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# Inward-Oriented Development — An Alternative Strategy for the Third World

by Urs Heierli, St. Gall\*

**Both free trade and protectionism have been proffered as prescriptions for Third World development but neither has carried universal conviction. Neither import substitution nor export promotion strategies have come up to expectations. The author advocates a limited measure of delinking from the world market combined with inward-oriented technology adaptation.**

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When Ricardo pleaded for the repeal of the corn duties on the ground that high grain prices meant high wages for the workers in industry and were therefore an obstacle to the formation of capital<sup>1</sup>, he presented an argument for a British political interest. But the convincing logic of his ideas, leading on to a theory of comparative advantages, made him the intellectual father of free trade as such. Ricardo's theorems have ever since been part of the standard vocabulary of economists, and the idea of free trade has been extolled as a virtue in economic policy although few countries have ever observed it in practice.

No one saw more clearly and argued more fervently that free trade is not working to the advantage of all countries than Friedrich List<sup>2</sup>. It was certainly greatly to England's advantage to persuade other countries to practise free trade and to use here and there a little force if they were not ready to be convinced; England was "the forge of the world" and was eminently interested in new markets and supplies of cheap raw materials. England's industrial superiority had however the effect of debarring the backward agricultural nations in Continental Europe — to say nothing of the colonial countries — from industrialization under free trade conditions. List pleaded therefore for an accentuated protectionism in order to enable Germany to establish her own industry and also fought for the construction of a railway network in Germany so as to open up the internal market. Since transport costs act on trade in like

manner as duties, the competitive strength of inland areas and coastal towns differed greatly. The transport costs on sea were a fraction of those on land; it was cheaper to ship cloth from London to Hamburg than to send it from Bavaria to Northern Germany.

## Diluted Concepts

Both free trade and protectionism have seen service as recipes for Third World development but neither has been fully convincing in this role, and nowhere else has there been such dilution of concepts as in the field of trade policy and external economic relations. Free trade advocates like to point to Singapore, Hongkong und Korea as symbols of successful industrialization without however indicating exactly to what extent such an open export strategy could be used to secure economic development of a large hinterland. It is no coincidence that these examples are city states or islands with extremely favourable transport connections. It is also a moot point what form world trade would take if the whole of the Third World were to emulate this aggressive export strategy and the industrialized countries were swamped with cheap textiles and mass consumer goods.

Other observers have therefore come out in favour of protected markets, and there are examples showing that protectionism has been of considerable help to industrialization; there is hardly a single major industry in a developing country which could exist without

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<sup>1</sup> Cf. David Ricardo: *An Essay on the Influence of a Low Price of Corn on the Profits of Stock*, in: P. Sraffa (ed.): *The Works and Correspondence of David Ricardo*, Vol. IV, Pamphlets 1815-1823, Cambridge 1951, p. 5 ff.

<sup>2</sup> Cf. Friedrich List: *Das nationale System der politischen Ökonomie (The national system of political economy)*, Jena 1922.

protection from the outside world. Many import-substituting industries are producing goods at prices far above the world market and using only a fraction of their capacity because of narrow markets and oversized plants. Most of them employ sophisticated technologies, are capital-intensive, liable to run into troubles and highly dependent upon imported raw materials and intermediate products. Some have a remarkable loss-making record; quite a few could not survive long without subsidies. Protectionism, usually first vindicated by the "infant industry" argument as a transient feature, later turns into an indispensable permanent measure and a stable element of economic policy.

A policy of import substitution has rarely led to large foreign currency savings; import substitution had soon to be supplemented by measures of export promotion. Extra exports were wanted not only to remedy the scarcity of foreign exchange but to create employment. But in the recent past export strategies have also failed to live up to their promises; by virtue of their comparative advantages the developing countries should have been able to export labour-intensive products and provide employment for the masses – also in the hinterland. The world market, however offers only limited sales opportunities for labour-intensive products because the industrialized countries tend to protect their markets most strongly against this kind of competition. Besides, the qualitative demands in the world market are going up all the time, and formerly labour-intensive products are also being raised to a higher technological level and becoming more capital-intensive.

The markets of agricultural products are in any case – with the exception of a few commodities – stagnating throughout the world, and rapid mechanization has made millions of agricultural workers redundant. They are now populating the slums in the big cities. It is conceded even by as dedicated an advocate of the export strategy as Diaz-Alejandro that the export achievements of Colombia – as well as other countries of Latin America – in the sphere of non-traditional exports have so far failed to yield significant employment impulses<sup>3</sup>.

A way out of this predicament may be available in the form of a strategy which at first glance may seem inappropriate but is Japan's real secret: delinking from the world market and reinstatement of native standards and talents so that the indigenous élite – which is often

fascinated and at the same time paralysed by the western successes – is encouraged to mobilize its own innovative capabilities. At the time of the Meiji restoration Japan took to voluntary isolation and allowed only highly selective contacts with the West. Foreign technologies were taken over but adapted to Japan's specific conditions. The whole of the production went into the technologically and qualitatively less demanding home market. Above all, a climate of creativity was engendered: "If Japan's experience teaches any single lesson regarding the process of economic development in Asia, it is the cumulative importance of myriads of relatively simple improvements in technology which do not depart radically from tradition or require large units of new investment."<sup>4</sup>

### **Inward-Oriented Technology Adaptation**

Delinking from the world market was however not the sole and crucial strand in this cardinal development although it was a vital element of Japan's cultural autonomy but essential was an inward-oriented adaptation of technology. With modern western technologies alone will the employment and equilibration problems of the Third World never be solved but if anything be aggravated. All technical advances in the past decades bore the mark of specific rationalization efforts in the industrialized countries which turned even formerly labour-intensive sectors into capital-intensive industries; ever more workers are made redundant in the modern textile industry and, even more so, in the mechanized agriculture unless these can achieve a truly dynamic growth rate. The markets in these areas tend to stagnate according to Engels' laws. True, the products in question cover essential basic needs for which it should be possible to develop proper mass markets, but mass markets for such basic products can only come into being if mass incomes are generated as well, and this is possible only with labour-intensive production methods. In the Third World mass production must take the form of production by the masses.

The choice of an appropriate technology is of prime importance in such a concept. A strategy of inward development must rely predominantly on small and medium-sized industry, whose potential is today largely unused in most developing countries. They are often not merely neglected but systematically discriminated. Small and medium-sized enterprises generally employ

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<sup>3</sup> Cf. Carlos F. Diaz-Alejandro: *Foreign Trade Regimes and Economic Development: Colombia*, National Bureau of Economic Research, New York 1976, p. 240 ff.

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Cf. W. Lockwood: *The Economic Development of Japan and Structural Change 1868-1938*, Princeton University Press 1954, p. 198 f.

more labour-intensive methods than big ones<sup>5</sup> and usually produce more appropriate and less sophisticated products; frequently they employ however an anachronistic technology which they have never improved. Technical progress in the modern sector renders such obsolete technology in smaller firms more and more marginal because modern products replace traditional ones and modern technology operates as a "package": it depends on modern supplier industries so that small firms are displaced in increasing measure from the markets, and a pronounced dualism develops between the modern and the traditional sector. What is known as the "trickle-down effect" cannot operate because the modern sector uses virtually only imported or modern-sector inputs; dynamic employment impulses fail to materialize.

### Need for a Dual Approach

Appropriate technology must start with appropriate products; complex products like computers, automobiles, stereo sets, etc., cannot possibly be made without complex technologies. Use of appropriate products does certainly not involve a "return to the stone age", as many sceptics allege; what is different about mass products for basic needs is their relative simplicity, stability and low price. Mass markets do not demand the sophisticated products of the western consumer societies although, given the present income distribution, these products admittedly attract the buyers with the biggest purses. The use of the most modern technology gives rise to a vicious circle in that it creates itself this élitiste but small market: complex technology requires skilled workers who receive relatively high wages. As a result the income distribution remains uneven and the purchasing power concentrates on the modern sector. Mass markets can never develop in this way; the "desarrollismo" policy which invariably advanced the modern sector at the expense of the traditional one ends eventually in deadlock.

The correction of these tendencies by a strategy of inward-oriented development on the basis of appropriate technology requires a dual approach:

- On the one hand, the modern unadapted sector must be downgraded so that more simple labour-intensive technologies are used.
- On the other, the traditional sector has to be upgraded, for small enterprises operating with obsolete technologies can respond to changed consumer requirements only if they produce improved products<sup>6</sup>.

Finally, decentralization of production and promotion of the small markets is an essential element of an inward-oriented development strategy. Most developing countries have hitherto tried to use their big towns as growth poles, with the result in most cases that the markets for sophisticated products were artificially enlarged rather than that the technologies were adapted to market conditions. The big towns were given preferential treatment in many respects and made attractive by provision of subsidized infrastructural services while the smaller and medium-sized towns stagnated.

This happened in disregard of an important fact which Adam Smith already recognized and stated on one of the first few pages of the "Wealth of Nations": "The extent of the division of labour is limited by the size of the market"<sup>7</sup>.

### The Case of Colombia

But how little has this important truth perceived by the great economist been heeded in practice! The example of Colombia shows most clearly that the economic policy amounted in fact to an adaptation of the markets to the desired modern technology instead of an adaptation of the tools and machines to the wanted products.

On the surface Colombia seems to be committed to free trade; the average duty charge amounts to no more than 15 % of the import value<sup>8</sup>. A closer analysis of the trade regime reveals however marked protectionist tendencies. Paradoxically Colombia is – in spite of this protectionism – to an extreme degree integrated with and dependent upon international trade. The reason is that the capital- and import-intensive industries are selectively favoured by trade policy. Big industries encounter no problems in importing raw materials and machinery while small industries are at a great handicap, if only because of the bureaucratic procedures. The Colombian trade regime is tied up with the industrialization ambitions and import substitution policy and works with three main instruments on the import side – customs duties, import licences and advance deposits<sup>9</sup>. As for the exports, traditional

<sup>5</sup> Cf. John E. Todd: Efficiency and Plant Size in Colombian Manufacturing, Ph. D. thesis, Yale University 1972.

<sup>6</sup> On this concept of upgrading and downgrading cf. Frances Stewart: Technology and Underdevelopment, London 1977, p. 58 ff.

<sup>7</sup> Cf. Adam Smith: An Inquiry into the Nature and Causes of the Wealth of Nations, London 1776, Vol. 1, p. 19 (3rd chapter).

<sup>8</sup> Cf. Carlos F. Díaz-Alejandro: op. cit., p. 102.

<sup>9</sup> Cf. Carlos F. Díaz-Alejandro: Los Mecanismos de Control de Importaciones – El Sistema durante 1971 y un Recuento de su Evolución (The mechanisms of import control – the system in 1971 and a review of its evolution), Fedesarrollo, Bogotá 1971 (2 parts).

products like coffee are taxed while non-traditional exports are subsidized.

According to a study by Hutcheson and Schydowsky<sup>10</sup>, the effective rate of protection provides, in conjunction with institutional factors and incentives by the greatly distorted credit market, very high protection for the modern sector and, more especially, for capital-intensive industries like transport equipment, electric machinery and crude metals; it amounts to about 200 % of the value added.

The credit policy is anything but neutral; to those who have much, more is given. Mechanized agriculture and capital-intensive industries receive subsidized loans at interest rates of about 10 %. With inflation rates of 20-30 % first-class-risk borrowers can obtain credits in the commercial capital market at 18 % while the less well endowed small industries have normally to pay between 25 and 36 % for loans from non-bank sources. The state-owned Caja Agraria, which should consider assistance to smallholders its principal task, has been nothing short of "enthusiastic" in its support for the mechanization of agriculture, according to a study by Wayne Thirsk<sup>11</sup>; it imported tractors duty-free on a large scale and sold them to farmers on credit at interest rates of 9-11 %. Big farmers, however, were the sole beneficiaries of this remarkable subsidy since small farmers have little use for tractors on their tiny plots of land. Against the advice of World Bank experts Colombia also went ahead with the rapid establishment of a petrochemical industry. IFI (Instituto de Fomento Industrial – Institute for Industrial Promotion), a government agency, invested as much as 40 % of its portfolio in this sector<sup>12</sup>. The petrochemical industry is however so highly capital-intensive that an investment of \$ 100 mn creates barely 1,000 jobs whereas the same investment in the textile industry would have provided 102,000 jobs, in the shoe industry 56,000 and in wood working 49,000.

It was not only in the sphere of production that the cost of capital was reduced selectively and artificially by favoured treatment; on the demand side subsidies were also of great assistance. There are efficient marketing and export agencies for the modern cash crops of

mechanized agriculture such as cotton while the smallholders have still to depend on a mafia of middlemen. The production or assembly of automobiles is not only protected by an import duty of about 200 %, but in addition gasoline is being subsidized because car-ownership would be the preserve of an even smaller élite if motorists had to bear its actual cost.

The reduction of the transport costs by way of these subsidies has other effects as well: it extends the exclusive market of the highest income bracket which comprises 3,000,000 consumers with a very high purchasing power – 10 % of the population. Thanks to subsidized transport costs this market can be reached easily throughout the country. To put it differently, one large factory can supply the whole of the vast country and this one factory is usually protected from the adverse influence of the world market so that it is free to exploit a comfortable monopoly position.

### **Elements of an Appropriate Strategy**

In positive terms an economic policy embracing the strategy of inward-oriented development would have to comprise the following elements:

- The trade regime would have to favour smaller and medium-sized firms and discriminate against big capital-intensive industries. The trade policy would have to discriminate conceptually against inappropriate technologies with downgrading tariffs, thus reducing the effective tariff protection for the modern sector. To avoid a consequent heavy increase of imports of manufactured goods, the country's currency could be depreciated.
- The upgrading of the traditional sector in agriculture and small and medium-sized industry would have to be vigorously promoted. This calls for an active policy on technologies and credits and individual support for smaller firms through consultancy, technical assistance and subsidies in addition to the classic tools of economic policy.
- The small markets would have to be upgraded and protected by an emphatic policy of decentralization. All transport cost subsidies should be dropped, and the smaller towns should be given the same institutional rank as the mammoth cities: in spite of the immense social costs, the Colombian capital Bogotá is still enjoying artificial locational advantages as a consequence of the administrative centralization; the discrimination of the decentral market will continue as long as people have to undertake several journeys to Bogotá if they need an import licence, merely because the competent authority has its office in the capital.

<sup>10</sup> Cf. Thomas L. Hutcheson, Daniel H. Schydowsky: Incentives for Industrialization in Colombia, World Bank paper on a research project under the direction of Bela Balassa, as yet unpublished, Washington 1977, p. 2-20.

<sup>11</sup> Cf. Wayne R. Thirsk: The Economics of Colombian Farm Mechanization, Ph. D. thesis, Yale University 1972.

<sup>12</sup> Cf. David Morawetz: Import-Substitution, Employment and Foreign Exchange in Colombia: No Cheers for Petrochemicals, in: Peter Timmer et al.: The Choice of Technology in Developing Countries, Harvard Studies in International Affairs, No. 32, Cambridge (Mass.) 1975, p. 95 ff.