

V

Some Broader Issues

Rent-Seeking and Other Costs of Protection

The orthodox costs of protection result both from the distortions it generates in the pattern of production and the use of inputs into production, and from the distortions it causes in the pattern of consumption, brought about by price signals that do not correctly reflect the trading opportunities open to a country. Mostly the effect of protection is, as noted earlier, to lead to excess production of import-competing relative to export production as well as to distortions within the import-competing sector from uneven effective rates of protection. The net result is then to reduce national income. Such costs result even from a system of fixed and well-defined tariffs. But the actual costs of protection are usually much greater than these "orthodox" costs, essentially because trade interventions are often very complicated and are frequently altered, responding to pressures of various kinds. In particular, they involve licensing of imports and ad hoc bureaucratic decision making.

Three kinds of costs in addition to the orthodox costs of protection then arise. These are (1) costs of administration and compliance, (2) "rent-seeking" costs, and (3) disincentive costs of made-to-measure systems.

Administration and compliance costs can be very high when there is an elaborate licensing system. This is a particularly important argument for preferring firmly fixed tariffs to import quotas in developing countries. The complexities and inequities in quota (and exchange control) systems multiply, and scarce administrative talent in government and industry is diverted into nonproductive channels. Such activities are unproductive for society and create a particular problem in developing countries where there is often a scarcity of trained personnel.

Rent-seeking costs (which have received much attention in recent analyses) result from efforts devoted to obtaining scarce import or foreign exchange licenses, and from lobbying legislators to obtain or to reduce protective tariffs or quotas. Rent seeking does not refer to pure redistribution effects (which result from bribery) but rather refers to actual resource costs—principally labor costs—involved in the various activities, notably lobbying. The scope for rent seeking is particularly great

with import quotas (unless they are auctioned) and provides another argument for preferring tariffs to quotas if there is to be protection.

Protection systems are made to measure, or attempt to be so, when they are frequently adjusted to reflect the profitability of import-competing activities. In systems that try to be made to measure the more profitable local production is, the more protection would be reduced, while a rise in domestic costs for whatever reason—causing local industry to become less competitive—leads in such a system to an increase in protection. Systems that are based on quantitative targets for imports (for example, when there is a provision that a given share of local absorption should be imported) have this effect. Such systems involve high administrative costs and stimulate rent seeking. Even more important, they reduce, or possibly even eliminate, the incentives to improve efficiency and to cut costs, and are thus clearly undesirable.

Protection and Growth

The provision of protection for a particular industry or category of industries may well, for a time, lead to higher growth of these industries. Thus a country that provides infant industry protection for manufacturing is quite likely to find that the rate of growth of manufacturing does accelerate as a result. But such protection is at the expense of other industries (perhaps agriculture) which are likely to grow less fast; hence there is no presumption that growth in the economy as a whole would be higher. A correlation between sectoral growth and protection rates tells one nothing about the overall growth effects.

The central question is whether the various protectionist devices improve or worsen the overall efficiency of the economy both in terms of the orthodox resource allocation concept and the other considerations (such as rent seeking) just discussed. The general presumption which follows from the discussion so far is that they worsen efficiency. In that case, growth is also likely to decline because the efficiency of investment will decline. A given amount of savings when invested will yield lower output gains. The capital output ratio rises. Thus

the growth effect is a by-product of the static efficiency effects.

While the principal implication for growth of various microeconomic interventions is through capital accumulation—which becomes more productive the more efficient the economy becomes—there are other growth implications of protection. Five might be noted here.

First, any change in efficiency is likely to develop gradually. For example, removal or simplification of a system of protection will raise the efficiency of the economy by increasing the productivity of given factor inputs. This may take place over a period of years and during this period, though not indefinitely, the rate of growth will be higher than otherwise.

Second, protection policy may affect the relative prices of investment goods, and this could affect the growth rate. If protection raises the domestic cost of investment goods, or forces local industries to use domestically produced equipment of lower quality, the growth rate is likely to be reduced as a result.

Third, “made-to-measure” systems of intervention, which compensate industries in trouble by providing more tariffs or subsidies when their profits fall, and which reduce protection when the industries are successful, reduce the incentive to innovate and are thus likely to lower the growth rate.

Fourth, rent seeking, referred to above, can lead to a serious diversion of entrepreneurial effort and hence reduce the rate of growth.

Fifth, the overall growth rate will decline if protection preserves old-established industries which have relatively low rates of technological progress at the expense of potential high-growth industries.

Extensive research on the relationship between growth rates and outward-looking policies versus inward-looking policies has been done at the World Bank and elsewhere. Outward-looking policies can be defined as policies that do not discriminate significantly against exports and allow market forces to determine (to a reasonable extent) the degree of openness, while inward-looking policies are those that create a bias in favor of import substitution. More and more evidence seems to be emerging that developing countries which have been outward looking have also enjoyed high growth rates.⁹ Higher export growth resulting from some trade liberalization combined with appropriate exchange rate adjustment has been associated on average with higher overall growth. Outstanding examples here are Korea, and, for a limited period from about 1966, Brazil. There are also examples from the earlier history of now-developed

countries, such as Sweden. Of course other factors, such as investment ratios, have also been important in explaining relative growth rates.

Outward-looking countries have never had completely free trade, and governments have usually played an important role in development policy, but the bias in incentive systems has not been against exports during their high growth periods. In some cases there has simply been some reduction in the import-substitution bias of the incentive system. This has stimulated export growth, and in turn an increase in overall growth seems to have resulted.

Distribution

Intervention policies usually benefit some sections of the community at the expense of others. Trade liberalization in industrial countries would, for example, reduce profits and employment in the clothing and textile industries while benefiting consumers at large as well as other industries (through the exchange rate depreciation or labor cost adjustment with which it might be associated).

Some of the benefits to the gainers spill over fairly directly to the losers, so providing partial compensation, especially if there is an effective taxation and social welfare system. Thus, if trade liberalization has the net effect of raising aggregate national income it will raise the tax base, and some of the revenue may be spent on transfers or extra public facilities that benefit present and former employees in the losing industries.

Nevertheless, on balance there are likely to be some net losers since full compensation rarely takes place. It has been frequently calculated that the potential gains from removing protection on particular industries, notably clothing and textiles, are so large that it would actually be possible to compensate most generously employees in those industries, and yet still leave consumers better off.¹⁰ But in practice full compensation rarely takes place, primarily because it is difficult to identify losers precisely. Further, if compensation policies became customary and hence rationally expected, there would be an incentive for protected industries to stay in existence and even expand, even if they knew that their protection is unlikely to last.

Given that there will be gainers and losers from liberalization or protection, can anything really be said about “national” gains or losses? There are three possible approaches:

1. The traditional answer of economic theory has been

¹⁰Cost of protection figures and further references can be found in the Fund's Occasional Paper 38, OECD (1985), Balassa and Michalopoulos (1985), and World Bank (1987). A detailed calculation for the United States has been made by Tarr and Morkre, summarized in their contribution to Salvatore (1987). Figures on clothing and textile protection in the United States will appear in Cline (1987).

⁹The large literature analyzing this issue and giving strong support to this conclusion is surveyed in Balassa (1985), Balassa (1986), and World Bank (1987).

to focus on the concept of potential welfare, which allows for the possibility of compensation. If gainers could compensate losers and yet have something left over, there would be a national gain as the policy change would represent an improvement in national efficiency. It is accepted that actual compensation may not take place, but the potential exists, and if nations choose not to compensate fully, then, they must be satisfied with the income distribution that has resulted.

2. One can argue that there is a presumption in favor of trying to foster national efficiency, but that particular measures that have well-defined distributional effects which are thought to be adverse should be accompanied by appropriate compensating measures. Various calculations have shown that the potential efficiency gains from liberalization are often very great. There is then a strong argument for pursuing liberalization combined with compensation of losers, if only to make the liberalization politically acceptable. Various methods of compensation which might also improve efficiency are available, for example, retraining and relocation grants.

3. Finally, there is the "long-term mutual gain approach," which probably represents more closely the views of those who advocate efficiency-oriented pol-

icies. The argument is that policies which consistently foster national efficiency will eventually make everyone better off. There is a long-term mutual gain, or at least it is probable that there would be. While particular individual steps that improve national efficiency may make some parts of a population worse off, other further steps will make them better off, and so finally all will be better off.

It must be emphasized that this distributional problem—almost a philosophical problem—does not create any presumption in favor of protection even if one dismisses the "long-term mutual gain" approach. It would still have to be shown that protectionist regimes in practice actually have favorable distributional effects when judged by some kind of objective criterion. In many developing countries, protection benefits the urban population relative to the rural one and average incomes in the latter are usually lower, so that the overall distributional effect would normally be regarded as adverse. Furthermore, when protection takes the form of quantitative restrictions, which inevitably involve the issue of licenses, there is scope for the benefits in the form of monopoly profits going to privileged persons with contacts and influence, and also for direct corruption. Poor people are unlikely to be the beneficiaries.