent that reassurances can potentially be given in advance, the classic dilemma in mining is how much to offer foreign companies (in the way of prospective profits and shares of the output as well as fees) in

exchange for a search for minerals, and/or in exchange for initiating mining and processing operations, and helping to market the output, once minerals are found. Another question is how to organize the undertakings. These days, when governments can easily make mining unprofitable, no matter how rich the mineral deposits may be, joint ventures, involving partnership rights that expire after not-so-many years, are more credible than long leases to private companies. Increasingly, as an alternative, governments can hire private contractors directly to drill for oil or search for minerals taking all the financial risks themselves.

High capital requirements compared to the resources of local private investors are another special reason for public intervention to promote primary exports. Especially taking into account their transport requirements, both mining and agriculture tend to call for heavy investments and often have high investment-to-output ratios compared to most manufacturing industries. This is especially true when it comes to production for export. In mining, capital-intensive extraction and processing are the rule, while in agriculture, exports usually come from capital-intensive subsectors requiring irrigation (as in cotton or rice), planting of tree crops (as in coffee or rubber), expensive processing (as in sugar), and/or investment in livestock. By contrast, manufacturing for export is rarely very capital intensive in developing countries--whether the product is clothing or electronic components or wooden bowls, it is generally labor intensive and involves only a modest investment in plant and equipment. Where investment requirements are high, the government may have to be systematically involved with export-oriented development projects, since getting together funds on the required scale may be beyond the means of the domestic private sector.

9. Exports and Processing Industries

A few additional words may also be useful on the subject of policies toward industries processing primary products for export. Processing of exported primary products involves a wide spectrum of activities, some of them labor intensive, others capital intensive, some hardly more than extensions of agriculture, others technically complex industries. It is hard to generalize about shelling nuts, freezing fish, canning tomatoes, tanning leather, threshing grain, or sawing logs, along with smelting copper, concentrating iron ore and hundreds of other processes. However, it is generally true that processing of primary commodities enjoys transport cost protection since weight is reduced relative to value, and it is (and should be) a major industrial activity in developing countries. Nevertheless, desirable as processing industries may be to provide a foothold for industrialization in otherwise backward economies, there is room to suspect that many developing countries provide excessive incentives for processing, when it is industrially distinct, compared to its true social profitability in light of world prices. This often occurs as a byproduct of overall incentives to promote manufacturing industries, interacting with high taxation (and poor rewards) of the corresponding primary industries. The input becomes artificially cheap (in ways already noted) and the processing receives subsidies besides. In some cases, as has been already noted, export taxes on primary producers may be socially optimal--for example, as a way of giving stronger incentives to manufacturing--but then the processed primary product should bear some export tax, too, to avoid windfall incentives and socially wasteful methods of processing.

Paradoxically, however, more processing would probably take place under socially optimal policies in many developing countries, since there would be more primary production for export and thus more output to be processed. Increasing the availability of the primary product is the main key to the expansion of processing industries.

It would not be an adequate defense of unprofitable processing, even if it were true, that the unprofitability is due in part to monopolistic buying practices, distorted freight rate structures, and/or tariffs in developed countries that depress the price of the processed product compared to its crude raw material.^{1/} These points call for directly eliminating the distortions, if possible; but meanwhile as in so many other imperfect situations, the country has to make its choices based on the situation and prices it actually faces.

Compared to most other manufacturing industries, most processing industries probably involve a high share of learning that is specific to a particular product or process, and cannot be transferred easily to other industries. To the extent that this is true, and also because their expansion is more limited by raw material supplies, processing industries may be less attractive candidates for subsidization than most manufacturing industries. These are further reasons for being wary of giving these industries extra incentives. There is some danger in any case that the benefits go abroad to users of the product who gain from depressed prices, thanks to subsidized processing, and to rival exporters who receive higher prices for the crude

^{1/} Evaluating these influences is beyond the scope of this paper.

form of the product than would be the case if developing countries were more ready to export in crude form.

D. Classifying Trade Regimes

1. The Need and the Dangers

For purposes of further analysis of trade policies, their effects, and how to switch policies, there is a need to decide on a descriptive terminology or classification scheme for trade regimes; but here there are dangers and difficulties. Perhaps the main one is that any terminology that is chosen is likely to be laden with preconceptions, emotional associations, implicit value judgments, and/or false analytical premises. Such terms such as "inward-looking" and "outward-looking," "import substituting industrialization" and others have been used too much by too many authors to allow them to be used here without bringing in overtones and undertones from other people's writings; and perhaps these terms have always meant different things to different people. But it is hard to get away from use of words that already have strong associations or contain implicit judgments. Seemingly technical terms here such as "export" and "protection" have been part of so many litanies on what is good and bad in development and trade policy, that readers are likely to react to them on a subconscious emotional level.

A second danger, or at least a difficulty, is that, as has already been shown, there are multiple dimensions of trade policy so that a multiplicity of combinations is possible. Most writings are based on archetypes or caricatures based on a whole cluster of frequently associated

characteristics, but this approach oversimplifies the choices involved and damns by association what may sometimes be useful policy instruments.

A third difficulty is that any classification of existing trade regimes based on "strategies" and overall policy alternatives is likely to be misleading as to how policies actually typically come about in the "real world." As a rule, policies in trade as in other spheres are the result of sequential decision-making under uncertainty, in which most decisions are taken in a piecemeal fashion, sometimes by different sets of people, in response to shifting circumstances. Once an authoritarian, autocratic government has been in power for a few years, it may have had time to overturn a whole set of old decisions and to remake policy in a coherent fashion that deserves to be called a strategy. A few developing countries do have strategies of industrialization involving trade policies in this sense. But others have only a patchwork of policies and expedient measures stitched in an emergency here, a reform there, and a concession to some interest group over there. Anyone who criticizes the result as the product of an unsatisfactory strategy of development may be being insensitive to the problem.

2. "Phases" of Policy as Defined in the Bhagwati-Krueger Project

Among the many classification schemes used by different authors in classifying and describing actual trade regimes in developing countries, one is sufficiently new, unusual and important in recent research, to deserve special mention here. This is the "phases" approach used by Bhagwati, Krueger and their associates as part of their effort to create a common analytical framework in their recent comparative study of trade policies in ten developing countries.

Since the descriptions of these "phases" in the original are somewhat cumbersome, it is useful to quote a succinct summary by Michael Bruno (1978):

- Phase I: Significant imposition of quantitative restrictions (QR) on imports in a rather "crude" and "unsophisticated" manner.
- Phase II: QR still reign but the control mechanism becomes very complex and differentiated with supplementary price measures, tariffs, export rebates. Even when there are export subsidies, the effective exchange rate on exports is always lower than on imports, which are highly protected.
- Phase III: There are tidying up operations, rationalization of import tariffs; some tariff subsidies are replaced by formal parity changes. It may take the form of devaluation-cum-liberalization package accompanied by external grants to facilitate expansion of (liberalized) imports.
- Phase IV: This is a successful culmination of Phase III liberalization efforts. There is much greater uniformity of incentives. Inter alia, the effective exchange rate on exports is equated to that on imports.
- Phase V: There is full convertibility on current account, no quantitative restrictions are employed to regulate the B.P.^{1/} Pegged exchange rate in equilibrium or else flexible rate regime. Monetary and fiscal policy are employed as instruments to achieve payments balance instead of reliance on an exchange control mechanism.^{2/}

In this scheme, Phase V is not only the culmination of a potential cycle of change, but it is also the typical starting point from which Phase I departs.

1/ Balance of payments.

2/ Bruno (1978), pp. 6-7.

Of the five phases, Phase I and Phase III appear transitional rather than the result of a full process of adjustment, so that in some ways the scheme boils down to Phases II, IV and V, as three alternative systems.

This scheme by itself is somewhat lacking in dimension and richness, compared to the concerns of the present study, but it is an advance for most purposes over two-way classifications that in effect generally lump Phases I and II together as "inward-looking" or "import substituting" industrialization, and contrast them with an amalgam of Phases IV and V, which are lumped together as "outward-looking" or "export-oriented" or "export substituting" industrialization.

One of the defects in the Bhagwati-Krueger classification, for present purposes, is that because their study is looking almost wholly at trade regimes heavily dependent on QRs, there is no subdivision of trade regimes that have few or no QRs: all are lumped together as Phase V regimes.

As a minimum, in regard to trade regimes that rely on prices and exchange rates rather than QRs and exchange controls, one would probably want to draw a distinction between those strongly biased against exports (through high tariff protection and lack of attention to the treatment of imported inputs) and those designed to promote exports along with industrial development for the home market. This distinction would roughly correspond to the one drawn, among QR-dependent regimes, between Phase II and Phase IV, but with more explicit concern for effects on exports.

The other principal shortcoming of the Bhagwati-Krueger scheme, for present purposes, is that it focuses more on the use of QRs and exchange controls than on the hidden biases against exports in the resulting trade regimes. As part of this shortcoming it pays too little attention to differences in the treatment of inputs in general and imported inputs into manufactured

exports, in particular. Countries are classified as in Phase IV or V based on exchange rate regimes alone, without taking into account that inputs remain overpriced as a result of protection, labor policies, and neglect of the needs of exports.

In this regard, Paul Streeten has made the interesting suggestion^{1/} that it may be useful to draw a distinction between trade policies that concentrate on raising the rewards to outputs and those that concentrate on reducing the costs of inputs. However, this distinction may not be essential for present purposes, especially since unless this last is done, manufactured exports will clearly be discouraged by the existence of protection.

3. A Classificatory Terminology for Present Purposes

To avoid the unappealing qualities of Roman numerals and get away from the beaten path, the classificatory terminology used in the rest of the paper will put the old wine in new bottles with evocative, but essentially accurate, labels.

QR-based policies or regimes will be distinguished from price-based ones according to whether quantitative import restrictions and associated exchange controls are major instruments of protection and balance of payments adjustment. Price-based regimes rely on exchange rates, tariffs, other taxes and subsidies but make very little or no use of QRs.

High tariffs
is pro-
trade?

The main use of new terms, however, is that pro-trade policies or regimes will be distinguished from anti-trade ones. Pro-trade policies or regimes provide strong incentives for exporting manufactures, roughly

^{1/} In commenting on a previous draft of this paper.

equal to (or not far short of) the incentives provided for industrialization around the home market. Exports of primary products, though generally not given such strong incentives as manufacturing industries, are not severely discouraged. Anti-trade policies or regimes discourage exports and, thus, trade in general, both in manufactures and (usually even more) in primary products. This distinction corresponds, among QR-based regimes, to the one between Bhagwati's Phase II and Phase IV except for one feature. Here, a QR-based regime will not be labelled "pro-trade" unless it involves major steps to provide easy access to imported inputs into exports, and many-sided energetic efforts to promote manufactured exports, much more than has been done in some of the situations labelled as Phase IV in the NBER studies.^{1/}

These two basic distinctions provide, in effect, a four-way classification between QR-based, anti-trade regimes (Bhagwati and Krueger's Phase II), QR-based, pro-trade regimes (their Phase IV as practiced in Korea, but defined more narrowly to exclude most of their other cases), and price-based, anti-trade or pro-trade regimes (lumped together by Bhagwati and Krueger in Phase V).

In practice, it must be conceded, these new terms probably make little difference compared to the old ones. The scheme does not get away from the problem of archetypes and caricatures, since regimes close to two ends of a spectrum of policies are being contrasted in each of the two dimensions singled out. Moreover, in the sections that follow, the four-way scheme is often reduced to a two-way comparison between pro-trade and anti-trade policies.

^{1/} For example, in Turkey and Colombia.

And in some circumstances, for example, in dealing with policy alternatives , early in development, or when trade has major side effects, the distinction between these policies is either not fully clear or not what matters. Despite these practical shortcomings, however, there may be some virtue all the same, in trying to wipe the slate clean by using new terms. In any case, the terms chosen call attention to the central effects of pro-trade policies in expanding not just exports, but trade in both directions and all the accompanying effects, while anti-trade policies discourage not only exports but also imports and the effects that accompany a growth of trade. In this sense the terms may be less misleading and more precise than most of those used previously.

Part II

INTERACTIONS OF TRADE POLICY WITH
POLITICAL SYSTEMS AND SOCIAL GOALS

A. Interactions With Political Systems and Social Policies

1. Trade and the Interests of Political Elites

This second part of the paper returns to a strategic level of policy-making to examine interactions of trade policy with political and social systems and with selected social goals. Much of what is said ranges beyond the usual literature on trade policy, yet the importance of the issues would appear to justify exploring them, even where this is a hazardous venture.

A central problem in reforming trade regimes is that they typically tend to reflect the interests of political leaders and officials in a developing country. Moreover, the use of policy instruments such as protection and QRs builds up vested interests not only in favored sectors and activities but also in the government itself.

The exercise of discretionary economic power is all too often within the ambitions and personal expectations of rising officials in developing countries, based on a mingling of ideologies and hopes, among which those that call for active intervention are especially appealing. Given a choice, all but the most intelligent and/or forebearing of officials are likely to err in an activist and interventionist direction: it is unusual for officials to recognize their own limitations and those of the tools and ideas at their command. Yet exercise of discretionary power within the economy is hard to do well in developing countries, not only because of the limitations of the

personnel and organizations available but also because no one has devised reliable general rules and recipes, in what are usually complex questions.

There may be increasing offsets reducing this bias today at least in the realm of ideas. Many young would-be advisers and officials from developing countries with a poor performance record, have been training and preparing themselves to correct the mistakes of their elders by reforming the economic system. At the same time, pro-trade policies are being increasingly accepted within a wide range of economic philosophies. As a result, leaders at the very top level, who do not need to engage in detailed economic intervention in order to enjoy the exercise of power and to tangle with complex issues, are being persuaded and setting in motion the wheels of change.

At least until recently, however, QR-based and anti-trade policies have been popular with actual and would-be economic officials in developing countries because, other things equal, QR-based policies offer a higher intensity of official intervention than price-based policies, and anti-trade policies offer greater scope for intervention than pro-trade policies. This last relationship occurs because the economy is made to deviate widely from the dictates of cost and comparative advantage, with the government deciding what industries should be emphasized. Thus, in the initial stages of shaping national development policies, if officials interested in their own active roles have their way, there will be a tendency to choose QR-based, anti-trade policies. This tendency is reinforced, of course, by the fact that conditions in the economy usually leave much to be desired in the first place, and many sources of advice and political philosophy blame the existing system, so that it is difficult to build policies around that or around patient moderation.

Today, an important reason for the popularity of reforms in the direction of pro-trade policies is that such a policy transition offers new opportunities for creative activism.

There has also been another strong political reason, in the past, for the emergence of QR-based, anti-trade policies, and that is short-run political expediency. A government is ordinarily faced with many demands for public expenditures and special treatment of nascent industries, which are difficult to deny. At the same time, taxes and public revenues are difficult to increase. So budget deficits emerge, and the balance of payments goes into deficit. Or exports fall and imports cannot be reduced to match. Or the government tries to prove it needs a lot of foreign aid, so it undertakes too many projects for its resources, in hopes of getting more. Once the balance of payments gets into trouble, it may be infeasible, or at least politically inexpedient, to cut back public expenditures. Instead, the government slaps on QRs and exchange controls.

Once begun, QRs become addictive because they create vested interests in as well as outside the government. Officials discover the power of dispensing valuable permissions to import. Businessmen come to appreciate the special advantages of imports at artificially low prices and of QR protection. Corruption flourishes to the advantage of key officials, who either enrich themselves with bribes or enrich their friends and relatives with exceptional opportunities. New instruments for these purposes come to be discovered--officials have become millionaires from presiding over a reduction in the number of models of passenger cars allowed to be assembled, or from selling their national currencies ahead of devaluation. Added to

this, the powers and privileges of some officials may reflect positively on the prestige and social standing of others.

Above all, however, one crisis solved through short-term expediency soon leads to another, and governments in economies always near the brink of crisis are too insecure to institute basic reforms--even doing what the International Monetary Fund (IMF) recommends is politically dangerous. Thus, addiction to the use of QRs is partly due to inability to afford the time and pains needed for a cure.

Inertia and the search costs associated with trying to change policies also make it easier to go on with policies that are not satisfactory in their results, yet can be held together from month to month with new prohibitions and restrictions if necessary. Sometimes the resulting atmosphere of crisis and precarious economic survival may even be a political asset, as the people struggling with this complex economic system gain prestige from the obvious difficulty of their task.

Another potentially important feature of a political system, as it interacts with trade policies, is the degree to which government officials and businessmen share the same outlook and social origins, and are socially congenial. Here there exist dangers at both extremes. Where their social relationship is very close, the possibilities of corruption and favoritism are enhanced, and one sees government officials or their close relatives exploiting these possibilities, as in much of Latin America, often with the help of excessively interventionist, anti-trade policies. Conversely, however, where the social relationship is very distant and the groups have almost nothing in common, as in India, and many other countries in Africa

and Asia, the government is likely to impede the growth of private business enterprises, and of manufacturing sectors in which the private sector enjoys preeminence, concentrating its assistance instead on public enterprises in sectors that "belong" to and appeal to the official classes--for example, capital goods industries and technologically impressive, high-visibility plants. This is likely to cause a bias against industrialization built around comparative advantage; hence it leads to QR-based, anti-trade policies by a different route.

Given these and related political explanations for anti-trade, QR-based policies, it is interesting to consider what may be the political reasons for pro-trade policies where they have first emerged.

In Southern Europe and Israel, the swing toward pro-trade policies in the late 1950's and early 1960's can perhaps be attributed largely to a desire to prove the countries were European and well-managed enough to do what the other European countries had recently done, as part of the postwar recovery. In addition, special benefits were sought from trade with the emerging European Community and European Free Trade Association. For this purpose convertible currencies and acceptable policies were needed. Probably another part of the explanation is that Spain, Portugal, and at times Greece, were right-wing dictatorships, and Yugoslavia a "non-aligned" although more or less socialist one. In each case, the dictator himself and his army and security chiefs had enough power to persuade officials and industrial interests to toe the new line. Moreover, the resulting economic "respectability" in the eyes of the United States and the West would contribute indirectly to the country's military security, by consolidating foreign

support in an emergency. In Israel this last consideration was no doubt important, and in addition, the country was so small and so much in need of foreign exchange that only pro-trade policies made sense. Finally, all these countries had engaged in so much QR-based, anti-trade intervention in the past that reforming the system was an activist, challenging task.

Several of the same considerations played a part in the Republic of Korea and in Taiwan within what was left of the Republic of China. There, too, the governments were right-wing dictatorships and wanted to forge stronger military and economic alliances with the United States. The foreign exchange needs of each economy, especially once U.S. aid was cut back, dictated a pro-trade policy, and the potential for selling to the United States and Japan strengthened the case.

Two other related special influences deserve emphasis. One was the presence of Communist regimes next door, taking strong measures to get rid of the bourgeois and the landlord classes in favor of drastic, income-leveling reforms. For their political survival, the regimes of Korea and Taiwan, down to the level of officials and businessmen who might otherwise have taken a different view, found themselves under pressure to demonstrate reforms and socially-desirable results in the area of income distribution. The other, closely-related influence was U.S. pressure to turn these economies and particularly that of Taiwan, into "showcases" for a "free enterprise" system. Thus, in Taiwan especially, power was tipped by U.S. influence toward experts and advice that pointed in this direction, at times by tying military aid to economic reform. At the same time, of course, Korean development policy since 1960 has been very much a reflection of the personal views of President Park Chung Hee.

In Malaysia the persistence, first of British rule, and later of conservative institutions, has been partly due to an effort to use the power of the state, and outside ties, to maintain Malay influence and well-being in face of an energetic, urbanized local Chinese community making up over one-third of the country's population. With agriculture largely in Malay hands, and private industry under the domination of ethnic Chinese or foreigners, a pro-trade policy coupled with subsidization of rice farming has been pursued partly because of its effects on the distribution of income among the country's ethnic groups.

In Brazil a swing at least part way toward pro-trade policies appears to have been in part a political choice by military leaders in favor of weakening the combined power of civilian officials, organized labor, and pro-interventionists of various stripes, while building up the strength of Brazilian business. Some of these same influences have been present more recently in the economic reforms in Chile, Uruguay and Argentina. In each case too, reform itself has been a challenging interventionist adventure.

More recent years have seen, in many developing countries, a swing in the views of officials themselves, their economic advisers, many business leaders, and much educated public opinion, toward support for pro-trade policies complete with widespread economic reforms. The strength of this swing is perhaps most clearly sensed from the policy shifts in this direction under elective governments with strong civil services in India and Sri Lanka,^{1/}

^{1/} Elected governments in Colombia, Costa Rica and the Dominican Republic are among those now pursuing a shift toward promotion of manufactured exports. In these three cases, as in Sri Lanka, much of the effort is being centered in free trade zones to get around the system of protection, which is difficult to attack directly.

as well as in dictatorships from the Philippines to Haiti, and in countries with strong regimes with their own special, partly socialist traditions, for example, Tunisia.

2. Advantages of Repressive, Authoritarian Political Systems in Setting Coherent Trade Policies; Possible Tradeoffs and Dangers

Perhaps the most troubling dimension of development economists' current advice, to try to "get prices right" on all fronts at once, ^{1/} from real wages to real interest rates as well as real exchange rates, is that this turns out to be extremely difficult to do, except in a repressive, authoritarian political system.

When economists recommend coherent, pro-trade policies, therefore, it is all too legitimate to ask, what sort of political system is being implicitly recommended?

Representative, elective governments in political systems full of checks and balances cannot, as a rule, reform more than one or two policies at a time, piecemeal, and even then they are vulnerable to organized pressures from vested interests. The trade and development policies which prove to have the best results, and make the most sense, are likely to be extremely difficult to achieve in this piecemeal fashion. Indeed, this is contrary to the basic thrust of the prescription. It is also typically recommended that the rules not be modified to accommodate pressures from special interests, since if this is done, protection is likely to enjoy eternal life, along with other price

^{1/} There is something less than complete unanimity on this point, of course, and economists disagree among themselves what "right" means in many particular situations.

distortions that are profitable to powerful interest groups. Are these policy prescriptions consistent with elective governments? And are they consistent with personal liberties? "Getting prices right" may mean smashing the power of the labor unions, the favored industrialists, the corrupt politicians and officials. Is this an implicit recommendation for repression, or at least "technocrats backed by tanks"?^{1/}

The question can be made less worrisome, but cannot be dismissed, by pointing to elective governments that have been promoting manufactured exports, for example, in Israel or Ireland, and increasingly in Colombia and Costa Rica and Sri Lanka.^{2/} Evidently an approximation to pro-trade policies can be achieved under democratic regimes, if a sufficiently strong consensus can be created; and this may be achievable where the economics of the situation is compelling.

It is also not an adequate answer, though it is evidently true, that some of the cruelest and harshest dictatorships have opposite policies --witness North Korea or the recent regimes in Cambodia, Uganda or Equatorial Guinea; and that on a world-wide basis, for countries under a certain income level (say \$2,000 per head), there is probably no significant correlation between political repression and trade policies.^{3/} Even if not many developing countries are havens of human rights, civil rights and representative government, one must be cautious in advocating policies that can only be implemented by abandoning those that survive.

^{1/} John Holsen's phrase, in commenting on an earlier draft.

^{2/} Not to mention very small island economies such as Malta, Mauritius or Barbados.

^{3/} Indeed, in some areas, such as sub-tropical Africa, there is a (coincidental) association between dictatorships and anti-trade regimes.

Whatever may be the case elsewhere, the roster of governments that have succeeded in instituting coherent, pro-trade policies is not exactly a list of repression-free, anti-authoritarian regimes. Hardly any astute observer will have failed to notice that some unsavory dictatorships have been involved. Anyone would have to count the East and Southeast Asian countries, headed by Korea, Taiwan and Singapore, as the outstanding performers in achieving manufactured exports and economic "miracles" based on the new policy prescriptions, but much as one may admire Prime Minister Lee Kuan Yew of Singapore or other leaders, the only free press and politically neutral jails in the area are in the British-run Crown Colony of Hong Kong. And the most striking recent reforms in the direction of pro-trade policies have come as a result of a switch to dictatorship in the Philippines. Elsewhere, one finds the Brazilian miracle under the generals who have repressed human rights, and now the groundwork is being laid for pro-trade policies in Argentina, Chile and Uruguay, among other places, by repressive regimes. Even in Southern Europe, the decisive policy shifts came in the past, as a rule, under dictatorships of varied types. Having labor leaders in jail as well as achieving enough political stability to take a long-run view seem to be very common accompaniments to the creation of pro-trade policies.

It is clear from the policies themselves that this association is not wholly coincidental. It takes a strong as well as efficient government to raise adequate revenues, resist pressures for expenditures, hold down real wages, overcome the resistance of vested and vulnerable interests, and make coordinated adjustments in exchange rates, QRs,

treatment of imported inputs, tariff protection and assorted other policy instruments.

Fortunately, the requirement for powerful governments would appear to apply more to the transition to pro-trade policies than to maintaining these policies once they are well launched, since their success is likely to increase social harmony and create a consensus in support of them. Even in the transition, repression might be mitigated in countries with pro-trade policies, as a result of their accessibility to foreign observers and foreign ideas and standards.

Another source of comfort here is that governments that were more authoritarian than democratic persisted in Britain, France, Germany, Italy and Japan through large parts of the "industrial revolution," when wages were still low. Perhaps the East Asian dictators and the South American generals are laying the groundwork for future democracies, as they would claim.

At least in regard to a transition to pro-trade policies, however, it becomes necessary to ask, what are the unavoidable costs and tradeoffs in this area? To what extent must repression and authoritarian rule be accepted, and in what forms, as part of the price for rapid development? What will be the long-term effects on the nation's political system, and the eventual costs of getting rid of the repression, or of not being able to?

Evidently there are some unavoidable tradeoffs and costs in this area. Given the political concomitants, it may be unwise to push

strongly for pro-trade policies in some cases where political conditions are not propitious, or to recommend them as the answer in all situations.

Conversely, it may be important to think hard about priorities and sequences of reform in situations in which only piecemeal reforms are politically feasible, and in which the cost of an alternative system might be high.

In this light the types of reforms that have been achieved in recent years in India or Colombia and those now being pushed forward in Sri Lanka, for example, deserve attention and respect.

More generally, development economists require, as part of their toolkit, a sensitivity to these costs and tradeoffs, and more good advice than is now available about what to do in situations where "the best may be an enemy of the good."

3. Effects on Expectations, Consumption Standards and Living Styles

An important social reason for the use of QRs, and a frequent concern in development policy, has not been discussed up to now. This is the impact of the availability of consumer goods on expectations, consumption standards, and living styles.

The spread of unfamiliar but desirable products has a double-edged impact on people in developing countries. On the one hand, positive effects are generated, stimulating economic growth and development. New possibilities are recognized, new aspirations and standards are introduced, people are motivated to work new ways to satisfy new wants; "an impulse to trade and an impulse to imitate"^{1/} are provoked. On the other hand, new

^{1/} In W. Arthur Lewis' words.

dissatisfactions are created through what is often called "the revolution of rising expectations"; while old ways and old standards are thrown into question, even where they cannot be easily replaced. Some of the desirable products cannot be supplied for a long time in a developing country, except to a fortunate few people through trade: the country is not rich enough for ordinary people to afford them; and mass production for everyone is not technically or economically feasible. Allowing these goods to be imported and flaunted by the rich could mean that everyone else will be made to feel poor and frustrated by comparison.

The problem is one of negative "externalities," based on interpersonal comparisons made famous by Veblen.

In theory and in practice, the existence of luxury goods, the consumption of which is socially detrimental to everyone else, furnishes grounds for a very large tax on their consumption, or in an extreme case, an outright prohibition against their use.

In some developing countries this line of thinking has been elevated to an argument that, since average living standards are going to be low, spartan consumption standards are best for the entire population. Non-availability of luxuries will hold down the living standards of the rich and the material differences between rich and poor. Thus, the poor will not feel so deprived and consumption expectations and goals will not be raised prematurely, in directions where they cannot be widely fulfilled. Another benefit will be to reduce pressures on the balance of payments caused by imports of consumer goods or inputs into them.

This line of thought is often advanced as a rationalization, and/but at times it is a genuine reason, for QRs prohibiting the importation of many foreign consumer goods. However, in themselves, QRs will not be sufficient since they will stimulate imitative production of domestic substitutes. A principal test of whether this effort is genuine is what is done to tax or prevent luxury production for, and consumption in, the home market.

Even when the effort is genuine, it can be argued that if consumption taxes are correctly set to match the social tradeoffs--taxes collected and income channeled from the rich to the community, traded off against ill effects on others through envy and unfulfilled hopes--a price-based approach would be superior and perfectly equitable. A contrary argument would hold that a high price created in this fashion only gives the product more "snob appeal" in ways that may be socially harmful or divisive.

In addition to being put forward as an argument for QRs, this line of thought based on consumption effects is sometimes cited in defense of anti-trade policies. Here the case is very weak.

The argument is roughly as follows. Pro-trade policies will lead to more and a greater variety of consumer goods, available earlier, through imports, to the frustration of the masses who cannot afford them. Inevitable inequities in income distribution will be made more conspicuous and painful, as a result of imported goods being available.

This line of argument may apply effectively against some types of pro-trade policies, but the objectives can be met, and almost certainly be

met better, within the framework of pro-trade policies as they are defined here. After all, these policies will not necessarily result in more trade in consumer goods. Indeed, as Mahbub ul Haq has pointed out, negative features of conspicuous consumption of imports strengthen the case for real devaluation in developing countries, because of the import substitution effects.^{1/} Local consumer goods industries, and local consumption, can then be suitably favored or taxed, taking "externalities" into account. QRs can be added exceptionally, but only for strong reasons.

At early stages of development, if and when export earnings are so plentiful that they spill over into consumer goods, this argument may mean that the costs of anti-trade policies are lower than they would otherwise be; but it probably also means that the country should, if possible, maintain an undervalued exchange rate and save foreign exchange reserves for use later as development moves forward. This is good advice anyway, if it can be done.

In some places and circumstances the whole line of argument is used hypocritically. Industrialists and officials, with a selfish interest in a QR-based, anti-trade regime, put this argument forward as a rationalization, and as one more excuse for the poor quality of product that results. Often domestically-made luxury goods are not taxed or prohibited to a degree consistent with this alleged purpose. Not infrequently, the system of QRs, combined with selected permissions to travel abroad, is used to enable a privileged elite to enjoy a qualitatively higher living standard

^{1/} Including replacement of imports by products more suitable to being made using local resources, such as soft drinks made out of local fruit juices.

based on more-or-less exclusive access to foreign-made goods, so that QRs become another way to reinforce a sort of caste system in which only high officials and their close relatives and favored friends end up wearing foreign-made shoes and clothes--as in Tokugawa, Japan, only samurai were allowed to wear swords, or in other places and times, people of different castes or religions have had to wear different clothes or different colored headdresses. The Soviet Union and some of the other socialist countries, are apparent examples of this hypocritical use of QRs, combined with special stores and luxuries for the elite. The end result may well be more materialism and more popular thirst for the goods affected than would be the case under price-based, pro-trade policies.

For all these counter-arguments and qualifications, however, this line of thinking is a genuine concern in many of the more soberly-led developing countries. Consumption-leveling through QRs has been turned into a virtue in China, Cuba and Vietnam, and to some extent in a number of other socialist and/or purist-minded developing countries such as Guinea, Burma and Mozambique.^{1/} There is even an element of this sort of attitude in the Republic of Korea, for all its adherence to a "capitalistic" market economy.

A Korean example illustrates how questions of consumption standards come up at a middle level of development: the decision must be made, when should the country introduce television broadcasting in color? At this point a high proportion of households already own "black and white" TV sets,

^{1/} Sometimes this is done out of religious conservatism, as in Oman up to 1970 or Tibet before the Chinese takeover. Today Albania may be the most isolated small country, with a proclivity in this direction.

and Korean firms are assembling color sets for export, based on imported components. But the government hesitates to introduce a luxury product that would create new wants and cause differences in consumption standards, leaving poorer families behind.

The main concern in regard to use of QRs and/or anti-trade policies for their consumption effects, however, must be negative effects on growth and development. Along with the other usual negative effects here, there is serious reason for concern about the effects on incentives and labor productivity as a result of restricting the availability of a wide variety of goods.

Consumption incentives are, of course, only one aspect of a broader problem of how to derive adequate incentives out of income-leveling policies. This problem will be taken up shortly when other such policies are considered.

In this regard, however, it is immediately obvious that even in the case of luxury goods, severely restricting their availability may damage the incentives of entrepreneurs, managers and other key high-level people, and if carried to extremes, can help cause these people to move to other countries.^{1/} If the dearth of goods extends to ordinary workers there may be serious motivational problems for ordinary work, as has often been the case in the Soviet Union, and at times elsewhere (e.g., Cuba and Chile).

Another possible cost comes when not having experience in producing higher-income goods leads to poor capabilities in relation to

^{1/} The Soviet system provides positive incentives for these people, however, to the extent that they want to move up into or stay in the privileged elite.

exporting, and learning to design and market these goods. This is a major problem in QR-based regimes in Eastern Europe, Turkey, Egypt, Pakistan and many other places, when they try to promote manufactured exports. It is even a problem at times in Korea, where, for example, design and marketing of color television sets is not as sophisticated as in Taiwan, where color sets are made for the local market in competition with imports.

4. Relationships Between Trade and Direct Programs of Redistribution

A more general and even more important subject than this last one is the relationship between trade and trade policies, on the one hand, and direct measures of redistribution on the other.

Given the long, slow nature of the eventual cure through successful growth and development, in which unskilled labor become scarce, perhaps the most important policy question in regard to developing countries today is, what can be done to alleviate poverty and redistribute income earlier in development, without severely hurting growth?

As part of the answer it is almost certainly correct to stress, as World Bank experts have done, the importance of "redistribution with growth." But much remains to be learned about how to achieve this.

To put the point slightly differently, the Bank's World Development Report, 1978 repeatedly calls attention to the "twin objectives of growth and poverty alleviation," but its main explicit policy prescriptions --pro-trade policies, "getting prices right," improved public services to the poor, increased yields in agriculture, more foreign-supplied resources, etc.-- cannot be expected to reduce the incidence of absolute poverty in

a hurry, except under very favorable circumstances. At least by implication, the report calls for redistribution as well, in circumstances where this can be done without seriously harming growth; but the report is not very explicit on how to do this, although references are made to land reform and public works programs, among other possibilities. Rather, the report and that of 1979 implicitly admit that not enough is known about how to reduce the incidence of poverty.^{1/}

This generalization is well justified. If anything, the difficulties in combining growth with early redistribution, under unfavorable conditions, appear more forbidding than the World Bank has generally acknowledged. For example, the Bank commonly recommends increasing agricultural output from very small farms, increasing the productivity of rural unskilled labor, and, more generally, increasing the productivity of the poor. Yet this will not necessarily increase their incomes, except in subsistence farming, because there is a danger that output increases will turn the terms of trade against them, transferring the gains to other groups. That is, successes of the poor in production will drive down the prices of the goods and services they sell, cancelling out the gains in volume. A rather similar effect occurs in education: when several years of public education at the primary level are provided to practically every young person, the wage premium for that much schooling is driven to zero. Similarly, if the health of masses of poor people is improved,

^{1/} The hope is also expressed, in effect, that the World Bank and the developing countries will learn more about how to do this in the near future through experience, experiment and research.

their incomes may be little affected, with the gains going, instead, ^{1/}predominantly to their employers and customers.

These are among many reasons why "redistribution with growth" looks difficult to achieve. Others will be mentioned later.

Even though not enough is known about how to do this, the importance of the subject is so great that the appropriate choice of trade policies for development could hinge on the connections between trade and trade policy, on the one hand, and redistributive measures on the other. This would include the question whether desirable redistributive measures are likely not to be taken as an indirect result of one or another trade regime, taking into account its political effects. To answer these questions one must look briefly at redistributive policies and experience with them, along with related political questions, to see what the underlying relationship may be.

Let us look first at the political impact of trade policies, a subject that has already been discussed, in terms of their effect on the political will to improve distribution and the power balance between rich and poor in the competition for public expenditures.

After all, there are two sides to early redistribution. One is creating and maintaining the political will to improve the lot of the poor, and the other, solving the technical challenge, under what may be difficult conditions. Concerning the second, there is a danger that much

^{1/} Much of the answer lies in rapid, economy-wide growth at the same time, to complement these productivity gains by providing added demand, and to give the poor a share of other people's productivity gains. Some income gains will be made by the poor despite this terms-of-trade effect, through greater gains from self-employment and from increased opportunities to get higher levels of schooling or training that do pay well.

of the advice commonly given, especially to social revolutionaries, may be poor advice for purposes of achieving growth with redistribution; but before these questions can be tackled in practice, the political will must be created.

The difficulties of doing this are suggested by the fact that a great many developing countries have done next to nothing to try to redistribute income or alleviate the lot of the very poor. All too often, redistribution of income through the public budget works in the opposite, regressive direction, from the poor to the elite and well-to-do. Special needs of the poor are badly neglected. The poor have little political influence, especially when they live in rural areas, and their living conditions are of minor concern to the people in power.

On the whole, this unconcern and lack of will seems to be correlated with either anti-trade policies or no serious attention to trade policies, in the present or recent past. It may be that the process of creation of vested interests, in business and in government, through sustained use of anti-trade policies, weakens the will to do anything about the income distribution, except to the extent that so much discontent and injustice are generated that the grounds are laid for social revolution. This may be an expensive and unsatisfactory way to get to redistribution, especially if most revolutionaries will not be very good at doing it without badly hurting growth.

A process of weakening the will to do anything about income distribution could also conceivably occur, however, as a result of pro-trade policies, if only because, in early and middle phases of development,

success of these policies is likely to be associated with increasing inequality in the distribution of income, for reasons to be discussed in a later section. This may well lead to a gravitation of political power into the hands of the richer classes, who will then use this power to bias public expenditures in favor of their own needs and those of the urban sector. Thus the needs of the poor and the rural sectors may be neglected. Whether this has been a serious problem in practice in any developing country is doubtful, since pro-trade policies have been rare up to now in early phases of development.^{1/} But it is not easy to reject the notion that political effects from the power structure created by pro-trade policies could be a shortcoming of these policies. More basically, one could also argue that the predominant thrust of the recommended policies is toward a private-enterprise system in some sectors of the economy, creating vested interests against redistribution.

Political will to improve income distribution is sometimes associated with pro-trade policies, as in Korea, Taiwan or Singapore, but this has to do with both of them being the "right thing to do" either for their own sake or for deeper political reasons. Another link is that pro-trade policies may make it easier to turn attention to distribution because growth results are satisfactory. A third may be that development is sufficiently advanced, particularly in terms of education and human resources and labor absorption, so that income inequalities are not greatly accentuated anyway.

^{1/} Possibly the implicit model of government here is implausible because the same sorts of pressures that skew the distribution of public services also unbalance trade policies and/or cause trade opportunities to be neglected.

Conversely, the common association between anti-trade, QR-based policies and left-leaning social reform has mainly to do with payments problems associated with the implementation of institutional reforms, to be discussed, and ideological biases in the choice of trade policy.

In practice, the rise to power of socially concerned governments in developing countries has generally come about either almost directly following independence from colonial rule--as in Sri Lanka, Burma, Algeria, Guinea, Tanzania, (North) Vietnam, Angola, Mozambique, Malaysia, or Singapore--or in rivalry with communists next door, as in Korea, Taiwan, Yugoslavia, or through the overthrow of a particularly unsatisfactory, "unmodern," and/or less than fully independent ("neo-colonial") regime, such as that of the Chinese Nationalists on the Mainland before 1949, Batista in Cuba, Haile Selassie in Ethiopia, or King Farouk in Egypt.^{1/} In the latter cases and others like them, the unsatisfactory management has generally included anti-trade policies, but this has not been a central issue.

In summary, it is not clear that adoption of pro-trade policies will be inimical to social reform in the direction of redistribution or that anti-trade policies will lead in any dependable way toward redistributive policies, much less redistribution with growth. Rather, there seems to be no reliable political mechanism under either type of trade policies, to trigger early redistribution efforts.

^{1/} Other examples along similar lines are not quite so clear cut, but have much in common with this last group, for example, Bolivia prior to the land reform of 1952 or Peru or Iraq before socially conscious governments took control.

Turning then to the technical difficulties of redistribution, as a starting place it may be useful to group redistributive measures other than trade policies, in early and middle phases of the development process at least for purposes of discussion and analysis, into three categories as follows:

(1) Orientation of public expenditures and programs toward poor people, poor districts and so-called "basic needs," through services, infrastructure investments, programs to increase their productivity, public works programs, and the like, coupled with heavier taxation of other groups, so that on balance the incidence of public revenues and expenditures, as well as the composition and design of public programs, favors the poor. (Since other measures of redistribution, listed next, also involve public expenditures, spending for these two other purposes can be conceptually excluded from this first category.)

(2) Direct transfers to the poor together with controlled and subsidized prices involving goods and services not ordinarily provided by governments, but consumed mainly by the poor. This would include public distribution or supply of foodstuffs either free or at subsidized prices, and use of price controls and subsidies to affect the cost of living for the poor, as well as welfare payments. This category can also be extended conceptually to include wage measures outside the public sector and farm price supports. (A few measures are difficult to classify or else overlap between these first two categories, for example, special programs to promote the use of "appropriate" employment-creating technology, or guaranteed employment through public works programs.)

(3) Reorganization of the institutional framework, and redistribution of property outside the government itself. This involves transfers of property rights, and related measures to shift income distribution and/or raise the productivity of the poor by shifting the distribution of assets and by reorganizing activities so that the poor will be benefitted by cooperative action. For some purposes it may be useful to sub-divide such institutional reforms into two sub-categories: (a) rural and agrarian reforms including land tenure reforms; and (b) urban and industrial-sector reforms. Each affects institutions, property structures and cooperative action, but in different settings.

In addition to, and working simultaneously with these three categories of measures, trade policies themselves will have a direct impact on the incidence of poverty through their effects on employment, agricultural incomes, and the real wage of unskilled labor, as well as growth itself. These relationships are analyzed in the next major section, but for the moment, they will be left out of the discussion for simplicity.

Among the three categories of redistributive policies listed, each can obviously involve either very mild measures or strong ones. Other things equal, however, the first category of measures are the least radical and the ones most easily combined with uninterrupted production and ongoing use of a price system reflecting social tradeoffs in development. The second set of measures can lead to misleading price incentive signals and hence negative side effects along with heavy budgetary costs, while the third may be viewed as radical and likely to interrupt or

disrupt production through turmoil or transitional confusion. Partly for these reasons the first category of measures are least controversial and most widely accepted, in the World Bank and elsewhere. However, almost everyone is ready to accept some transfer payments, if only to people who are disabled or too old to work; and many people are ready to accept land reform, creation of cooperatives, worker participation in profits and management if only in public enterprises, subsidized food for young children and their mothers badly afflicted by poverty, and a few other measures in the second and third categories.

Leaving aside for a moment the question of how well these measures work in promoting an improved income distribution, it is important to be clear about their effect on trade and trade policy.

Practically any major measures or programs undertaken in this area will divert resources to some degree away from industrial development, and from export expansion and other worthy objectives, into programs to redistribute income directly, at least in the short run. After all, a public program of institutional reform, or provision of "basic needs," or any other major new program to help the poor, will involve budgetary costs and requirements for skilled personnel, managers, and technicians. The budgetary costs will be high in proportion to the amounts of income, food or other goods directly transferred into the hands of the poor, even if this is done in exchange for work on public projects.^{1/}

A resulting immediate effect will be to increase aggregate demand without an offsetting increase in aggregate supply. As part of

^{1/} In this case, however, there will be an eventual return in output.

this, to the extent that poor people are made a little less poor, demand for food (and to a lesser extent, clothing) is likely to expand. All these effects mean that exports are likely to fall, and imports will increase, so that the balance of payments will be driven into deficit, except to the extent that this can be prevented by tax increases or expenditure cutbacks in other programs. These effects will be small if the redistribution expenditures are small, but if they are large the country may have to do without imports of (e.g.) industrial equipment, because of the program.

The negative impact on the balance of payments, and/or growth, will be intensified if redistribution measures are accompanied by disruptions and disincentives. Here again the effects may be large or small. Private investment may be reduced for a few years, out of alarm over the program. There may be capital flight. Industrialists, managers, technicians and entrepreneurs may even interrupt or cease their activities and leave the country. Confusion, disorder, or reduced incentives among ordinary workers may lead to a disruption or decline in agricultural and/or industrial production.

Obviously to the extent possible, it is desirable to achieve redistribution without disruption and without interrupting growth, even if this means moving forward at a rather deliberate pace.

In view of the effects on the balance of payments, including the possibility of capital flight, efforts to redistribute income make it difficult to maintain pro-trade policies and to avoid use of QRs. Pro-trade policies can be maintained, perhaps, by repeated devaluations and

strong efforts to keep the government budget in balance, while mere temporary exchange controls can be invoked to restrict capital flight, but when disruptions are large this become a precarious management act, so that any severe disruptions or large new import demands as a result of redistribution are likely to force much use of QRs, and create an over-valued exchange rate. Thus, one of the costs of any big program of redistribution may be to force the adoption of inferior trade policies.

Despite these difficulties, in the best of circumstances, the effects on output could potentially be positive in the long run, through more productive institutions, better human resources, desirable public works investments, and better motivation for work (for example, when farmers get ownership of their own land). Thus, eventually output could catch up or overtake what it would otherwise have been. However, redistributive measures of this type, such as strong systems of education for even the poorest districts, can be broadly embraced as part of a growth strategy. The concern here is more with redistribution that conflicts with growth.

In the abstract it is already obvious that institutions which are optimal for reducing absolute poverty are not necessarily optimal for growth. Heavy expenditures on education and services for the poorest elements of the population may have to come out of competing programs, in which the same teaching or technical assistance could be lavished on people with greater readiness and immediate ability to use the information productively. In short, under all but the best circumstances there are likely to be tradeoffs between growth and distribution in the design of

programs and expenditures. Thus, growth may never catch up to where it would have been, even if the redistribution is justified on an equity basis. In this case, hard choices have to be made between redistribution now that delays growth, or alternatively, policies that instead foster growth and development which will eventually raise poor people's income through labor scarcities and other "natural" processes, and through social welfare measures when incomes are higher, achieving results later on that cannot be matched through policies based on early redistribution.

Having said this much, it may be important to add that on the whole, up to now, the lessons of experience are not very encouraging as yet in regard to the impact of all these redistributive measures in alleviating poverty. Taken by an ordinary government, with ordinary resources and power, the measures that are widely accepted appear weak in their impact, as well as hard to do well. The more controversial measures of direct transfers, large-scale subsidies and radical institutional reforms appear to carry a high cost in growth given up, through a combination of high direct resource costs, disruptions and consequent losses of productive capacity, weakened incentives, and distorted price signals, not least as a result of their effects on trade policies.

Some of the difficulties, such as terms-of-trade effects from better education and increased productivity of the rural poor, have already been mentioned. This is obviously not the place to discuss technical problems in tax systems or "basic needs" delivery systems; but a few words may still be useful reminders. Reaching needy mothers and pre-school children with nutritional assistance, persuading people to build and use

improved sanitary facilities, or setting up paramedical health care systems all have their severe practical difficulties, but even if they can be accomplished this will not radically change the distribution of income. And it is well known that redistribution through the tax system, in a progressive direction, is a slow process, in which negative incentive effects on growth and development must be balanced against redistribution at every turn.

Institutional reform is known to make sense and be desirable in some conditions--Korea and Taiwan and Japan instituted land reforms with good long-term results, and Yugoslavia has had considerable success in improving equity through institutional reforms--but results are often disappointing. Labor productivity has been known to fall drastically, as in Bolivia, and the form of exploitation may merely shift without leaving the poor better off. In some cases landholding patterns return inexorably toward the same patterns dictated by powerful economic forces, as is said to have happened repeatedly in the past in parts of Hungary and, in recent decades, in much of Mexico; or a high price must be paid for twisting ownership away from this pattern, since smallholdings are not economical for one reason or another. As for urban areas, reorganizing industry may or may not have positive effects on equity, but it usually does almost nothing for the absolute poor, since they do not have jobs in the formal sector. Bringing them into the productive labor force is likely to depend on public works programs or artificial creation of jobs in distribution and services--all expensive undertakings that may carry a serious cost in growth.

Similarly, there has been much experience in the developing countries in providing subsidized food supplies at artificially low prices, especially in urban areas. Sri Lanka has had perhaps the most comprehensive programs in this regard. In some important respects these programs have had positive results but on balance they have almost certainly been costly in regard to growth.^{1/} Moreover, it is difficult to extend them to the rural poor without adverse effects on rural food output, although some of the effects on poor people's health are undoubtedly beneficial. Sri Lanka has recently cut back its programs in this area.

Whether redistribution is really costly will depend, of course, not only on effects already analyzed, but also on effects on output potential and technical progress and indirect distributive effects from changing the composition of demand, so that there is more demand for "poor people's goods" such as food and simple clothing and housing, and less demand for durables and luxuries. Unfortunately, a lot of the technical know-how and the economies of scale available, and consequent possibilities for rapid growth of output through borrowing of technology from developed countries are in consumer durables and "high-income" consumer goods, so that it may be much easier to generate a rapid burst of output to serve a middle-class market for the well-to-do, as in Brazil, than to increase the output of beans and bread and cheap cotton clothing. But on the other hand, increases in the demand for "poor people's goods" may perhaps raise the returns to unskilled labor and smallholdings of land, and thus benefit the poor indirectly.

^{1/} On this subject, useful analyses have been made within the World Bank by Paul Isenman and others.

Any full assessment of the possibilities of redistribution would not be complete without attention to what has been done in some of the socialist countries, and particularly in China and Cuba.

Probably the most renowned program of massive income redistribution--but one that depends on highly exceptional government power and influence--is that of the People's Republic of China. This program involves all three types of measures sketched above, especially the first and third.^{1/}

In the first category, the government raises most of its revenue in urban areas, largely from the profits of industrial enterprises, yet it undertakes very substantial public expenditures in rural areas. Public spending on some types of services is probably roughly proportional to population, if not heavier in the poorer and more backward areas. This is only part of the fiscal story, since a part of the profits of the urban enterprises is made through sales in rural areas. However, the most basic reason for these profits is that urban wages are held artificially low--a sort of payroll tax effect. Moreover, the rural areas that buy these goods in large quantities are not the poorest districts. By any reasonable comparative standard, judging by available data, the total transfer effect is quite a massive one.

In the third category, the most basic institutional reform has been to organize the rural areas into communes and subordinate smaller units, within which, as in a family, the size of everyone's real income

^{1/} For more complete information than is given here, see for example, Keesing (1975), Rawski (1978) and their references, and the May 1978 issue of World Development.

is dependent on the total and hence the average product of the collective unit, even though an individual's income is based partly on what he or she contributes, and it depends heavily on what his or her small team produces. In effect, the individual is guaranteed income related to the overall productivity of the unit, but in return, he or she is obliged to work hard at tasks, however unpleasant, assigned by the collective.

In the second category, there is food rationing along with rationing of cloth and assorted other goods. Indeed, to buy some types of consumer goods, the purchaser may be required to have not only the cash price, but also one or more types of ration coupons and a permission from his or her production unit, based on good performance. Basic food rations are normally adequate for health, but the amounts given depend to some extent on job and performance, and may be used as part of the incentive system. As another part of the system, apart from some pensions and equivalent measures to insure that old people and cripples are able to survive, there are few welfare payments and everyone is expected to work where he or she is assigned, even if this involves a separation from spouse or family.

The degree of suppression of individual rights, and of authoritarianism and repression of enemies and critics, involved in this system, far transcends that seemingly required to implement coherent pro-trade policies, so that previous qualifications about costs and tradeoffs, raised in that context, apply even more to the Chinese system of redistribution. However, observers who can stomach these features, or who suppose that the Chinese have special tastes in these matters, are often quite

enthusiastic about the results in eradicating the worst types of poverty, although they might linger on in prisons and penal camps and out-of-the-way districts that visitors are not allowed to see.

Historical qualifications are also interesting. The first is that most of the gains in overcoming absolute poverty seem to have been made already by 1957, only a few years after the government came to power, and before the rural collectivization reached its present form. A second is that some of the attractions of hardworking rural China, to a Westerner raised on sturdy moral precepts, were already there in 1930, or 1730, or in Marco Polo's day.

Perhaps the most important historical qualifications have to do with the not wholly satisfactory growth results and the costs that China paid in achieving some features of this system, particularly during the Great Leap Forward (1958-60) and the Cultural Revolution (1966-68). Chinese leaders recently have expressed much dissatisfaction in retrospect with the policies followed and their results.

On the whole, experience in social revolutions in smaller developing countries confirms that it is very difficult to obtain redistribution with growth, and to avoid paying a high price in growth, and indeed it is even sometimes hard to attain a net reduction in poverty, in countries with weaker instruments and less experience than China had. Some of these problems may be especially acute in small countries because of their openness and vulnerability to damage through emigration, capital flight, and distortions or suppression of trade.

A long roster of cases could be mentioned in this regard: neither Arab, African nor Caribbean "socialism," nor the small-and-poor centrally planned economies have been outstanding successes.^{1/} Certainly the output record where there has been a long record of experience, as in Burma, Tanzania or Guinea, leaves much to be desired.^{2/} The aftermaths of institutional and land reforms, for example, in Mexico, Bolivia, Egypt, Algeria, Syria, and Peru, have not been wholly positive. And the newest experiments in massive social change, as in Angola, Ethiopia, Mozambique, Guyana, Jamaica, Laos and an enlarged Vietnam, not to mention Kampuchea alias Cambodia, do not promise conspicuously greater success in "redistribution with growth" (or in bringing happiness in their wake) than the earlier ones. Indeed, reaching social revolutionaries with better policy advice on trade, growth and techniques of redistribution may be an urgent need of our times.

Among these smaller country cases, perhaps the most interesting is that of Cuba. There one finds a classic example of motivational difficulties in the wake of a large-scale redistribution of income. In its first years after coming into power in 1959, the revolutionary regime took strong measures--including food rationing, institutional reforms, health programs and welfare payments--that had the effect of assuring a minimum of income to everyone. However, the stores were soon denuded of

^{1/} Tunisia, which seems to be the closest of the Arab socialist countries to being a real success, is also the closest to employing pro-trade policies.

^{2/} Morawetz is now revising a study on socialism in small developing countries which generally reinforces this conclusion. In Burma and Guinea, output per head has actually declined.

most "incentive" goods, and differences in living standards between different income groups were compressed.

At this point, in addition to difficulties in getting people to work hard elsewhere in the economy, great difficulty was experienced in motivating people to cut sugar cane, Cuba's principal export crop, which for technical reasons, had to be harvested mainly by hand with cane knives (machetes). Cutting cane in the Caribbean sun is unpleasant, hard work, but in pre-revolutionary days hundreds of thousands of Cubans had to do it or face starvation. Once the rewards and penalties were reduced, it became difficult to get people to do the harvesting. Even enormous propaganda and mobilization efforts have not been conspicuously successful, here or in other work-motivation situations. Finally, in the early 1970s the Cubans had to surrender some of their principles and institute material incentives modeled roughly along Soviet lines.

All this has a familiar ring, of course, to students of Soviet economic history from 1917 to the early 1930s. Stalin's answer was exaggerated piecework incentives, food rations based on labor performance, huge pay differentials, large bonuses for managers meeting their plans, and draconian penalties for economic "sabotage."

More generally, Cuba has achieved a fine record in redistribution at the cost of a poor record in growth,^{1/} and some political repression. One particularly interesting aspect of Cuba's policy experience has come in

^{1/} The growth record would have been better, of course, were it not for political measures to impede trade with Cuba, and to deny the country aid, even when Cuba would have been an excellent candidate on economic grounds.

trade policy, where a QR-based, anti-trade regime yielded such poor results that Fidel Castro began emphasizing the virtues of exporting, in general, and exporting sugar, in particular!

5. Production Effects of "Learning by Doing Without,"
(but Seeing and Trying to Produce)

One other aspect of socialist (and protectionist) experiment deserves further attention, based on historical experience, not least because it might strengthen the argument for QR-based, anti-trade policies. Moreover, it applies especially to producer goods, where it calls for policies rather different from the typical QR-based, anti-trade policies as they are known in Latin America and most other developing countries.

The argument in the abstract is that in the long run much can be learned from doing without new supplies of products such as machinery and assorted other goods, while seeing examples of them, knowing they can be made, and trying to produce them. This applies especially to products that are not terribly difficult to make, given time and opportunities to experiment using the advice and resources locally available.

Two threads come together in this argument. One is that people in developing regions lack confidence and generally lack incentives to try to produce complex products or solve unfamiliar problems. Under ordinary policies there are only weak incentives to begin to master basic principles of engineering and mechanical design, or to learn confidence and gain through experience the ability to find solutions independently, or with only modest outside assistance. Obviously the usual import-substitution projects do little to meet this need; they provide, as a rule, a whole

package designed and built with foreign advice and imported equipment. Strong measures are needed to force people to learn and to master the principles of the industrial revolution for themselves.

The other thread is that for many mechanical and engineering purposes the latest equipment is not especially suitable for developing countries with superabundant unskilled labor. They can do very well with older designs or with models they can build themselves through trial and error. People may be able to learn more from simpler and less automated equipment and more employment will be provided.

The usual anti-trade policies only trigger attention to these possibilities when they cause a wide range of imports to be cut off by severe foreign-exchange shortages, or when they overlook important import needs. However, policies can potentially be designed deliberately to foster what might be called "learning by doing without," based on "learning by seeing" but not being able to buy.

Historical prototype experiences in this regard have included supply cut-offs in wartime, breakdowns of trade in the Great Depression and in local payment crises, and massive withdrawals of foreign assistance, for example, in China when the Soviet Union withdrew its technical experts in 1959-60. In each case, it has been discovered that the people afflicted with shortages could do more than they thought they could.

Perhaps the most interesting deliberate choice of policy regimes along this line has occurred in the People's Republic of China, in its efforts to foster output of machinery and complex products and learning by doing at a local level, in each province and "county" (hsien) and in

individual communes.^{1/} This has been done through use of deliberate QR-style restrictions on internal trade in most producer goods, as well as many consumer goods. Some goods are to be produced at the national level, under the central authorities, others in the region or province, and still others under local authorities in narrower units such as the hsien (which on average has about 300,000 people), with blueprints and a little advice and equipment from higher levels.

Only the most difficult-to-produce items and those involving huge economies of scale are supplied through distribution by the central authorities. Another set of products, involving substantial difficulty and scale economies--for example, tractors and motor trucks--are expected to be produced in each province, with technical assistance and equipment from the most advanced regions. Another range of simpler items--including agricultural implements, pumps, and assorted other farm equipment--are expected to be produced at the hsien level; while industrial enterprises of locally suitable types, complete with auxiliary workshops and repair shops are expected to be set up within each commune. At each level, a sequence of learning and increasingly sophisticated production is fostered. At the hsien level this is expected to start with repair activities and making of simple equipment, and replacement parts, then advance through a sequence involving successively more difficult items. Often local factories are set up with workshops, equipment and advice for making replacement and spare parts for their capital equipment.

In part, the inspiration for this policy is military security--an effort to diffuse China's metalworking, armaments-making and machine-

^{1/} For further information beyond what is given here, see for example Sigurdson (1977).

building skills so widely that a foreign invader such as the Soviet Union could not destroy the nation's capability to resist and strike back. But in part it is an effort to spread development to where the people live, and to get the whole nation to begin to foster industrial skills, rhythms and technical know-how even in what were previously very backward and nonindustrial rural areas.

The emphasis on learning by doing, starting by "doing without," is partly a reflection of Chinese experience when the Soviet Union withdrew its technical assistance. Many of the new plants with excellent equipment, set up only just before on Russian models, proved almost useless for lack of know-how and experience on the part of the labor force; indeed, the complexity of the equipment proved a bar to learning. Instead, as Rawski's research has shown, the really valuable Chinese industrial plants proved to be the older Shanghai machinery plants, many of them small or medium-sized. Among the latter, many were first set up in the 1920's or 1930's to serve the textile industries by repairing and replacing their equipment. Gradually they became diversified, producing a variety of not-very-complex engineering products. In the 1950's most of Shanghai's machinery firms survived rather precariously, after the Communist takeover, by making a variety of machines with equipment they made for themselves (since they had low priority in getting imported equipment--China was already trying to shift its industries geographically away from the older industrial centers). Beginning in the 1960's, after the Russians pulled out, these plants took over the responsibility for supplying plant and equipment to the most complex industries such as heavy metallurgy and petroleum drilling and refining, moving from

one product to another. They also supplied technical assistance to some of the plants in the rest of China, but as a general rule, throughout the "modern" industrial sector, factories and enterprises were required to struggle to design and build new products, or bigger versions of products such as ships or generators, while solving engineering and design problems for themselves.

No dependable evaluation of the benefits as against the costs of these Chinese efforts is available, but there are several good reasons to discount the claims made on their behalf, for example, in the late 1960's and early 1970's. On the whole, foreign engineers and technical experts do not seem to be impressed by the engineering accomplishments or the technical quality of the plant and equipment that have resulted. For the most part, the Chinese machine-builders have only produced what amounts to old and elsewhere obsolete types of equipment; and typically their designs are many years or even decades behind the West. China continues to depend heavily on foreign "turnkey" plants and imported equipment, in many of its larger and more sophisticated operations, for example, in chemicals and offshore drilling for petroleum. The average levels of labor productivity in Chinese industrial plants, when one includes the commune and hsien factories, are quite possibly lower than those in any other country. Perhaps most significant, China's most able leaders, now back in power, appear to be highly critical of the policies followed since the Cultural Revolution, particularly in the realms of education and science,

where the mistakes were glaring,^{1/} but also in the realms of technology and industrial policy, where the leaders are greatly concerned that China must overcome its backwardness.

Another part of the problem of evaluating these policies is that the Soviet pullout of 1959-60 was triggered largely by disagreement with China's Great Leap Forward (1958-60), which involved a naive effort to industrialize the countryside in a hurry, complete with backyard steel mills and falsified statistics to raise morale. The Great Leap ended in a disastrous setback for China's growth and development, and the Chinese leadership conceded quickly that it had been a grave mistake. Yet many of the institutions and measures applied since, in decentralizing China's industrialization, came out of experience in the Great Leap and the subsequent temporary collapse of modern-sector industrial output. If the costs of these episodes and the disruptive effects of the Cultural Revolution are weighed in the balance, it becomes harder to be enthusiastic over China's rural-industrialization experiments.

In smaller socialist developing countries--Cuba, Vietnam, North Korea, Kampuchea, Mongolia--and others with leanings in a similar direction --Burma, Guinea, Syria, Tanzania, Laos, Ethiopia, Angola, etc.--it would be hard to find a success story involving "learning by doing without," apart from military success in Vietnam and elsewhere.

^{1/} Universities were closed for long periods, scientific research organizations and universities were disrupted and politicized, students and higher personnel were selected on political merit with little regard to their intellectual credentials, scientists and technical experts were discriminated against, forced to do manual labor, not listened to, etc. For as long as ten years practically no student received a professional education in science or technology.

There is also room to argue, here again as usual, that to the extent that the approach makes sense, it can be combined with pro-trade, price-based policies, as these terms are used here, not only by using the exchange rate to discourage use of imported machinery, but by protecting and/or subsidizing local engineering industries as well, to foster learning by doing.

It must be conceded, however, that as a matter of semantics, the term "pro-trade" may not be fully appropriate, here and in other contexts, where exchange rates and supporting measures are being used to limit trade in order to reduce its negative effects in the short run, whether on people's self-confidence and learning-by-doing or on consumption standards or cultural change. Granting that part of the intention and effect of these policies is to create more trade in the long run, when the economy is ready to benefit, there is still a real sense in which the arguments try to make a case--which is almost certainly correct--that under some conditions more trade will be harmful to development and/or happiness. There is in fact some doubt as to exactly what policies should be called pro-trade policies where the long-run trade effects are either unclear or else differ sharply from the short-run effects.

In the present instance, anecdotal evidence suggests that Hong Kong, Taiwan and Korea are among the developing economies that make most use of labor-intensive methods, and of second-hand and locally-made machinery, so there may be no conflict between learning in this area and pro-trade policies. However, the general problem persists, in analyzing whether any country does too much or too little of this, that too little

is known about what ought to be done, both in fostering production of machinery and in selecting machinery in developing countries, apart from carefully applying cost-benefit analysis in particular cases. An even more fundamental problem already mentioned, highly relevant here, is that not enough is known about how best to foster learning throughout the industrial sector, and what trade policies make most sense for their long-run development effects, early in development. In regard to these issues the underlying problem may be one of ignorance more than semantics.

B. Effects of Trade Policy on Poverty, Employment and Income Distribution

1. Introductory Overview

Compared to some of the topics treated in the previous section, those treated in this next one -- the effects of trade policy on poverty, employment and income distribution -- have been somewhat better explored and are more amenable to economic analysis.

Relationships uncovered and trade policy measures recommended as a result of focusing on the goals of eradicating dire poverty, expanding employment and contributing to an equitable distribution of income turn out to be not startlingly different from those already suggested in Part I in view of the requirements of economic growth and industrial development. No doubt there are excellent reasons for this. One is that many of the recommendations now made by development economists already take these social goals into account. Another is that in the long run, economic growth and development generally have favorable effects in these areas. In any case, pro-trade policies turn out, as a rule, to have superior employment and poverty reduction effects compared to anti-trade policies, particularly in the middle and later stages of development -- in early stages there may be little difference.

The situation seems to be somewhat more complex in regard to income distribution. In earlier and middle stages, pro-trade policies by their very successes are likely to lead to increasing inequalities in income distribution and wealth, but these inequalities may be at least partly necessary for rapid growth, based on their consequences for incentives and resource allocation. At any rate, the resulting inequalities more closely reflect "real" contributions to development and the essential needs of

growth, than do the severe inequalities often generated (along with less growth) through QR-based anti-trade policies. Under the latter, the distribution of riches and special opportunities is often arbitrary based on favoritism, connections, or good luck. In later stages of development these complications disappear. Having at first widened inequalities, growth in later stages evidently helps to reduce them instead, notably through its effects in expanding demand for unskilled labor, and thus driving up wages.

Apart from these direct effects, in the long run growth provides the means for substantial further redistribution and poverty eradication through social welfare measures on a scale that would be infeasible or excessively costly at lower income levels. Thus, to the extent that pro-trade policies help to open up these results earlier and more surely than anti-trade policies, they can contribute in the long run to substantial achievements in regard to all these social objectives.

While this seems to be the general picture, it must be qualified at a number of points, especially since a reliance on uncorrected market prices can have negative side effects in regard to the objectives under study. Where perverse influences occur they become the basis for modifying policies and incentives to take these side effects into account, even if they do not demand fundamental departures from pro-trade policies. With these concerns in mind it becomes useful not only to clarify why pro-trade policies generally have positive effects in these areas, but also to search carefully for the exceptions.

2. The Impact on Agriculture, Rural Poverty and Rural Development

Typically in developing countries a large majority of the very poor live in rural areas, where most of them are engaged in agriculture. Thus,

the effects on poverty from trade policy might be expected to depend above all on their impact on rural poverty and the agricultural sector, particularly on landless laborers,^{1/} people operating very small farms, inhabitants of depressed and backward regions, and people who are so handicapped in one way or another -- by blindness or other crippling defects, malnutrition, chronic illness, or their language and cultural background (for example, in tribal cultures with primitive technology) -- that they are not easily employable. These people and their families make up most of the rural poor.

In practice, however, until quite late in development, pro-trade policies will only lead to superior outcomes for these people through a few restricted routes, none of which is liable to have any very large effect in reducing their poverty except under particularly favorable circumstances:

- To the extent that pro-trade policies lead to better overall growth results they will have some net effect in the direction of increasing aggregate demand for agricultural output and thus driving up prices. They will also gradually create more opportunities for employment in the more advanced parts of the economy so that the day will be hastened in which wages are driven up, unskilled labor becomes scarcer and more valuable, and young people are presented with new opportunities.
- A favorable effect on wages through migration to the cities and through interlinked labor markets may be accentuated by the greater employment created as a rule under pro-trade policies, though this effect would be small in a country like India or Pakistan compared to the scale of the employment problem.

^{1/} Including artisans and plantation workers.

-- By definition, pro-trade policies give somewhat better rewards to agriculture for export and this is likely to extend to some other tradeables such as grain, even if they are not exported. Thus, a wide range of cash-crop agriculture is likely to be better rewarded. This may well lead to a stronger demand for labor, improving the wage earnings of unskilled workers in rural areas. Even small-scale farmers may be able to gain from sales of cash crops. One way or another, if at least some people in rural areas are made better off, the benefits are likely to trickle down to the poor. Conversely, to the extent that rural areas are depressed and even "incentive" goods are unavailable or of poor quality under QR-based, anti-trade policies, the rural poor are likely to be hurt along with everyone else in these areas.

Even if these influences work in favorable ways, however, it must be recognized that most of the rural poor will not easily be pulled out of their poverty as a result. Most of these people have practically no assets -- land, capital, skills, education, know-how -- that might command a good return in a growing market economy. Often they are already the culled-over remnant of a process of outmigration that has been attracting away a disproportionate share of healthy, bright, energetic and ambitious young people. Or they are the heirs of generations of downtrodden, defeated, exploited, socially despised people forced to take the most menial jobs or cultivate the land no one else wanted. Many are not physically fit to work and most are not culturally well prepared to seize new opportunities. The quality of human resources and the land available per head have been further reduced

by high rates of population growth, limiting what families have been able to give to any one child. Opportunities for young people have been curtailed too by a need for children to work in the home and field, from an early age, to help their families survive amidst desperate poverty. In this setting, vicious cycles abound, and poverty perpetuates itself. Indirect economic influences from trade and trade policy are likely to prove too weak to break these cycles for more than a small fraction of the people trapped in them, in any but the most fortunate of generations.

Moreover, and in any case, several qualifications must be entered in regard to the positive effects. One is that the expansion and improved rewards of cash-crop agriculture are likely to cause, among their effects, bidding up the value of land, expanding the share of output devoted to marketable crops rather than subsistence foodstuffs, and spread of a cash economy. Although these are necessary accompaniments of economic growth in the long run, their immediate impact in rural areas may lead to hardships for many of the poor. One effect can be a restructuring of ownership and property rights in which many of the rural poor are forced out of their meager farms or traditional cultivation rights, fairly or unfairly. Another result can be a breakdown of traditional obligations, customs and rights that sometimes protect the weak and the poor better than their legalistic and commercial replacements. A third side effect may be that commercialization of the economy accentuates the inequalities among rural inhabitants based on contrasts in their preparation and ability to handle commercial transactions. A fourth can be to bring about such an inequality of power and influence between the wealthier and poorer rural classes, at a local level, that one may well expect local institutions and their workings --

even including the market for wage labor -- to operate in a grossly unfair manner to debase and oppress the rural poor. Nowhere, even in a city environment in which repressive police are on the side of employers, is there commonly such a one-sided, potentially exploitative bargaining situation for adult workers as in a remote rural area where the worker cannot easily go somewhere else and the powers-that-be are unabashedly on the side of the employer or creditor.

On the whole these effects do not appear to offer a sound argument for embracing anti-trade policies, even in a country where they would help to maintain a subsistence economy with the semi-equality of a situation in which everyone is more or less poor. To accept this approach would be very nearly to reject the objectives of growth and development with the possibilities they offer for the future. Moreover, this choice frequently does not exist, because in a large number of developing economies the semi-equal rural economy is already gone if it ever existed, and instead, anti-trade policies will only perpetuate an existing situation with some or all of the ills just sketched. For that matter, the inequality-generating effects of a cash economy are almost certainly greatest in a situation in which people from two or more cultures with vastly different levels of commercial experience are living together, and in places with a long history of inequality and exploitation or where different groups have contrasting amounts of political influence with officials -- situations all too common in developing countries -- and here too, there is no remedy from anti-trade policies. All things considered, these qualifications call for direct measures to try to alleviate the worst of these effects, perhaps along with other measures far removed from trade policy, and also at the same time,

discriminatory incentives against particular agricultural products associated with the worst social side effects.

A related qualification is that the conversion of a rural region to a commercial, cash-crop orientation may make the affected region -- and especially the poor and landless workers in it -- vulnerable to vicissitudes in crop prices and more generally to outside economic forces, to a degree not matched in a semi-subsistence economy. Linked closely to this difficulty, as well as restructuring of landholdings, is the concern that this sequence of economic changes will create a landless proletariat in the countryside subject to harsh and insecure conditions, which will eventually have to include migrations in search of work. More than the rural poor who stay in one place, migrant workers are likely to suffer deprivations, above all in nutrition, but also in shelter and sanitary conditions.

The dietary effects of a shift to a modern-style, market economy are among its most dangerous accompaniments in any case, under any trade policy. Traditional village diets in most parts of the world, even if they seem unattractive to outsiders, are generally well balanced and nourishing as long as there is enough food to go around. But the spread of a market economy leads to substitutions in the diet -- soft drinks and sugar, for example, -- that destroy its balance and make it no longer healthful. Almost every disease known to man can be spread in the wake of this process of dietary disruption as people are weakened by malnutrition due to ignorance. The dangers are greatest among physically displaced migrants who must shop for unfamiliar foods; and indeed, severe malnutrition is typically found in urban slums or squatter settlements, and in migrant workers' labor camps,

much more than in the poorest farm areas where home-grown foods mitigate the effects. These qualifications too, however, do not in any obvious way favor one trade policy over another; they only underscore the inadequacies of trade policy to deal with the deeper ills of development. However, the circumstance that disturbing new ills and inequalities are frequently associated with the integration of an area into the larger market economy contributes to a readiness to accept ideologies that blame the market system; and to the extent that food advertising is misleading there is some basis for this association. The nutritional effects of an unalloyed capitalist system are in truth one of the most powerful arguments for a paternalistic socialism that emphasizes health and nutritional education, restricts the availability of unhealthy foods, and rations essential foods when they are in short supply. However, measures along these lines are almost certainly compatible with pro-trade policies, in which side effects in consumption are taken into account systematically.

One other qualification of some importance is that the effects of alternative trade policies on rewards and employment creation in rural areas depend on what happens to agriculture not for export, and on the employment requirements of the particular types of agriculture affected. Since some types of food and raw material imports are almost certain to be reduced under anti-trade policies, for lack of foreign exchange to pay for them, some agricultural products are likely to become more rather than less profitable under these policies. In other words, as between pro-trade and anti-trade policies, each approach will lead to some agricultural products commanding higher rewards than they would under the opposite policies. The same effects are likely to occur also in rural manufacturing, construction and processing -- anti-trade

policies will generate a certain amount of demand based on doing without imports, while pro-trade policies will generate demand based on better market prices for exportables and some other items (e.g., importables where imports would actually take place). Each pattern of demand will lead to a pattern of employment and income distribution effects which will depend on the particular details and factor requirements of the production affected.

This qualification like those before it is not an argument for anti-trade policies, with their high cost in growth, but rather for special direct measures and incentive shifts to take into account side effects in employment and income distribution in one type of production against another. If commercial beef or wool production has negative side effects in reducing employment opportunities compared to mixed or crop farming, production of beef or wool can usefully be hit with a special tax -- if necessary an export tax. If doing without some imported construction material, or a particular type of imported labor-saving machinery, will lead to positive effects on employment of the rural poor, its use in rural areas can usefully be subjected to a tax; and so on.

Since these qualifications are all cases of side effects (externalities) there is really no serious contradiction of the "mainstream" view on trade policy already given. However, the best of both worlds may not be available in practice. Advocates of growth through trade are sometimes adamant in defending world prices as the "right" prices, or in asserting the inability of policy-makers to judge externalities, without enough concern for the side effects that do hurt the rural poor. In the opposite camp, political groups sensitive to these side effects and ready to take measures to correct them may be wedded, at the same time, to unsound policy notions on other fronts, including disastrous trade policies.

3. The Impact on Urban Employment and Urban Poverty

In their employment and poverty effects in urban areas, even more than in rural areas, pro-trade policies appear superior as a general rule compared to anti-trade policies. Moreover, the differences are likely to be felt sooner and more strongly in the towns than in the countryside.

In cities and towns, the beneficial effects of pro-trade policies are likely to operate largely through employment creation and reduced disparities in wages and working conditions for similar types of labor, while anti-trade policies foster dualistic conditions leaving many potentially productive workers below the poverty line, and others unable to find steady work.

Increases in desirable employment and a reduced incidence of dire poverty are brought about mainly through four mechanisms, all of which are likely to yield better results under pro-trade policies:

- By generating successful growth; and a rising demand for exports and industrial output, pro-trade policies create jobs directly as a reflection of the rising demand for goods and services. As part of the (derived) demand for workers to make the output required, employment will be spread through what economists call "linkages" and "multiplier effects" by which prosperity in one part of the economy spreads to other economic activities around it. This positive growth effect will be most pronounced over the long run.
- Employment opportunities are likely to be favored under pro-trade policies by socially desirable labor-capital substitution, based on realistic price relationships encouraging the use of suitable combinations of labor and capital. Here, anti-trade policies, by

setting the exchange rate too low and then allowing duty-free imports of equipment, make the price of capital equipment artificially low for favored industries. Meanwhile, these industries end up paying artificially high wages, since under high protection the pressures are usually irresistible to share their gains with their labor forces. As a result, labor-saving equipment is generally overused as well as misallocated, reducing employment opportunities in these industries. Pro-trade policies tend to establish more realistic prices of equipment together with lower, more uniform and realistic wages in the "organized" or "formal" part of the urban sector. As a result, opportunities for using labor instead of capital are not neglected.

- Through a full use of trade possibilities the mix of output is shifted to take advantage of the country's factor supply situation including its abundant and cheap unskilled labor, which becomes the basis of manufactures for export.
- Undesirable migration caused by high wages of some unskilled industrial workers under anti-trade policies tends to be reduced by pro-trade policies as a result of their wage-leveling effects. Under anti-trade policies, as already noted, wages of even the most unskilled workers in some favored industries become prematurely and artificially high. As several economists have helped to show, this can and does result in a migration of labor to urban areas based on what might be called a "Hollywood" principle: even a slender perceived possibility of "making it big" and enjoying high incomes draws people to the cities, who have no such prospect in the rural economy. The indirect effect is to swell the ranks of the urban poor, while driving down wages in the "informal" sector.^{1/}

^{1/} See for example Todaro (1969) and Harris and Todaro (1970).

One aspect of this employment effect deserves comment before turning to the qualifications.

To some extent it is artificial to speak of the employment effects of alternative economic policies in developing countries. Even where many able-bodied men are underemployed or unemployed in some sense, and most women are discouraged from looking for work outside the home, the typical problem can be viewed in terms of low incomes side by side with unattractive, unproductive uses of people's time. Usually there is no welfare system beyond relatives and friends, and the more desperately poor, especially, have to find something to do, however precarious and temporary, to survive. Unemployment as it exists in richer countries is something of a luxury, engaged in mainly in developing countries by dependent family members. In these conditions there is no very satisfactory definition of employment. In some ways what matters is creation of jobs in "modern," productive, socially-beneficial activities. It is also important to create more steady jobs. Since this is what is really at stake, it is not really feasible to distinguish the employment effects clearly from the poverty effects.^{1/}

To some extent the qualifications help to illustrate this theme.

The first is that if a country starts with a clear-cut comparative advantage in agriculture, anti-trade policies might well expand industrial employment -- and perhaps total employment as well -- more than pro-trade policies would, at least for a time in the earlier phases of development. These favorable effects on incomes in urban areas would come, however, at the expense of agricultural and rural income, and they might lead to more urban poverty as well as more urban wealth. Thus, they do not constitute a sound argument for anti-trade policies.

A second qualification is that under an anti-trade policy, and particularly a QR-based one, -because of the unavailability of imported equipment

^{1/} This applies as well in rural areas.

and imported inputs, once foreign exchange shortages become severe, much employment may be generated in making up for the gaps in what is available for imports. Moreover, QR-based regimes permeated by an overall excess of aggregate demand over aggregate supply are frequently marked by much public sector job creation, including jobs in factories that are state-owned. Thus almost everyone in urban areas may be employed doing something though productivity may be low, given the shortages holding up particular lines of production and the overstaffing of enterprises and agencies in the public sector.

A closely related qualification is that anti-trade policies tend to generate sharp contrasts in the costs of capital as compared to the cost of labor in different business enterprises. As a result, while substitution of labor for capital is being discouraged in the larger, favored, "formal"-sector businesses, it is indirectly promoted at the same time in the small, disfavored, "informal"-sector ones, in which funding and capital equipment are difficult to get while wages are driven down by an economy-wide excess supply of labor. Capital-starved "informal" enterprises often "make do" with labor instead.

Together these last two qualifications mean that the contrasts between the effects of pro-trade and anti-trade policies may show up in contrasts in the quality and steady nature of the jobs provided, and/or low productivity and/or low incomes throughout much of the urban economy. Poverty may be affected more than employment.

Before leaving this subject it may be useful to comment briefly on the dimensions of the job-creating effects in manufacturing for exports, since the possibilities here are sometimes misrepresented by enthusiasts.

The direction of the effect here is not in question. Plainly pro-trade policies will generate more demand for exports of manufactures, and for

exportable urban services as well, than anti-trade policies will, although whether the absolute differences are large will depend on the country's resources and level of development. Exports in turn, and particularly exports of manufactures, are likely to have a strong employment impact, since the comparative advantage of developing countries tends to center in products and processes that make intensive use of unskilled labor.

These expectations are confirmed by experience: the direct employment effects in and around manufacturing, from pro-trade policies, have been very impressive in several of the "success story" economies, for example, Singapore, Taiwan and Korea. Even where this thrust has been a lesser part of development policy, as in Mexico and Malaysia with their special export-oriented manufacturing zones, tens of thousands of manufacturing jobs have been created.

However, the employment possibilities in manufacturing for export, for the developing countries as a group, are clearly limited, particularly compared to the scale of their total employment problem, and this will remain true even if richer countries provide easy access to markets and developing countries pursue pro-trade policies. Today the total labor force in the developing countries is in the order of 600 to 800 million (30 to 40 percent of their population of about 2.1 billion), depending on the lines drawn and the definitions used, notably in regard to women. By comparison, probably no more than three million workers at most are engaged in factory production of manufactures for export to developed countries, while probably less than one million more are producing manufactures for export for other developing countries. Even so, manufacturing for export probably accounts for a substantial share -- in the order of 10 to

15 percent -- of the factory employment reported by the United Nations in manufacturing in these countries, which totalled less than 30 million in recent years, or less than 25 million if Southern Europe is excluded. These industrial statistics generally do not include very small manufacturing establishments with a handful of workers each.^{1/} Also not shown in the statistics are tens of millions of non-factory workers in tiny manufacturing and handicraft enterprises. Many of these people are engaged in production for export, notably in handloom weaving and handicraft industries.

Looking forward to the future, although further rapid growth of the developed countries' manufactured exports is expected, a large share of this growth will come from rising productivity of labor, especially in successful newly industrializing countries -- such as Korea, Taiwan and Hong Kong -- where the pool of underemployed, unskilled labor has been shrinking to small proportions as a result of their success. The limits of expansion based on exports to developed country markets are clearly set in any case by the gross number of jobs in the richer countries that might conceivably be displaced through rapid adjustment over the next two decades. This number might be in the order of 3, 4, or 5 million, compared to perhaps one million workers displaced up to now^{2/} (this gross estimate does not take into account the added employment created through the exports to developing countries that have been made possible as a result of imports from them; when the trade effects in both directions are counted

1/ Estimates by the International Labor Office show much larger numbers of workers, and so do national population censuses.

2/ For further discussions, see for example, Keesing (1979), Balassa (1979), and UNIDO (1978).

the net employment effect is likely to be very small, with as many jobs created as are displaced). The gross number in turn would probably translate to at least twice as many jobs in developing countries, where labor productivity is much lower. But by this or any other method of estimation, it is unlikely that there could be as many as 15 or 20 million factory jobs in developing countries by the 1990's, in manufacturing for richer countries' markets, while the developing countries' labor force is growing by about that number every year. Indirect employment creation as a result of these exports would not be much larger than the direct employment effect. Thus, attractive as manufactured exports may be in contributing to industrialization, they cannot be expected to make more than a very small dent in the overall employment problem of the developing countries.

4. Income Distribution Effects of Alternative Policies

It has already been suggested that in early and middle portions of the development process the choice between pro-trade and anti-trade policies, and that between QR-based and price-based policies, are likely to be choices between severe inequality by one set of mechanisms or by another.^{1/} Pro-trade and/or price-based policies may not have very much net effect in reducing inequality; they will only change its pattern and link it more closely to people's contributions to development. Other influences, including government policies in areas other than trade, are likely to play a major role in determining the extent of inequalities, but it is not likely that the underlying forces generating inequality can be combatted without sharply reducing

^{1/} The writer has argued this before in a rather incomplete and unsatisfactory fashion in Keesing (1974).

growth. And to the extent that growth and development are likely to be achieved faster under pro-trade policies, this is almost certain to contribute to increases in inequality over time in this part of the development process. However, in a sense the inequality generated by a price-based, pro-trade policy will be "fairer" since it is based on true scarcity value and open competition rather than distorted incentives and arbitrary intervention.

The main reason for severe and growing inequality under realistic prices is, of course, that essentially unskilled labor, which is what the vast mass of people have to offer as their main productive asset at this stage of development, tends to be in excess supply so that its price is set, through a long portion of the development process, by the minimum wages that people will accept, which will be governed largely by their subsistence living costs (including food and travel needed to work), and by their alternatives, if any, in dependency and family enterprises and self-employment. Unless notions of a "just" minimum wage have an influence -- and such a wage may be eroded over time by inflation and competition and despair -- or official minimum wages are brought into play, the resulting wage is likely to be very low, where agricultural land is scarce, and higher where it is abundant. But in the latter case this wage may be driven down over time by population growth. The limited substitutability of unskilled labor for other factors of production plays a large role in holding down wages of ordinary workers.

Inequalities are increased because, compared to the wages of unskilled labor, the prices of a number of other factors of production are likely to be pushed up as part of a process of rapid and successful development,

particularly in the middle portions of the development process where availability of these factors is likely to set serious constraints on growth.

These factors include:

foreign exchange and the capacity to produce it, savings and financial resources (particularly the ability to put together large blocks of funds, since many attractive investments are large and indivisible), managerial and entrepreneurial skills, the skills of trained professional workers (for example, engineers), technological know-how, existing productive capacity (such as modern-sector plants and equipment) and effective institutions and organizations.

In view of their nature, and as a result of existing inequalities in developing countries, valuable growth-linked resources -- except, perhaps, arable land,-- are almost certain to be concentrated in the hands of a small fraction of the population. Government actions that accelerate output growth should serve to increase the scarcity value of these growth-linked resources, and increase their potential rates of return.^{1/}

Increases in these inequalities over time are likely to occur over a large part of the growth process for related reasons as well. One is that the supply of some of the scarce factors expands rapidly (without driving down the price) as part of the growth process. Another part of the explanation can be found in process of accumulation. Possession of capital and skills and know-how leads to further wealth through savings and (particularly) successful investment. In a broad sense this includes investment in obtaining additional training and know-how, and efforts to expand and diversity successful businesses.

These unequal factor incomes lead over time to unequal assets

^{1/} Keasing (1974), p. 190.

and opportunities in succeeding generations, so that children of the rich and educated have immensely greater opportunities than the vast majority of the population. Of course, this problem is likely to be equally serious under anti-trade policies. But these inequalities based on inheritance and wealth should be a matter of immense social concern in any process of development, especially to the extent that they do little to motivate the process.

Universal public education is not much of an answer, in shifting factor prices in favor of the poor, even though it contributes to a long, intergenerational process of human-resource development. The basic problems here are two: first, it may be practically impossible to design, let alone deliver, any sort of public education that will be valuable to, and suitable to the needs of ordinary rural children from poor families, trapped in a vicious cycle of poverty in economically underdeveloped surroundings. Their families may have to be coerced to get them sent to school at all, in view of tasks at home and on the farm; and once in school they may have little motivation to learn, based on a rational and all-too-realistic calculation of the benefits to them in the life they are likely to lead. Of course, this problem is much less severe in urban and fast-developing rural areas. The other problem has already been mentioned in a previous section: when public education at any level is provided on a massive scale that saturates the demand, the effect is to drive down the economic returns to that type of education because it becomes so common. Similar problems with delivery systems and the effects on relative prices occur in any other massive effort to improve the productivity of poor people.

In more favorable circumstances, particularly later in development, as in Taiwan, the impact of pro-trade policies, involving a realistic price system, has been to reduce inequality through a systematic rise in the earnings (and opportunity costs) of unskilled labor. This has come about, however, because the economy was already quite advanced in its development, and had managed to achieve a great deal of remunerative employment in the agricultural sector, prior to the rapid expansion in manufactured exports. Thus, the employment effects of pro-trade policies -- which were heightened by the skills, education and discipline of the labor force -- led to labor shortages which pushed up the price of unskilled labor. This is what one would expect in what starts as a labor surplus economy when the surplus begins to dry up; the same effect seems to have occurred in recent decades in most, if not all, of the industrial economies. But this situation, in which development leads to a rise in real unskilled wages and a reduction (or at least no widening) of contrasts between wages of skilled and unskilled people, appears to be atypical except in late phases of the development process. There is also room to worry that this condition is becoming more difficult to achieve, as a result of labor-saving capital equipment.^{1/}

In any event, depending on the level of development and characteristics of the country, "getting prices right," even coupled with the strongest possible system of education, may well fail to prevent a severely

^{1/} The effect may be to shift the terms of trade throughout the world in favor of skilled labor relative to unskilled labor.

and increasingly unequal distribution of income and of opportunities as well.^{1/}

Price effects of anti-trade policies, especially when QR-based, are in some ways more arbitrary, with rewards and incentives based on government intervention rather than contributions to development, and with inequalities caused more by differences in rewards to people with the same assets and qualifications. As one aspect of this, for reasons already noted, anti-trade policies lead to large contrasts among firms and industries in the wages of unskilled or semi-skilled workers. There may also be a fragmentation of markets for other factors of production leading to contrasts in their prices as well. This is likely to be true, for example, in the cases of foreign exchange and imported equipment, to the extent that their availability is made contingent on particular uses.^{2/}

A related, noteworthy characteristic of QR-based, anti-trade policies is that the allocation of resources becomes divorced from the factor price system. Allocation of foreign exchange and material inputs and, indirectly,

^{1/} The reasons are quite similar, in a fundamental sense, to those for inequality among nations in the international distribution of income, which also grows, in some senses, in periods of healthy international economic growth when trade is relatively free from distortions and restraints. This analogy may help to clarify further the distinction between income distribution and poverty alleviation when prices are realistic -- absolute poverty is likely to be diminished, but relative deprivation may be intensified by the further successes of those who start out ahead.

^{2/} Conceivably and in theory, even if they were not transferable among uses their returns could be equalized indirectly through trade among enterprises in keeping with their "endowments" and comparative advantage, but this would depend on their being equally well utilized by all recipients. In practice, some recipients will lack the requisite technology, know-how, and cooperating factors.

the allocation of labor are all based to some extent on command decisions or highly distorted incentives. One side effect is that at least in the organized sector, the structure of wages is likely to be shaped by philosophical, ideological, political and social considerations, partially eclipsing the effect of the forces of demand and supply.

By contrast, a pro-trade regime or even a price-based anti-trade regime will lead to an allocation of resources based largely on prices and will tend to push the price and wage structure in the direction of relationships determined by opportunity costs and the productivity and scarcity of each factor of production, in the resulting economy.

One qualification is important here, however. The government and its public enterprises command a predominant position in the market for skilled professional and technical workers, managers, and highly educated people. As a result, public sector wage and salary policies have an enormous impact on the structure of pay and benefits, and the types of formal education and personal characteristics demanded in the economy at large. To be sure, no developing country is completely free from the effects of international competition in these respects, unless it can enforce a bar on emigration; yet there is much latitude for either using the government's market power to maintain a fairly low structure of salaries, as is done, for example, in India or Pakistan, and also in Korea or Singapore, or alternatively to allow salaries to rise quite high as they have done in much of Latin America (for example, Brazil)^{1/}, and also in tropical Africa where salary structures

^{1/} High salary structures in Latin America are largely a result of publicly-owned enterprises acting like independent private enterprises to bid up salaries, but with fewer budgetary constraints.

designed for expatriate colonial administrators could not be drastically revised downward, and where in many places expatriate skills are still needed. In other major markets, too -- notably energy pricing -- governments cannot avoid becoming directly involved. However, if policy-makers in developing countries act in accordance with considerations of economy-wide management already discussed in Part I, they are practically required as part of a pro-trade approach to keep public sector pay structures quite modest ^{1/} and to maintain realistic pricing of energy, to avoid creating deficits in the public budget and upsetting the wider balance in the economy.

Compared to the inequalities generated by a pro-trade policy, those resulting from an anti-trade, QR-based one are almost certain to be more "unfair" and hence inequitable in important ways in regard to profits and business opportunities, even more than in regard to wages.

Under QR-based, anti-trade policies, the government is deeply and inextricably involved in a process of creating millionaires and redistributing the national wealth, or at least creating privileged elites, based on arbitrary decisions as to who is qualified or otherwise deserving of the opportunity to become owners and/or managers in charge, in the new and artificially profitable industrial sector. People who will be financial and business successes are pre-selected, either on the basis of some combination of perceived characteristics--memberships or friendships in the political elite, family connections, education, apparent ability, previous business experience--or through some other selection process that may

^{1/} But not too low, or the result may be poor quality public administration, as illustrated by past experience in Indonesia.

involve quick action, bribery or luck. The resulting elite and privileged classes, and their profits and wealth, do not reflect contributions made to development so much as benefits that have been given out in the name of development.

Of course, to some extent this sort of unequal justice exists under any set of policies. Even under price-based, pro-trade policies, large enterprises are set up with state ownership and participation, and there are natural monopolies in the provision of infrastructure, and powerful and well-paid positions in the government itself. There are also likely to be subsidies and tax benefits to individual firms. Even under laissez faire, the workings of the system will often give business success to people with pre-existing wealth, family connections, political influence and apparent qualifications over rivals with greater talent, drive, judgement and imagination. Thus, the difference is one of degree.

Substantial profits are normally made under QR-based policies--especially anti-trade ones--through windfall gains from being favored with import licenses and invitations or permissions to invest in protected industries. However, not all protected industries and not all import licenses are profitable. In some instances the favored candidates will be the only candidates; because the business is not likely to be profitable, no one else will take the risks and accept the task, even with access to subsidies, further import licenses and blanket protection. Similarly, high tariff protection is not always redundant, since the protected industries are not necessarily profitable.

The existence of windfall profits as a result of QRs is clearly indicated by the existence of premia and competition for import licenses. This is almost always the case when there is a suppressed balance of payments deficit. However, at that point there is likely to be a wide dispersion in the profitability of import licenses, according to the product permitted to enter, and its tariff and demand situation.

A QR-based regime will lead to businesses being enormously dependent on government officials and policies. This is true even if there is a pro-trade orientation. As an example, the largest Korean industrial-and-trading firms are intimately dependent on government treatment, and are responsive to government plans, suggestions and guidance, even in matters such as major investments and continuation of unprofitable operations. The same is true of most Korean medium-sized business and many small ones. The whole economic system contrasts very sharply with that, for example, in Hong Kong where old-fashioned laissez faire capitalism reigns supreme, and "business is business."

Not only QRs but also many other interventionary instruments such as subsidized credit, tax holidays, government purchases, and tariff protection, when used on a discretionary or case by case basis, have similar effects in linking business profits to government treatment of individual firms. Thus, even pro-trade, price-based regimes as in Singapore or Malaysia are not without similarities to a QR-based system, at times, in government powers to make potentially arbitrary decisions heavily affecting industrial profits of individuals and individual firms.

To get away from this set of problems, attempts have often been made to operate QR-based systems on the basis of predictable rules which

give equal treatment to all applicants. Unfortunately, the results are often worse in many respects than in the case of discretionary policies. One typical effect is to give QR protection automatically to anyone competing with imports, even in producer goods, with disastrous economic consequences. Another typical effect is to parcel out QRs in proportion to historical import shares. This leads to treating equally the efficient and inefficient firms alike, to the detriment of total output, while freezing the historical pattern of ownership in each industry, so that opportunities for entrepreneurship are greatly reduced.^{1/} Similarly, of course, rationing subsidized credit "fairly" on the basis of the commercial banks' preferences will result in having it go to the businesses with fewest risks and most collateral--hardly a way to foster newcomers and spread business opportunities.

The most predictable systematic difference between pro-trade and anti-trade regimes, in regard to business profits, is that anti-trade policies lead to an artificial concentration of profits in import-competing manufacturing industries, while pro-trade policies distribute profits more evenly across the entire economy. Another difference is that under an anti-trade regime profits are more likely to be made from actions and inactions that are socially undesirable in one way or another, since the incentive system is distorted.

There is probably no simple rule, however, as to what sort of trade policies will generate more total profit income for private businessmen

^{1/} India has added twists of its own, for example, incentives previously mentioned, to build up unneeded capacity in order to get import licenses given on the basis of firms' production capacity, and again, systematic discrimination against the larger and more successful private firms to keep them from expanding and getting an "unfair" advantage.

in a mixed or capitalist economy. Here the effects depend heavily on the characteristics of a developing country, as they interact with the way the system is managed. Comparing Korea with Hong Kong, for example, it is very likely that Korea's more egalitarian distribution of consumption and to a lesser extent, incomes if not wealth, is due in part to constant government-created pressures on businesses to invest, plowing back practically all their profits, and to focus on long-run development in the sense used here, that is, expansion of national production capabilities including skills and human resources, even where this means narrow immediate profit margins because of costs paid directly or indirectly for wages as well as materials. In Hong Kong, by contrast, businesses are induced by risks as well as capital scarcity to try to make profits and recover their investments quickly. Partly as a result, a larger share of the territory's product no doubt goes into profits than is the case in Korea. This association is not a general one, however. In a QR-based system where there is much political uncertainty--for example, Pakistan, Peru or Zaire today--businesses are likely to look for quick and high profits, although at times there may be no way to achieve them, and thus, almost no investment; conversely, Japan at the turn of the century would be a well-documented example in which major industrialists in the "modern" sector accepted very low profit rates, and took a very long-term development-minded view, within a price-based system. A price-based system also has advantages in being equitable in that it is open to entry without government assistance.

More could easily be added in this subject area, but what has been said is perhaps enough to explain how inequalities are generated under each

type of policy, along with practical areas for concern as a result.

5. Effects on Spatial Development and the Size Distribution of Industry

A related defect of QR-based, highly interventionary, anti-trade policies as they affect equity or distributive justice as well as efficiency, is that they tend to discriminate in favor of large firms and large plants and enterprises well represented in or located in or near the capital city. Medium-sized and (especially) small manufacturing firms are discriminated against and may be artificially discouraged and badly hurt, to the detriment of the country's development. Regions far away from the capital may be unable to develop nearly as well as they would under price-based, pro-trade policies, largely because firms decline to locate far from the place where profitability is largely determined.

Heavy use of QRs tends to discriminate against small enterprises and undertakings, because the government has only a limited information-processing and administrative capacity. Thus, it cannot easily intervene to give many thousands of small firms and projects import licenses and special attention, comparable to what it gives to major firms and projects. This also tends to be a defect in the granting of tax holidays, subsidized credit and the like, even under price-based and pro-trade policies. Where special banks and programs are used to foster small and medium enterprises, this is likely to be only a partial offset for the benefits they miss from being too small to be eligible for tax holidays or to get other industrial loans (at least in practice), or to enjoy the same certainty of getting licenses for imports when they are rationed, as a larger firm. Similarly,

special programs for development of disadvantaged regions may be only a very imperfect offset for the overall workings of the system.

The same biases occur to some extent where price-based policies are combined with very large-scale use of subsidies and direct intervention in an anti-trade direction, as in Venezuela with its efforts to use its oil revenues for development purposes: above all, small enterprises tend to be neglected.

Under pro-trade policies, even when they are QR-based as in Korea or Brazil, these difficulties are likely to be reduced. This is partly because a significant share of a developing country's manufactured exports is likely to come from small firms. However, exporting is an activity involving scale economies in some stages, such as marketing and shipment. What few numbers exist, suggest that manufactured exports almost always come in greater proportion from large enterprises than does manufacturing output, at least at the stage of final shipment.^{1/}

One of the most attractive effects of a pro-trade policy, in later stages of development, is that the drive to keep costs internationally competitive will push the larger firms to set up plants in the countryside or wherever wages are lower, and to subcontract and encourage the emergence of specialized small suppliers of many kinds. In Taiwan it is now very striking that manufacturing jobs have been moving to the countryside and small towns, to take advantage of pools of labor there. The same thing is happening increasingly in Korea.^{2/} These economies are also characterized by very

^{1/} This is partly because there are many small scale enterprises, from rice mills to bakeries, located near primary production and final consumers, on the output side, while even handicraft export operations require some central collection and distribution.

^{2/} Of course, it is also commonplace in industrial countries.

large numbers of very small manufacturing plants and firms, many of which produce directly or indirectly for export.

All things considered, it seems likely that an appropriate choice of trade regimes is a much more powerful instrument for fostering small and medium-scale enterprises throughout an economy -- in commerce and services as well as manufacturing--than are special programs to promote and help these enterprises directly. "Getting prices right" is the main key to getting scale right. And it is also an important means of getting location right. But here, of course, "right" may not mean located in disadvantaged regions; for this, special incentives may be necessary.

6. Effects on the Incomes of Foreigners and Foreign Enterprises

Not wanting the benefits of national development to go to foreigners from wealthier nations may be perfectly reasonable in developing countries. Trade policies have to be chosen with regard to their distribution of benefits between foreigners and local citizens.

In practice, much of the animosity against foreign multinational corporations (MNCs) in developing countries comes as a result of a sense, which under inappropriate trade policies is likely to be correct, that they have become deeply involved in the local economy and have obtained sizeable profits out of its development efforts, without a positive net benefit having been obtained by the developing country in return.

This happens because anti-trade policies encourage premature import substitution projects in which the country pays very heavily, often through subsidies as well as higher prices of the product, for industrial projects

that hurt growth and contribute little or nothing to development. Except where these "white elephant" projects are put under public ownership and management, they almost always involve foreign firms.

As Carlos Díaz Alejandro has aptly noted, in developing countries, "Common sense soon began to question whether the learning-by-doing of infants bearing names such as General Motors and Ford should be subsidized by local consumers." ^{1/}

Whether the result comes about directly through foreign direct investment, as is typical in many places, or indirectly through fees and interest and royalties and contractual obligations paid by local publicly-owned enterprises to their foreign partners, mentors and bankers, there is a serious danger under anti-trade policies that national wealth will be paid to foreigners with little or no useful benefit to the local economy as a whole. Sometimes, instead, the result is to give the MNCs a permanent presence and ownership role within the economy, in circumstances where profits taken out will be greater than positive contributions put in.

In short, most of the dissatisfaction with MNCs and their role in developing economies springs from anger and disappointment at the effects of anti-trade, interventionary policies. Foreign firms are among the important special interests that are actively engaged in getting unjustified benefits from protection, and receiving windfall gains from QRs and subsidies. The left-wing view that some of these firms are intimately involved in local

^{1/} Díaz (1978b), p. 32.

government decisions, and have established cozy relationships with the local powers-that-be, is likely to be correct at least in relation to discretionary intervention that affects these firms, because that coziness tends to be part of the system.

One irony here is that foreign firms are usually discriminated against, in greater or lesser degree, within each sector or industry, as they perhaps should be depending on the country's priorities, but the discrimination among industries and sectors often produces the opposite net effect, since many are active in the sectors that are favored.^{1/}

Finance ministers of developing countries have often complained with justice that foreign firms expect to be handsomely rewarded through their private profits if their investments go well, but if their investments fail and lose money, the investors often go to the government and ask for public compensation, arguing that not to give this would hurt the country's standing and dry up investments in the future. On top of this, of course, MNCs expect infrastructure and subsidized credit and much else, for making tires or some chemical in a local plant, or building a hotel.

Not least of the advantages of well-chosen, pro-trade policies is that foreigners are not likely to benefit except in exchange for real contributions to growth and development. If "prices are right," prices for foreign technical assistance and participation and training services are likely to be right. Foreigners are less likely to get paid for undertakings that make a

^{1/} Meanwhile, in the old types of foreign investments, in mining and railroads and public utilities and agricultural plantations, foreigners have been largely squeezed out and have been badly hurt by defaults or high taxes or nationalization or controlled prices, to such a degree that their image is no longer mainly associated with these sectors.

negative net contribution. And policy makers can more easily judge when there is a real social need to go to foreign firms, and get their help or participation.^{1/}

On the whole, where pro-trade policies have been pursued, there is less social tension over the role of foreigners and their profits than where anti-trade policies prevail.^{2/}

1/ As has been noted already, there is a danger under price-based, pro-trade policies, that foreigners will buy up local assets when they are being made artificially cheap; and measures to prevent this may be essential as part of this approach, as in Japan, or at least the foreign role ought to be carefully regulated, as in Singapore. There is also some danger that a country will pay too much in subsidies to achieve manufactured exports; here, as anywhere else, use of discretionary intervention requires judgement.

2/ There are also probably systematic differences in the types of foreign firms that do well for themselves. "Big name " multinational manufacturing giants play a lesser role under pro-trade policies, while smaller, flexible, innovative manufacturers and the major trading and retail-chain buyer firms do better and make valuable contributions.

PART III

TRANSITION: HOW TO SHIFT TO A DESIRABLE TRADE POLICY

A. The Problem in Practice

1. The Need and the Setting

Based on logic and experience, including what has been said here, it is not difficult to see the desirability under a wide range of circumstances of trade policy built around a realistic exchange rate and a coherent system of incentives favoring exports--notably manufactured exports--alongside production for the home market. The need for such a trade policy is especially compelling in the middle and later stages of development, once industrial development is well started and primary export earnings are no longer abundant compared to the essential import requirements for development. The resulting system of incentives will be more balanced and much easier to manage sensibly if the trade policy regime relies primarily on prices rather than quantitative measures such as QRs.

Unfortunately, however, a desirable trade policy regime along the lines recommended will not be easy to achieve in a developing country that now has a very different regime with much protection, distorted incentives, a multiplicity of quantitative restrictions and controls, an overvalued exchange rate, and an unsatisfactory export performance. In varying degrees, this is now the case in a high proportion of all developing countries. The analysis in Parts I and II has turned up many reasons why such trade regimes are extremely common in practice, not only due to policy mistakes, but also due to short-term pressures and imbalances

that could not easily be met by alternative means. The analysis up to now also offers many powerful reasons--political as well as economic--why unfortunate policies, once started, perpetuate themselves or get worse, and why the resulting disequilibria are difficult to overcome.

Outside the countries seriously afflicted by payments disequilibrium and obvious trade policy distortions, one also finds many other developing countries that continue to maintain much stronger incentives for production for the domestic market than for exports. Even when their economies seem to be moving forward in a fairly satisfactory and balanced fashion, these countries may well be paying for this bias in slow growth and poor qualitative results. However, the reasons why this situation continues are not hard to understand. Not only is it politically difficult to dismantle high protection once started, but also, short of a major crisis, the costs of this bias are not obvious.

In view of the forces, pressures and policy fashions that have pushed developing countries into these anti-export and hence antitrade biases in their policies, it is perhaps not surprising to find such a strong contrast between trade policies now recognized as desirable and those actually being practiced in a majority of developing countries.

This contrast, nevertheless, sets up tensions and desires for change; and today, in many of the developing countries in which inferior policies persist, one finds a receptivity or even an eagerness for a shift toward the policies now recommended. One reason is that in many cases results associated with the inferior policies have been so disappointing and unsatisfactory as to force leaders to cast about for a more

satisfactory alternative. Another reason is that the logic of what are called here pro-trade policies and the good results obtained in practice are becoming widely appreciated. For reasons such as these, policy makers in many developing countries would now very much like to overcome the bias against exports, and particularly manufactured exports, in their countries' policies, and they would like to provide a more balanced and coherent set of incentives, taking into account the best advice now available. However, they do not want to pay a high political and economic price for such a policy shift and they are naturally concerned about how to carry it out in practice.

To an outside observer, it looks as if the potential value of a widespread policy switch would be enormous. Hardly any other policy change appears so desirable in the drive for successful growth and development. Countries now held up by slow growth, inadequate exports, and poor qualitative performance would be enabled to break out of their difficulties. Meanwhile, the recommended trade policies would foster other changes that are needed, by testing the country's infrastructure and policies in the crucible of international competition, and exposing them to the light of socially realistic prices, while generating balance and momentum in the development process that would make easier the achievement of sound economic management, together with other needed policy improvements.

Admittedly, of course, any really widespread policy shift in this direction in developing countries would act to make world export competition even more fierce, holding back to some extent the positive

export results that could be achieved under the new policies. As noted earlier, the overall export expansion that could be achieved by all developing countries combined would remain limited by the dimensions and adjustment capabilities of the world market. But export success would be redistributed from developing countries that, in several cases, now have exports so huge there are problems in turning added export earnings into added growth, to those now held back by their lack of import capacity. (Alas, poorly chosen trade policies by the latter have been redistributing exports in the opposite direction up to now!) Many of the laggards' export gains, especially in primary products, would represent trade creation and others would come at the expense of richer countries. In exchange for new competition in many of their existing exports, both industrial countries and the more advanced developing countries would benefit over the long run from a booming market for capital goods as well as other development-related exports, based on expanded import capacity in the developing countries with improved policies.

Today these gains for world development are not yet being reaped to the degree they might be, since only a few developing countries have been improving their trade regimes very markedly at any one time. However, for any one developing country doing this, the benefits from shifting policy in the recommended direction are even greater at present than they would be if more countries were doing this.

Given the situation just sketched, the central issue challenging experts and policy makers in practice, in designing trade policy for

development, is how to shift from undesirable, unsatisfactory, highly distorted, trade-reducing policies to a desirable, successful trade regime making full use of the trade opportunities available. This issue is the focus of the rest of this paper.

As yet the answers to this enormously important and infinitely practical question are neither well known, nor well understood, let alone conveniently available in the existing economic literature. The subject is still too close to the "cutting edge" of current research, advice, and policy experimentation.

What follows is an effort to put forward the best answers now available, based on a distillation of the lessons of experience up to now in countries that have experimented with policy transitions. The emphasis is on what to do in the more difficult situations, in which economic management over the course of the transition runs high risks and faces severe quandaries. Though built where possible on published evidence and other people's insights, the policy suggestions made here go beyond what can be found clearly in the existing literature. No doubt more and better advice can be given pooling these ideas -- which are drawn from a variety of sources, notably discussions and writings within the World Bank and published case studies^{1/} -- with further analysis and ideas from experienced practitioners.

Not much attention is given here to the finer technical aspects of transition; recommendations here and throughout the paper are not meant

1/ Martin Wolf (1978a) made a first distillation of ideas along these lines.

to be a substitute for expert advice, in the course of transition, in such matters as setting tariffs and combining devaluations with adjustments in protection.

Though the answers given here must be considered tentative, there is a strong argument for attempting to answer the central question now without waiting for further research. In the first place, many developing countries have to make trade policy decisions and design transitional policies now without waiting for the available advice to be perfected. Second, thinking in this field is likely to move forward as a result of providing a framework and hypotheses for discussion; other writers will hopefully be spurred to think further about the problem and improve the ideas offered here. Third, when all the points made here are put together it becomes obvious that quite a little is already known about the principles and tactics of transition.

2. Situations Leading to a Transition

A transition from unsatisfactory to better trade policies is likely to take place in either one of two economic situations. The first can be called the easy case because the country already enjoys a reasonably favorable balance-of-payments situation and there is no immediate crisis. The leaders want to improve the trade policy for long-run reasons at a time when the short-run conditions make this fairly easy to do, economically if not politically. The opposite situation, the difficult case, comes about when a policy transition must be launched because the country's trade policies have become disastrous and untenable. As a result, the first

steps must take place under conditions of payments crisis, and indeed, more likely than not, amidst a crisis too serious and too profound in its growth effects to be patched over by more QRs and exchange controls. In this second situation the economic management of the transition poses severe challenges. The politics is likely to be extremely difficult as well, all the more so because of the "real" adjustments that have to be made, but also because of the political influences contributing to disequilibrium in the first place. Of these two contrasting cases, the difficult case is much the more interesting as a challenge in economic management. Accordingly it will receive much more attention than the easy case here, and will be treated first.

In most instances the political situation too will fall into one or another of a few patterns. The trade policy reversal may be launched under conditions of political takeover by new leaders. Commonly such a takeover is marked by initial uncertainty and severe political tensions and apprehensions. A second frequent pattern is that the trade policy shift occurs as a result of persuasion from within by reformers, without a change of regime. The leaders recognize a need to try something different. But in this case, there are likely to be pressures for quick results, criticism and sabotage by opponents, and uncertainties as to whether the reform will be only a passing phase. A third situation is that a reform is made under pressures from outside as a condition for foreign assistance or IMF loans or further bank credit, so that the national government is not really behind the reform at all. In short, the political situation at the onset is likely to add to the difficulty and hazards of the

transition, especially in the difficult case.

Even on a technical level, especially since export growth tends to lag behind the creation of a suitable incentive structure, a sharp transition in trade policies is difficult to carry out in face of a payments crisis, without paying the price of a serious depression, high unemployment and much political dissatisfaction as part of the "cure." The demand restraint and incentive and hence income changes required in the transition will of course add to the political difficulties.

Given these political realities, one reason that strong, repressive governments are so often associated with pro-trade policies is surely that it takes a strong government to survive the transition. In fact, a sensible economic minister might understandably request that his political superiors demonstrate firm control of the country, on what looks like a secure, long-term basis, as part of an economic strategy for successful and relatively painless transition. After all, foreign and private resources are likely to be made available in proportion to the perceived long-term stability of the situation: investors and lenders like to see secure governments with only weak opposition!

Clearly the political hazards are much smaller when trade policy reforms are undertaken in the easy case. Of course, there will be opposition based on self-interest and defensiveness, especially on the part of the least competitive industries. But compared to the policy measures required in the difficult case, the measures needed to shift the structure, starting from a situation of initial payments equilibrium, are really very mild. If this is done correctly, hardly

any "real" adjustment will be required immediately. Instead the fight will be over what may happen in the future.

3. Experience and Case Materials

Recent years have witnessed a rapid increase in the evidence available, in the form of well-documented case studies and new experiences in individual countries, illustrating processes and problems in would-be transitions toward more desirable trade policies. In addition there is a growing literature synthesizing and analyzing these lessons through comparative analysis, including a new book by Anne Krueger (1978).

This body of evidence shows indeed that shifts toward more desirable policies are full of complexities, hazards and failures. Moreover, no two situations are exactly alike. There are disagreements among experts over interpretations and lessons drawn in some of the key cases, for example, the depressed period in the Brazilian economy in 1964-67, bearing in this case on the issue of whether, when and how depressed conditions are avoidable. An example of another disputed issue is whether and when credit from abroad has a positive or negative effect in the adjustment process.

One point that is clear is that a majority of the more successful pro-trade regimes in developing countries are the results of transitions from highly distorted, anti-trade policies. In each case, the transition process has taken several years, and has involved a whole succession of reforms and policy revisions, not always uniformly in the same direction.^{1/} Many other attempts at reforms have failed and/or had

^{1/} In all, the N.B.E.R. studies found twenty-two "liberalization" episodes in the nine countries studies; see Krueger (1978).

little permanent effect. In not a few of these cases the policy shift has been half-hearted, in exchange for credit from abroad.

In some of the seemingly important recent experiences -- for example, in India, Chile, Argentina and the Philippines -- the results are not yet in, since the change is not yet over. Meanwhile, there are growing needs for policy improvements in some of the more distorted cases -- payments crisis in Turkey and Peru, stagnation of exports in Pakistan, new hopes in Egypt. At the same time, groundwork for change is being laid in some of the smaller countries -- for example, Sri Lanka and Uruguay. But elsewhere, reformist efforts have been largely abandoned for one reason or another, for example, in Mexico as a result of the oil discoveries there, and in Morocco with the death of a minister concerned to promote reform. Thus, most lessons in this field must be considered tentative, pending further experience and analysis of the results.

B. A Distillation of Lessons of Experience on Policy Transitions

1. Lessons and Recommendations for a Policy Transition Starting in a Payment Crisis

In the more difficult case to be considered first, a trade policy reversal must be started in the midst of a situation of payments crisis and faltering growth. Several of the requirements in this situation have already been discussed in connection with export promotion and economy-wide management, for example, the need for real devaluation and measures to re-establish balance between aggregate demand and aggregate supply.

Along with recommendations deriving from these and other basic requirements of export promotion, the answers regarding how to carry out this difficult policy transition must necessarily emphasize priorities and timing. Perhaps the most important points to be made regarding priorities and timing are these:

- A successful transition requires a whole sequence of changes over a period of several years with the eventual system emerging only late in the sequence.
- The initial measures should be aimed almost exclusively to expand exports. Success in this effort makes it possible and indeed very easy to liberalize imports later as import capacity expands.
- In the initial crisis situation, a high priority should be given to measures that maintain aggregate supply and avoid the costs of a depressed economy.
- In designing measures for the longer run the first priority ought to be to create an overall development program that will

use well the import and output capacity generated by the improved policies. Successful growth and development is the objective, while a well-designed system of incentives is only one of the means.

These and other basic principles are elaborated below within a larger list of eleven lessons of experience in regard to this sort of policy transition. Much that has already been said in Part I regarding economy-wide management, export promotion and the proper design of incentive systems also applies here. These eleven lessons of experience are as follows:

1. Even amidst a crisis full of uncertainties, and all the more so otherwise, to the extent that time permits, it is highly desirable to plan a sequence of policy measures looking several years ahead, and then to advertise at least the general direction in advance. Planning years ahead is essential since a highly distorted trade policy cannot be corrected quickly in only one or two steps; a full transition requires several phases, spread over a number of years, and in each of these phases it pays to prepare for the next one.

Advertising in advance what is going to happen is practically essential since expectations and perceptions are crucial, in moving the country through a transition. Time, and belief in the reality of a changed policy environment, are required for business and other actors to begin to respond actively to new

incentive systems and a new environment. As expectations and perceptions change, capital flows are likely to be almost immediately affected. Other economic decisions will also begin to shift, affecting investment, savings and consumption patterns, as well as efforts to export. Of course, if the policies and plans announced are not sensible and realistic they will generate the negative expectations they deserve, and will soon have to be abandoned and rejected. If they contain a misplaced sense of certainty and control over events, this will cause trouble sooner or later. Obviously it is necessary to build flexible plans in which the timing and details of further steps are left somewhat open. As a rule it seems desirable to announce and advertise the main features of the plan honestly, although without reference to contingency planning for things that can go wrong. Then, as the timing, content and dimensions of further measures become clearer, concrete steps can be announced in advance, with reference to the overall plan. Deviations from these plans may well become necessary, due to unforeseen circumstances or better advice, but as long as these changes are consistent with the spirit and objectives of the original plan, there should be little cost from having had to stray from it in detail.

2. Whether or not a strong political commitment has been made to a transition to pro-trade policies, and whether or not political stability and continuity can be provided at the start of the

transition, these objectives must be sought vigorously alongside the technical ones, because their attainment is practically essential for success. This is partly because actions required in the transition will lead to redistribution of incomes and opportunities. To provide the necessary support and muscle to effect the transition, it will be highly desirable to demonstrate political intent and ability to stay in power long enough to implement these policies, and/or to insure that likely successors are committed to the same path. If the regime is weak, and/or its political commitment to the shift in policies is weak, the transition is likely to fail, but if they are strong and the goal is pursued with determination, the shift is likely to succeed. However, early success of a transition, and the expectations created, will help to build political stability, and sound measures based on political realism will help to strengthen political commitment. Any minister who views the transition as only an economic and technical matter, and does not emphasize to his superiors the political dimensions, deserves to fail and lose his job.

3. The first step in a transition must be to create strong incentives to expand exports, especially manufactured and non-traditional exports, while making crystal clear that export expansion is a central objective to be pursued regularly, from now on, by all feasible means. For this purpose the strength of the incentives and the clarity of the message are at first much more important than the balance, perfection, or even the long-run desirability and international acceptability of the methods and schemes

initially used. Rationalizing, polishing, liberalizing, and otherwise improving these instruments is a task for subsequent phases in the transition. At first the government cannot afford to be picky in its methods. Devaluation applying initially, in its workings, mainly to exports, will be the most important first step of the program. Only one kind of import liberalization should be undertaken and that is liberalization of imported inputs into exports. Here vigorous measures should be launched right from the start, with more added later as soon as they can be organized, including prompt and generous rebate schemes, bonded warehouses, and duty waivers subject to evidence of subsequent export. Meanwhile, within manufacturing, administration of QRs should be strongly linked to exporting by whatever means are feasible and fit the country's QR system. Here it may be useful to use hidden cross-subsidies and threats of withholding QRs along with entitlements for obtaining foreign exchange as positive and negative incentives. These instruments should eventually be dismantled along with the QR and exchange control system, when the country begins to earn lots of foreign exchange; but while QRs still exist they should be adapted to the nation's objective of expanding exports. Similarly, export subsidies may even be instituted, openly or under the guise of a unified system of tax rebates. Of course, the International Monetary Fund will be unhappy with these measures, to the extent that they violate its rules calling for "unified exchange rates;" economic purists will counsel against them; and trading partners are likely to exert powerful pressures against continuing them

in blatant forms, once they prove successful in expanding non-traditional exports. But everyone will accept them much more readily as a temporary component of a comprehensive plan for a transition to new trade policies, than they would as either ad hoc or permanent measures. In short, the country can probably get away with them, and they are likely to work for a while, in the context of a transition program. A variety of other measures may also be useful, for example, creation of a high-level official or officials charged with expediting the needs of export-oriented manufacturing and getting it special behind-the-scenes treatment under existing licensing, investment subsidy and tax programs; special tax provisions for exports; reorientation of investment toward export-oriented infrastructure and plant sites; reduced prices for intermediate inputs when used for exports; subsidized credit for exporters, and so on. In all these measures, what matters in the first phases of the transition is strong signals and strong incentives, so that it is not wise to be overly concerned with their efficiency and correctness as ongoing schemes; their budgetary and foreign exchange costs must be carefully weighed, but penny-pinching in them is likely to be a bad idea: it is better to err on the side of making the incentives too generous at first, in any particular scheme, to make up for the fact that so few measures can be implemented quickly, and especially to make the signal unmistakable. After all, the first year or two of a transition will involve in large measure symbols and promises of regularized incentives in the future, evidence of concern, and demonstrations

of political commitment. A businessman would be a fool to invest in export expansion on the basis of hastily built incentive schemes that might vanish tomorrow; he must be made to believe that strong positive incentives will persist for years to come. By the same token, however, later phases in the program are concerned with building solid foundations, by adjusting institutions and by regularizing and rationalizing export incentives. Here, above all, preparation must be made for unlinking export incentives from QRs as these are dismantled or lose their bite,^{1/} and replacing hidden cross subsidies and export subsidies by other incentive systems, once these temporary expedients lose their force or are no longer tolerated by trading partners. Thus, the initial phases must be concerned with making plans and "blueprints" and laying the foundations for an ongoing, liberalized system of export promotion, that can be maintained in the long run, even while giving signals and incentives based on expedient means, to get export expansion under way in the short run.

4. The heart of pro-trade policies and of an ongoing system of export promotion will be a realistic exchange rate, so that economy-wide management and exchange rate policy aimed at this goal will be of central importance throughout the transition.

Here what is most important is not the exchange rates in the first year or two of the transition--though they are important--but the ongoing system after several years. Particularly in a payments crisis, and before government budgetary expenditure

^{1/} Once export earnings expand, QRs will be needed much less to "ration" imports, and the premia or windfall profits associated with import licenses will diminish or vanish.

can be brought into reasonable balance, the initial exchange-rate change will cause some inflation and will not have sufficient force to solve the problem in the long run; hence its role is partly to serve as a harbinger of further devaluations and real exchange rates to come, while giving exporters a taste of the gains to be made in future. In these circumstances, it may be useful to go a large part of the way to a full adjustment, in the short run, as a strong signal and strong incentive, but this should not be confused with solving the problem, since all that will happen is a larger reward for exports and a smaller premium at first for import licenses--a sort of added tax on imports if you can get permits for them; and these adjustments will soon be largely offset by rising prices. In some transitions there may be special reasons for not going very fast, very far in devaluation at first, for example, if imported foodstuffs are a big item so that the cost-of-living and inflationary effects would be rapid and large--in this case a smooth transition, through month-by-month devaluations, might be better. Whatever is done in this regard, however, it will be a mistake to accompany devaluation even temporarily by export taxes to reduce the windfall gains, except in the cases of traditional products for which export taxes are likely to remain part of the system, or in very special cases. Such taxes would reduce the strength and clarity of the signal. Successive further phases of the transition should be marked by further devaluations, or a transition to a system of frequent small devaluations, until

these are no longer necessary. In this entire transition, it ought to be kept in mind that the country's aim ought to be to create and maintain a realistic exchange rate, within a period of a few years, not only to stimulate exports, but also to provide a stable and realistic environment for successful development across a wide range of economic activities, including industrial production for the home market. Success in bringing the balance of payments into equilibrium, and in creating a realistic exchange rate, depends basically not only on export success, but also on increasing the competitiveness of production for the home market, and on holding expenditures (especially of foreign exchange) within the country's means. In pursuit of this whole combination of objectives, each objective serves the others.

5. Balancing the government budget, and reducing its foreign exchange budget until import capacity grows, can usefully be regarded as integral parts of the transition program, since they are required to bring the balance of payments into equilibrium, and to make the exchange rate realistic. This means that taxes must be increased and public expenditures economized wherever this is politically feasible and economically sensible, notably by delaying new expenditure programs until exports (and private capital inflows) expand to provide matching resources. If the government does not have a strict foreign exchange budget already, with centralized planning and supervision of all foreign exchange spending by the public sector, this should be implemented. Since this sector is likely to account for a large share of the import

bill, the balance of payments problem may in some cases be solved in large part in the government itself: Overall budgetary restraint is essential, and credit controls may be needed as well, to avoid inflation and hold down private demand for imports.

6. Savings must be increased, and investment must be initially cut back or switched as part of the transition program. Measures to create positive real interest rates for depositors and for borrowers, notably in commercial banks, are an important part of the transition. The financial intermediation system can usefully be fostered and improved at the same time, although how to do this lies outside the present discussion.^{1/} Cutting back investment in projects and programs where there is a large foreign exchange component is of course crucial in face of a payments crisis. However, switching of investment to projects and programs with low foreign exchange requirements is preferable wherever feasible, to hold down unemployment in the construction industries and the economy as a whole. A useful strategy, suggested by Michael Bruno based on Israeli experience, is to switch back and forth between industrial and housing investment, according to whether foreign exchange is plentiful or scarce.^{2/} Roads and some types of agricultural, sanitation and rural development investments, like housing, tend to have low foreign exchange requirements, as a public sector foreign exchange

^{1/} Here the reader is referred to McKinnon, Shaw, Gurley, Goldsmith, Patrick, and other specialists.

^{2/} Bruno (1978).

budget will help to show. Careful provisions should also be made to invest using domestically-made capital equipment, where it is available without heavy indirect import requirements.

7. It will be extremely important, during the transition, and particularly when the government devalues and cuts back its budget and tightens credit in a payments crisis, to channel available foreign exchange into maintenance of current production rather than investment, and to take special measures to alleviate a squeeze on working capital in industrial firms that are not hopelessly inefficient. After all, the imbalance between aggregate supply and aggregate demand can be cured least painfully by expanding or at least maintaining aggregate supply to the extent possible, while cutting back or at least reshaping aggregate demand to fit the resources available. Devaluation, by raising the cost of imported inputs, is likely to exert a squeeze on working capital even in very efficient firms that ought to be fostered. Special lines of credit through the banking system can usefully be opened up, and the situation of firms in important industries can usefully be monitored to avoid disruption or destruction of useful enterprises. Of course this will result in more monetary expansion and more demand for imports than an opposite course, but there will be more output and more production capacity throughout the transition. Similarly, foreign exchange shortages can easily do unnecessary damage to current production. Foreign exchange should be allocated mainly on the basis of its

contribution to current production and employment. Remember that the goal is to cure and build up the economy through a multi-year transition, not to purge it more than the minimum necessary to make it healthy.

8. Another key part of the transition program must be to hold down increases in wages and prices, promoting a long-term program of austerity and reduced anomalies in wages and a switch to realistic prices, notably in publicly supplied products and services. Such public-sector prices can be adjusted, however, in special cases to provide hidden subsidies, preferably targetted ones, for well-defined objectives including export expansion. The wage measures may have to include reducing not only payroll taxes but also fringe benefits, including especially job security and indemnification for dismissal. Here the objective must be to reduce benefits to what the country can afford at its present income level and stage of development, and to do what is most required to expand exports. The austerity and export orientation being forced on employers, and the upward drift of prices, will make wage anomalies easier to reduce, but this goal may imply a need for conscious intervention to weaken the power of labor leaders in strongest opposition to the national objectives, and an effort to explain to rank-and-file workers the need to expand employment and make the country competitive by holding down wage

increases. These measures need not be announced ahead, except in a very general way, and they should not be taken as part of the transition program until the earliest parts of the program, especially the export drive, have been set in motion in a dramatic, highly visible fashion.

9. Liberalization of imports and rational redesign of the system of protection are measures that can usefully be delayed until export growth has begun and the payments situation has eased. Too many reforms of trade regimes start with the import side--this has proved a mistake. Export expansion will lead very naturally to import liberalization, and as long as exports are still artificially small and capital is poised to flee, liberalization would be untimely and unwise in any case. The long-run intention of achieving import liberalization and redesign of protection can be usefully announced from the start, since this will lead industrialists to strive to become more competitive to the extent that they expect the transition program to be carried out successfully; but in early stages it may be best not to tinker with the system of protection except as it affects exports directly, and through devaluation and other indirect measures. Note carefully, however, that redesign of tariffs may be most painless in the middle phases of the transition, while QRs are still in effect-- this should not wait until tariffs have become the main instrument

of protection, since their increased importance will make reform more difficult politically. But import liberalization and redesigned protection should not be made the main objectives of the transition; they are only instruments to a set of higher goals, centering on successful growth and development. As instruments, they can be adjusted gradually as part of devaluations once the transition is well underway, since some liberalizing of imports can be done each time, "compensating" the devaluation, to hold down prices and keep overall protection from increasing through the interaction of tariffs and real exchange rates. But even if no deliberate effort is made to liberalize imports, this will be the inevitable effect of growing exports -- the premia on import licenses, and the need for QRs, will start to melt away, leaving only tariffs as the effective instrument. Meanwhile, the export drive will indirectly make the country's manufacturing industries more competitive, and the exchange rate adjustment will give them a form of protection, so that the need for artificial protection will diminish as well.

10. Credit in the form of loans to the government from abroad should be used to cover balance of payments deficits, if at all, only as a carefully planned part of the transition program with allowances for contingency needs and debt service throughout the program. It is important not to

mortgage the fruits of the export drive, more than the minimum essential to avoid severe hardship and destruction of production capacity in the early stages of the transition. In some ways, reliance on public sector borrowing under anti-trade policies is the opposite of a fundamental reform in the trade regime and can lead to high costs in development delayed and forgone because improvements in the policy environment are postponed, weakness and flabbiness in the industrial sector and the "wrong kind of learning" are allowed to continue, and a drive toward full development based on the country's own resources and learning capacities is put off until another day, perhaps indefinitely. Physical capital may be built up, but human resources and institutions are likely to be weakened. Thus, lending easily, with no strings attached, to a country with badly distorted, QR-based, anti-trade policies may not be doing it any favor. Lending to a country such as Korea, with pro-trade policies, an ambitious development program, and a shortage of capital is quite another story. Taking into account the dangers of overborrowing, some potentially available loans may be better refused.

11. For the later phases of a transition program, the key requirement is a well-thought out, ambitious development program, that will use the import and output capacity generated by export growth and by the growing competitiveness of the country's industries. The transition program is designed to get a slow-moving economy "off and running" toward successful growth and development. A crucial effect in the medium and longer term will be more capacity to import. How exactly will this be used? Unless there is a whole development program waiting to be implemented, involving a rapid growth of imports, investment and consumption demand, the import capacity is likely to be poorly used, and to go into idle foreign exchange balances; or a wasteful cycle will begin in which the economy will consume or dissipate its new resources, and lose its momentum. India seems to be caught today in a situation in which its import capacity exceeds its plans partly for lack of ambitious plans, and partly because there is a reluctance to import any type of manufactures, even capital goods, in competition with domestic industries. The incentive to import is being lost in the process, partly because the equilibrium exchange rate is less favorable to exports

under conditions of low growth and few investments, and partly because the abundance of imports has caused most of the QR-based import-export links to lose their force (and relevance) as incentives. To take a more extreme example, it would be gross negligence today to allow foreign exchange reserves to pile up and have practically no programs for growth and development, in a very poor country, as happened in Cuba and Portugal during much of the 1940's and 1950's. Of course, if development programs are too ambitious and taut, they may lead to a continuing use of QRs and QR-based import-export links, probably at a significant cost in inefficient allocation of resources. But this is surely preferable to an unambitious development program leading to an equilibrium exchange rate so low that export potentials are not tapped.

These recommendations will have to be modified and adapted in any particular case, of course, to fit the specifics of the situation and the political realities and economic peculiarities of the country. Any number of variations and qualifications could easily be suggested. However, the list may at least be a useful place to start, together with what has already been said in Part I, in what might otherwise be a bewilderingly difficult economic situation.

2. Problems of a Policy Transition Under More Favorable Circumstances

The easy case, in which a policy shift is made in conditions of ample exports and exchange rate equilibrium, is very similar to the later stages of the transition sequence just described, although there

will have been no opportunity to reduce tariffs quietly while QRs are still in effect, or to announce the direction years in advance while other concerns are uppermost.

What is basically required in this easier case is to improve export incentives, without on balance reducing the incentives for industrial production for the home market. This is technically not very difficult. The central measure required is a reduction in the level of protection of imports -- lowering tariffs and liberalizing or eliminating QRs -- while at the same time making a large real devaluation in the exchange rate that will immediately substitute exchange rate protection for the protection taken away. This change can be spread over several years in a series of steps advertised in advance. In addition, a battery of additional export promotion measures may have to be created to supplement the added incentives provided through the exchange rate. These actions will mainly have to do with liberalization of inputs into exports and other cost reducing measures -- including improvements in the tax system -- along lines desirable and sustainable in the long run.

The difficulties in practice are likely to be political more than economic. Resistance to these changes will come mainly from industries and firms that are inefficient, defensive and worried about their future with less protection; and despite the compensating devaluations these opposed interest groups will have good reasons to be worried. In the first place, some of these enterprises only manage to survive because of exceptionally high protection. This is especially true in a policy regime full of QRs and/or high and uneven effective

tariffs. Reducing the distortions and biases in the incentive system will lead to an intensified competition, weeding out the most inefficient enterprises while expanding the more efficient ones. Those likely to shrink and lose out will be reluctant to be exposed to this pressure. Second, even though devaluations will compensate in the short run for a reduction in protection, the import-competing firm has to worry that in the long run, even if the real exchange rate is maintained at the new level, exports will expand in a major way, opening up the possibility of intensified competition from imports based on the country's expanded import capacity. In this light, there is substance in a view that protection provides greater reassurance against foreign competition than a new exchange rate policy.

Over the long run, the extent to which the nation's industry flourishes and expands under the new policy will depend partly on the degree to which, in harmony with a principle already emphasized, the nation pursues an ambitious program of development making effective use of the improved import and output capacity made possible by improved trade policies. If the expanded import capacity is used primarily for capital equipment and other strategically chosen imports from abroad, there will not be enough foreign exchange left over to pay for a floodtide of imported consumer goods, moving threateningly into the markets of the country's established industries. Rather, any reasonably efficient industry will find itself under pressures to expand. Of course, this balance between demand and available resources can be made too taut; Kornai may be quite right in arguing that economic

systems perform best when aggregate demand remains a little smaller than potential supply, so that sellers have an incentive to work hard and compete for customers, and there is economic flexibility to switch output responsively, along with assorted other benefits of a market economy at its best. However, at the other extreme, if policy reformers concentrate on creating a theoretically optimal structure of incentives while neglecting to make sufficiently vigorous use of the added capacity created, the result could well be a depressed economy as a result of a large shortfall of aggregate demand below the country's potential supply capacity. This situation would probably correct itself eventually through exports and a buildup of private-sector institutions to do many of the tasks required, including organizing large-scale investments, but such a reversion to pre-twentieth century methods would probably carry a cost in slowing growth and development, particularly compared to the activist policy approaches available and recommended today.

As this example helps to emphasize once again, the trade policy measures recommended in this paper are only a means and not a goal in themselves. They will only achieve their full potential as part of a wider strategy of growth and development designed to achieve rapid progress on many fronts at once, so as to lift a developing country as swiftly and surely as possible from the blight of poverty and the curse of a low level of development, which means not being able to perform up to a respectable standard in all too many areas. Achieving rapid progress in development appears to depend, nevertheless, on choosing the right trade policy. The measures recommended here in relation

to trade thus form an essential part of the actions required for this larger purpose.

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