THE ROLE OF IMPORTS IN INDUCING ECONOMIC DEVELOPMENT

by

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I. INTRODUCTION

This paper has two purposes. The first purpose is to ascertain the effects that imports have upon economic development. The second purpose is to consider criteria that underdeveloped nations can use in the selection of proper import policies. Thus, the problem is to examine imports and import policies, and their impact on economic development.

The problem is complicated by two factors. First, each underdeveloped nation has its own peculiar problems. Second, groups who have analyzed the problem have arrived at different conclusions.

To overcome the factors which add to the complexity of the problem, several assumptions have to be made. The first assumption is that the general problems which Krause, Liebenstein, Prebisch, Myrdal, et. al, list as obstacles to economic development are common to all underdeveloped nations. The second assumption is that all of the analyses of the problem have a realistic basis. However, in an arbitrary manner, certain analyses, e.g. Colin Clark's rosy future for primary producing nations, have been rejected because of space and time limitations.

The investigation of the problem consists of examining the theoretical background, present obstacles to development, and the dynamic role of imports. The first chapter, "Historical Perspective," is devoted to the historical development of thought concerning imports and economic development. The second chapter, "Obstacles to Economic Development," surveys factors which restrain economic growth in most underdeveloped nations. Criteria are set up as guidelines for the nation which wants to achieve economic development. The third chapter, "The Role of Imports and Commercial Policy in the Process of Economic Development," is an examination of the role which imports and import policy play in overcoming obstacles to economic growth and in satisfying the criteria which a nation must follow to achieve economic development. The final chapter summarizes the effect which various import policies have on economic development.

II. HISTORICAL PERSPECTIVE

"Generally, the writings of the past have to be looked upon in terms of new contemporary interests as well as continuing old interests."[1] Thus, the purpose of this section is to examine some of the historical views of economists, businessmen, and politicians who have been concerned with imports and economic development.

Men have contemplated economic matters as long as human society has existed. Therefore, it is difficult to justify any time period, any person, or any school of thought as the beginning of the emphasis on imports and economic development. However, Mercantilism appears to be a good starting point for two reasons. It occurred at a period in history that resembles our own.[2] It was the first "school" of economic thought to stress the relationship between the development of the nation state and international trade.

Mercantilism

Imports were detrimental to a nation's economic development, according to the advocates of a "Nationalization of Regulation."[3] These men, who were mainly businessmen and government officials, focused their attention upon bullion, which they equated with wealth. The strength of the military forces, and, therefore, the nation was dependent upon the amount of bullion which the nation possessed. Bullion was the base of

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[1]Edmund Whittaker, Schools and Streams of Economic Thought (Chicago: Rand McNally & Company, 1961), p. vii.

[2]P. C. Newman, The Development of Economic Thought (New York: Prentice-Hall, Inc., 1952), p. 1.

[3]Ibid., p. 18.

the money supply of a nation. In a crude manner, some of the Mercantilist writers understood how the money supply, through its effect on the interest rate, determined investment, savings, production and employment.[4] Thus, an outflow of bullion, caused by an excess of imports over exports, was an undesirable occurrence. To prevent an unfavorable balance of trade, restrictions were imposed on imports to preserve or expand the nation's bullion supply.

Production and employment in the nation, not the world, were to be maximized in the Mercantilist "model." Imports often threatened to undermine the position of an industry. If the industry were not protected, production and employment in the nation would be curtailed. Therefore, imports of finished goods were prohibited so that the industry could continue in operation, providing goods and employment.

However, raw material imports were recommended. Domestic industry needed raw materials to produce finished goods. By importing raw materials and exporting finished goods, the nation could employ its people, and in the process, earn bullion.

Mercantilism's basic philosophy was that a strong nation state was needed to protect the welfare of the people.[5] The implementation of the policy of selective restriction of imports was a major tool in striving for the goal of aggrandizing national power.

Mercantilism was a product of its time and environment, and the environment shifted. In Hegelian terms, an antithesis evolved to oppose the Mercantilist system. Men such as North, Davenport and Cantillion formed the first reaction to the "Nationalization of Regulation." A for-

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[4]Ibid., p. 21.

[5]Ibid., p. 16.

mal embodiment of their views was expressed in the writings of the men of the Classical School of thought.

Classicism

Adam Smith took issue with the Mercantilist's concept of wealth and, in so doing, he regarded it as a flow of goods available for consumption over a period of time.[6] Bullion represented purchasing power because people accepted it as such, and its only value was that it was a scarce item. Since imports were part of the flow of goods, they were considered wealth, and it was foolish for a nation to restrict them.

Armies and navies were maintained, "not with gold and silver, but with consumable goods."[7]

Imports into a nation were a vent for the surplus productivity of certain goods of another nation. Conversely, the exports of a nation were goods obtained from its surplus productivity. Each nation benefited in that it exchanged its own surplus goods for needed goods and, thus, raised its real wealth.

Three benefits were to be derived from a greater division of labor and a greater amount of specialization, both of which were dependent upon all nation's minimizing their restrictions on imports.[8] First, the "dexterity of workers" would be increased because each worker would be able to concentrate on a specific task. Second, the time necessary to produce commodities would be reduced. Third, better machines and equipment would be invented because people would be specializing in their jobs.

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[6] Whittaker, op. cit., p. 103.

[7] Adam Smith, The Wealth of Nations (New York: E. P. Dutton & Co., 1957), I, p. 317.

[8] J. F. Bell, A History of Economic Thought (New York: The Ronald Press Company, 1953), p. 171.

Import restrictions were allowable in two special cases.[9] Industries which were crucial to the defense of a nation should receive protection if they were unable to compete with foreign producers. Also, duties were to be levied on imported items which were competing with home goods subjected to a domestic tax. The rate of the import duty was to equal the rate of the domestic tax so that neither good would be penalized in the price market.

Ricardo, utilizing Smith's principles, developed a proof of the benefits of international specialization. The proof was the theory of comparative advantage. Based on static assumptions, it incorporated a labor theory of value. If each nation of the world would specialize in the production of the commodity(ies) in which it had the greatest relative advantage, world production would be maximized. Thus, a greater quantity of goods would be available per capita, and, disregarding product distribution, a higher real income per capita would be achieved. A higher level of real savings would correspond with a higher level of real income. Consequently, a higher level of savings would by Say's Law, be equaled by a higher level of capital accumulation, which was the Classical key to economic growth.

Elimination of all import restrictions had to occur so that each nation could expand the export markets of products in which it had a relative advantage. Resources would be most efficiently utilized by this elimination. Conversely, as Ricardo stated, "the only effect of import duties...was to cause a pernicious distribution of the funds of

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[9] Smith, op. cit., p. 410.

the society" by "divert(ing) a portion of capital to an employment which it would not naturally seek."[10]

Still another advantage could be gained from the elimination of import restrictions. Imported goods constituted not only consumptive wealth, but a portion of imports would be "materials, tools, and provisions" for the "employment and maintenance of industrious people, who would reproduce with a profit the full value of their consumption," i.e. some of the imports would be capital equipment and materials which could raise the real wealth of the society.[11]

J. S. Mill observed certain indirect benefits which were a result of international trade. The populace of an underdeveloped nation, when exposed to new import products, would be induced "to work harder...to save, and to accumulate capital, for the still more complete satisfaction of those tastes at a future time."[12] Communications between dissimilar people which corresponded with their imports from each other were the "primary sources of progress."[13] Likewise, "the great and rapid increase of international trade...is the permanent security for the uninterrupted progress of the ideas, the institutions, and the character of the human race."[14]

The Classical theory considered commercial policy from an international rather than a national point of view. In disagreement with this perspective was Frederick List.

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[10]David Ricardo, The Principle of Political Economy and Taxation, (New York: E. P. Dutton and Co., 1926), p. 98.

[11]Ricardo, op. cit., p. 76.

[12]J. S. Mill, Principles of Political Economy (New York: D. Appleton and Co., 1881), II, p. 112.

[13]Ibid.

[14]Ibid., p. 113.

List

List felt that commercial policy should be employed to develop the economic potential of a nation. Optimization of world production was of secondary importance.

To develop economically, each nation had to diversify. Agriculture, manufacturing, and commerce had to be developed and expanded. However, each nation had to develop along lines best suited to its own culture, resources, etc.

Following the thinking of Alexander Hamilton, List proposed that tariff protection be extended to new industries which could not compete against foreign imports in the early stages of their growth. These "infant industries" could produce wealth. Emphasis was placed on the idea that the power to produce wealth was more important than wealth itself.

Imports of raw materials were to be duty free. Thus, the inputs of the "infant industries" would cost less, which would lower the price of the finished good and aid in the "infant industry's" struggle to become competitive.

Protection entailed costs for the nation but it was temporarily necessary. A nation "must sacrifice and give up a measure of material prosperity in order to gain culture, skill, and powers of united production, it must sacrifice some present advantages in order to insure to itself future ones."[15]

Ultimately, after a nation had accomplished the development of its agriculture, industry, and commerce, it was to abandon protectionism.

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[15]Frederick List, The National System of Political Economy, trans. S. S. Lloyd, (New York: Longmans, Green and Co., 1904), p. 117, quoted in Bell, op. cit., p. 312.

By returning to free trade, imports would provide competition to force the infant industries to become more efficient. Because the nation had diversified and developed, it could preserve its culture and maintain a high level of real income.

Marx

Marx contended that capitalism's businessmen exploited the import demand function of the underdeveloped nations in their quest for profits. Raw materials were imported by the advanced nations from the underdeveloped nations. By importing raw materials and exporting finished products, only the advanced industrial nations benefited from international trade. To maintain their profitable position, industrial businessmen denied benefits to underdeveloped nations so that they could not also industrialize and thus be competitors.

Schumpeter

Innovations and the entrepreneur were the 'mainsprings' of economic development in Schumpeter's theory. Assuming that innovations would induce entrepreneurship, economic development would occur with the advent of any or all of four factors. The factors were the introduction of a new good, the use of a new method of production, the conquest of a new source of raw material supply, and/or the reorganization of any industry.[16]

Imports could play a vital role in his model. The introduction of a new good into an underdeveloped nation could be accomplished by importing the good. Capital equipment imports could provide a new method of production. Import equipment, not used in the nation previously, could

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[16] Gerald Meier and Robert Baldwin, Economic Development (New York: John Wiley & Sons, Inc.), p. 87.

be the means to technologically conquer a new source of raw material supply. New capital or raw material imports could induce the reorganization of an industry.

Neo-Classicism

As the Classicists, the neo-classicists advocated that the principle of comparative advantage be utilized to optimize the allocation of resources of the world. An optimum allocation of resources would produce the highest level of real income possible. Higher real incomes meant a larger amount of savings which, thus, raised the rate of capital accumulation and economic growth.

Nations were to import commodities whose production requirements were better fulfilled by other nations that had different factor endowments and different costs of production.

Bertil Ohlin, a member of the "Swedish school" of economists, attempted to explain international trade on a realistic basis. His analysis differed from that of other neo-classicists in that he applied a system of simultaneous equations to international trade by using an equilibrium theory of prices.

Ohlin developed a general equilibrium model of international prices which was primarily based on the differences of absolute production costs between areas.[17] Production costs varied because of each area's limitations in the supply of the factors of production.

Ohlin criticized several aspects of the theory of comparative advantage.[18] He questioned the assumption that the costs of production

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[17]Bell, op. cit., p. 642.

[18]Bertil Ohlin, Interregional and International Trade (Cambridge: Harvard University Press, 1935), p. 215.

could be reduced to the common denominator of labor units. He contended that the quality and wages of labor of each nation would be different because of factors such as education, trade unions, etc. Viewing trade dynamically, he contended that the supply of productive factors will create a basis for trade but will also be affected by trade. Real incomes of various segments of the society would not only rise, as the Classicists had maintained, but they could also fall or remain constant. Real incomes of certain people might fall when imports undercut the advantage which their product(s) had possessed. His final criticism was that the principle of comparative advantage ignored transportation costs.

Ohlin's analysis and his criticisms of Classical theory changed the perspective toward imports. Theory concerning imports and trade was tested less on the internal consistency of the logic; rather, theory was tested on its relation to conditions in the real world.

Therefore, import restrictions were conceded in two cases by the neo-classicists.[19] First, the "infant industry" argument was allowed. Second, import restrictions were necessary when a deterioration in the terms of trade was threatening a nation's real income.

The neo-classical position on import restrictions can best be summarized by a quote of Nickolson, "Free trade, like honesty, remains the best policy."[20]

Keynes

J. M. Keynes shattered the full employment postulate, upon which the Classical theory of free trade had been built. However, he contended

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[19]Gerald Meier and Robert Baldwin, <u>op. cit.</u>, p. 79.

[20]<u>Ibid.</u>, p. 80.

that monetary and fiscal policy should be utilized to maintain full employment rather than policies of import restriction.

Attention was focused on the distribution of income which international trade caused. An excess of exports over imports was positive foreign investment. An excess of imports over exports was negative foreign investment. The foreign investment, whether positive or negative, had a multiplier effect on national income.

The question was raised whether modern technology was narrowing the differences in comparative costs among nations and thus reducing the gains from trade to a level below the risks inherent in specialization.[21]

A decrease in money wages in nation A, while all other nations held their wages constant or decreased wages less than nation A should expand the exports and decrease the imports of A. A's exports would expand because export prices should drop as money wages drop. A's imports will decrease because the price of foreign goods has remained constant or has decreased less than the price of A's goods. However, a decrease in A's export prices which is greater than the decrease in her import prices would worsen A's terms of trade, and her real income would fall. Real income would fall in A because a larger volume of exports is needed to obtain a given quantity of imports after the terms of trade have worsened.

Excessive competition between several nations would depress their export prices and worsen the terms of trade of each. Real incomes would, therefore, fall.

Real national income is maximized when unit costs of production are minimized. Elimination of import controls would achieve this end, if the

[21]Charles Kindleberger, International Economics (Homewood, Illinois: Richard D. Irwin, Inc.), p. 134.

nation were in a period of full employment. However, if unemployment exists, import restrictions designed to create jobs would result in a higher level of national income. A higher level of employment would, ceterus paribus, raise the level of effective demand which would raise national income. As stated previously, Keynes felt that a superior alternative was the use of domestic monetary and fiscal policy to maintain employment.

Summary

Imports have been a controversial issue. Within the context of economic development, the merits of free trade and protectionism have been debated by various men. The Mercantilists contended that national production should be maximized and bullion should be stockpiled. To accomplish this, imports were to be restricted. List supported this contention in that "infant industries" were to be established to diversify and develop the nation's economy. The Classicists and neo-Classicists retorted that import restrictions would not promote the optimal utilization of resources, which was the most effective method to raise world real incomes and capital accumulation. Resource utilization would be optimized if each nation adopted the principle of comparative advantage in its production.

Agreement on import restrictions was forthcoming on several issues. "Infant industries" were a valid reason for the restriction of imports. A deterioration in the terms of trade which threatened a nations real income was also a justifiable basis for import restrictions.

By focusing attention on the distribution of income through international trade and by reiterating the effects of imports on production and employment, Keynes reoriented economic thinking in this area.

This brief sketch has demonstrated the diversity of views concerning imports and their effect on economic development.

III. OBSTACLES TO ECONOMIC DEVELOPMENT

Estimates indicate that there are approximately 50 underdeveloped nations which account for two-thirds of the world's population.[22] What is an underdeveloped nation? A typical definition asserts that an underdeveloped country is one that, on the average, affords its inhabitants an end product of consumption and material well being inferior to that of developed nations.[23] For simplicity, let an underdeveloped nation be defined as one in which the annual per capita income is five hundred dollars or less. Low per capita incomes are a reflection of the general inability of a nation to achieve economic growth.

In recent years, the obstacles to economic growth have been considered by many writers. In order to provide some background for the nature of the problem of economic development, this section examines some of the factors retarding economic development and establishes certain criteria for overcoming these obstacles.

Factors Retarding Development

Income inequalities

Although the level of per capita income is low, there exists a wealthy landlord and renter class in these nations. The wealthy class is perpetuated through inheritance, and usually controls the nation economically and politically, preserving the status quo. Thus although the great majority of people within the nation have a subsistence level of living,

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[22]Walter Krause, Economic Development (San Francisco: Wadsworth Publishing Company, Inc., 1961), p. 7.

[23]Ibid., p. 6.

great income inequalities exist. The result of these income inequalities is that the wealthy can often block economic attempts at development and can also attempt to preserve the status quo in order to retail their incomes and property.

Political instability

Further, income inequalities promote political instability. The masses of people have been caught up in a "revolution of expectations." They want a better way of life, but the income inequalities are a barrier to vertical mobility within the economy. As the peoples' frustrations mount, they become receptive to any political group which will promise them a better way of life. Many of these political groups are revolutionary in nature, and will attempt any means to achieve power. With constant tension and struggle being generated by these groups, the government in power rarely is in a secure position. The government in power often has to also withstand assaults by dissatisfied military elements. Thus, political instability seems almost to be an inherent characteristic of many underdeveloped nations. How is this an obstacle to development? Political instability retards development because it lends uncertainty to the future. Uncertainty is not conducive to economic development because it affects adversely economic decisions made in the present, e.g. capital flight.

Vicious circles

Income, capital accumulation, technology, and production are all interrelated and are caught in "vicious circles." Underdeveloped nations are characterized by a low level of savings. People living at a subsistence level must consume the entirety of their income to survive. Savings of the wealthy class usually tend to flow out of the nation. A low level of savings restricts capital accumulation. Little capital accumulation limits production which, in turn, perpetuates the low per capita incomes. Technology, in terms of industrial science, is often non-existent or very crude in domestic production. Technological progress and capital accumulation often go hand in hand, but a low level of capital accumulation prevails.[24] Limited technology restrains the productivity of the nation and acts as a constraint on production. Technology is also limited in that educated people are needed to adapt to or create it. But people with low incomes often cannot afford to purchase an education and, therefore, lack the skills or training necessary to adapt or develop industrial technology. Government has difficulty in providing education and technology because it lacks the funds necessary to train people and to build the proper facilities.

Population attitudes and characteristics

Several obstacles stem directly from the population. As previously mentioned, there are shortages of both skilled labor and technicians. Aside from this, an absolute overpopulation is engaged in agriculture. Industrial jobs are lacking because of the low level of industrial production. Labor must remain in agriculture and because of the overpopulation, agricultural productivity is very low. In varying degrees, depending on the nation involved, segments of the agricultural labor are classified as "disguised unemployment." Many men are in the military forces. If they were not serving in this capacity, they would probably also be classified as "disguised unemployment" because of the shortage of industrial employment openings. The population does not provide enough entre-

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[24] Kenneth Kurihara, A Keynsian Theory of Economic Development (New York: John Wiley & Sons, Inc.), p. 49.

preneurs. This stems from the "vicious circles" which cause almost insurmountable problems in production. A lack of n-achievement also retards entrepreneurship. N-achievement is the motivational drive of the individual which emphasizes self-reliance as he attempts to better his economic and social life.[25] Many people in underdeveloped nations lack n-achievement because of the block of vertical immobility, i.e. they resign themselves to a lower station in the society because they feel that it is impossible to better themselves. With this apathetic attitude, entrepreneurship is not forthcoming within the economy.

Cultural obstacles

Cultural obstacles present a unique problem. For a nation to achieve economic development, these obstacles must be overcome. However, if the people are strongly oriented toward their traditional culture and wish to maintain it, are satisfactions being maximized when these traditions are destroyed? Let it be assumed that economic development is the desirable goal for the society. What, then, are the cultural obstacles which permeate the nation?

The rural life is often preferred to the urban life. Many peasants would probably remain in agriculture even if industrial employment were available.

The industrial labor force poses problems. Aside from usually lacking the necessary skills, the labor force is not industrially disciplined, e.g. they commit excessive absenteeism.[26] A backward bending labor supply curve is typical in many nations. Laborers work for a few days and then

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[25] David McClellan, Studies in Motivation (New York: Appleton-Century-Croft, Inc., 1955), p. 415. N-achievement is the need for achievement.

[26] Kurihara, op. cit., p. 73.

use their wages to loaf for as long a period as possible, i.e. a worker will labor long enough to earn wages so that he can sustain himself during a period of leisure.

The tradition of the "extended family" destroys incentive and hinders entrepreneurship. Men who do attempt to better their economic conditions change their outlook as soon as any surplus of goods which they accumulate is consumed by relatives, who have the right to do so by custom.

One governmental problem is acute. Historically, civil service has been on a patronage basis. The result has been a weak and, often, a corrupt public administration. Tax collection has been inefficient and unjust. Graft has often been exposed in the area of commercial policy. Political instability reinforces these tendencies.

Inflation

Related to many of the other obstacles is inflation which is often rampant and almost inherent within many underdeveloped nations. Goods and services demanded by the wealthy for "conspicuous consumption" are often in limited supply. The "revolution of expectation" among the masses has increased their demand for goods and services, which are also in short supply.[27] Supply is limited because of the previously mentioned problems of production. The foreign exchange shortage which limits the capacity to import increases inflationary tendencies. Inflation breeds inflation when a capital flight from the nation is caused by it. Investment of this capital could, in the long run, produce goods and services which could alleviate inflationary pressures.

Hirschman contends that inflation can be an inducement to develop-

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[27]Krause attributes the coinage of the label, "revolution of rising expectations," to Adali Stevenson. Krause, op. cit., p. 43.

ment if it is restrained from developing into a hyperinflation.[28] Basically, his reasoning is that price rises signal increased profit margins which will induce entrepreneurs and investment. If these two items are forthcoming, then a nation can expand its production and raise real incomes. However, for this paper, let it be assumed that inflation should be controlled lest it become hyperinflation and because of the adverse effects that it has on the balance of payments.

Foreign exchange shortage

Political instability promotes another obstacle to development, the foreign exchange shortage. The wealthy individuals of an underdeveloped nation will often send their capital abroad to financial centers in politically secure nations. The investment climate within the nation is often poor for foreign investors because of the uncertainty of the political situation. Thus, little foreign capital is forthcoming. Both the tendencies of a capital outflow and the lack of a capital inflow worsen a nation's balance of payments problem. A worsening of the balance of payments diminishes the already too meager foreign exchange supply.

Other than the net capital outflow, what factors cause a drain on the foreign exchange supply? Imports of capital goods are needed to expand domestic industry. Depending on the nation, industry may also need raw material and fuel imports. Consumer goods imports are often rising as the wealthy indulge in "conspicuous consumption" and the masses attempt to emulate higher living standards. To purchase imports, nations have to export to earn foreign exchange. But many underdeveloped nations depend on primary product export conclaves which face limited international

[28] A. O. Hirschman, Strategy of Economic Development (New Haven and London: Yale University Press, 1962), p. 163-164.

markets. As a result these countries have difficulties in expanding the foreign exchange supply.

<u>Prebisch-Myrdal thesis</u>

Economic literature since 1950 has had a large amount of material devoted to the import-export relationship and its effects on the supply of foreign exchange in an underdeveloped nation. This material has been centered about the writings of Raul Prebisch and Gunnar Myrdal. Both of these writers contend that underdeveloped nations receive disproportionately small benefits from international trade in comparison with the advanced nations. Their arguments, known as the Prebisch-Myrdal thesis, will be examined in detail.

Preceeding the Prebisch-Myrdal thesis, was the argument of Mihail Manoilescui, who was Rumanian Minister of Industry and Trade during the latter 1920's. While serving in that capacity, he maintained that the free trade implications of comparative cost theory did not apply to the underdeveloped nations whose economies were primarily based on agriculture and whose agricultural productivity was low.[29] Agricultural production was inferior to industrial because capital and labor were assumed to be more productive in industry than in agriculture. This argument has been named the "infant economy" argument and has important implications concerning imports and commercial policy, as shall be seen in the next chapter.

Prebisch, in his thesis, assumes the existence of a Centre and a Periphery. The Centre is the developed industrial nations of the world. When Prebisch first appeared with his thesis around 1950, the U.S. was considered to be the Centre. At present, the Centre would also have to

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[29]Meier and Baldwin, <u>op. cit</u>., p. 399.

include the industrial nations of Western Europe, Canada, and Japan. The raw material producing areas of the world are the Periphery. The majority of the nations of Africa, Asia, and Latin America comprise the Periphery.

The Classical theory of the international division of labor assumed that the benefits of the maximization of production, income, and consumption would be spread to both the Centre and the Periphery. According to Prebisch, this assumption is invalid. Two factors have derived the Periphery of "the fruits of higher productivity."[30] First, the Centre has a low income elasticity of demand for imports. Secondly, the prices that the Periphery has paid for imports have reamined constant or have risen.

The Centre's low income elasticity of demand for imports stems from its low growth of demand for food and the lay in the growth of its demand for primary products. Engel's Law and the pronounced tendency of the developed nations to employ a protectionist policy with regard to agricultural products substantiate the assumption of a low growth rate of demand for imported foodstuffs by the Centre. The lag in the growth of demand for primary products is attributable to two factors. As technology has advanced in the developed nations, primary inputs have been used more efficiently. An increased use of synthetic substitutes in the Centre has resulted from advancing technology. Nurske has asserted that a shift from "light" to "heavy" industries has also reduced the Centre's demand for primary imports.[31] This shift has occurred as textile industries have been established in cotton growing areas. Thus, the primary import, cotton, is imported by the Centre much less than formerly because Periphery

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[30] Werner Baer, "The Economics of Prebisch and ECLA," Economic Development and Cultural Change, Vol. X, No. 2 (Jan., 1962), p. 170.

[31] Ragnar Nurske, Patterns of Trade and Development (New York: Oxford University Press, 1961), p. 23.

nations such as India, Mexico, and Pakistan manufacture their own textile products.

Complementing the Centre's low income elasticity of demand for imports is a tendency for the ratio of foreign trade to national income to decline as Net National Product increases. Imports as a percentage of national income in the U.S. declined from 15% in 1870 to 10% in 1913 to approximately 3% at present.[32] The same trend has appeared in Great Britain and in Sweden.[33] This trend has occurred because a rising percentage of new income is spent for services which are consumed on the spot, rather than for goods (i.e. few services enter into international trade channels).

Prebisch assumes that three factors have caused the Periphery's import prices to remain constant or rise.[34] First, monopolistic elements of the Centre restrict supply to maximize their profit position. Secondly, the strong trade unions of the Centre demand higher wages which hold prices constant if productivity in the Centre increases. Prices will probably rise if wages increase faster than productivity. If costs of production do fall in the Centre, then the entrepreneurs hold prices constant and increase their incomes from profits. Thirdly, the high income elasticity of the Periphery's demand for imports may equal the productivity rises of the Centre. Capital good imports are needed for the Periphery's investment program and can be best obtained from the Centre where technical progress has been greatest. In an effort to emu-

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[32] Charles Kindleberger, Economic Development (New York: The McGraw - Hill Book Company, Inc., 1958), p. 1-7.

[33] Ibid.

[34] Werner, op. cit., p. 170.

late the richer Centre's consumption habits, the Periphery imports consumer goods.

The labor market is assumed to be competitive in an underdeveloped nation.[35] Wages are, therefore, held constant or reduced as the "disguised unemployed" exert pressure on the labor market. The "disguised unemployment" of an underdeveloped nation are the people who are engaged in agriculture. The marginal productivity of their labor is usually quite low and may even be negative.

Higher productivity which accrues from technical progress lowers labor input requirements and the costs of production in the Periphery's export sectors. Increases in productivity must be equaled by increases in production or else employment declines. However, competition increases in the Periphery's export markets as each firm attempts to gain a larger share of the Centre's limited markets. The increased competition and lower costs of production drive export prices down. But because the Centre has a low income elasticity for imports, it is unprofitable for Periphery firms to expand production. The results are a decline in employment, a deterioration in the terms of trade, and a constraint on capital accumulation.

Employment declines because productivity increases in the export sector are not matched with increases in the volume of production. Therefore, a smaller labor force is needed in the export sector.

A deterioration in the terms of trade occurs as export prices fall. Import prices rise or remain constant, thus requiring a greater amount of exports to purchase the same amount of imports. In this situation a nation must export a greater quantity of goods, cet. par., to maintain the level

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[35] *Ibid.*, p. 172.

of imports it is receiving. But the products of an underdeveloped nation's export sectors face a limited international market. Therefore, an underdeveloped nation is forced to lower the amount of goods that it imports, i.e. reduce its capacity to import.

A fall in export prices reduces profits in the export sector or holds them constant. Domestic savings from export profits are reduced or held constant. Therefore, with domestic savings limited in this manner, domestic capital accumulation is constrained.

Standards of living are prevented from rising in the Periphery as a result of the deterioration in the terms of trade. Domestic capital accumulation which is necessary to expand production facilities has been retarded. The reduced capacity to import limits the amount of capital goods which a nation needs to build productive facilities. Employment opportunities are restricted because productive facilities are restrained from increasing. Employment has declined in the export sector because the productivity increases in this sector are larger than the increases in production. Thus, low domestic employment and production levels prevent a rise in living standards.

Historically, according to Prebisch, "the price relation turned steadily against primary production from the 1870's until the Second World War."[36] Table 1 is used to substantiate this point.

Prebisch based his thesis on the statistics used in Table 1. The statistics were based on data displaying a rise in the British terms of trade. British import prices were computed C.I.F. while export prices

[36] United Nations, The Economic Development of Latin America (New York, 1960), quoted by Werner, op. cit., p. 169,

were calculated F.O.B.[37] Freight costs declined between 1876 and 1947.[38] This would overstate the rise in the British terms of trade or, conversely, overstate the fall in the Periphery's terms of trade.

TABLE 1.

RATIO OF PRICES OF PRIMARY COMMODITIES TO THOSE OF MANUFACTURED GOODS (AVERAGE IMPORT AND EXPORT PRICES, ACCORDING TO DATA OF THE BOARD OF TRADE)

BASE: 1876-80 = 100

Periods		Amount of finished products obtainable for a given quantity of primary commodities
1876-80	....	100
1881-85	....	102.4
1886-90	....	96.3
1891-95	....	90.1
1896-1900	....	87.1
1901-05	....	84.6
1906-10	....	85.8
1911-13	....	85.8
—		—
1921-25	....	67.3
1926-30	....	73.3
1931-35	....	62.0
1936-38	....	64.1
—		—
1946-47	....	68.7

Source: "Post War Price Relations in Trade Between Underdeveloped and Industrialized Countries," document E/CN.1/Sub.3/W.5, 23 February 1949.

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[37] Werner, op. cit., p. 175.

[38] Ibid.

Another general criticism of the statistics in Table 1 which is true of most statistics of this nature is that they do not disclose changes in product quality or in the introduction of new goods. Prebisch assumed technical progress to be greatest in the Centre. He also assumed that the Centre's export prices would remain constant or rise. Therefore, new products or improved products of the Centre would cost the Periphery more while the Periphery's primary product exports would remain constant.

However, evidence accumulated during the decade of the 1950's seems to further validate Prebisch's thesis. Table 2 shows the change in the terms of trade of several nations of the Centre and the Periphery during the 1950's.

TABLE 2

TERMS OF TRADE OF SELECTED COUNTRIES IN THE 1950's

(1953 = 100)

Country	1950	1951	1954	1955	1956	1957	1958	1959	1960	
United States	100	91	96	98	98	102	106	109	108	(Aug.)
Latin America	107	100	109	99	94	92	88	84	83	(June)
Argentina		111	97	93	80	74	81	88	94	(II)
Bolivia	101	128	100	98	102	89	82	88	89	(II)
Brazil	112	112	136	106	99	96	93	79		
Colombia	87	92	130	105	116	103	88	78	76	(June)
France	98	88	95	97	97	95	99	99	102	(II)
West Germany	80	80	100	98	99	100	108	110	111	(Sept.)
United Kingdom	100	88	100	99	101	104	111	111	114	(Sept.)
India	109	130	108	108	107	98	103	103	109	(May)
Australia	121	119	92	81	80	82	64	69	65	(III)
Ghana	94	103	148	132	101	95	135	121	100	(I)
Japan	92	104	100	100	104	101	103	111	116	(Sept.)

Source: International Monetary Fund, International Financial Statistics (February, 1961).

Myrdal's thesis for the most part parallels that of Prebisch. However, certain observations also complement Prebisch's thesis. Myrdal assumes the existence of "a sort of laissez faire," i.e. there are few interferences with market forces in the non-Communist world.[39] Also assumed is the hypothesis that the commercial policies of the underdeveloped nations are of the traditional type, i.e. each nation follows the laws of comparative advantage and free trade.[40] Under these assumptions, international trade has 'backwash' and 'spread' effects.[41] 'Backwash' effects retard the economic growth of underdeveloped nations. Skilled labor and entrepreneurs, scarce factors in underdeveloped nations, emigrate from the poorer areas to the richer areas of the world to take advantage of better job opportunities. Capital emigrates in the same manner as investors seek better investment climates, thus retarding capital accumulation in the poorer areas. The poorer areas are faced with greater economic problems as their capital, entrepreneurs, and skilled labor leave because these factors are their most productive agents, i.e. domestic production is difficult to undertake with scarce supplies of these factors.

'Spread' effects provide stimulants to economic growth for the underdeveloped nation. As developed nations grow, they will purchase more goods from poorer nations, thus providing the poorer areas with a larger market and a greater amount of foreign exchange. Capital from the developed nations may flow into the underdeveloped nations as investment opportunities slacken in the developed nations.

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[39]Gunnar Myrdal, Economic Theory and Underdeveloped Regions, p. 50.

[40]*Ibid.*, p. 50.

[41]*Ibid.*, p. 27-37.

Overall, Myrdal feels that the 'backwash' effects will tend to predominate over the 'spread' effects.[42] Hirschman agrees with Myrdal on this point.[43]

Most of the obstacles presented in the Prebisch-Myrdal thesis stem directly from an underdeveloped nation's inability to earn foreign exchange. Basically, a lack of foreign exchange limits the capacity to import capital goods. By being a constraint on capital goods imports, a lack of foreign exchange retards the nation's domestic productive capacity. Low levels of production hold per capita real incomes and standards of living in check. Foreign exchange could be expanded if the nation were a recipient of foreign aid from a developed nation. Aid, if efficiently used could help in solving the problems of production and per capita real incomes. However, it is beyond the scope of this paper to deal with foreign aid.

Criteria for Overcoming Obstacles

Within the framework provided by the foregoing obstacles, certain objectives may be established to serve as criteria for commercial policy.

The primary objective to be considered is that of raising the material well being within the nation. Stated more concisely, per capital real incomes have to rise. To accomplish this end, productivity and output have to be increased. What methods can accomplish these ends?

Political stability is a necessary prerequisite for a nation which wants to attain economic development. To achieve political stability, the wants of the masses have to be satisfied to a greater extent. Income

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[42] Ibid., p. 55.

[43] Hirschman, op. cit., p. 189.

redistribution could aid in satisfying the wants of the masses more fully. However, because this issue has ethical and ideological implications, it will be avoided. For purposes of expediency, let it be assumed that the political system will become more stable as economic conditions improve.

The foreign exchange shortage is the prime obstacle to overcome in order to raise productivity and output, and, thus, improve economic conditions. Foreign exchange earnings should be expanded, if possible to increase the capacity to import. Domestic production in order to expand needs capital good imports, and, perhaps, fuel and raw materials. Foreign exchange has to be allocated through the method most conducive to economic development.

Inflationary pressures have to be reduced to preserve foreign exchange.

Capital accumulation has to increase. Domestic savings, if possible, should be squeezed out of the economy. Savings of the rich, rather than being allowed to flow abroad, should be channeled into domestic investment.

Employment opportunities have to increase. Workers with incomes save more than "disguised unemployed."

Entrepreneurship must be induced.

Cultural obstacles, e.g. the backward bending supply curve of labor, must be overcome. Incentives have to be established to induce the people to work harder and save more.

Utilizing these broad criteria, what role can imports and commercial policy play in achieving the objective of raising per capita incomes? The next section is devoted to this question.

IV. THE ROLE OF IMPORTS AND COMMERCIAL POLICY IN THE PROCESS OF ECONOMIC DEVELOPMENT

In every economy, decisions have to be made concerning import policy. As the preceding has suggested, these decisions are especially important in the underdeveloped nation.

In this chapter, the impact that imports and import policy have upon a nation's industrial development will be examined. Stress will be placed on industrial development because of the important effects which it has on production and employment levels.

Organizationally, this chapter will proceed along the following lines. First, the role that imports play during the initial stages of development will be considered.[44] During this phase, a free flow of imports and the impact which they can have in overcoming specific obstacles can orient a nation toward a production climate. Second, reasons will be advanced as to why a policy of selective restriction of imports should replace the initial policy of free trade in order to spur economic development. Third, the nature of the domestic industry which can

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[44]The initial stages are considered to be the period when a nation is making the transition from a traditional society to the society ready to "take off" into self-sustaining economic growth periods. The traditional society is one which has inherited a social hierarchy from the past. The hierarchy controls the political-economic system of the nation. Before a nation can pass into the "take off" stage, it must achieve certain "preconditions of growth." A central political authority must be established. Science must be introduced into the economy and must be translated into agricultural and industrial production. An industrial sector and a commercial system must be started. 'Social overhead' capital must be developed. Having established these prerequisites, a nation must mobilize its resources for the "take off" stage when at least ten to twelve percent of its National Income should be invested. For more detail, see Walter Rostow, The Five Stages of Economic Growth (Cambridge: University Press, 1960), p. 4-7 and p. 17-31.

be encouraged by "selective protectionism" will be examined. Certain prerequisites which must exist for the induced industry will be discussed. Also, several contentions regarding the type of industry to be induced will be advanced. Fourth, the effects of import policies on economic development will be considered. A policy of "selective protectionism" to induce domestic industry will involve the use of import controls, and these import controls can stimulate economic development.

The Positive Impact of Imports

Imports have a positive impact on the economy in that they overcome some of the obstacles to economic growth. Imports provide the stimulus needed to overcome barriers which are restraining productivity. They can overwhelm cultural obstacles and monopolies which may be stagnating the economy. They stimulate new technology. New investment can result directly from imports. As a final result, imports can orientate a nation toward a production climate. Let us examine the positive impact of imports in more detail.

Cultural obstacles

Cultural obstacles may be affected by the "demonstration effect" of imports. Consumer desire for products is increased as they are subjected to a higher frequency of exposure to the imports, i.e. imports condition the consumer to the product by breaking down his initial resistance to it.[45] As consumer demand for imports increases, the attitudes of the consumers may change. Workers will no longer substitute leisure for work because the greater amount of pay that corresponds with more work will purchase newly desired goods. This type of worker reaction will reshape

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[45] Hirschman, op. cit., p. 121.

the backward bending supply curve of labor, described earlier, into a labor supply function more conducive to development. Labor will work at any time for a given wage and will not substitute leisure for work. By stimulating the people's desire for goods, imports provide incentives for people to work harder and produce more.

The extended family tradition may be destroyed when members of a family who had been living on the earnings of the family's productive member begin to labor so that they can earn money to purchase new goods. Rural labor will move to the urban areas if their newly created demand for goods can be satisfied there. Thus imports can realign people's attitudes and, by so doing, create the forces necessary to overcome cultural obstacles. However, the new demand caused by imports can create inflationary pressures and adverse pressures on the foreign exchange supply. These problems will be discussed later when imports succumb to domestic industrial development.

The demand creation effect of imports induces entrepreneurship. Imports lend a certain amount of order, probability, and predictability to economic relationships. The existence of a domestic market is proven as imports are purchased within a nation.[46] The volume of imports provides some knowledge of the size of the domestic market.

Over a period of time, import statistics reveal trends and characteristics in the domestic market. These factors may provide knowledge of economic opportunities and be the basis of profit estimates. Thus, an inducement mechanism for entrepreneurs is inherent in the knowledge which stems from import statistics, i.e. imports are "isotopes of market

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[46] Ibid.

research" providing knowledge of the domestic market for future entrepreneurs.[47]

Monopolies

Monopolies may exist which are stagnating the economy. Monopolies eliminate some of the forces which are necessary for economic growth, e.g. entrepreneurs are unable to enter productive areas which are controlled by monopolists.

Imports provide competition which can force the monopolies to become more efficient. The monopoly may have to lower prices and, perhaps expand output because of the competitive pressure exerted by imports. The lower prices which the monopolies receive may force them to achieve new efficiencies in their operation. If greater efficiency is not forthcoming, imports may force the monopolies to discontinue operations, e.g. the monopolist may not be able to lower his prices to the extent that his product is competitive with the import product.

New techniques

Techniques may be reproduced by the direct copying of the objects incorporating them.[48] In other words, by studying a product, technicians can determine the processes and/or equipment that was used to manufacture the product. Imports can be the medium by which new techniques are absorbed into the economy.

By breaking down cultural barriers, imports strengthen the "propensity to accept innovations."[49] Entrepreneurs are attracted toward the

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[47] S. B. Linder, An Ess on Trade and Transformation (New York: John Wiley & Sons, 1961), p. 138.

[48] William Parker, "Economic Development in Historical Perspective," Economic Development and Cultural Change, Vol. X, No. 1, (Oct., 1961), p. 4.

[49] Ibid., p. 5.

new items and processes which can be derived from imports when they realize a profit can be made from the use of these new processes.

Imports provide a means for the dissemination of technology. The diffusion of technology depends on the erosion of environments which resist change. Specifically, the "demonstration effect" and the inducement of entrepreneurship are two factors which may place the existing status quo system in a state of disequilibrium, which is susceptible to change. The change in the people's attitudes as a result of these two factors can create forces, e.g. n-achievement, among the people which will break down cultural barriers which thwart change.

Reinforcing the tendencies of change, imports can overcome complementarities dictated by the present technology of underdeveloped nations. Capital goods imports and raw materials imports can lower the existing capital output ratio if the new equipment and/or new product processes produce a greater output per unit of capital than was previously achieved. A lower capital output ratio could allocate the capital in a manner more conducive to economic development, i.e. higher productivity per unit of capital could be a benefit of a lower capital-output ratio. Assuming that the capacity creating effects of the new equipment or processes are greater than the income creating effects, inflationary tendencies could be alleviated. However, if the new capital or process has greater income creating effects, inflationary tendencies will be strengthened.

New investment

Imports need facilities which stimulate investment and employment. Docks, warehouses, transportation facilities, etc. must be constructed to facilitate the handling and distribution of imports. Retail organizations have to be established. The transportation facilities and retail organizations are external economies for new production units. Workers are needed to construct and maintain the import facilities. Their incomes will add to inflationary pressures, but the flow of imports will dampen these same pressures. The adverse pressure on the foreign exchange supply remains, however.

Although the direct investment which is stimulated by imports is only a small portion of the capital formation needed by an underdeveloped nation, it may aid in overcoming the inertia of the economy.

More importantly it is hoped that the imports will be influential in creating a social-political-economic climate conducive to substantial increases in investment from both domestic and foreign sources.

Production climate

Imports can orient the underdeveloped nation toward a production climate. Environments which resist new products, new technology, and new techniques can be eroded by imports. By stimulating the desire of the people for new goods and by disseminating knowledge about the domestic market, imports can overcome cultural barriers and induce higher productivity from workers and induce entrepreneurship. External economies stem from imports. The dynamic element of change has been introduced into the economy. Emphasis has been placed on raising production, employment, and income.

Imports can have a positive impact on the early stages of a nation's economic development. But after setting these forces into motion, imports will be doomed to extinction by the very same forces that they created. Why do imports cause their own extinction? The next section is devoted to this question.

Some Justifications for Selective Import Restriction

Although imports may alleviate several problems confronting underdeveloped nations, the fundamental structural difficulty remains. New domestic industry is still necessary to raise production, employment, and income. Domestically produced goods can satisfy excessive domestic demand and, thus, alleviate inflationary pressures. The foreign exchange problem is relieved if domestic goods are substituted for imports. However, new plants in an underdeveloped nation, because of their lack of economies of scale and lack of external economies, would not be competitive with the industry of advanced nations. What is the solution to this problem?

A number of economists have addressed themselves to this problem with varying views. But, the general theme of those to be discussed is one of "selective protectionism."

According to Prebisch, the underdeveloped nations need a "rational and selective import policy...to encourage...changes in composition in order to accelerate the rate of economic growth, so that imports are adapted to the need for greater technical progress in primary production and for more intense industrial development."[50] "Changes in composition" mean changes in the economic structure of the nation.

Prebisch advocates that the underdeveloped nations should industrialize.[51] Protectionist import policies will aid in the accomplishment of this task. He argues that consumer goods imports should be restricted in order to conserve foreign exchange. Capital good imports should be

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[50]Raul Prebisch, "Commercial Policy in the Underdeveloped Nations," American Economic Review, Vol. XLIX, No. 2, (May, 1959), p. 265.

[51]Ibid., p. 266.

admitted duty free so that domestic industry will have the equipment which it needs. Domestic industrial expansion behind the walls of such protection will prevent transfer of the "fruits of higher productivity" to the Centre.[52]

Myrdal concurs with Prebisch. Protectionism is a tool which underdeveloped nations should utilize in their attempts to develop.

Myrdal believes that the social value of protected industries is greater than their private value.[53] New industries would benefit the economy, not through profits, but by providing external economies for future industry. Any profits earned, of course, could be channeled into further investment. Also, the "disguised unemployed" labor which is employed as a result of import restrictions is a "net advantage to a country."[54]

Protectionism is necessary to promote higher production in agriculture. Industry provides technology for agriculture, not vice versa, and to raise productivity in the agricultural sector, technical progress is needed. Therefore, industry which can only be formed with the aid of protectionism may be the only source of the technology which will raise productivity in agriculture.

Protectionism may be necessary because industry can "make use of growing resources which cannot with comparative advantage be absorbed by the traditional sectors."[55]

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[52]Ibid.

[53]Myrdal, op. cit., p. 95.

[54]Ibid.

[55]Nurske, op. cit., p. 36.

Manufacturing industries which are initiated because competitive imports have been restricted are growth points for future economic development. Industrialization not only creates Marshallian external economies and increases technical knowledge, but it adds a new dynamism to the economy and it stimulates mass urban education.[56]

A nucleus of new industry induced by import restrictions is an insurance premium against the risk of future disaster to the predominant sector's export market.[57] If the predominant sector would lose its external demand, a period of acute hardship would be in store for the nation until resources had been shifted to new uses. However, a nucleus of new industry would cause a shift of resources before the period of acute poverty would occur.

The foregoing reasons have been advanced to substantiate the use of import controls to induce new domestic industrial development. But, upon what basis should the new domestic industry be initiated?

Factors Influencing Domestic Industry

The United Nation's Manual on Economic Development Projects states:

> "Substitution of imported goods and services normally constitutes one of the greatest possibilities for developing domestic production. A careful examination of import statistics can provide the basis for selecting possible projects, considering in a first approximation the quantum of specific imports, and the minimum economic scale for producing them."[58]

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[56] H. W. Singer, "The Distribution of Gains Between Investing and Borrowing Countries," American Economic Review Papers and Proceedings, Vol. XL, 44 (May, 1950), p. 481.

[57] J. E. Meade, Trade and Welfare (London: Oxford University Press, 1955), p. 257.

[58] United Nations, Manual on Economic Development Projects (E/CN.12/426/Add.1/Rev., 1958), p. 7.

Thus, it seems that the United Nations recommends import substitution and import processing industry if a "minimum economic scale for producing them" exists.

Import substitution and import processing industries do have several advantages. As seen previously, imports can provide domestic entrepreneurs with information about the domestic market. With this information, domestic entrepreneurs would probably be inclined to invest in import substitution industries, if protection is granted these industries. Domestic processing of imports would mean that this type of work would be done in the underdeveloped nation rather than in the nation in which the imports originated. A domestic market is known to exist for this industry. Thus, entrepreneurs would be willing to enter this area because little risk is involved. If import protection is now granted to import substitution industry, the prices of these goods will rise. Thus, domestic profit expectations of these goods will rise and resources are induced to flow toward this industry. Import substitution and import processing firms save foreign exchange and, thus, reduce pressure on the nation's balance of payments, because the value of imports is lowered.

Import substitution industry is preferable to expansion in the traditional export sectors or to manufacturing for export.[59] The traditional export sectors face a low rate of expansion in external demand. Exports of manufactures would be dependent on commercial policy in the "older industrial nations." Manufacturing for export is also restricted by market entry and transportation costs. Therefore, the only means for industrialization is output expansion for home consumption.[60] Import

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[59]Nurske, op. cit., p. 41-44.

[60]*Ibid.*, p. 41.

substitution industry is best for this expansion because it can induce entrepreneurship and other resources.

Several factors have to be taken into consideration when an attempt is made to determine the "minimum economic scale" of an industry and the proper selection of an industry. An estimation of costs is the vital factor because the estimated price of the product has to be low enough to sustain demand for the product. Transportation costs are crucial. The weight, size, shape, fragility, etc., of the product are important elements to be considered. A suitable market has to exist. The prerequisites of a suitable physical, social, and political environment have to exist. There must be an endowment of the necessary factors of production, i.e. a proper resource mix is necessary for industrialization. However, imports could overcome some absolute input limitations. Could the capital equipment, labor, etc. used in the "infant industry" be utilized more efficiently elsewhere even if the "infant" might eventually become economically feasible? Should the early operating losses due to technical diseconomies, e.g. the training of labor, be charged to capital costs? Consumers may have strong loyalties toward the products of foreign suppliers. Can the proposed industry produce a good that is of comparable quality when compared with the same good produced by foreign industry? Will the industry save or earn foreign exchange? Will the creation of a new industry alleviate the risk of a future period of acute hardship resulting from disaster to the nation's export market? What is the probability that such a risk will occur? What is the social undesirability of that risk? Will the new industry provide external economies? Should all new industry or "infant industries" be incorporated into "industrial estates" where each industry would contribute and derive external economies? Does the proper social overhead capital exist? These are some of the factors which have to be examined in the selection of "infant industries."

Meier contends that if protection is to contribute to development, it must stimulate basic key industries, rather than import competing industries.[61] Hirschman advocates that "infant industries" should be established if they have a high "backward linkage," i.e. a high dependence on purchases from other sectors, because this will induce establishment of industries to supply the "infant industry."[62] Both of these views should be added as criteria in the selection of an "infant industry."

Viner has criticized the use of "infant industries." He contends that Listian doctrine has been rejected on a historical and a practical basis.[63] The selection of industry has often been arbitrary or irrational. Once protection is granted, a way is opened for promiscuous protection. Protection shields a firm against the consequences of inertia, inefficiency, or restrictive monopoly and, thus, may easily stifle a firm's progress. Protection tends to become permanent. Protection entails costs for the nation as a whole, including other industries if they use the protected industry's goods as inputs. Unprotected industries also have to compete for skilled labor with protected industries. Market forces tend to evade protective controls so that the additional costs of protection may be evaded. Often supporting controls have to be established. Subsidies are

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[61] Gerald Meier, "The Problem of Limited Economic Development," Economics of Underdevelopment, ed. A. N. Ugarwala and S. P. Singh, (London: Oxford University Press, 1958)

[62] Hirschman, op. cit., p. 112.

[63] Jacob Viner, International Trade and Economic Development (Glencoe: The Free Press, 1952), p. 59.

better than protection because the cost of the aid is calculable and prices are lowered to the rest of the nation. These problems must be overcome in the selection of an "infant industry."

Import Controls

It has been contended that import controls should be utilized by the underdeveloped nations as they attempt to industrialize. Levels of income, production, and employment supposedly can be raised as industrialization takes place. Some points have been raised concerning the use of "infant industry" in economic development. However, beside the "infant industry" proposal, little has been said about the more general impact of import controls. What are some of the major effects of import controls on economic development?

Import controls, if properly utilized, can diversify the economy and reduce its exposure to a fluctuating world demand. Diversifying the economy isolates it to a greater extent against foreign depressions. Diversification will also counteract the 'bias' of the economy towards the export production of primary products. Caution must be exercised, however, so that export production is not reduced or that resources are not pulled out of the export sector if it has a comparative advantage and is earning foreign exchange.

Import controls can be used, as Prebisch recommends, to alter the composition of imports. Consumer goods can be restricted so that scarce foreign exchange can be used to purchase capital goods. However, when consumer good imports are restricted, inflationary pressures mount. Fewer goods are available for domestic consumption, and consumers will bid the prices of these goods up. Import duties are inflationary also because consumers have to pay higher prices for imports, i.e. imported goods' prices rise by the amount of the import duty. Inflation of this type, as Hirschman contends, may be the inducement mechanism which will stimulate the start of a consumer goods industry. If the total amount spent for imports is less after the prices of the imports rise, i.e. the demand for imports is elastic, then a greater amount of consumer savings is available for domestic capital accumulation. However, luxury goods protectionism, initiated to promote a higher level of domestic savings and to conserve foreign exchange, can give rise to higher priced domestic luxury goods industry which would draw the nation's scarce supply of capital into relatively unessential uses.

An "optimum tariff" may be used to improve the terms of trade. Underdeveloped nation A could impose a tariff on the products of advanced nation B, in the hope that B will lower the prices of her exports in order to gain access to A's market. If B would lower its export prices, A would be able to obtain her imports at a lower price and, thus, her terms of trade would improve. However, the underdeveloped nations lack the monopoly and monopsony power which is necessary to bargain effectively with the richer nations who might retaliate. Perhaps, underdeveloped nations could, as a group, levy "optimum tariffs" and prevent a deterioration in their terms of trade. But the question of regional blocs is beyond the scope of this paper.

Investment

Import duties have varied effects on the inducement of domestic production. Import duties do raise the prices of the protected goods, and to a lesser extent, the price of substitutes. Thus, the profit expectations of the protected goods and their substitutes will rise, and resources are induced to flow towards them. The profit expectations of complementary goods and of goods which used the protected goods or their substitutes as inputs will fall, unless they can effectuate a corresponding price rise.

Tariffs may attract foreign investment to the underdeveloped nations. "Tariff factories" may be established by foreign companies in the underdeveloped nation so that the firm can sell its products without having to clear a prohibitive tariff. To entice this type of investment, the underdeveloped nation must have a market of sufficient size which will have enough demand to justify new industry.

"Tariff factories" have several advantages. Foreign capital is used to expand domestic production, incomes, and employment. Thus, it adds to the domestic supply of capital. "Tariff factories" can reduce inflationary pressures if the capacity creation, i.e. production of goods, of the plant is greater than the incomes which are generated. In the short run, "tariff factories" help the underdeveloped nation's balance of payments problem. Foreign capital flows into the nation, thus raising the nation's supply of foreign exchange. This will be somewhat offset in the payments balance by an inflow of capital goods. In the long run, however, the adverse pressures on the balance of payments will become stronger as dividends, patent license payments, etc. are claimed by the foreign capitalists.

Import duties can be utilized to alter the domestic distribution of income, which may be a politically desirable goal in an underdeveloped nation. Progressive import duty rates tax the wealthy to a greater extent than the poorer members of the economy. The revenue earned from import duties can be used for economic development projects which would benefit the majority of the people within the nation.

Import controls can enhance the liquidity of the banking system by alleviating the drain on its financial resources. If import controls restrict the amount of imports in both physical and monetary units, then a greater amount of the underdeveloped nation's currency remains within its banking system. With a larger amount of currency in the banking system, the interest rate would tend to be lower. A lower interest rate would, by Keynes' General Theory, tend to stimulate investment. However, interest rates have to be maintained at a level which is high enough to induce the national's short term capital to remain within the nation. Also, if possible, the interest rate should be at a sufficient level to entice short term capital from abroad. Foreign short term capital flowing into the nation would give the banking system a higher degree of liquidity and it would aid in alleviating the balance of payments problem.

Criticisms of controls

Import controls are often criticized because they do not allow world production and world trade to be optimized. However, national production is maximized with the aid of import controls, and maximization of national production is a goal in an underdeveloped nation.[64] Underdeveloped nations often do not worry about the optimization of world trade and world production because as Myrdal pointed out, nationalistic states do not always have a harmony of interests.[65]

Subsidies may be preferred to import duties because prices of products would lower and the cost of supporting an "infant industry" would be calculable.[66] However, import duties are a relatively cheap instrument

[64] Mead, op. cit., p. 169.

[65] Myrdal, op. cit., p. 136.

[66] Viner, op. cit., p. 59.

for the government to use. The use of import duties rather than subsidies does not force the government to allocate its scarce capital to directly productive activities, i.e. the use of subsidies would mean that the government would be spending a portion of its funds to support private industrial enterprises. Import duties, by 'taxing' purchases of imports, raise revenue which the government of an underdeveloped nation can use for development purposes, e.g. social overhead capital.

Import duties are often characterized as being complex and arbitrary. Trade regulating bureaucracies develop rigidities, inertia, and red tape which result in delays and additional costs for businessmen.[67] Import duties fall under the authority of the legislature. Rates are thus frozen for lengths of time.

Exchange controls - an alternative to trade controls

An alternative to import duties are exchange controls. Exchange controls are a currency criteria rather than a price criteria as are import duties. Exchange controls are more administratively flexible than trade controls. Exchange controls are more positive in their impact upon import levels. If currency is unavailable for a certain classification of imports, then these imports are domestically unobtainable.

Foreign exchange can be channeled, through the use of exchange controls, into the most desired development projects. Import licensing and/or quotas can be utilized to allocate foreign exchange. Desired imports can be "subsidized" to induce a desired project or industry, i.e. import quotas and/or licenses can be made available by the exchange control authority for certain imports which can only be used in specific projects or industries. Thus, exchange controls can draw resources to a desired

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[67] *Ibid.*, p. 106.

project or industry and this can reshape the nation's economy.[68] A corrupt administration can abuse this technique, however.

Progressive exchange rates supply the government with domestic currency which can be used for developmental purposes. Being progressive, the exchange rates provide a method for the taxation of the rich. Foreign exchange auctions have the same effect. Both of these methods can reduce inflationary pressures by transferring excessive private purchasing power to the government.

An underdeveloped nation may devalue its currency in an attempt to decrease imports and expand exports, and, thus, restore a payments balance. However, devaluation worsens the nation's terms of trade.

Exchange depreciation will not decrease imports if the level of prices and wages within the nation is not compressible. Exchange depreciation is of little aid if the demand for imports is price inelastic. Depreciation is ineffective in expanding exports because the developed nations have an inelastic demand for primary products. However, if the nation faces competition in the sale of its export products, depreciation will expand export sales.

Disregarding the regulations of the International Monetary Fund, if all the underdeveloped nations would appreciate, imports for each nation would cost less foreign exchange and exports would earn more foreign exchange. To accomplish this bettering of the terms of trade, all underdeveloped nations would have to appreciate so that no one of these nations would gain a competitive advantage in the sale of its exports.

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[68] Krause, op. cit., p. 233.

Two prime difficulties confront nations when they attempt to use exchange controls. I.M.F. regulations do not condone it. Exchange control authorities are often inept or corrupt in an underdeveloped nation, which is usually burdened with a poor civil service.

An interesting point is that the gold hoards of wealthy individuals in the underdeveloped nations could be used to great advantage.[69] The gold could be used to acquire capital goods from the advanced Western nations. The capital goods would accelerate industrial development in the underdeveloped nations. The gold that the Western nations would receive would give them a greater amount of the international liquidity that they require.

Exchange and/or trade controls employed to change demand from foreign to domestic goods must switch the demand in the right direction. Domestic productive capacity must be available to satisfy the domestic demand for these goods after the switch has occurred. Thus, import controls induce and demand the formation of domestic industry.

[69]Charles Kindleberger, International Economics (Homewood, Illinois: Richard D. Irwin, Inc., 1963), p. 69.

V. SUMMARY

From the foregoing discussion, it has been suggested that imports play a dynamic role in economic development. Imports set up forces which induce and stimulate development during the early stages of economic growth. After these forces have been initiated, imports restrain industrial development. Therefore, import controls must be utilized to induce domestic industrial production and the benefits that accrue to the nation from this production. To state this more concisely, imports pass through three stages while a nation is in the process of economic development. Chronologically, these stages, in terms of commercial policy, are free trade, "selective protectionism," and free trade.

Imports have their positive impact upon the economy in the first free trade period. Through the demonstration effect, imports provide incentives for people to work harder. Thus, imports overcome certain cultural obstacles. Entrepreneurs in underdeveloped nations need to be "imitators" and importers more than "innovators." Imports, in that they are a means to disseminate technology, induce entrepreneurship in this respect. By reducing uncertainty about the domestic market, imports also induce entrepreneurship in this respect. The indirect benefits which Mill observed would also accrue to a nation in this period.

During the period of protectionism, a selective restriction of imports occurs. Capital goods and raw materials are to be imported duty free as the Mercantilists advocated. These imports are used to develop industry and commerce, as List recommended. The "infant industry" argument is used to stimulate domestic industry, so that the nation's levels of production, employment, and incomes will rise. "Infant industry" also diversifies the nation's economy. Thus, the nation's reliance upon the export sector in terms of employment and income may be reduced.

Certain prerequisites have to exist before the "infant industry" is established. Predominate among the preconditions are a "minimum" resource mix and the existence of a domestic market. The existence of a domestic has been "proved" by imports. Absolute input limitations can be overcome by imports. Also, experience has shown that most mass production can be performed in most countries and climates with equal efficiency.[70] To substantiate this, the new "chemical technology" is based on "universally available materials."[71] Also, machine production has been standardized and, almost all workers can master the techniques needed to run these machines.[72]

Aside from the duty free importation of capital goods and raw materials to build domestic industry during the period of protectionism, consumer goods imports are to be restricted in order to preserve foreign exchange. The deterioration in the terms of trade has caused a foreign exchange shortage in the nation. By restricting consumer good imports, the nation can allocate foreign exchange for the purchase of capital goods rather than for the purchase of consumer goods. The restriction of consumer goods imports also allows "infant industry" to initiate operations without having to compete with the large scale industry of advanced nations.

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[70]J. M. Keynes, "National Self-Sufficiency," Yale Review, Vol. XXII, No. 4 (1933), p. 760.

[71]K.N.B. Nair, "Exchange Control and Economic Planning in Underdeveloped Countries," Indian Journal of Economics, (Oct., 1959), p. 164.

[72]Ibid.

Viner's criticisms of "infant industry" should not be overlooked. Flexibility is required of the use of imports and import controls in an underdeveloped nation as the nation passes from the second to the third period.

During the third period, free trade should result. The nation is, during this period, included among the ranks of the advanced nations. In this stage, duty free imports will aid in stimulating the economic liberty and freedom of competition which provide the most favorable environment for a dynamic economic growth.[73]

These stages are not absolute in nature. Each nation's economic progress may be different. Within a nation, various sectors may be in different stages of development. However, the three stages do demonstrate the various effects of imports during the process of economic development.

The various effects of imports provide criteria for underdeveloped nations as they select import policies which will aid in raising the material well being of the nation's people.

[73]Kindleberger, op. cit., p. 469-470.

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THE ROLE OF IMPORTS IN INDUCING ECONOMIC DEVELOPMENT

by

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AN ABSTRACT OF A MASTER'S REPORT

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ABSTRACT

This paper has two purposes. The first purpose is to ascertain the effects that imports have on economic development. The second purpose is to consider criteria that underdeveloped nation can utilize in the selection of proper import policies. Thus, the problem is to examine imports and import policies, and their impact on economic development.

The orientation of the paper can be attributed primarily to the influences of Hirschman, Prebisch, Myrdal, and Nurske.

To provide background material for the problem, a sketch of the various and, often, diverse historical views concerning imports and economic development was drawn.

Contemporary obstacles to economic development, basically comprised of impediments listed by Krause and the Prebisch-Myrdal thesis, were listed so that criteria could be established to overcome these factors retarding economic development.

Utilizing the established criteria, imports and import policies were examined as to their effect on economic development. Emphasis was placed on the growth of domestic industrial production.

Imports were viewed in a dynamic perspective. The positive impact which imports have on obstacles in a nation during its early stages of development was considered. Once this impact had been achieved, however, the manner in which imports restrained the growth of vitally needed industry was examined.

The manner in which import controls induce domestic industry was analyzed. Diversity within the economy and investment were stressed.

In the final summary, it was suggested that an economy should pass through three stages during the process of economic development. Chronologically, these stages are free trade, "selective protectionism," and free trade. These stages are relative in nature, and vary from nation to nation and within sectors of a nation.