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Trade Protection in India: Economics vs. Politics?

by Ira N. Gang (Rutgers University) and Mihir Pandey (Ramjas College)

EXECUTIVE SUMMARY

India historically imposed high tariffs and strict import controls, restricted the introduction of foreign capital and taken other measures to protect domestic industries. The justification for these import-substituting policies is that they were necessary to promote industrialization and modernization. However, it is not clear whether protection was in fact truly based on the goals of industrialization and long-run comparative advantage, or whether it was determined by other, more political motives. This paper investigates the determinants of protection in the secondary (manufacturing) sector across three plan periods, using data from 1979-80, 1984-85 and 1991-92. Both economic and political factors are at work. Economic factors, summarized by the infant industry argument, should result in industries that are relatively efficient compared with the rest-of-the-world to have low levels of protection and the degree of protection should change as the relative efficiency of an industry changes over time. Political factors reflect by pressure group politics: relatively inefficient industries may enjoy a great deal of protection because of political lobbying.

The economic argument given for the high levels of protection is usually in terms of the infant industry argument. This says that a certain period of protection is necessary to enable newly emerging industries to catch up to world efficiency levels. This was indeed emphasized by all the Five Year Plans in India, but is not supported by our empirical analysis. Instead, political variables seem to be more important. The political strength of labor as well as business are important in varying degrees over the three years. This is seen through the variables relating to employment size, average wage, rent to capital and concentration. Some of these variables, especially concentration, go against the expected signs. This may be, however, due to either to the bias of government policy toward social objectives or to the hysteresis of policy. During the entire period of planned growth after the Second Five Year Plan and right up to the Eighties, the Indian government deterred the import of consumption goods largely to conserve scarce foreign exchange that was needed for vital imports of investment and intermediate goods. Thus, the consumer goods industries received a higher level of protection. This particular aspect of policy is therefore in concordance with the interests of Indian business because a large proportion of consumer goods industries was in the private sector, whereas the public sector had a large share in the intermediate and capital goods industries.

Another explanation for the apparent anomaly between what was expected and what happened is the hysteresis of policy in the Indian context. The guiding principle of all policy for more than three and a half decades was expounded in the Second Five Year Plan. Trade and industrial policy became increasingly complex over the years, and there was very little change in the industries that enjoyed protection. Thus, even when economic reasoning would favor the lifting of the protection, it would have been virtually impossible to effect a change in the face of opposition from businesses, politicians and the bureaucrats.

Studies of other countries show that different factors have been important in different countries. Pack (1994) in his study of Indonesia concluded that the structure of protection was largely a result of economic forces, while Bar-Nathan and Baruh (1990) conclude that relative efficiency and lobbying pressure were both important determinants of protection in Israel. Finally, Trefler (1993) concludes that lobbying by both business and labor are important determinants of the protective structure in USA. Our study has thrown up results that are comparable to that of Goldar & Saleem (1992). They had found low explanatory power for their political economy model, but with the variable for labor and business being significant.

Our study contributes to the literature on trade policy by examining the factors that lead to these differences in protection. The course of liberalization is not easy, given the history of controls within a regulated economy. It becomes even more difficult if pressure groups succeed in influencing policy. By examining trade policy in a political economy framework, we show the strengths and weaknesses of political pressure groups across sectors, and the likely hurdles in implementing economic reforms. The continued influence of pressure groups suggest that differences in the protection structure will remain, despite the economic arguments underlying the current liberalization effort.