CHAPTER 3:

STRATEGIES FOR IMPORT SUBSTITUTION INDUSTRIALIZATION

3.1. Import Substitution Industrialization (ISI)

An import substitution (IS) policy seeks to replace imports of specific products with domestic production. Without doubt, the simplest way to do this in a market economy is to impose limitations on imports, which creates gaps in the economy, that makes for obvious investment opportunities in non-traditional areas of the economy, usually manufacturing (Power, 1966). Then, resources of the economy are directed to new industrial sectors, and expected profits may lead to an increase in the savings rate and to further increases in investment (Bruton, 1970). Thus, IS policy seeks to cope with external trade imbalances and to promote industrialization (Prebisch, 1959).

Prebisch (1950) and Singer (1949) used the argument of deteriorating terms of trade for primary products in developing countries to support the IS industrialization. They postulated the danger of dependence on primary commodity exports in the developing countries. Their presumption was that the income elasticity of developing countries' demand for industrialized countries' exports is relatively high, while the price and income elasticities of the industrialized countries' demand for developing countries' exports were relatively low.

Moreover, it was argued that in parallel with technological progress, labor productivity in both developed and developing countries has increased. But the result of higher productivity is not the same between developing and developed countries. In

developing countries, increases in productivity lead to a reduction in export prices, and therefore have a detrimental effect on the external terms of trade, while in developed countries, this gives rise to higher manufactured goods prices[1]. Consequently, Prebisch (1962) rightly concludes that gains from technical progress in the developed countries will usually be kept for themselves, while some of the fruits of technical advance in developing countries will benefit the developed countries (see similar arguments in Nurkse, 1952; Myrdal, 1958; and Park, 1977).

Consequently, according to Park (1977) and Prebisch (1979), developing countries need to overcome and respond to this by developing domestic industry[2]. Thus, the manufacturing sector would demonstrate its superiority against the agricultural sector as an engine of growth. It leads to technological knowledge and has a great tendency to create a dynamic and resilient economy. By using empirical data, Maizels (1963), Kaldor (1966) and Batchelor (1980) express support for Park and Prebisch's idea. They argue that manufacturing industries have a greater ability to produce externalities and linkage effects, and would therefore generate a diversified, broad-based and an integrated economy. The manufacturing sector is also argued to have a higher capacity to absorb labor. The scope for labor absorption through output expansion and diversification is much greater in manufacturing than in the primary sector (Rosenstein-Rodan, 1943: 245;

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[1] In general, increases in productivity can lead either to increases in wages or to falling prices. In developing countries, because of surplus labor, the latter occurs (export prices go down), while thanks to shortages of labor in developed countries, the former also happens (export prices go up). Therefore, the gap in the average standards of living between developed and developing countries widens.

[2] It should be noted that there does not appear to be a particularly close relationship between industrialization and the rate of per capita income growth in developing countries. The presumption remains that sustained economic growth in the longer run requires industrialization (Nixson, 1990: 329).

Park, 1977: 125). However, initially, manufacturing commodities made in developing countries cannot compete with that of developed countries, even in the domestic market. Import restrictions seek to encourage the establishment and expansion of domestic industry by the protection of domestic markets and exclusion of competing imports.

Almost all developing countries have concentrated on manufacturing consumer goods because the cost difference between domestically produced and imported consumer goods is less than for capital goods or for intermediate goods. Moreover, consumer goods are universally deemed not essential for development, and an increase in their costs will not affect other activities in the economy. Thus, it appears to policy-makers that by preventing the importation of consumer goods, the advantages of IS can be achieved at minimum cost[3] (Rokiah, 1994: 16). When the expansion of finished consumer goods capacity fully satisfies domestic markets, the stage of consumer goods' import substitution ends. At this point, the economy has a number of new activities whose survival depends on some form of protection and whose expansion cannot continue.

Therefore, IS of consumer goods involves either expansion of the domestic production of supplies and intermediate goods, and later capital goods for the domestic market, instead of importing goods or expanding production of consumer goods for external markets (Balance, 1982: 41), meaning that there is the need for existence of a

[3] At the beginning, in order to utilize the consumption effect (see section 2.2.1), governments use not only tariffs and exchange-control policies, but also exchange rate policies that keep the costs of imported capital goods below real costs. The rationale of these policies favoring the importation of capital goods rests in general on assumptions as to the essential or strategic role of physical capital in the development process. The relatively low tariff rates on raw materials, intermediate and capital goods further means that the effective protection afforded to the value added producing activities of many consumer goods is markedly higher than the nominal rate of protection on the consumer goods.

systematic body enacting measures to encourage the development of different types of industries at different phases of the development process. Thus, a successful ISI strategy requires either a systematic sequencing of industrial production from consumer goods to intermediate and capital goods, or from an ISI strategy to an export industrialization strategy.

3.2. State Intervention for Import Substitution Industrialization

3.2.1. Infant Industry

It is well known that ISI is always carried out with strong state intervention to spur industrial activity for import competition. In this process, the infant industry argument[4] is widely utilized to justify the protection of import-competing industries in developing countries. Normally, due to lack of managerial experience, technological know-how, and other entrepreneurial expertise, and due to the backward stage of development, the average cost of production for domestic producers is much higher than for world rivals. These factors make new local producers unable to compete with established and efficient world rivals. Hence, they are reckoned to be infants in comparison with mature, efficient

[4] The infant industry argument was first time utilized by the German economist, Friedrich List, in the mid-19th century, when Germany started to industrialize her economy. List (1856) argued that German industrial producers could not compete with British producers (the industrial leader at that time), and therefore, he proposed that new German industries should be protected against British products. He argued that laisser-faire and free trade ideas of classical theorists might have been relevant to an industrially advanced country like Britain, but it was less applicable to newly industrialized countries like Germany and the USA, which had not reached the stage of Britain. These countries did not expect that their new industries could compete with Britain without some degree of protection provided by the state.

and competitive producers in industrialized countries. As a result, if an infant industry is to be established, then it must be protected and supported for a certain period to grow up.

According to Johnson (1970), in classical economics, the infant industry argument for protection is one of two exceptions allowed for intervening in free trade[5]. The main rationale for the infant industry argument is that the present (static) cost of protection is accepted for the sake of future (dynamic) benefits, where under protection, infant industries should experience faster productivity growth and can eventually compete in the domestic and world market (Weiss, 1988), meaning that infant industry protection is a dynamic comparative advantage oriented policy (Schydlowsky, 1984). Protection, which is considered state intervention, enables the local producers to reap the benefits of economies of scale in production resulting from protecting a domestic market for them[6] (see section 2.2.2). The infant industry argument has been applied to both industrialized and developing countries.

The duration of protection is considered as the core of the infant industry argument, implying that after a certain period of time, the domestic firm or industry must become internationally competitive[7] (Bruton, 1989). Then, productivity growth of local producers must be faster than for foreign producers through dynamic internal and external economies.

Apart from the criterion of international competitiveness in choosing an industry to develop, according to Bastable (1921: 140-43), there is another necessary criterion[8].

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[5] Another exception favouring state intervention instead of free trade is the optimum tariff argument.

[6] As output increases, scale economies lead to declining costs of production and to industry becoming efficient and competitive over time through learning by doing.

[7] This is well-known as the Mill test (more in Mill, 1824)

[8] This is called the Bastable test (more in Bastable, 1921).

The long-run benefits of establishing an industry (firm) must recoup the costs incurred during the learning period. In other words, the costs of production of those benefiting from the development of the activity must be enough to repay the initial losses and to provide a reasonable rate of return on these losses.

Thus, infant industry protection is only warranted if three propositions - namely (i) the protected industry achieves fast productivity growth over time; (ii) satisfaction of the Mill test (the infant industry must grow faster than competing world producers); and (iii) satisfaction of the Bastable test (i.e. the benefit of infant industry promotion must compensate for the costs involved in the learning period) - are fulfilled.

3.2.2. Protection Measures for Infant Industry

State intervention has usually been most justified in an economic environment where markets do not function perfectly (discussed in section 4.4). In this context, "the general theory of the first best" argues that for every market distortion, there is a certain policy remedy that most directly corrects for market failure but does not create any additional distortions (more in Balassa, 1971; Krueger, 1978; Lall, 1987; Lall, 1990; World Bank, 1993, and so on). However, if there is no designated policy remedy for one or another reason, an alternative trade related policy may exist that indirectly attains some of the same efficiency benefits, i.e. is a second-best policy.

Trade related policy, or more exactly, protection can be used to promote the infant industry by several means: subsidies or protection against imports[9]. Subsidies may

[9] Nevertheless, there are two controversies related to the protection. The first debate has been about whether

subsidize the use of labor, provide training facilities and other services, provide cheap credit and so on. Such policies are promotional because they are not merely protective. Trade related policies include exchange rate policy, tariff and non-tariff policies (import quotas, exchange and trade restrictions). But normally, most countries begin protection by using tariffs and/or import quotas.

In the opinion of neo-classical economic analysts, subsidies are better than trade related policies because they are more transparent, less distorting and more likely to be reviewed. They argue that trade related policies easily bring further distortions in the economy. As a result, they consider using protection measures to promote the manufacturing sector is a third best option[10] (more in Heller, 1968: 163-4; Baldwin, 1969; Little, 1970: 128-9; Caves & Jones, 1973: 201-2; Corden, 1980: 62-3; Krueger, 1981: 6-8).

Others argue that using subsidies may require collecting extra taxes to finance these subsidies, therefore leading to political problems, and then leading to disbursing subsidies financed by these taxes. By contrast, they argue that protecting with tariff or non-tariff barriers does not result in a disbursement cost problem, involves less administrative costs and is easier to implement. The tariff automatically taxes consumers and subsidizes producers in one transaction. Consequently, trade-related policies, particularly tariff protection for infant industry promotion, are more popular than subsidies. Tariff protection is divided into two broad categories, namely uniform (or

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subsidy or protection is the best instrument to promote newly established industries. The second debate has paid attention to whether tariff protection should be given at a uniform rate or a selective basis case by case.

[10] Corden (1980) argues that if the object of the policy is to increase employment, the first best policy is to subsidize employment in manufacturing. The second best policy would be to subsidize manufacturing production, perhaps through tax concessions or direct subsidies related to value-added.

functional intervention) and selective.

(i) Uniform tariff protection, which is also called functional intervention (more in Pack & Westphal, 1986; World Bank, 1987; 1993), is used to remedy market failures[11] (normally in agricultural sector) without favoring one activity over another, implying that the same rates of protection are applied for all production activities. Hence, the idea of uniform protection may only generally encourage manufacturing so as to create the right industrial atmosphere, or to foster reciprocal external economies, and so on. Thus, in respect of the principle, such protection is very simple, but in practice, it is complex because equality of effective rates does not necessarily mean equality of nominal rates. Very different nominal rates of tariff and export subsidy may be needed to yield equal effective rates. Among the economists supporting uniform tariff protection, Balassa (1975) advocates a two-tier system of protection. One tier is uniform effective protection at 10-15% for all manufacturing activities, while another tier provides the temporary protection for individual infant industries that declines to the first tier level over a period normally of five to eight years.

(ii) Selective intervention/protection is designed to remedy market failure for specific activities and may favor selected manufacturing activities for promotion over others. Thus, selective intervention is also referred to as differential (or discriminatory) treatment for particular manufacturing industries (more in World Bank, 1987, 1992, 1993). Selective protection is also known as tailor-made protection (more in Balassa, 1978) or made-to-measure protection (Corden, 1980).

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[11] Market failure refers to when a market economy fails to allocate resources efficiently. There are many sources of market failure and many degrees of failure. The implications for the role of state and the form of public intervention can be quite different in each case (World Bank, 1997).

In Corden's opinion, the most practical difficulty in implementing selective intervention is to estimate the cost curve so as to decide what level of tariffs will ensure the survival of at least one firm, given that domestic protection is desired (Corden, 1980: 77-8). Moreover, the selective approach requires that tariff authorities estimate the costs of production, involving a good deal of judgment and discretion on the part of the authorities. The process of estimation is complicated and aims to avoid excessive profits. In general, selective intervention is very popular among developing countries to protect infant industry.

Practically, with an ISI strategy, almost all countries have applied selective protection measures for infant industries, but protection levels have been different among countries. Among the neo-classical economists skeptical of protectionism, Max Corden and Harry Johnson primarily developed indicators of so-called rates of effective protection (REP)[12]. The REP is defined as the proportionate increase in value-added in an industry that is possible as a result of the whole structure of protection, on both the output and the inputs of the industry. In other words, the REP is a measure of the proportion by which the tariff structure permits the domestic prices of factors used exceed their world prices. This measurement takes into account the amount by which input prices are raised

[12] Normally, production often involves the processing of or adding value to purchased intermediate inputs, which are transformed into higher-stage or final goods. In these circumstances, examination of the nominal tariff (the tariff applying on the imports competing with the final product) may not accurately represent how the activity is effectively protected by tariffs affecting the whole the production process. The nominal tariff on final goods that compete with the industry's output tells only part of the story about how much effective protection the industry receives as a result of tariffs. The other element is the tariff the industry must pay on the inputs that it buys. The output tariff is considered as a subsidy to the domestic producer, while an input tariff is a tax on local production (Williamson & Milner, 1991: 121-3).

by tariffs and NTBs as well as the amount by which value-added is raised by the whole set of tariffs and NTBs (Corden, 1970; Balassa, 1971; Krueger, 1972).

The basic formula for measuring the REP (e_j) in the single input case is:

$$e_j = (t_j - a_{ij}t_i)/(1-a_{ij})$$

where: t_j = tariff rate on output of final good j

t_i = tariff rate on input i

a_{ij} = proportion of total price accounted for by inputs

While the formula looks simple enough, the problems of actually measuring effective protection are formidable[13]. Despite the difficulties, a lot of serious work has gone into the measurement of effective protection. Through this work, three important general conclusions have emerged. The first is that differences between nominal and effective rates of protection can be substantial: use of the former to measure the protection given to an industry is likely to be highly misleading. This results from the fact that only where input and output tariff rates will uniform are nominal and effective rates be identical[14]. That is $e_j = t_j$ when $t_j = t_i$. The second general conclusion of the empirical

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[13] A first problem is that any given industry will usually face a variety of tariff rates on its output, and certainly on the several inputs that it buys, so that both t_j and t_i must be measured as weighted averages, rather than simply looked up in the tariff regulations. A second difficulty is that where an input is also supplied locally, its price need not rise by full amount of the tariff if domestic supply increases to the point where imports are eliminated. But it would be wrong then to reduce a_{ij} to reflect the fall in the import component, since domestic input supplies are also more expensive as a result of the tariff. What is needed is an estimate of the extent to which the costs of inputs rise as a result of the tariff. A third difficult is that the calculation should also include implicit protection given by quotas and the effects of taxes and subsidies.

[14] The statement assumes that all protection is given by tariffs. Matters are even more complex where other forms of protection are involved.

work is that although there is some evidence of a positive correlation between nominal and effective protection in many countries, effective rate of protection are often highly uneven. This is especially the case in developing countries, where tariffs and NTBs are generally higher in nominal terms than in industrialized countries. The third conclusion of the empirical work is that for developing and industrialized countries alike, there is a general tendency of tariff escalation, implying higher nominal protection on final than intermediate stages of production.

Generally, in order to minimize state interference in the market, neo-classical economists prefer uniform tariff protection to selective intervention to prevent lobbying by special interests. They assert that selective intervention is acceptable only in case well established industry generates substantially greater (lesser) external economies than the average, meaning that different levels of protection to various production activities would only be granted if the more protected sector was expected to lead to greater cost reductions than the less protected one[15] (Balassa, 1975: 374-6; Balassa, 1978; Krueger & Tuncer, 1982). They also argue that perhaps policy makers know little about scale economies[16], externalities[17] and the prospect of learning in particular industries. Consequently, policy makers want to use selective protection.

[15] This is only a partial criterion for selective government intervention and need to be put alongside the Mill-Bastable test.

[16] More in section 2.2.2

[17] Externalities arise when the actions of one person/firm hurt or benefit others without that person/firm paying or receiving compensation. Pollution is an example of negative externalities, which imposes uncompensated costs on society; the broader benefit to society at large of a literate population is a positive externality of primary education. Government can curb negative externalities and promote positive externalities through regulation, taxation or subsidy, or direct provision.

3.2.3. ISI and Empirical Evidence of Economic Growth

At the beginning, ISI policies were appreciated in the post-war period until 1970s, when ISI policies were practised almost everywhere in the world, and contributed to the golden age for rapid economic growth. According to World Bank data, scores of developing countries experienced rates of economic expansion that were virtually unprecedented in the history of the world economy (see Table 3.1). The ISI policies created protected and therefore profitable home markets for domestic entrepreneurs to invest in, and thus spurred growth. Robinson (1997) argued that ISI policies is good particularly for resource-rich countries such as Argentina because liberalization policies would have shifted power to agricultural interests, and were therefore blocked by domestic capitalists. Contrary to received wisdom, ISI-driven growth did not produce tremendous inefficiencies on an economy-wide scale. In fact, the estimates of Collins & Bosworth (1996) show that the total factor productivity (TFP) measures of many Latin American and Middle Eastern countries were, in comparative perspective, exemplary. The indicators of many Latin American and Middle Eastern countries prior to 1973 looked quite favorable in comparison with those in East Asia (Table 3.2).

As a result, until the 1970s, ISI policies with the intention of increasing domestic investment and enhancing productivities - apparently worked well and would never have acquired their dismal reputation; nor would East Asia have earned its miracle appellation (Bruton, 1998). After 1970s, the Middle East and Latin America not only fell behind, but actually experienced negative TFP growth on average (see Table 3.2). Then, the key question to be answered is why TFP growth in these economies declined then.

According to Rodrik (1999), many turbulences have beset the world economy

following 1973, including the abandonment of the Bretton Woods system of fixed exchange rates, two major oil shocks, various other commodity boom-and-bust cycles, plus the interest rate shock of the early 1980s brought on by the tight money policies of Federal Reserve chair Paul Volcker. The proximate reason for the economic collapse of Latin American and Middle Eastern economies was the inability of their governments to adjust macroeconomic policies appropriately in the wake of these external shocks. It means that the governments of these economies were then rather weak and did not work out domestic institutions efficient enough to manage the distributional conflicts triggered by the external shocks of the period. Macroeconomic maladjustment gave rise to a range of syndromes associated with macroeconomic instability such as high inflation, scarcity of foreign exchange and large black market premiums, external-payments imbalances and debt crises that greatly magnified the real costs of the shocks. Furthermore, ISI policies also spawned many disadvantages discussed below (section 3.3), explaining why many countries did not follow ISI and why ISI policies failed to create more economic growth in the following period[18].

[18] Rodrik (1999) also argues that ISI policies per se were not exhausted. The dismal reputation of ISI is partly due to the subsequent economic collapse experienced by many of its adherents in the 1980s, and partly to the influential studies of Little, Scitovsky & Scott (1970) and Balassa & associates (1971). What these two important studies did was to document in detail some of the static economic inefficiencies generated by high and extremely dispersed effective rates of protection in the manufacturing sectors of the countries under studies. The discovery of cases of negative value added (exceptional cases where countries would have been better off throwing away inputs rather than processing them as they did in highly protected plants) was a particular shocker. Moreover, the only region of the world that experienced a significant rise in TFP growth after 1973 was South Asia (that is Bangladesh, India, Myanmar, Pakistan and Sri Lanka), which is not exactly the region that comes to mind when one thinks of outward orientation (Table 3.2) (Rodrik, 1999: 70-74).

***Table 3.1*: Per Capita GDP Growth Rates, by Period (%)**

Country	1960-73	1973-84	1984-94
South Korea	*6.69*	*6.45*	*7.32*
Taiwan, China	*8.10*	*5.78*	*6.33*
Singapore	*6.90*	*5.54*	*5.09*
Hong Kong	*6.18*	*5.54*	*4.66*
Malaysia	*4.09*	*4.50*	*3.87*
Thailand	*4.49*	*3.93*	*7.21*
Philippines	*2.10*	*1.13*	*-0.10*
China	*2.48*	*5.39*	*8.52*
Brazil	4.74	1.72	0.81
Mexico	3.18	2.05	0.43
Colombia	2.45	1.68	2.37
Argentina	2.29	-0.23	1.07
Bolivia	2.23	-0.70	0.32
Israel	*5.03*	*1.45*	*2.37*
Malta	*5.22*	*7.19*	*n.a.*
Egypt	*2.64*	*6.05*	*0.33*
Iraq	*2.60*	*-0.93*	*n.a.*
Pakistan	*3.10*	*2.70*	*2.37*

***Source*:** Rodrik, 1999: 69-70

***Table 3.2*: Economic Performance by Period**

(annual average growth rates, in percent)

Country	1960-73		1973-84		1984-94	
	GDP per worker	TFP	GDP per worker	TFP	GDP per worker	TFP
China	*2.2*	*1.4*	*4.3*	*2.2*	*8.0*	*4.6*
South Korea	*5.6*	*1.4*	*5.3*	*1.1*	*6.2*	*2.1*
Taiwan	*6.8*	*2.2*	*4.9*	*0.9*	*5.6*	*2.8*
Singapore	*5.9*	*0.9*	*4.3*	*1.0*	*6.0*	*3.1*
Malaysia	*4.0*	*1.0*	*3.6*	*0.4*	*3.8*	*1.4*
Thailand	*4.8*	*1.4*	*3.6*	*1.1*	*6.9*	*3.3*
Indonesia	*2.5*	*1.1*	*4.3*	*0.5*	*6.2*	*2.1*
Philippines	*2.5*	*0.7*	*1.2*	*-1.3*	*-0.3*	*-0.9*
Argentina	2.6	0.2	0.4	-1.0	1.1	1.0
Brazil	4.4	2.9	1.0	-0.8	0.5	-0.2
Chile	1.6	0.7	-0.6	-0.7	4.7	3.7
Mexico	3.8	1.6	0.7	-0.8	-1.1	-1.8
Peru	2.6	1.4	-1.1	-2.2	-1.5	-1.3
Algeria	*2.3*	*1.6*	*2.4*	*-0.1*	*-3.3*	*-3.3*
Egypt	*3.0*	*1.8*	*6.2*	*2.3*	*0.0*	*-1.5*
Iran	*6.1*	*2.4*	*-2.9*	*-5.7*	*-2.2*	*-2.2*
Israel	*5.1*	*3.3*	*1.2*	*-0.1*	*2.7*	*1.9*
Malta	*3.7*	*1.9*	*6.6*	*4.9*	*3.9*	*2.0*
Bangladesh	0.0	-0.6	2.5	1.8	1.1	0.7
India	1.8	0.1	2.4	1.0	3.1	1.6
Sri Lanka	2.1	1.0	3.2	0.7	2.7	1.0
Myanmar	0.5	0.1	3.5	1.9	-0.6	-1.6
Pakistan	3.9	0.2	2.8	2.0	2.7	1.5

***Source*:** Collins and Bosworth (1996)

3.3. Import Substitution Industrialization Issues

3.3.1. Failure in Transition to Manufacturing Intermediate & Capital Goods and Export Commodities

The ultimate purpose of ISI and protection is to move from production of consumer goods to production of intermediates, and after that, capital goods as well to develop the dynamic comparative advantage of the economy to move from production for the domestic market to production for international markets. As a result, the relative protection accorded each category should change accordingly, favoring first one set of industries and then another. This sequence is to accelerate the acquisition of technological capabilities and hence promote productivity improvements and efficiency gains. In turn, this quickens the pace at which the costs of infant industry protection decline (Westphal, 1981: 30).

However, empirical evidence from many countries shows that this sequence did not take place. The protection of consumer goods has become a permanent feature of industrial policy. The fundamental problem is that these countries have neglected their comparative advantage in the pursuit of industrial development. Neo-classical economists argue that this is because domestic producers, particular of consumer goods gained substantially more economic rents from selling goods in protected home markets than the returns from exports at internationally competitive prices (Bruton, 1970; Balassa, 1971; Jomo, 1993). Thus, exports are harmed by import protection through (i) raising the cost of imported (or import competing) inputs into export production and reducing the incentives for production of exportable goods relative to importable ones. This conclusion is illustrated by the three cases of Brazil, Chile and the Philippines, where there is

considerable bias in favor of import substitution and against exporting in the manufacturing industries (Balassa, 1971).

3.3.2. Rent and Rent-Seeking Activities

According to neo-classical economists, protection for IS leads to rent-seeking activities[19]. For the economist, rents refer to "excess incomes" which, in simplistic models, should not exist in efficient markets. More precisely, an individual or firm gets a rent if he or she earns an income higher than the minimum that person would have accepted, usually defined as the income from his or her next-best opportunity (Khan & Jomo, 2000: 21). Since rents loosely represent incomes which are higher than would otherwise have been earned, they constitute incentives to create and maintain these rents (Khan & Jomo, 2000: 21). Rent-seeking activity is particularly prevalent in countries where, the government and bureaucracy are easily persuaded and influenced by businessmen to provide tariffs and quotas.

Rent-seeking activities may cause resource misallocation of uneconomic purposes like corruption, patronage, lobbying and kickbacks. These activities may result in domestic producers becoming slack and less efficient, or spending resources on "public relation" to persuade ministers or other policy-makers of their case for protection

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[19] Rent-seeking activity was, and is, endemic in both developing and developed countries. The difference is that in developing countries the rent-seeking can be more extensive, can include illegal forms and is more often damaging for economic growth. At the same time, many types of rents and rent-seeking activities play a key role in process of development and are likely to do so again in the future (Khan & Jomo, 2000: 1-2)

(Krueger, 1974) because the firms deem that a high level of protection will produce rents big enough to justify spending lobbying resources to get them. Thus, a tariff system[20], intended to be made-to-measure, may lead to a great deal of rent-seeking activity. It is bound to involve an element of bureaucratic discretion (Corden, 1974: 235). The less uniform and automatic the tariff system is, the more scope there is for lobbying, and so the more rent-seeking expenditure may be expected. Consequently, rent-seeking activities may cause inefficiency and weaken productivity growth.

3.3.3. Low Technical Change

Empirical studies use the indicator of domestic resource costs (DRCs)[21] to measure the extent of inefficiency of an activity in protectionist countries. Thus, neo-classical economists conclude that ISI dampens productivity growth as well as curbs the incentives to catch up with the international competitors (Balassa, 1971; Steel, 1972; Bhagwati & Srinivasan, 1975; Behrman, 1976; Bhagwati, 1978; Krueger, 1978). Balassa argues that as a result of restriction to the domestic market, ISI limits the possibilities of using more efficient large scale techniques, and may therefore, influence the choice of relatively inefficient, small-scale production techniques (Balassa, 1971). He argues that with limited competition and high profit behind protective tariffs and NTBs, firms will have little

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[20] In fact, the tariff system is complicated, and often depends on the judgments of officials or tariff commissions about the production costs of protected firms.

[21] There was a wide variation in DRCs between different activities because evidence of resource misallocation is likely to have been made possible by the different set of incentives created by the import protection system.

incentive for productivity improvement and technical change (Balassa, 1971: 23). In addition, Bell argues that guaranteed high domestic prices provide comfortable profits for firms without pressure to enforce technical change and to reduce production costs. This implies that technical change and improvements become secondary objectives of the firm (Bell, 1986: 56). In other words, protection allows firms with high costs - in both economic and commercial terms - to survive, and in the absence of reforms to the protective system, they have little incentive to lower their costs (Weiss, 1988: 189).

3.3.4. Capacity Under-Utilization.

Protection for import substitution has created home market biases, which gives rise to uneconomic scales of production because (i) protection increases profitability and attracts entrants into protected industries manufacturing for a small domestic market, therefore leads to restricting the ability of individual firms to benefit from economies of scale and sometimes even from fully utilizing its existing production capacity (Scitovsky, 1969: 42); (ii) for capital-intensive industries[22] requiring large-scale outputs to bring costs of production down to levels correspondent to that of more advanced countries, the domestic market is too small to absorb firm outputs, meaning that it is impossible to achieve the economies of scale; therefore, costs of production will be high and remain higher than international competition as long as output is limited (Scitovesky, 1969; Balassa, 1982).

3.3.5. Monopolistic Behavior

[22] In many countries, due to inexpensive credit, ISI encouraged capital-intensive and large scale production (Griffin, 1989: 109).

Protective ISI policy for capital-intensive and large-scale industries is often supported by licensing mechanisms and heavy investments, which restrict the number of new entrants into an industry to secure the domestic market for a limited number of firms to more easily achieve economies of scale in production. Therefore, this policy leads to the possibility of creation of a monopolistic position[23] and hardly creates effective competition because the high profits assured by continuing protection are conducive to a "live and let live" attitude in industry (Balassa, 1971: 79). High profits guaranteed by protection will tend to adversely effect the firm's motivation in the "hot-house" atmosphere of a protected domestic market. Hence, in that circumstance, most firms tend to follow a policy of low turnover and high profit rates, and have little incentive for product improvement and technical change. Furthermore, as a result of the lack of competition, it is easy to develop x-inefficiency in such industries.

3.4. Conclusion

There are many empirical studies of such as studies by Tullock, 1967; Little (1970); Krueger (1978); Balassa (1978); Bhagwati, (1980); Balassa (1982); Amsden (2000b) on the performance of ISI strategies. These empirical results were used to argue against high

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[23] Some commentators argue that monopolistic positions can give rise to positive efficiency effects. Thanks to economies of scale, monopolistic firms are spurred to improve technical, managerial and technological change. In this circumstance, the monopolistic firms are associated with improvements in efficiency over time. Thus, the monopolistic position's consequences are ambiguous; depending on the circumstances in particular cases (Kirkpartrick, 1984)

levels of protection to sustain ISI, which held down imports via high tariffs and NTBs with the aim of creating the viable markets for domestic suppliers, first for consumer products, and then for intermediate and capital goods (Taylor, 2000b: 2-3). This ISI strategy for protection of infant industries has been criticized for not promoting efficient and competitive industrial production, for encouraging rent seeking behavior and monopolization, for generating insufficient employment[24] and foreign exchange shortage, and for failing to reduce income inequality (Krueger, 1990: 106; Taylor, 2000b), as discussed above. That means the welfare losses due to protection could include: dead-weight consumer/producer surplus; resource costs associated with lobbying; x-inefficiency due to monopoly. Thus, it is suggested that by exploiting the comparative advantage of developing countries, the strategy of export-oriented industrialization (EOI) is more efficient and dynamic, requiring lower capital-labor ratios to achieve high rates of growth (Krueger, 1990). Moreover, this EOI strategy has created additional efficiency benefits from the realization of scale economies through sales on regional and world market as well as improved income distribution in labor-abundant countries through export of labor-intensive manufactures.

[24] Prebisch (1964), then Baer & Herve (1966) and Morawetz (1974) concluded that industrial growth under an ISI strategy in many countries was not accompanied by a significant growth of employment.