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Economic Development and Commercial Policy

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by

Reed J. Irvine,
Adviser,
Division of International Finance,
Board of Governors of the
Federal Reserve System.

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Broader Aspects of Economic Development

Most people when they speak of economic development have in mind a process which brings higher standards of living defined largely in material terms. They think of improved levels of living in terms of more and better food, better housing, better clothing, and more healthful environment through better sanitation and pest control, and more of the luxuries such as radios and TV, bicycles or automobiles, electric appliances, etc. However, there is much more to living standards than this. There are no doubt some who would agree with Thoreau that "most of the luxuries and many of the so-called necessities of life are not only not indispensable but are positively hindrances to the elevation of mankind." Any rounded definition of higher living standards would surely have to include, among other things, more and better education, greater availability of worthwhile reading matter, and more widespread appreciation of and participation in the arts.

The Greeks after having defeated the armies of the invading Persians and having captured the camp of the Persian commander, Mardonius, marvelled at the contrast between the luxury enjoyed by the Persian general and the Spartan simplicity of their own way of life. The Greek commander, Pausanius, had the servants of Mardonius prepare a typical meal in the Persian style and laid out beside it a meal customarily prepared for a Spartan general.

He then invited in his generals and said, "I sent for you, O Greeks, to show you the folly of this Median captain, who, when he enjoyed such fare as this must needs come here to rob us of our penury."

Materially the Greeks were extremely poor in comparison with the Persians, but who would say that they were the more backward and underdeveloped of the two nations?

Another aspect of living standards is the amount of leisure enjoyed by the people. A standard that measures only the material that is produced by work is faulty since there is some point at which men place a greater value on leisure or respite from work than on additional acquisition of goods. This point varies greatly from individual to individual and from society to society.

Leisure which gives men time to rest, to play, and to enjoy "the finer things of life," is undeniably one of the important components

of the standard of living. It is also one of the most difficult for an observer to evaluate. The man who places a low valuation on leisure and a high valuation on material possessions has an especially difficult time understanding the point of view of those who value leisure highly, and he is inclined to view the difference in moral terms. On the other hand the man who professes to have a high preference for leisure does not necessarily view material possessions in the same light as Thoreau. He may well earnestly desire material improvements even though he may not be willing to expend the effort and would contribute to their acquisition. His failure to act, may on the other hand reflect more a lack of knowledge, opportunity or confidence than a lack of will. He may be willing to work more if given the proper opportunity or a different social environment.

There are other even less tangible aspects of the standard of living that are likely to be ignored because their value is so difficult to measure. There is the matter of security of person and property against lawless attack, which relates in part to the state of public morals and in part to the efficiency of the law enforcement agencies. On the other hand there is the matter of security against unreasonable interference in one's private life on the part of the police or other organs of the state. Confidence that one will not be dragged off to jail or driven from one's home in the middle of the night for no reason other than that one has achieved a certain degree of prosperity, or was born a member of a minority group, or has ventured to express criticism of the regime must be considered an element in the standard of living. The law is no less important than a house and fence in insuring a man protection against the elements that threaten his security and enjoyment of his life and property.

Another important intangible is the nature of the human relationships that are governed by custom rather than law. The nature of family relationships may have an important bearing on the satisfactions associated with living. Industrialization with its requirements of greater mobility of labor and elimination of the family as the basic laboring unit, inevitably alters intra-family relationships, tending to weaken parental authority and the sense of responsibility that each member of the family feels for the welfare of the other members of the circle. In those societies where the family rather than the individual is still considered the basic social unit, there would be considerable question as to whether changes that involved the weakening or destruction of the family system would be regarded as progress toward a higher standard of living.

Economic Change Not Necessarily Welcomed

Economic change that aims solely at an improvement in the material conditions of life might very well fail to qualify for the appellation, "progress", if it deprives men of the enjoyment of these and other intangibles that constitute an important but easily overlooked element of the standard of life. One hears frequently that the backward areas of the world are in a state of ferment and are clamoring for economic change at almost any price. It is suggested that the masses of the people in these countries will not hesitate to sacrifice the intangible aspects of their standard of living to increase their material well-being, that they are in immediate danger of turning to communism if something is not done to improve their material standards by other means. When it is pointed out that in view of the tremendous population increases the gains in physical comforts can at best come slowly and in small increments, it is said that this may suffice since what is wanted is chiefly evidence that material conditions are improving.

Even though such statements are frequently made by men of great honesty and sincerity, they must strike anyone with any familiarity with non-westernized Asians as the rankest distortion of fact. The Asian peasant, like peasants the world over, is a conservative who places no small store on the intangibles that contribute to his way of life. He will not willingly sell his birthright, in the form of his traditional values and approach to life and work, for a slightly increased supply of material goods. The notion that he wants to see change above all else, even if it doesn't mean much in terms of actual improvement of living conditions, is strictly a western invention, or at least the invention of westernized Asians. The peasant dislike of change was demonstrated in Russia by those who sacrificed not only material advantages but even their lives in resisting collectivization.1/

The traditional Asian outlook which is characteristic of peasant societies the world over is not what the westerner calls "progressive." "....traditional societies are nonhistorical in that they do not imagine themselves to be in linear motion toward temporal goals. Their records are not histories but simple chronicles which delineate no pattern in human events other than a kind of cycling like the rotation of the seasons. Their political philosophy is to maintain the balance of nature upon which the human community depends, and which is expressed in public rites celebrating the timeless correspondences between the social order and the order of the universe.

1/ See Fainsod, Smolensk Under Soviet Rule, Princeton, 1958.

Thus, the focus of interest in the traditional society is not the future but the present, 'the still point of the turning world.'" 2/

An understanding of this attitude toward change and even innovation is essential to appreciate the true magnitude of the problem of attempting to transform Asia economically. The resistance of the bulk of the population to change makes it extremely difficult to obtain the increased output per capita that is essential if Asians are to enjoy a greater abundance of goods. Unless the peasant is willing to adopt more efficient techniques of cultivation or work more intensively, per capita agricultural production cannot be steadily increased. Unless agricultural output can be increased most of the Asian countries will be hard pressed to support the larger urban populations that industrialization requires. Indeed, it may not be possible in many cases to even attract the necessary labor into nonagricultural activities at rates of compensation that reflect the actual economic contribution of the labor in these fields.

Manufacturing Not Always More Productive Than Agriculture

Although it is true that the most highly industrialized countries generally boast of higher per capita national incomes that the non-industrial countries, it would be a grievous error to conclude from this that a given amount of labor in a factory is always more productive than an equivalent amount of work in the fields. This will depend on the relative fertility of the soil and efficiency of the techniques, among other things. The economic worth of the labor will depend upon the values it creates, and these will in turn be determined by the cost of obtaining the same products through trade. If the cost of the manufactured article imported from abroad were so low that it would not be possible to pay workers hired to manufacture the product enough to attract them away from agricultural pursuits and still earn a profit, one might conclude that in this particular case factory labor was less productive than agricultural.

However, it could be argued that although labor might be less productive in industry per hour worked, industry might still represent a more efficient use of labor simply because it would tend to cut down on leisure time and would induce more concentrated productive effort. This, if true, could enable workers to earn more in industry than in agriculture even though production per man hour of actual labor might be lower in industry.

2/ Watts, Allan W., Man, Nature and Woman, Pantheon, New York, 1958, pp. 15-16.

Obstacles to Transformation of a Peasant Society

However, if factory labor were more productive in this sense, or even on the basis of a comparison of the value of output per man hour of actual labor, it could be that entrepreneurs would still have difficulty attracting labor into the factories at wage rates consistent with the higher level of productivity. The agricultural population might demand a still larger material compensation for giving up valued intangible elements in their standard of living. If they valued leisure highly, they might look askance at higher incomes that required much longer hours of work. If they placed a high value on proximity to nature they might not be tempted by the offer of a larger money income in return for spending long hours cooped up in a factory engaged in some monotonous task. If family ties were of transcendant importance, the family might be reluctant to see one of its members go off to a strange place to live and work under unknown and perhaps dangerous or disagreeable conditions.

The peasant's resistance to change may therefore be a greater obstacle to industrial development than to improvements in agriculture in many cases, even though industry might afford higher material rewards. Where the material gains to be derived from industrialization are slight or non-existent, there would seem to be little prospect of securing change in this direction voluntarily and little sense in forcing it.

The Stick or the Carrot

Where real gains in productivity may be obtained by transferring labor from agricultural to industrial pursuits but where the agricultural population is slow to sacrifice intangible elements of its standard of living to secure greater material rewards the question of employing the power of the state to force or induce the change becomes one that merits serious consideration. This question is not one that can be answered by an economist, as an economist. It is basically a philosophical problem and one that should not be decided without consideration of the sociological and political implications of the decision. The economists and politicians, who are most often involved in making such decisions, are seldom disposed to ponder the philosophical aspects of the problem. It is difficult for urban-dwelling intellectuals to understand or sympathize with the peasant's approach to this matter. Karl Marx, whose doctrines have beguiled so many Asian intellectuals, exemplified this lack of sympathy for the peasant point of view. To Marx the peasant was nothing but a dull clod, and peasant life was stupefaction with no rewarding compensations.

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Some Causes of Economic Change

The communists, who are the leading exponents of the doctrine that an expansion of the production of material goods is the supreme good, have not hesitated to use brutal force to achieve any changes that they thought would contribute to increased productivity. Mass deportations, imprisonment and execution of the objectors, intensive persuasion and punitive economic measures characterized the Russian effort to transform agriculture, and the same is true of Communist China, on an even larger scale.

In countries where the governments have to be more responsive to the sensibilities of the people, such tactics cannot be used. In Britain the desired results were achieved by the Enclosure Acts, which simultaneously tended to make agriculture more efficient and provided an indigent industrial labor force. In the United States the accidents of war had a good deal to do with stimulating the change. Manufactures in the North became sufficiently profitable to attract labor during the Napoleonic wars and the War of 1812, and in the South the Civil War and emancipation of the slaves upset the plantation economy and provided the necessary impetus for a switch to manufacturing.

In Asia, and here the Philippines will serve as a fairly typical example of the occupied lands, World War II did not trigger any profound economic changes. What impresses the Filipinos even today is how well they were able to get along during the Japanese occupation when they were cut off from imports. The standard of living, materially speaking, deteriorated, especially for city-dwellers, but when poverty is called "austerity" it becomes honorable and somehow less grinding. The Philippines produced food to feed the occupying armies and probably even provided some exports to Japan. On the other hand there was no striking industrial development during these years and the Philippines and the other Southeast Asian lands that were subject to the Japanese occupation emerged at the end of the war with essentially the same type of economies that they had at the beginning. The war, however, did create changed political conditions and it left in many countries large numbers of young men who had been torn from the peaceful pursuit of agriculture and accustomed to the excitement of military adventure, either in regular military units or as guerillas. Many of these men had lost their taste for the traditional way of life and were willing to believe those who told them that through political action, a better, more exciting life could be had. This helps account for the disorder and turmoil that has persisted in the Japanese occupied territories in the postwar period.

The situation was very different than in the American South during the Reconstruction period, when the impoverished ex-soldiers and

others who could not gain a satisfactory subsistence from the land in meek desperation sought employment under very hard terms in the nascent textile industry. There is considerable doubt whether these politically inspired rebels would find the prospects of long hours of closely supervised toil in an industrial plant for little if any greater return than could be gained from the land very attractive. Reliance on such an expectation would not provide the best basis for building a reliable industrial labor force.

However, the existence of these discontented souls provides a stronger incentive and also justification for governmental action to stimulate economic changes. If the government is not one disposed to the use of the stick to effect these changes, it may rely upon the more politically palatable technique of the carrot. Through subsidies of various kinds and protective measures that permit domestic industries to charge higher prices for goods sold in the domestic market it is possible to enable selected industries to offer higher compensation to labor than might otherwise be possible. This may make industry relatively attractive to labor, especially since the burden of paying for the carrot is likely to fall most heavily upon the peasant. The desired shift in labor may be effected voluntarily, and where the peasantry lacks leaders of sophistication it may even be possible to win their support for the measures which are really designed to squeeze them.

Protection and Subsidies as Instruments of Change

This constitutes an economic justification for subsidies or protective tariffs for infant industries. It does not, of course, justify these devices from an ethical standpoint, but it would probably be agreed that if the only alternative is the stick, as exemplified by communist techniques, these measures are much to be preferred. It is very important to bear in mind, however, that the economic justification is based on the condition that the changes effected significantly increase productivity. If they fail to do so, the society will either not improve or will suffer a decline in its material standard of living. The new industries will become a burden rather than a boon. In this case the burden on the agricultural sector is likely to create grave discontent which may not only pose a serious political problem but which may also affect agricultural productivity. If a country has foreign exchange reserves that can be drawn down or access to foreign financial assistance it may be possible to delay the impact of the failure of the program. When these resources are exhausted the government will have to face the problem of dealing with an increasingly discontented peasantry and possibly a discontented industrial labor force as well. To satisfy the demands of the peasantry it will very likely be necessary to reduce

the incomes of the industrial workers, either by cutting wages or by creating unemployment. Neither alternative is likely to be palatable, and the solution may be to abandon the carrot and to resort to the stick, which means to abandon democratic processes.

It is therefore very important from the point of view of the material welfare of the people as well as the preservation of political liberty that governments do not make the mistake of subsidizing or protecting economic projects which will reduce productivity, especially if the projects are large ones which make significant demands on the country's resources. From an economic point of view it is desirable that resources be utilized for projects that will contribute the most to increased production, but in this imperfect world it would be expecting too much to hope that a government could with any precision discover in advance what those uses would be. In fact, there is a serious question as to whether government officials can very successfully determine in advance whether a particular industry will increase productivity over and above the amount required to pay the capital costs. This requires good advance estimation of production costs, but it is surprising how little attention is paid to this in industries in many developing countries. Managements, to say nothing of governments, very often have only vague ideas of what their costs are even after the plants are built and operating. Seldom, if ever, is any effort made to compute costs in economic terms, estimating what the cost would be if production were in no way subsidized or protected.

It is clearly unwise for a government of a poor country to artificially stimulate the development of new industries on a large scale without reasonably good evidence that the investment will contribute at least as much to the satisfaction of consumer demand as alternative uses for the capital. This is the error that has been largely responsible for the economic malaise that has afflicted Argentina ever since the Peron era. Argentina has not yet been able to undo all the damage caused by Peron's policy of developing inefficient industries at the cost of more productive agricultural development.

Similarly, India is now beginning to pay a fearsome price in the form of famine for her investment policies in the second and third five-year plans. Old-fashioned economists who insisted that the law of comparative advantage had not become obsolete, foresaw this outcome at the time these plans were adopted. For example, D. K. Ragnekar, writing in 1957, made this observation:

> At a time when conditions seemed most favourable for an all-out attack on the agricultural problem, Indian planning has been oriented towards spectacular industrialization

leaving agriculture far behind. Developments in other sectors of the economy, too--power, transport, commercial activities, and training facilities--are out of step with the present industrial plans. Furthermore, in contrast to the enormous investment in heavy industry (and other development expenditures), the targets for consumer-goods industry are markedly low. Such unbalanced growth of the industrial sector, unaccompanied by complementary changes in the other sectors--the agricultural sector in particular--may give rise to hazards and phenomena which, in the long run, are likely to retard India's economic growth--chronic inflation, balance-of-payments difficulties, social distortions, and so on.3/

Mr. Ragnekar noted that the government was embarking on a program of importing surplus food from America to make up for domestic shortages. He warned,

> These are costly expedients: they do not solve the basic problem of agricultural productivity on which depends India's steady, integrated economic development.4/

Does Uneconomic Industry Save Foreign Exchange?

The most frequent justification advanced for investment in industries that require a high degree of protection is that they will save foreign exchange. The saving is usually computed by estimating the direct foreign exchange costs involved in the manufacture of a particular item and deducting this from the c.i.f. cost of the same item when imported from abroad. The difference is supposed to represent the advantage to the economy of producing the item at home rather than importing it.

This type of computation could easily be used to justify the growing of grapes in Scotland or the cultivation of silk worms in New York City. The direct foreign exchange costs in either case would be small in comparison with the cost of the imported grapes and silk. This would obviously be a nonsensical basis on which to decide whether or not grapes should be produced in Scotland or silk in New York. It casts no light whatsoever on the essential question of whether or not the proposed project will increase the efficiency of labor and capital in satisfying consumer wants.

3/ D. K. Ragnekar, Poverty and Capital Development in India, Oxford, 1958, p. 272.

4/ loc. cit.

A country that relied solely on this criterion to determine whether investments should or should not be made would be very fortunate if it did not find itself in serious difficulties before too long. Only luck and the laws of chance would stand in the way of its investing in projects that did little or nothing to increase productivity. In the end, a country that tries to save foreign exchange by building industries that do not appreciably raise productivity will find itself losing far more foreign exchange than it saves. India, for example, has had to look abroad for the huge supplies of food needed to keep its population fed. The industries that used the capital that ought to have gone into raising agricultural productivity have neither saved nor earned enough foreign exchange to pay for the required food imports.

In view of the obvious logical fallacy in the foreign-exchange-saving argument and the even more impressive empirical evidence that the results are usually bad for the balance of payments, it is surprising that this reasoning continues to be used not only in developing countries but even by U.S. lending agencies as a justification for financing of enterprises which could not survive without the protection of high tariffs or direct restrictions on competing imports.

Some Protectionist Arguments Analyzed

It may be desirable to employ protectionist policies to encourage the shift of resources into economic activities which will clearly result in an improvement in the efficiency of labor and capital. This may be justified by the impediments that ignorance and tradition put in the way of factor mobility. However, the premium paid to secure greater mobility should probably be quite small, since it represents a deduction from the incomes of all who are not engaged in the favored industry. The greater the gains in productivity, the less need there should be for any subsidized premium to either labor or capital. The best interests of the community as a whole will be served if efforts are concentrated on promoting increased investment and employment in activities which can operate profitably without subsidies.

It may be argued that this is too shortsighted and that protection and subsidies for industries that might not otherwise survive in their early years will often pay off handsomely in the end when these industries "mature." This is the traditional "infant industries" argument, which has long had considerable appeal.

The world has seen many cases of industries that were started under protected conditions that eventually became competitive. It has seen many that did not. There have also been innumerable cases of industries that succeeded without protection and in the face of strong competition.

There are two risks that must be weighed against each other. One is that the protected infant industry may never grow up and will remain a perpetual burden on the economy. The other is that without protection, opportunities for new investment will not be exploited. The tendency in the less developed countries for the past two decades has been to consider the latter risk more serious than the former. The result has been that many countries have found themselves burdened with a large number of aging but still dependent infant industries. They can neither be weaned nor killed off. As a result, appreciation of the seriousness of the first risk has heightened. At the same time, the example of Hong Kong has provided an impressive demonstration of the possibilities of vigorous industrial development without protection.

If an industry is completely protected, the only pressure for increased efficiency will come from internal competition. If the protection is in the form of import duties, the tendency will be for the industry to over-expand in the early stages when profits are high. If there is unlimited entry, the competition may eventually become keen and cause a fall in profits. This could cause the failure of the less efficient firms. The end result may be that the industry will become competitive with other countries and may even become an exporter. This is what has happened in Taiwan with the textile industry. However, this would appear to be an unnecessarily costly method of achieving this result. If the competitive potential is there, it ought to be possible to bring it out without overbuilding the industry and over-rewarding both capital and labor during the period of "infancy."

If the industry is not one in which factor costs can be lowered sufficiently to make it competitive, either because the resources can be used more efficiently in other fields or because workers do not find the type of employment offered attractive, the theoretical gains in efficiency will never be realized as long as protection exists. In either case, if the protection is applied in the form of import quotas and if new entries into the business are limited by licensing or restrictions on imports of raw materials and equipment, the desired improvements in efficiency are unlikely to be forthcoming, since even the pressure of internal competition will be lacking.

In the establishment of any new industry, there is bound to be a period in which efficiency will be less than optimal because of the need to train new workers, and perhaps management as well. There is a question whether the cost of training should be borne by the general public, by the investors or by the beneficiaries of the training themselves. Protectionists, in effect, maintain that the public should bear the burden. This may be justified if the public is fairly quickly enabled to share in the benefits of the improved productivity, but it is unjust if the benefits are not passed on to the public. A more

logical approach is to treat the cost of training as one of costs of the investment. The management may, in some cases, be able to transfer part of the cost to the labor force, paying lower wages during the period when the labor is relatively inexperienced.

If the labor supply is not abundant or easily attracted into the type of work offered, it may be necessary for the investors to accept little or no return on their investment until such time as the workers can be trained up to a satisfactory level of efficiency. If this risk is too great for the entrepreneurs who will reap the profits, or for the workers who stand to earn higher wages eventually, it is probably too great for the general public.

It is difficult to prove that a country loses in the long run by not subsidizing unprofitable operations for long periods of "infancy." The fact that such operations may eventually become competitive and profitable proves very little. Changes in relative wage levels, technology or market conditions may have far more to do with the improved competitive position than any improvement in managerial or labor efficiency traceable to the experience gained in the operation over a long period of time. For example, the U.S. became a great steel producer not because the inefficient charcoal-based steel production was protected for many years, but because improved technology made it possible to use raw materials that were abundantly available in this country. In the cotton textile industry there is said to be little improvement in a mill operative's skill after one year, and Hong Kong mill owners consider six months to be an adequate training period for the average operative. In such an industry, there is obviously little benefit to be gained by the public from the subsidization of training periods lasting 10 or 20 years.

Immediate Gains vs. Speculative Hopes

Policy makers must bear in mind that substantial losses can be incurred by diverting labor and capital from employment that is immediately productive and profitable to uses which offer only hopes of greater productivity in the future. Governments should certainly not discourage the farsighted entrepreneur or investor who sees opportunities for growth and expansion in new fields of endeavor, but public policy should not weight the scales unduly on the side of speculative ventures that may or may not pay off and thereby divert resources from more mundane operations whose yield is more immediate and more certain.