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PROBLEMS OF CAPITAL FORMATION IN UNDERDEVELOPED COUNTRIES

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Chapter V

COMMERCIAL POLICY AND CAPITAL FORMATION

WHAT can commercial policy do to promote the accumulation of capital in underdeveloped countries? Can import restrictions help by increasing the incentive to invest? How, if at all, can the supply of capital be enlarged through foreign trade? Can capital formation be increased by restricting imports of consumer goods? These are the questions to be taken up in the following pages.

In pure theory the two subjects—commercial policy and capital formation—may not seem to have anything in common, In the world of practical affairs we often find them linked together, although the exact nature of the connection sometimes remains obscure. The one form in which the connection has been extensively discussed in the past is the 'infant industry' argument for tariff protection. I would like to begin by confronting, very briefly, this argument with the problem of capital formation in underdeveloped areas.

Infant Protection and Infant Creation

The theory of tariff protection for infant industries has been associated with nationalist movements and aspirations. Alexander Hamilton and Friedrich List can certainly be called economic nationalists. The situation is somewhat paradoxical in view of the fact that this is the only argument for import restrictions that can be held even from a cosmopolitan point of view, on the grounds of world benefit. If it is true that a temporary interference with the freedom of trade can develop new skills and aptitudes, and bring dormant resources into active use so that production of goods and services is greatly expanded, there is a distinct possibility of ultimate gain for all countries.

If protection, however, were all that is needed for economic development the problem would be very simple. Indeed, one would have to be surprised that the problem is not much nearer

to its solution, since there has been no lack of tariff protection in underdeveloped countries. This does not prove that the argument is wrong, but it does suggest that tariff protection alone is an ineffective means of promoting economic growth.

Why is it ineffective? Because infant industry protection overlooks the problem of capital supply. This is the task of creation, of finding the sources, open or concealed, available for accumulation, and of devising the ways and means of moulding them into productive forms. Infant creation must take precedence over infant protection. In industrial as in human life the most perfect arrangements for the protection of infants will not guarantee that infants actually come into existence. For this certain steps of prior importance are required. Tariff protection of infant industries has failed because it has done little or nothing to create the capital needed for industrial development.

How could infant protection be expected to contribute to capital formation at all? One might think that even if it could do nothing directly to increase the supply of capital, it could at least make a contribution on the demand side by increasing the incentive to invest in domestic industry. Undoubtedly an important underlying motive for tariff protection has been the desire to preserve the domestic market, small as it may be, for domestic investment and so at least partly to overcome the weakness of investment incentives. It is highly questionable, however, whether this alone can release a process of 'balanced growth' in the domestic economy. Without such over-all growth, the inducement to invest in a certain protected industry is not likely to endure beyond the point at which imports have been replaced. At that point the expansion of that industry may come to a stop, so that little, if anything, will have been achieved. This limitation of tariff protection has been observed, for example, in India in some particular industries (such as cotton cloth and sugar).

But even if we accept any contribution that infant protection can make on the demand side of the capital problem, an increase in the rate of accumulation is nevertheless not certain. Who is to supply the capital required? The increase in profit prospects, by itself, may not increase the flow of domestic voluntary saving in an underdeveloped country. The domestic capital supply may remain unaffected by the rise in the inducement to invest caused by tariff protection. It has been customary in economic theory to treat the rate of personal saving as independent of, and irresponsive to, the rate of return from capital. An increase in the rate of return, while it may induce some people to save more, will lead others, those who save for a given future income from capital, to save less.

It is more likely that the rise in the inducement to invest in the protected industries will lead to credit expansion for the establishment of these industries and hence perhaps to a flow of forced saving resulting from inflation. This possibility is doubtless important in practice. But forced saving through inflation, if it can be had at all, can be had even without tariff protection. It can be brought about, for instance, by government outlays financed by monetary expansion.

Another possible effect of the restriction of imports is that foreign capital will respond to the increased inducement and will come in to set up 'tariff factories' producing for the domestic market. In fact, however, private business capital in the past has not moved in large volume to low-income countries for the purpose of producing for the domestic market. This may have been due to many reasons but the underlying obstacle has generally been the limited size of the existing market in these countries. As a means of giving foreign capital a greater inducement to come in, tariff protection does not help much because there is not much of a market to protect. It is of little or no use as an incentive for foreign business investment unless a substantial domestic market is already in existence. To put it bluntly: tariff protection, if it can help at all, can only help the strong—it cannot help the weak.

Here is an example to illustrate this proposition. Of the total American business investments outstanding abroad, Canada has about 30 per cent. More than half of the investment in Canada is in manufacturing and distribution. Apparently American capital finds it profitable to work in Canada for the local market. That is because the country is highly productive and prosperous. It may be to some extent because of the Canadian tariff; it is probably impossible to find out exactly to what extent. But this much I think we can say: the Canadian tariff alone would have

made very little difference as an inducement to foreign capital if the Canadian people had been miserably poor.

It is sometimes said that the imperial preference system set up in 1932 gave American business firms an incentive to establish factories in Canada, to produce for the United Kingdom and British Commonwealth markets. If this were an important factor, it would show up in the composition of Canadian exports; actually it does not do so in any significant measure: Canadian exports have continued to be mainly foodstuffs and raw materials.

American business investments in manufacturing industries in Canada seem to work largely for the Canadian market. In low-income countries they concentrate on production for export, in spite of the tariff protection enjoyed by domestic markets. Abstracting from all political difficulties, it seems doubtful whether even a super-tariff would be capable of attracting much foreign business capital to work for the domestic market in a country like China. A country like Brazil is probably in an intermediate position and may well be able to induce some capital imports through restrictions on commodity imports. For underdeveloped countries as a whole, however, the figures shown in the last chapter do not suggest that import restrictions have so far had much effect in this respect.

So we see that, even on the demand side of the problem of capital formation, the contribution which import restriction can make, by stimulating the incentive to invest, is of doubtful efficiency in attracting an increased supply of capital. It is conceivable that domestic saving is increased in response to the rise in the prospective rate of return, but it is not likely on general grounds, and particularly unlikely in poor countries that live fairly close to the subsistence level. It can happen that tariff protection sets into motion the inflationary process of forced saving, but this is a particularly painful and objectionable method of infant creation. It is possible that foreign business capital comes in because the tariff protection may at least reduce the discouraging effect of the small size of the local market, but it appears that the inducement has been relatively ineffective. Foreign capital has gone to underdeveloped countries to work for export rather than for domestic markets.

Some people take the view that tariff protection could bring about an increase in the real national income directly, in the case where surplus agricultural labour is absorbed in a new industry protected by a tariff. The productivity of the labour transferred to that industry was very low before, and is now much higher. The result of tariff protection, according to this reasoning, is a clear increase in national product.

This argument is subject to three reservations. First, from the apparent increase in national product we have to deduct the loss in real income which is suffered by the consumers of the product because of the higher price they have to pay. (If, as is possible, this deduction is even greater than the gain in productivity of the labour transferred, then the industry is clearly uneconomic and results in a net loss in real national income.)

Secondly, the deduction on this account, representing both a subsidy to the protected industry and a tax on the people who happen to be consumers of the product, is greater than it needs to be. Financing the subsidy in this way creates an excess burden compared with financing it from general taxation in accordance with ability to pay, which would eliminate the need for tariff protection and replace it by a direct subsidy.

The third point is the most important and also the most obvious. Even if the net change after applying the deduction turns out to be positive, we cannot credit this increment in national product to tariff protection. It must be credited to the capital embodied in the new protected industry. It is the application of capital, not tariff protection, that increases real national income. Protection as such tends rather to reduce real income and must be counted as a negative offset to the output increment that results from the use of capital. The infant industry argument rests on the hope that the initial comparative disadvantage from which the industry suffers, and because of which it needs protection, can be overcome in the course of time so that this negative offset eventually disappears.

But where has the capital come from, the capital now embodied in the protected industry? That is what we have to ask when we look back, draw up the accounts, so to speak, and try to explain what has happened. Looking forward, if we should contemplate

adopting such a policy, again the question is, where is the capital to come from? Protection by itself does not provide it. In nearly all statements of the infant industry case it seems to be tacitly assumed that capital is available for setting up the new protected industry. In the low-income countries at the present time the availability of capital cannot be so taken for granted. Perhaps it could be taken for granted in some of the countries which, in the past, practised infant industry protection in a big way and with success: countries like the United States and Australia, which received a great inflow of both capital and labour from Europe. In these countries, and under these conditions, infant industry protection was probably a quite effective policy. Under the entirely different conditions that face the economically backward areas to-day, tariff protection alone is probably of little or no use. From the point of view of capital formation, it seems a completely secondary matter.

I hope I will not be misunderstood. I am not opposed to infant protection. I am only directing attention to the prior need for infant creation.

Effects of Import Restrictions on Money Income and Saving

The major point now to be examined is of a different order. We shall abstract completely from international capital movements and assume that there is no foreign aid or foreign investment. We want to consider how, if at all, a country's stock of capital equipment can be increased by way of foreign trade and what, if anything, commercial policy can do for this purpose. The infant protection argument is mainly concerned with incentives to invest, that is, with the demand side of the capital problem. Here we revert, in the main, to the supply side.

Foreign trade is a means of obtaining capital goods from the advanced countries, and it is tempting to suppose that by restricting imports of consumption goods a country can increase its imports of investment goods. For an undeveloped country the possibility of acquiring machinery and equipment by means of international exchange is one of the great benefits of trade. It was a great advantage for Russia in the early stages of her industrialization, especially in the 1930's when she imported much modern equipment in exchange for her exports of primary products. Great Britain, when she was the first in the field of industrial development, did not have this advantage. She had to start by developing her own capital-goods production almost from scratch. Russia was able to import capital goods in exchange for her exports, but not without an act of saving.

The importation of capital equipment into any country necessarily presupposes an act of saving in that country. It may be merely ' retained ' saving, in the form of depreciation and obsolescence allowances, if the equipment is imported for replacement purposes. It requires new saving if the equipment is imported as an addition to existing plant and machinery.

In an all-inclusive view, a country that is importing capital equipment is *ipso facto* saving, in that it is abstaining from the enjoyment of the consumer goods it could have imported in place of the capital goods brought in, or else abstaining from the consumption of the goods that it now exports in order to pay for the imported equipment.

In a completely planned economy there is perhaps nothing more to say. The state decides to impose more saving on the people, the state invests this saving in imports of capital goods. Saving and investment can become indistinguishable, merged in a single act of state.

In an individual exchange economy at least partly based on price, profit and income incentives operating in a monetary system, there is more to be said on the matter. This is the case that applies to underdeveloped countries outside the Soviet orbit (and perhaps even to some within). For these countries it may not be proper to suppose that it is a simple matter for the state to change the composition of imports, increasing imports of investment goods and slashing those of consumption goods, as if that were all there is to it.

Even in countries still largely based on price and income incentives, it is true that the state has tended to assume a greater degree of conscious direction of the process of capital formation and is beginning to take a more active interest in the share of national income going into investment. It is possible that even in an economy mostly run by private business the choice between

national consumption and national saving may become more and more a state decision.

Is a decision of this sort being taken when the government decrees a restriction of imports for current consumption and allows more imports of investment goods to enter instead ? There is certainly a widespread notion that, by cutting down imports of consumption goods through direct controls or prohibitive duties, a country can make more real capital available for its economic development in the form of imports of capital goods. Governments seem to be firmly convinced that they are promoting the accumulation of capital whenever, in their commercial policy, they banish consumable imports in favour of imports of machinery and equipment. And so this type of commercial policy—the policy of what we may call ' luxury import restrictions '—is very common in underdeveloped countries to-day.

In order to isolate as clearly as possible the effect of import restrictions of this sort, it is best to use as our starting-point a position of equilibrium in which imports are equal to exports and national income is at a level corresponding to full employment without inflation. Restrictions are imposed on imports of consumption goods, especially goods of a so-called luxury or semi-luxury character, with the object of making room for a greater volume of imports of capital goods. Unessential complications concerning, for instance, customs revenues or quota profits can be left aside by assuming that these restrictions consist of absolute import prohibitions imposed on certain specified commodities not produced at home. The country's export proceeds are assumed to remain unchanged, or at any rate are taken to be outside the country's control.

Imports of consumption goods are reduced and imports of investment goods can now be increased. This is only the beginning of the story. What happens to the domestic flow of money income and to the balance between saving and investment ? It all depends on what people do with that part of their income which they previously spent on imported consumption goods. Let us make two different assumptions and watch the consequences.

In the first place, suppose that people save all this part of their income. They cannot get the foreign commodities, nor think of anything else on which to spend money, so they save all of it. Call it forced saving if you like, but the saving is real enough. Though this may be an unlikely case, it is none the less a possible assumption. The increase in the flow of investment goods imported will be matched by an increase in the flow of domestic income saved. Domestic monetary equilibrium remains undisturbed. (If we think of 'leakages' in terms of the multiplier analysis, an artificial reduction in the leakage of income spent on imports is exactly offset by an increase in the leakage of income into domestic saving.) The increased imports of investment goods will represent a genuine addition to the rate of capital formation.

In the second place, however, it is equally possible to assume that what can no longer be spent on imported consumer goods is spent entirely on domestic consumer goods and services. We now suppose, in other words, that import restrictions lead, not to any change in the volume of consumers' expenditure, but to a complete switch in the flow of spending from imports to domestic commodities. It is true that imports of investment goods can here again be increased, since export proceeds remain the same and less is spent on imports of consumer goods. The country's foreign-exchange account, considered by itself, seems to leave room now for more capital formation in the shape of imported equipment. But in terms of local currency the purchase of this equipment is likely to require financing through domestic credit expansion.

The crucial point about this case is that the people of the country have not voluntarily consented to any reduction in their consumption. They will seek to make up for the reduction in their imports by an increase in their expenditure on domestic goods and services. The result is a disruption of monetary equilibrium—an inflationary pressure on money costs and prices. When the escape valve of consumable imports is shut off, the pressure of the steam in the system increases; demand becomes excessive in relation to domestic supply and tends to push up the level of prices.

So much for the monetary aspect. What happens to the real volume of capital formation? Imports of investment goods have been increased, but that is not all. It is likely that domestic investment activities will suffer from the increased consumer

expenditure in the home market. Even in a poor country some factors of production are always engaged on capital production if not for new investment, at any rate for replacement and maintenance. Imports of capital goods represent usually the lesser part—something like one third perhaps, or even less—of the accumulation of capital in an underdeveloped country. The greater part consists of things that cannot enter into international trade, such as roads, buildings, public works and land improvements. The increase in consumer expenditure will tend to bid factors of production away from domestic investment and maintenance and will draw them into activities catering for current consumption. Domestic capital production will have to make room for the increased domestic consumer spending. Consumers have not agreed to any cut in their total consumption, and their expenditure forces instead a cut in the resources devoted to the maintenance or expansion of domestic real capital. In this way the increase in imports of investment goods tends to be offset by reduced domestic investment activities, or actually by domestic disinvestment caused by failure to maintain and replace capital as it wears out. So long as there is no increase in saving, there can be no increase in total net capital formation.

An increase in saving can come about in the present case only in the form of forced saving resulting from inflation. The effect of inflation is unpredictable *a priori*, depending as it does on the speed and other characteristics of the rise of prices, and on the psychological attitude of the public. We can merely point to some general possibilities. If the pace of inflation is moderate, there is a fair chance of some forced saving being imposed on the community through the lag of wages and salaries and through the shift of income distribution in favour of the wealthy (if the marginal saving ratio of the wealthy is higher than that of the poor). Here we do have a possible new source of real saving to finance the increase in real investment that occurs in the form of larger imports of capital goods as a result of import restrictions on consumption goods. Unfortunately, it is not only a socially painful but also an unstable and unreliable source. A general rise in prices may, after a while, lead to a reduced willingness to save in monetary form. No one will want to hold money as a store of value or to direct his saving into assets expressed in monetary terms. Saving, if it occurs at all, may immediately seek real forms such as residential construction, and will to this extent not be available for the financing of the additional imports of equipment. Inflation is apt to lead to misdirection of resources; not formally, perhaps, to a decline in total investment, but probably to malinvestment. Moreover, inflation can have a bad effect on capital formation when it leads to failure to replace inventories and fixed equipment through insufficient provision being made for actual replacement costs.

We have so far discussed each of the two extreme assumptions in turn. In actual fact the result is more likely to be a mixture of the two cases, where the money income previously spent on imports will partly be saved and partly spent on domestic goods and services. The inflation in this mixed case may be quite mild. The nature of the result will depend largely on the proportion in which the money flow hit by the new import barriers is divided between the two uses, saving and domestic spending. What can be said about the forces that influence this proportion?

The first point is that import restrictions on luxury goods are not unlikely, on the whole, to induce some new saving. The alternative to luxury expenditure is often just leaving the money unused.

Secondly, much depends on the composition of a country's imports. If practically all the non-essential consumer goods that enter into a country's consumption are imported, then the government, by imposing restrictions on a wide range of such imports, can perhaps enforce a substantially increased rate of saving.

In the third place, if import restrictions are announced as a temporary measure, or if it is widely believed that they will sooner or later come to an end, then consumers may be willing to accumulate their pent-up demand in the form of temporary saving. They will postpone their expenditure on imports. Spending will be deferred, but not permanently forgone. This is a temporary kind of saving which cannot be relied upon for the financing of capital development. It represents 'saving up' for future expenditure. It is apt to be followed by dissaving. If hope for a lifting of the import restrictions fades away, it may come to seek an outlet in domestic objects of consumer expenditure.

This leads to a general point. The proportion of saving is likely to decline in the course of time. Consumers will gradually readjust their spending pattern, which is never fixed, except possibly in the short run. In the longer run, the pattern will change, and domestic spending will increase to take the place of the spending previously directed to imports. Thus the proportion that is saved out of the income previously spent on imports is likely to fall as time goes on and people adjust their consumption habits.

The conclusion from all this is not entirely certain; it depends on varying circumstances. In any event some points of principle now stand out clearly. For the government to impose its decision in regard to investment and consumption in the composition of imports alone is of little or no use. Any such decision to increase the share of capital goods in this sector may be offset by opposite shifts in the domestic sector. The simple idea that more capital can be got for the country merely by pinching and twisting the foreign trade sector of the economy is, in my opinion, an instance of the fallacy of misplaced concreteness.

When we realize how the foreign trade sector enters into the circular flow of income, it becomes immediately evident that every piece of capital equipment imported represents an act of investment which, in the absence of external financing, calls for a corresponding act of saving at home. If this act of saving is not forthcoming, we have seen that the capital equipment imported may be offset by reduced investment or by disinvestment in the domestic economy, if the expenditure of money previously spent on consumable imports now draws away domestic factors from capital construction or maintenance. Only if this money is left unspent is the necessary saving generated quasi-automatically; this is in some degree possible, but is not likely to create anything like the whole amount of the necessary saving.

The real problem is not just to extract more capital goods from foreign trade, but to extract more saving out of the national income. It is only with a complementary domestic policy of voluntary or compulsory saving, in which public finance must probably play a vital part, that luxury import restrictions can make a fully effective net contribution to the supply of capital in the form of imported equipment. And even then the contribution will be attributable more properly to the increased saving than to the import restrictions as such.

In the absence of such a policy, any net investment that may result from the increased imports of capital goods is likely to be financed mostly through the forced and haphazard levy imposed by inflation, as long as inflation has not yet passed the point where it ceases to be effective as an instrument of forced saving. We cannot therefore deny the possibility that, even without a deliberate complementary policy of domestic saving, luxury import restrictions can lead, through the channels outlined, to some increase in the rate of capital formation in an underdeveloped country.

Effects on the Pattern of Investment

Besides the quantity of investment, however, there is also a question of quality. In order to isolate some of the effects of import restrictions on money income and saving, we have ignored up to now their protective effect. This we must now take into account.[1]

The restrictions we have discussed affect the luxury or semi-luxury type of goods. They are often justified on the ground that the country's export earnings should not be wasted on goods of this kind, but should rather be used for the purchase of machines and equipment. But unless these restrictions are accompanied by corresponding restrictions—duties, licences or prohibitions—on the domestic production of these goods, there will be nothing to prevent domestic resources from being 'wasted' on luxury consumption.

Import restrictions unaccompanied, as they generally are, by domestic restrictions will set up a special inducement to invest in domestic industries producing the goods—or substitutes for the goods—that can no longer be imported. If the domestic market is considered at all sufficient to warrant the establishment of such industries, the inducement will prove effective. We must note,

[1] Discussions with Professor Alexander Kafka have been very helpful to me in this context.

however, that the inducement will not operate fully, if at all, unless the restrictions are expected to be permanent. The factor that maximizes the incentive to invest is therefore precisely the one that tends, as we saw, to minimize people's propensity to save that part of their income which they previously spent on imports. This makes it all the more likely that the investment will call for credit expansion.

Thus again the engine of inflation goes to work trying to grind out the forced saving required, not merely to finance the investment in increased imports of capital goods, but now also to release the domestic resources needed for the construction of the new protected industries. The type of industry to be constructed is here determined by the type of imports against which the restrictions are directed. Since these are goods of a luxury or semi-luxury character, the result will be that the country's capital supplies, scarce as they are, and painfully brought into existence, will be sucked into relatively unessential uses. At the same time, the basic overhead capital facilities may not be able to attract or hold the productive factors they need and may actually suffer decay, for reasons indicated earlier.

Latin America is one of the areas to which this picture seems to apply. In a number of Latin American republics the rate of internal capital formation is far from negligible.[1] But some notice should be taken of the content as well as the size of the total volume of investment. Under the influence of inflation and luxury import restrictions, both of which are very common in Latin America, investment has tended in recent years to concentrate on residential construction, largely for the upper income groups, and on luxury industries, while essential public installations such as railways and ports have in some cases tended to fall into disrepair. It cannot be denied that economic development is going on, but it is taking a needlessly painful and contorted form.

The Rationale of Luxury Import Restrictions

A general interpretation of the 'luxury import restrictionism' so prevalent to-day suggests itself in the light of the hypothesis

[1] A table on p. 76 of the United Nations report on *Measures for the Economic Development of Under-Developed Countries* (op. cit.) suggests that in Latin America as a whole the average saving ratio was about 8 per cent of national income in 1949.

set up in Chapter III, concerning the international income disparities and their effects on the balance of payments and on the domestic saving capacity of low-income countries. The bars to the entry of 'advanced' consumer goods can be viewed as a defence measure against these unfavourable effects, intended both to suppress the disequilibrium in the balance of payments and, what is more important, to offset the deleterious effect of foreign consumption patterns upon domestic capital formation. The luxury import restrictions of the underdeveloped countries in the world to-day seem to represent, in the last analysis, a desperate effort to offset the handicap which the 'demonstration effect' imposes on the poorer nations; an effort to isolate the local consumption pattern from that of the advanced countries and so to make possible more domestic saving and capital formation.

This effort deserves our sympathy. The attraction of advanced living standards is an obstacle to the late-comers in economic development. No attempt to overcome this obstacle should be lightly condemned.

The method of import restriction, however, attacks only the surface of the problem. It attacks only that part of the propensity to consume which directly involves expenditure on imported goods. The demonstration effect tends, however, to operate through an upward shift in the general consumption function and not in the import consumption function alone. Luxury import restrictionism does not stop this pervasive indirect influence of international discrepancies in consumption levels.

A more basic attack, in my opinion, would be compulsory saving through public finance. But this is precisely one of the things that is made politically more difficult in the poorer countries by the enormous disparities in living standards. Commercial policy is easier. Commercial policy always appears as the easy way of doing things. When it is a matter of stimulating employment in an industrial economy, shutting off imports is a very simple method. When the problem is to collect taxes for the government, revenue tariffs are not difficult to establish, and have been very popular in the less developed countries in the past. When protection is wanted for infant industries, restricting imports is again

easier than raising funds with which to pay direct subsidies to the protected industries. Commercial policy is the line of least resistance in all these cases, not the most effective or equitable line.

Similarly, commercial policy is easier than keeping domestic consumer demand in check by measures of, say, fiscal policy, but it does not go to the root of the problem. It is perhaps the best that can be done; the root of the problem may be insoluble.

To summarize: luxury import restrictionism can be interpreted as a way in which the authorities in underdeveloped countries try to put spikes in the way of the great attraction which advanced consumption patterns exercise upon their nationals. The spikes are at least partly effective in keeping consumption goods out and allowing more investment goods to come in. But let us not be dazzled by the sight of more machines being landed in the ports. The crucial question to ask is whether the spikes erected against luxury imports result in a net increase in saving. If the answer is in the negative, an increase in capital formation is not possible. And even should the answer be in the affirmative, it would still be necessary to keep in mind the possible misdirection of the country's supply of capital.