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Prebisch on Commercial Policy for Less Developed Countries 5 pages

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Prebisch on Commercial Policy for Less Developed Countries

There have been numerous recent analyses of the differences in the nature and development of trade between the 19th Century and the 20th Century. Some discussions have concentrated on the implications of these differences for the process of economic development; 1/ others have provided prescriptions of policy for the less developed countries. Prominent among the latter is a recent article by Raul Prebisch, setting forth a recommended commercial policy for these countries. 2/ Prebisch' position as Executive Secretary of the Economic Commission for Latin America makes his proposal of considerably more than academic interest, and it is the purpose of the present paper to examine critically the main line of argument, and to establish the points of difference between it and the tariff policy generally recommended in neo-classical economics.

The Prebisch Proposal

For purposes of analysis, Prebisch begins by dividing the world into industrial centers and "peripheral countries engaged principally in primary production." He postulates that primary products have a relatively low elasticity of demand, with respect to both income and price, while industrial goods have relatively high income elasticities of demand.3/ He then proceeds to examine the appropriate basis for commercial policy for primary producing countries, considered as a whole.

Because of low price elasticities of demand for primary goods, increased exports of these products at any given moment will add relatively little (and, beyond some point, perhaps nothing) to the foreign exchange earnings of the peripheral countries. Because of low income elasticities of demand for primary goods, exports of these goods cannot be expected to parallel growth in industrial countries. Gains in productivity in the export industries of countries on the periphery (if they carry output to the point where sharp reductions in price are required to clear the market) may thus be almost completely "transferred" to the industrial countries. Countries on the periphery, therefore, cannot depend principally upon development of primary production as a basis for growth.

1/ See, for example, Ragnar Nurkse, Patterns of Trade and Development, Wicksell Lectures 1959, Stockholm.

2/ Raul Prebisch, "Commercial Policy in the Underdeveloped Countries," American Economic Review, Vol. XLIX No. 2, pp. 251-273.

3/ Prebisch makes no explicit assumption on the price elasticity of demand for industrial goods, but he appears to assume implicitly that it too is relatively inelastic. Prebisch' primary concern is with the implications of trade for growth, and so long as the income elasticity of demand for industrial goods is high, growth in peripheral countries will be accompanied by (at least) corresponding increases in their demands for industrial goods.

In order to prevent the transfer to industrial countries of the gains from increased productivity in export industries, the countries on the periphery must adopt policies to shift manpower from these industries. The best way to accomplish this shift, Prebisch argues, is to impose a tariff, which will increase the attractiveness of employing labor in the production of import-competing industrial goods. The appropriate degree of tariff protection under competitive market conditions is that which increases the value product of the marginal worker in each firm in industries producing for domestic markets to the point at which it is equal to the value product of the marginal worker in each export industry as a whole. 4/

Prebisch is thus proposing a reduced allocation of resources to the export industries such as would result from the establishment of a monopoly in these industries while competition was maintained in the rest of the economy. To evaluate this proposal, we need to examine Prebisch' specific argument with respect to (a) the gains from trade and (b) the over-all allocation of resources.

Gains from trade

Prebisch' general proposition on the effect of a tariff on the gains from trade is a familiar one in neo-classical economics. Scitovsky, for example, has shown that in the two-country, two-commodity case, a country can always gain through at least some restriction of trade (achieved in his analysis as in that of Prebisch by means of a tariff) so long as the other country does not retaliate. Prebisch' assumptions with respect to the elasticities of demand for exports of primary-producing countries merely reinforce the argument by increasing the potential trading gain to the primary producers through effective establishment of monopolistic export pricing.

While the theoretical argument as stated by Prebisch is unexceptionable on its own terms, it is useful as a basis for policy recommendations only if conditions approximate the assumptions of the analysis. One necessary condition is the equivalent of a two-country world -- that is, for the purpose of Prebisch' argument the establishment of an agreed pricing (and output) policy for all producers of any particular primary product. Prebisch does not consider the problems involved in establishing and maintaining these conditions, but he does recognize (p. 260) the gain which may accrue to an individual country from increasing its own output of a particular primary product to take advantage of the umbrella provided by output restrictions by other producers of that product. Thus, if all major producers of a particular primary product cannot agree on a monopolistic pricing policy, income will be "transferred" (in Prebisch' sense) from those countries which restrict output to those which do not.

4/ See, pp. 269-273.

Given the present structure of world trade, less-developed countries which produce many major commodities (e.g., grains, fibers and non-ferrous metals) could achieve the trading gains outlined by Prebisch only by entering into direct price-fixing arrangements with industrial countries which are also leading exporters of these commodities (e.g., the United States, Canada and Australia). 5/ By themselves, the less-developed countries which produce these goods could not gain from restriction of exports.

The above considerations are likely to be important even in cases where a country is able to secure agreements on prices and output policies with the producers of some of its major exports. If the country exports other goods for which the demand schedule confronting the exporting country is price-elastic (either because the demand schedule for the commodity itself is elastic or because the commodity is exported by several countries, including some with which the country is unable to reach an agreement) the average demand elasticity for its total exports -- which is the relevant statistic from Prebisch' point of view -- will clearly be much higher than the elasticity of a few specially situated export commodities. 6/

Therefore, apart from the practical difficulties confronting a country attempting to increase its gains from trade, it is obvious that the gains can be larger if the country employs direct means to improve the export prices of specific commodities, rather than attempting to employ indirect means which provide no distinction among exports. More important, the attempt to achieve the equivalent of monopolistic pricing through tariff policy prevents attainment of an optimum allocation of resources.

Tariffs and allocation of resources

Prebisch' principal concern in the matter of resource allocation is the allocation between the export industries on the one hand and the rest of the economy on the other; he mentions the allocation of resources within domestic sectors only in the course of arguing that reciprocal trade concessions by less developed countries may restrict their ability to allocate import "capacity" (through selective adjustment of tariffs) in order to promote rapid growth.

5/ Such agreements would, of course, operate to the disadvantage of countries on the periphery which are heavy importers of foodstuffs (or other commodities).

6/ It should be noted that the long-term price elasticity of a given commodity is in many cases undoubtedly substantially greater than the short-term elasticity, at least above a certain range of prices. While it may be difficult to demonstrate that the development of a synthetic material has been related to the prices of primary products for which it may be a substitute, there is considerable evidence that the price of a particular primary good does affect the extent of utilization of substitutes, whether synthetics or other raw materials.

By contrast, tariff policy in neo-classical economics is primarily concerned with the allocation of resources between import-competing industries and the rest of the economy, and proposes as the appropriate tariff for a developing country (in the absence of conditions favorable to the Scitovsky "optimum tariff" proposition) that which can be justified on the basis of the infant industry argument. 7/

Under either tariff policy, resources will be shifted into the protected industries (those competing most directly with imported goods) from the rest of the economy. However, where Prebisch' proposed tariff policy leads to a greater shift of resources than would occur under an infant-industry tariff, it can be shown to be inefficient in the sense that a combination of national export monopolies (made effective by international agreements) and an infant-industry tariff will result in a higher level of income than will Prebisch' policy.

The explanation lies in the fact that once one moves from the two-commodity economy (in which Prebisch conducts his analysis) to the multi-commodity economy, a shift of resources into one industry will, barring discontinuities, involve a shift out of industries with widely differing markets. To reduce output in those export industries in which monopolistic pricing would be advantageous, Prebisch advocates a policy which will shift resources to import-competing industries from all export industries, and also from industries which produce solely for the domestic market (and compete with imports mainly as an alternative use of income). Transfers of resources from industries which sell exports under competitive market conditions will adversely affect foreign exchange earnings, and transfers from industries producing exclusively for the home market will lower real income, assuming in each case competitive equilibrium conditions before the imposition of the tariff. If Prebisch' tariff makes such transfers larger than they would be under a tariff justified on infant industry grounds, it lowers the real income of the country. Prebisch' justification is that this reduction will be offset by improvement in the terms of trade, but this improvement can be secured directly through a monopoly. In short, that resource allocation which would result from an infant-industry tariff policy plus monopoly (in those export industries where the demand schedule confronting the country is inelastic) would produce larger foreign exchange receipts and greater real national income than would the allocation implied in Prebisch' proposal.

Conclusion

Economic analysis cannot hope to make contributions to policy formation unless the level of abstraction employed is suited to the problem at hand. One test of such suitability could be an examination of whether, and to what extent, the conclusions of the analysis are altered by changes in the nature of the simplifying assumptions. By this test, the Prebisch

7/ See, for example, Gottfired Haberler, International Trade and Economic Development, National Bank of Egypt, Fiftieth Commemoration Anniversary Lectures, 1959.

analysis which has been reviewed here is not a useful basis for policy decisions. The optimum tariff policy for one country in a two-country, two-commodity world is not the optimum for that country in a world in which there are at least several countries exporting any major commodity and in which there are important segments of the economy that are not engaged in production of exports or of import-competing goods.

This paper is not a brief for monopoly; less developed countries may sometimes gain by establishing monopolies, but there are grave risks. The above argument has merely attempted to point out that Prebisch' proposal will result in gain only if the conditions for monopoly are present; if they are, monopoly will yield larger gains. Prebisch, thus, has not given us a theory of the appropriate commercial policy for less developed countries -- that theory we find well-entrenched in traditional economics as the infant industry argument. What Prebisch' discussion emphasizes is any country which has inelastic demand schedules for certain export products can, under certain circumstances, benefit from policies which encourage the transfer of resources to other types of production. Prebisch has failed, however, to define adequately the circumstances in which that benefit might be realized.