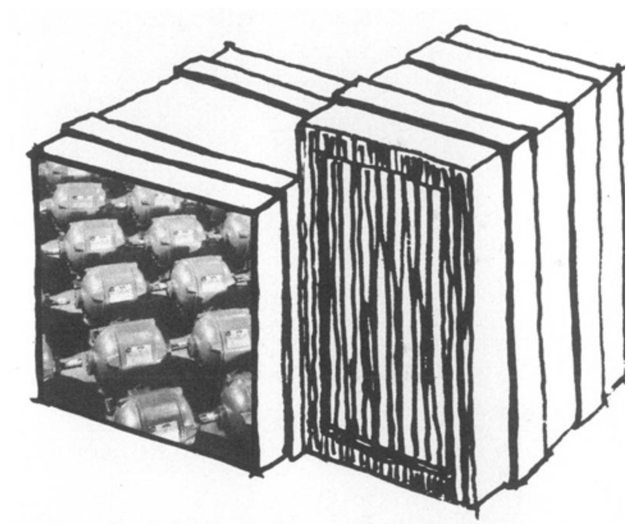
# Import Substitution

***Developing countries generally emphasize continuous import substitution as the way to industrialization and eventual self-sufficiency. In some situations this may be the right course, but the author argues against the acceptance of import substitution as a panacea for all the ailments of underdevelopment.***

***Jose A. Datas-Panero***



Import substitution means generally the satisfaction of a greater proportion of a country's total demand for goods (production plus imports) through its own domestic production. However, this phrase has been used ambiguously by authors depending upon the objectives of their studies. One authority defines import substitution as the change in the proportion of imports in total supply. In this context he distinguishes between three causes of industrial growth: (1) the substitution of domestic production for imports; (2) growth in final use of industrial products; and (3) growth in intermediate demand stemming from (1) and (2).

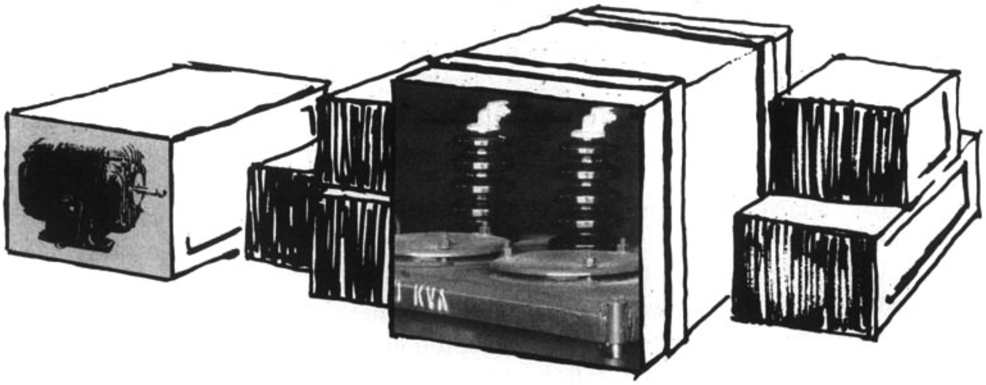
A second authority thinks of import substitution in terms of two stages. The first (easy) stage, is the take-over of an existing market for consumption goods from the foreign supplier. The second, and much more difficult stage, consists of extending production backward to intermediate goods, capital goods, and raw materials, and breaking into the world market with exports of manufactures. The first stage is self-contained and realistic. The second stage, however, includes too many variables and does not reflect the real aim of import substitution. It should be remembered that this strategy emphasizes production for domestic markets rather than development of export markets. In attempting to open up foreign markets it is not enough to rely on a policy of across-the-board import substitution.

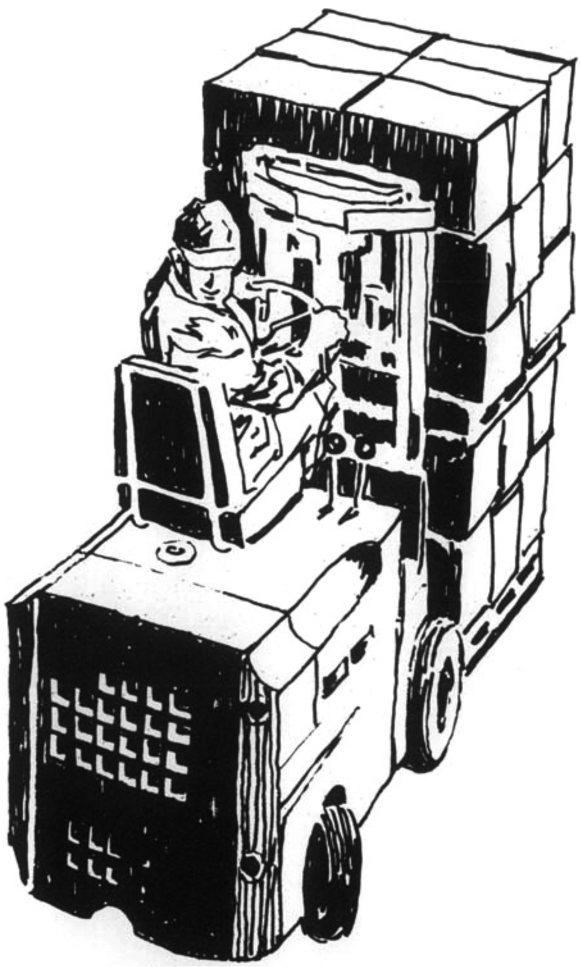
A third authority states that there is not a single definition of import substitution. In a broad sense it is used to refer to all arguments to the effect that modern developing countries cannot rely on exports as an engine of growth. In a narrow sense it refers simply to the take-over of an existing domestic market from the foreign producer by prohibiting his imports in one way or another.

Import substitution as carried out by modern developing countries usually takes place in a number of stages. As Hirschman puts it, the process "starts predominantly with the manufacture of finished consumer goods that were previously imported and then moves on, more or less rapidly and successfully, to the higher stages of manufacture, that is, to intermediate goods and machinery, through backward linkage effects." [1]

Developing countries cannot rely exclusively on the exports of a few primary products for achieving a reasonable rate of economic growth. However, this fact

[1] O.A. Hirschman. "The Political Economy of Import-Substituting Industrialization in Latin America," *The Quarterly Journal of Economics* (February 1968), p. 6.





does not justify the adoption of indiscriminate import substitution as a uniquely trustworthy development strategy, since in the long run it would not by itself lead to adequate growth or an efficient industrial sector. More attention needs to be given to expanding output and increasing productivity in the traditional sectors, especially since a large proportion of the incremental incomes will be spent on foodstuffs. For these reasons it is necessary to reconcile the expansion of the traditional sectors with a selective policy of import substitution.

An element of import substitution is, therefore, a necessary, although not sufficient, condition for expanding domestic markets and helping to sustain a satisfactory rate of industrialization. A well-conceived and adequately implemented strategy of import substitution can make a substantial contribution toward higher incomes and help to promote exports. It also can help to speed up the transition from a traditional and agrarian economy into an industrial society sharing in the benefits of international relations and trade. In my opinion such a strategy of import substitution should mainly:

- encourage local production of a limited number of goods without attempting to provide substitutes for all imports of consumer goods;
- promote, from its beginning, domestic production of consumer goods, intermediate products, and capital goods in which the country has or can realistically develop a comparative advantage;
- concentrate, from an early stage, on products with real export potential based on domestic resources where backward linkages can be maximized;
- introduce a system of moderate tariffs so arranged that the effective rates of protection do not vary significantly between industries;
- lower protective tariff barriers—protection should not be discriminate against either capital, intermediate, or consumer goods;
- set up a system of export promotion for products meeting specified conditions in order to facilitate prompt entry in international markets;
- ensure that the traditional export sector is not discriminated against;
- determine the size and timing of the import substitution strategy on the basis of a long-term industrialization program that relates the balance of payments position to the requirements for overall economic growth.

## *The Process of Import Substitution*

This is the idea; the picture in fact is usually very different. Import substitution is normally introduced to

solve balance of payments problems, and it is accompanied by trade controls or high tariffs that practically shut out all competition from imports. During the first stage, domestic production of consumer goods, frequently with a high import component, grows very rapidly. These goods are often of doubtful quality, produced in factories of uneconomic size, and sold at high prices in the protected domestic market. Once imports of consumer goods have been replaced, the growth of demand generally slows down and substitution moves on slowly and inefficiently into higher stages of manufacturing, e.g., intermediate goods and capital goods. High tariffs or controls on imports of final products and very low tariffs on raw materials become the main source of profits. Therefore, as the process develops, the businessmen concerned with it naturally oppose domestic production of relatively cheap imported raw materials which would reduce these profits. Frequently, as countries move on to higher stages of manufacturing they still retain the old economic policies that are no longer applicable to the new phase of import substitution. Another common weakness has been to start the import substitution process as a sudden strong push across-the-board without an economic study of which sectors or industries would deserve preferential treatment on the basis of their comparative advantage and contribution to growth.

The highly sequential or tightly staged affair of import substitution is not a prerequisite for industrialization. On the contrary, it would appear that the tightly staged sequence has been the basic cause of many failures. A better policy is to develop a long-term industrialization strategy which promotes a smaller number of specific industries and specific products with the least cost disadvantage and a production pattern that can be vertically integrated without too much dif-

ficulty. That is, the first stage of import substitution should emphasize the use of domestic raw materials and intermediate products which are, or could soon become, competitive by international standards. There should be no attempt at all-round self-sufficiency in consumer goods. This new approach should break the straitjacket of tight sequential stages and create a more fluid process leading to the penetration of export markets and avoiding the exhaustion of opportunities for import substitution. Such a strategy is different from the one generally attempted; most developing countries follow industrialization strategies characterized by large horizontal diversification and neglect vertical integration and specialization.

The two stages of import substitution have sharply contrasting effects. The first stage, the substitution of home-produced consumer goods for imported *consumer* goods, is usually characterized by rapid growth in industrial output and employment, accompanied by a significant decline in the share of imports in total demand for manufactures. The second stage, or substitution of home-produced for imported *capital* goods and intermediate products, is characterized by slow industrial growth, a sharp decline in employment opportunities, and little further reduction, or even an increase, in the import component of total demand for manufactures. Imports of capital goods and, to a lesser extent, intermediate products, tend to remain high while the consumer goods industries move on slowly because of practical exhaustion of import substitution possibilities. Industrial expansion, although slower than in the previous stage, becomes more dependent on imports. On the other hand, the process of import substitution discourages expansion in the traditional export sectors which are unable to earn sufficient foreign exchange to cover the import requirements needed to sustain a high rate of industrial growth. Because of the interaction between industrial output, the demand for imports, and the traditional export sectors, industrial expansion tends to move on inefficiently, in spurts, and, on the average, at an unsatisfactory rate.

Three economic factors have played an important role in the adoption of import substitution as a deliberate industrialization strategy of many less developed countries. These factors may be described as: the Economic Commission for Latin America-Prebisch thesis, the economic obstacles to the export of manufactures to developed countries, and high rates of population growth.

The Prebisch thesis, which stresses the deteriorating terms of trade for primary countries, although controversial, has been acted upon in generating policies of forced industrialization via import substitution designed to increase the national product and alleviate balance of payments difficulties. But to many economists and others it appears to have created in many instances new problems of inflation, misallocation of resources, inefficient production, and a running down of monetary reserves as the process of industrialization proceeded.

It is true that most developing countries depend heavily on the exports of a few primary products for which world demand is growing too slowly to supply all their requirements of foreign exchange. However, it is not true of all developing countries or of *all* products in particular markets; countries of which it is true can frequently find alternative long-run economic solutions.

Politicial and economic leaders of developing countries have tried to hammer home to the masses the blessings of decreasing dependence on traditional products in order to reverse the worsening of their terms of trade. Economic history teaches us the decreasing importance of primary production in the process of growth of the first countries to industrialize, and developing countries are making gallant attempts to emulate the process of growth of their predecessors without realizing that the underlying conditions of the eighteenth and nineteenth centuries may not hold good in the latter part of the twentieth. The strategy of import substitution has relegated to an almost forgotten secondary position the critical problems associated with increasing productivity and production in the traditional sectors.

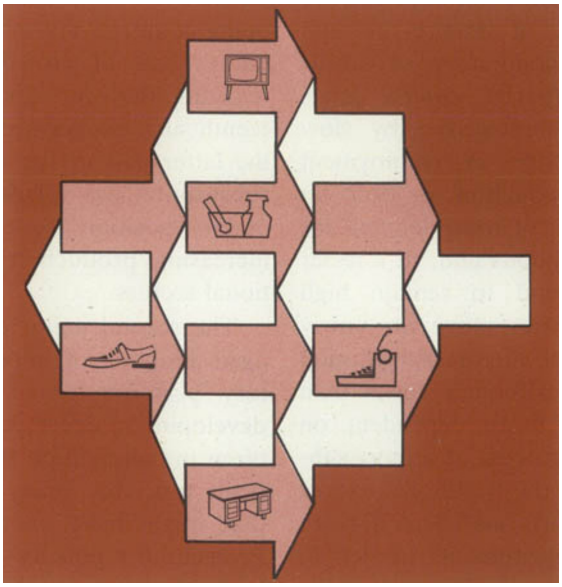
The second major economic factor that has encouraged adoption of import substitution is the unsatisfactory performance of exports of manufactures from developing to developed countries. To enter this market, often in competition with developed countries, is a difficult task that many of the less developed countries that might have attempted it have not tried to face. Protectionist policies followed by developed countries have of course made it even more difficult. A small group of developing countries, however, has already shown that with appropriate policies it is possible to achieve high rates of economic growth and a more efficient industrial sector by promoting exports of manufactures rather than import substitution. But excessive —and uncritical—concentration on import substitution by many countries has damaged instead of assisting their development performance.

The third major economic factor encouraging import substitution has been the fast growth of population in developing countries and their belief that the replacement of imports would create enough jobs to solve their unemployment problem. The first years of the import substitution strategy have in fact provided substantial employment. The supply of unskilled labor to meet this demand has always been plentiful; the real difficulty has been to find sufficient numbers of skilled labor. It is clear, however, that after a few years, the efforts at import substitution have become biased

toward the kind of production that depends more upon plant and machinery than upon large numbers of employees—capital-intensive production. This pattern indicates that after the initial impetus begins to disappear, the import substitution strategy makes little contribution to solving the unemployment problem of developing countries.

If the record of import substitution—particularly stage two import substitution—is so discouraging, why do countries continue to resort to it? Often it is largely for noneconomic reasons; because it seems the easiest way out of the problem. If exports are not growing fast enough to provide sufficient foreign exchange earnings for industrialization, the easiest solution seems clearly that of reducing imports by means of tariffs or other trade controls. This does not require much work, effort, or sophistication; its result is simply to preserve the domestic market for domestic producers.

A small but growing number of developing countries that have passed the practical limits of the first stage of import substitution are now better aware of the limitations of this approach and have started thinking about putting greater emphasis on export promotion. This is a change in the right direction which should be pursued vigorously.



## Performance and Planning

Supposing, however, that in some developing country there appears to be a case for import substitution on economic grounds. There is still a problem of when to launch a program. The fact that a country has, for example, recently begun to import certain products is not by itself a proof that import substitution is justified. Developing countries import a large variety of products and to start domestic production of all imports too early would only tend to create a large and inefficient industrial sector. Policies of import substitution are notoriously weak in allowing domestic production of new products without first calling for adequate studies of potential markets and related problems of distribution. It is necessary to make a detailed study of the import structure and start a gradual substitution plan that encourages domestic production of only a limited number of goods, taking into account prospective costs, contribution of growth, and the importance of economies of scale.

Two questions often neglected are the development potential of import substitution, and its cost in terms of domestic resources. If the domestic market is small relative to the number of items now produced domestically and the import content of domestic output is high, it is most likely that when the process of import substitution is completed, growth will rise slowly because of the small domestic market, since only a small minority can afford the substitute goods. At the same time imports of raw materials and intermediate products do not decline significantly and become a permanent burden on the balance of payments. Similarly, the protection required to keep import substitution profitable creates inefficient industries requiring excessive amounts of resources in order to save one unit of foreign exchange. The final result is that foreign exchange earnings may be insufficient to sustain rapid growth while prices of domestic industrial goods remain excessively high.

Across-the-board import substitution normally leads to restructuring of the economy and new and additional demand for imports; it is quite probable that import dependency will increase rather than fall. Although import substitution may take place in certain products its effect may be swamped by the additional import demand generated by the process. Normally, at the early stages, internal demand expands very rapidly and since domestic producers are just on the threshold of moving forward, they are not prepared to supply everything demanded. Therefore, an increase in imports is the only way to fill the gap. The ratio of imports to domestic supplies may either rise, fall, or remain stationary. Deliberate import substitution strongly imposed from above by means of high tariffs, trade controls, generous tax incentives, etc., is likely to create a situation in which expansion of the national product becomes increasingly a function of imports. The rigidities and misallocation of resources are such that domestic growth becomes linked to increases in the level of imports. Once the substitution process works itself out the import ratio stops falling. Failure of the import ratio to fall is mainly due to:

- Inelasticity of demand for imports. Exchange rate policies and the three other factors mentioned below encourage relatively high levels of imports.
- Uneven nature of income distribution. The rich continue to demand a high import content in the goods they purchase.

- System of protection. Protection given to import-competing industries encourages domestic production of final products and importation of raw materials and intermediate products. Moreover, only simple types of capital goods are produced domestically. Therefore, as the economy expands and more technologically advanced capital goods are required, the imports of capital goods tend to increase.
- Technology. Production techniques show little improvement under a rigid and highly protective system of import substitution.

## A Summing-Up

In my opinion import substitution has helped developing countries to achieve a faster rate of industrial expansion than would have occurred in the absence of such a strategy. The economic costs, however, have often been substantially greater than the benefits and worsened the outlook for long-term industrial development. Policies of import substitution have been notoriously weak in allowing domestic production of new products without first calling for adequate studies of potential markets and related problems of distribution. Contrary to expectations import substitution has generally resulted in

- High prices of industrial goods, with high import components, and usually unable to compete in international markets;
- High effective rates of protection which distort the pattern of resource allocation;
- Excessive horizontal diversification at the plant and industry level;
- Failure to develop domestic raw materials sufficiently for further local processing and export;
- Discrimination against labor-intensive industries and the traditional export sectors.

Since in the long term import substitution does not usually provide sufficient domestic demand to maintain a high rate of growth, the only alternative is to reconcile this strategy with a judicious program of export expansion. What is badly needed is not the abandonment but the revision of import substitution strategies. A well-conceived and adequately implemented strategy can make a substantial contribution to foster industrialization and higher incomes. There is an urgent need to promote specific industries and specific products within the framework of a long-term industrialization strategy. This new approach should break the straitjacket of tight sequential stages and create a more fluid process leading to the penetration of export markets and avoiding the exhaustion of opportunities for import substitution.

**Jose A. Datas-Panero,** a citizen of Spain, originally came to the United States as a Fulbright scholar; he received degrees in business administration and economics from Georgetown University, and his Ph.D. in economics from the American University. Mr. Datas joined the staff of the Economics Department of the World Bank, where he worked as an industrial economist, in 1961 and is now an economist in the Central America and Caribbean Department.