

INFANT INDUSTRY PROTECTION

“Legitimising limited, time-bound protection for certain industries by countries in the early stages of industrialisation. However misguided the old model of blanket protection intended to nurture import substitute industries, it would be a mistake to go to the other extreme and deny developing countries the opportunity of actively nurturing the development of an industrial sector. A requirement for international approval of such protection could be a help to the governments of developing countries in resisting excessive demands from their domestic lobbies (and from multinationals considering local investment).

[United Nations, Technical Report of the High-level Panel on Financing for Development – the “Zedillo Report”- page 41.]

1. There appears to have been a recent revival of support for infant industry protection, at least in UN circles. The above quote illustrates this, and two recent UNCTAD Discussion Papers have put forward the theoretical case for such protection. (Mehdi Shafaeddin, “What did Frederick List Actually Say?” and “Free Trade of Fair Trade”, UNCTAD Discussion Papers 149 and 153, 2000). This seems to reflect an emerging view in such circles that liberalisation in developing countries (notably under IMF adjustment programmes) has been excessively dismissive of the role of infant industry measures in fostering industrial development.
2. This note briefly sets out the theoretical economic case for and against infant industry protection. It concludes that, in theory, there may be cases where infant industry protection is a legitimate instrument for industrial development, but that there are very real practical problems in formulating the appropriate policy for the instrument to work. It then attempts to identify what empirical studies suggest about the success or failure of infant industry protection, and concludes that, in general, infant industry policies do not appear to have been profitable. Finally, it looks at the existing provisions for such protection in the WTO, and notes one criticism of them levelled by the supporters of infant industry protection –namely that while protection would normally be better given through subsidies rather than tariffs, it is actually easier in the WTO to secure tariff protection.

The theoretical arguments

3. It is important to note that the infant industry argument is not one for general protection in an economy (even though it may on occasion have been wrongly used to support such protection) but for selective protection. It is also primarily applicable to developing rather than developed economies (albeit its intellectual foundations were laid in the USA in the late 18th century and in Germany in the first part of the 19th century, when both countries regarded their industries as underdeveloped relative to those in the UK).

4. The argument claims that protection is warranted for small new firms especially in less developed countries. New firms have little chance of competing head-to-head with established firms located in developed countries, because developed firms have been in business longer and over time have been able to improve their efficiency in production. They may have been able to exploit any available scale economies, and they have better information and knowledge about the production process, market characteristics etc. Thus, new firms in developing countries will not be able to survive in the market. But if they were given protection (perhaps by a tariff, although this is not the only possible mechanism), they would be able to cover their higher production costs and remain in business. Over time, they would gain any scale economies and production and management experience would lower their costs until they became competitive on world markets. In “static” models of the effects of protection, the economic costs of protection to an economy will exceed any benefits. But the infant industry argument opens up the *possibility* (no more) of protection being of ultimate benefit to an individual economy- and conceivably the world economy- because it allows these dynamic effects on production to be achieved.
5. A number of points follow from this argument. Firstly, it implies that protection should only be given to industries where there are reasonable grounds to believe that the industry would become competitive in the long run; it cannot be valid for blanket protection. Secondly, it implies temporary protection: It is not welfare enhancing to continue to bear the costs of protection when the industry is competitive. Thirdly, it begs the question of whether, if achievement of scale economies is the mechanism by which the industry is competitive, it could ever be successful in countries with small domestic markets; with a few notable exceptions such as India and Brazil, m developing countries have small domestic markets. Fourthly, and perhaps most importantly, it implies that Government’s have the ability to identify the appropriate industries, and the self-discipline to confine protection to them.
6. It should be noted that the Zedillo recommendation (and the UNCTAD analytical work) by and large recognises the necessary implications of the argument. Thus, the Zedillo recommendation refers to “limited, time-bound protection for certain industries” and seeks a mechanism to prevent the process being captured by domestic (or other) lobbies.
7. The main purely economic argument against infant industry protection is that protection has traditionally meant a tariff or other border measure. But, even if the infant industry hypothesis was valid, that is not the best option. The key to the argument is that production experience causes learning which spills over into future productive efficiency in that industry and, perhaps, in other industries as well. But the first-best policy here would not be a tariff but a production subsidy targeted at the industry that generates the positive effects. (The UNCTAD work recognises this, and it may well be that the Zedillo concerns are actually about restrictions on the use of subsidies – see paragraphs 17 and 18 below).

8. The second argument against emphasises the very large informational needs required to make this policy work. Governments must decide which industries to pick, which requires knowledge of, for instance, those that have strong learning effects. They must also decide the appropriate size and duration of the tariff. The tariff must not be too low or too short (policy too weak to work), too high (excessive costs to consumers), or too long (weak incentive to firms). Opponents of the infant industry argument doubt that any government – developed or developing- has the knowledge or ability to select either the right industries or the appropriate degree of protection.
9. The third argument is that domestic firms may not respond to protection in the way the Government envisages. Protection may dampen their competitive edge, either in terms of costs or pricing. It may also encourage new entry into the industry by domestic firms. Either of these developments could mean that the hoped-for improvements in competitiveness through learning/economies of scale do not materialise.
10. The fourth argument is one of political economy. Political pressures can make it difficult to implement an infant industry policy in an effective manner. Protection – as the Zedillo report recognises- may be offered to the most effective lobby rather than the most “deserving” industry. And once protection is given, the protected firms are likely to resist any reduction or removal of it. It is not unknown for firms to try to convince Governments that they need just more time to guarantee the intended efficiency improvements. The infant industry protection afforded to the Australian car industry was still in place more than twenty years later.

The empirical evidence

11. Although it is possible to make a clear conceptual distinction between selective infant industry protection and more general protection (such as a general import-substitution policy), the available evidence does not always allow one to disentangle the two. Hence the debate often merges with the general one on the merits of free trade.
12. One line of argument takes a broad historical approach. Proponents of the infant industry argument like to cite the experience of the USA and Germany in the 19th century as evidence of its merits. They argue that the tariffs in those countries helped protect their fledgling industries from competition with more efficient firms in Britain and were a necessary requirement to stimulate their growth. Critics argue that this undoubted development took place largely because of an accumulation of physical, technological and human capital that would have occurred anyway: protection did not foster growth and may well have reduced it. The same critics point to the more recent experience of Africa and Latin America in the 1950s and 1960s with the use of import substitution strategies. Although not identical, infant industry protection through a tariff has some of the same characteristics (notably in that it does not initially mean the

industry is competitive on the world market). It is not questioned that these policies did not work.

13. Studies of the experience of individual industries given protection are a more direct source of evidence. They seem to suggest that past protection has not, in general, succeeded. A study by academics on behalf of UNCTAD (Bora, Lloyd and Pangesti, "Industrial Policy and the WTO", UNCTAD, Policy Studies in International Trade and Commodities, No.6, December 2000) says "There has also been a plethora of studies which show that industrialisation behind protective walls has often extended beyond reasonable grounds of infancy and has led to efficiency and welfare losses, and entrenched vested interests." It is important to note the growth of an infant industry is not itself proof that the policy has succeeded. If the costs of stimulating this growth exceed the benefits, the policy can be said to have failed. For instance, a study of the Brazilian microcomputer industry (Luzio and Greenstein, "Measuring the Performance of a Protected Infant Industry: The Case of Brazilian Microcomputers", Review of Economics and Statistics, 1995) notes that, with strong domestic protection, the industry did advance, but less quickly than elsewhere and with technical frontiers lagging behind those in international markets, whilst the cost of protection to Brazilian consumers was nearly 20% of domestic expenditure on microcomputers. The policy can therefore be said to have failed. A recent TPRM report for Malaysia highlights the relatively poor export performance of the car industry, which has received considerable protection through tariffs and local content programmes. Normally, infant industry protection has been as a way of fostering industrialisation in developing countries, and has thus been seen as particularly pertinent to manufacturing. But it can be extended to services. An analysis of developing country insurance markets (by Brian Hindley) shows that infant industry arguments seem to have been one of the motives for protection – and that the protection has not been successful.
14. A related approach is to look at the individual components of the infant industry argument in order to assess whether the conditions for success are likely to be met. For instance, analysis suggests that Governments trying to pick appropriate industries select those that are growing elsewhere or have some prestige (usually associated with technological content) attached to them. But these need not be the industries in which that particular economy would be capable of being competitive. The crux of the infant industry argument is the proposition that, behind a protective wall, the industry will actually become more efficient, either through exploiting economies of scale or through a learning process. A recent review of existing studies financed by the World Bank (Tybout, "Manufacturing Firms in Developing Countries: How well do they do and why?", WB working paper no.1965, 1998) concludes that this argument does not in general hold. It finds that unexploited scale economies in developing countries are modest and that protection reduces average efficiency levels at the margin. It concludes, "although the econometric evidence on technology diffusion in [developing countries] is limited, it

does suggest that protecting “learning” industries is unlikely to foster productivity growth.”

15. What conclusion should be drawn from this evidence? It would be untrue to say that infant industry protection has always been ineffective. There is no systematic audit of all cases where it has been applied, and there are arguably some success cases (e.g. the development of a low-cost pharmaceutical industry in India). But on balance the evidence appears to confirm the theoretical arguments against it- inappropriate choice of industries, great difficulties in removing protection once granted, and limited productivity growth in the protected industry.

Infant Industries in the WTO

16. The legitimacy of infant industry protection for developing countries has been accepted ever since the creation of the GATT. Article XVIII provides for the possibility of a wide range of government actions to help protect and encourage infant industries, subject to reasonable requirements to consult and notify WTO members and offer them compensatory adjustments where necessary. The provisions of Article XVIII have been invoked reasonably frequently by developing countries. According to the 1995 edition of the GATT Analytical Index, Articles XVIII A and C have been invoked a total sixteen times by countries such as Cuba, Haiti, India, Sri Lanka, Suriname, Indonesia and Korea.
17. However, modern supporters of infant industry protection now worry about the restrictions imposed by the Agreement on Subsidy and Countervailing Measures (ASCM). They see fostering of infant industries by subsidies as the way forward, rather than the traditional reliance on border protection. There is no doubt that, in theory, a subsidy is a more efficient instrument. Moreover, unlike border protection, it can be used to foster exports directly, and the supporters of the infant industry case are keen to distance themselves from the failures of import -substitution strategies and emphasise export-promotion ones. They hold (rightly or wrongly) that export-targeted subsidies played a key role in the economic development of the Asian tigers.
18. Their problem is that article 3 of the ASCM prohibits subsidies dependent upon “export performance” or “the use of domestic over imported goods” to be paid to firms (except for agricultural products). Shafaeddin complains, “The implication of this article is that a country cannot support its infant industries, whether or not for exports, either across the board or on a selective basis, when the subsidy is tied to export performance – a practice common until recently, particularly in East Asian countries.” It is not clear what instruments the Zedillo Report had in mind when it referred to “protection”, but it is possible that they were primarily concerned with subsidies. R&D subsidies are permitted. However, Shafeaddin complains that the needs of developing countries (unlike developed ones) are for production not R&D subsidies.

19. The infant industry argument thus appears to have shifted over time. Traditionally, it focused on tariffs that would allow domestic firms to develop within the home market. It was thus, initially, an instrument that relied on import substitution, even though the firms might be expected to be subsequently competitive in export markets. The latest proponents of infant industry protection however, appear to be much more devoted to the use of export subsidies.