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Comparative Analysis of the Best Practices in the Economic Policy of Import Substitution

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Abstract:

The modern challenges, the sanctions and the state of the economy made it possible to implement the import-substitution policy measures. This article provides a brief overview of the policies of import substitution, which have been carried out in various countries since the middle of the last century.

The evaluation of these practices by the scientists is considered and their conclusions are summarized. The main results of the policy of import substitution of the countries of Latin America, Asia, and Europe are summarized. To this end, the risks able to impede the implementation of the import substitution policies are identified herein, the performance criteria for the implementation of the policy at the general economic and sectoral levels are proposed, and the principles of the state approach to the import substitution are formulated.

Keywords: *Import substitution, developing countries, investment, transformation of the economy, improvement of the competitiveness.*

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Introduction

The change in the geopolitical situation and the imposition of the economic sanctions against Russian commodity producers showed the high import dependence. The modern, largely forced trend of import substitution in Russia is aimed at the maintenance of the food and national security while increasing the competitiveness of the economy (Kuzmin, 2015; 2016). The policy of import substitution is not new to the world community: a number of countries from Latin America to East Asia and Europe have circumvented several stages of its implementation. The positive results achieved by them were the growth of employment and the reduction of unemployment, the more complete utilization of the national resources, the stimulation of the scientific and technological progress, the improvement of the living standards and the competitiveness of the countries. At the same time, the weak points in the policy of import substitution were identified: the slowdown or reduction of the welfare growth, which is characteristic for a number of countries, the deterioration of the balance of payments, the emergence of the risk of a trade war and the negative impact on employment.

The import substitution in the context of the aggravation of the foreign policy and external economic situation in Russia is increasingly seen as one of the priority areas of state economic policy. Currently, Russia is at the beginning of this way and it is too early to draw any conclusions as to the success of the import substitution policy, but it can avoid the mistakes made by other countries and, if possible, identify the factors for their success, adapt them to the Russian conditions, and timely include in the list of measures of the import substitution policy in Russia. Therefore, it is possible to analyze the accumulated experience, to summarize the results achieved so as to develop recommendations for the implementation of the policy of import substitution in Russia.

Background

The theoretical foundations of the import substitution as the basis of “import-substituting industrialization” were laid by the Argentine economist R. Prebisch and the Swedish economist G. Myrdal in the 1950s. These scientists considered the protectionist measures on the part of the state as a solid basis for the development of industry of the developing countries. To achieve this goal, the tariffs, the quotas, the currency regulation, the price regulation of the production factors and interest rates, as well as the direct subsidies, were used in the form of tax benefits, direct state investments in the creation of new industries, the benefits in the provision of bank loans, as well as the benefits in the implementation of import contracts.

According to S. Molchanova, in the mid-twentieth century, the key direction of state policy of the Latin American countries was the protection of the domestic market from the foreign competition through high import duties. As a result, the enterprises, encouraged by the state, became uncompetitive, the general economic situation worsened, a number of industries, based on the administrative resources as against competition, appeared (Molchanova, 2015). D. Zykin in his review of import substitution strategies in Taiwan, PRC and Japan recognizes the experience of these countries as successful, since the implemented import-substituting policy helped them to leave the group of backward countries (Zykin, 2014).

The following main methods of import substitution used in different countries are distinguished by E.Y. Volynets-Russet:

1. The development and modernization of similar products, meeting the latest achievements of world science and technology and surpassing the level and the quality of the imported products. According to E.Y. Volynets-Russet, this method is extremely rare in the world practice. A prerequisite for its successful implementation is the availability of importers' own scientific developments, i.e. the R & D works performed allow to initiate the production of the products immediately.
2. The development by the importers, based on the inventions and know-how, of the similar products, surpassing the level and the quality and the performance of the products of the exporters. To implement this method, the intelligent developments and the ability to obtain in a short time the equipment for the production of the developed products are required.
3. The trade in licenses. According to the experience of Japan and other countries, the replacement of the import of the products with production of them on the basis of purchased licenses is one of the most effective types of import substitution. E.Y. Volynets-Russet proposes the Russian companies to purchase the licenses in China, India, Korea and other countries, which have achievements in the world science and technology and do not support the sanctions, to ensure the import substitution (Volynets-Russet, 2015).

Speaking of import substitution in Russia, K.A. Gulin, E.A. Mazilov and A.P. Ermolov aptly note that the result of import substitution should be the further increase in the export potential of the companies in the industrial complex of the Russian Federation in order to occupy a niche in the world market of commodity producers, rather than the support for the development of the enterprises and industries oriented to the domestic consumer and producing uncompetitive products (Gulin *et al.*, 2015). N.Y. Mukhin identifies two types of the economic strategy: the import substitution and the incitement of export development. At the same time, the import substitution is interpreted by him as the development of the national production, aimed at replacement of the imported products in the domestic market (this model was implemented in developing countries in the 1930s), and the incitement of the export development is designed to ensure the receipt of foreign currency to finance the economic development.

According to him, the second model began to be used in the second half of the 20th century in a number of Asian countries. The instruments to incite the industrial development under the state administration on the basis of export development were the reduction of the tariff barriers, the floating exchange rate, the state support for the export industries and attraction of the direct foreign investments. Among the indicators of the efficiency of the implementation of this strategy, the increase in the share of exports in the gross national product, the increase in the national income and the rates of growth in exports, as well as the rate of growth of the increment value of the manufactured goods in the exports should be noted (Mukhin, 2016).

According to S.D. Bodrunov, a policy of directed de-industrialization of the economy has been implemented in Russia. The main instruments of import-substituting industrialization in the sort of Latin America – the incitement of the expenses of the enterprises for technological renewal by the export earnings, etc. – have not been created, the numerous competitive industries have not appeared in the country, and the demand for domestic products in the domestic and foreign markets is still insufficient. The revenues from the exports were not invested domestically, but were used to create the state reserves. As a result, the enterprises, involved in modernization, faced with a shortage of financial resources (Bodrunov, 2015).

Analysis of historical preconditions

It can be seen in a temporary retrospective, that the states began to implement the policy of substitution at different times. The countries of Latin America were the first to initiate the import substitution. Then the countries of South-East Asia paid attention to their experience and achieved the greatest success in the policy of import substitution. The countries of Europe were the last in the last century to implement the policy of import substitution.

The countries of Latin America focused only on the domestic market without a combination of import substitution policy with the policy for promotion of the goods to the foreign market. The positive effect of the imposed import restrictions took place, but was very short-term. The annual growth of gross domestic product (hereinafter, GDP) amounted to 5.5% in the period from 1950 to 1980, the GDP growth per capita averaged to 2.7%, and the increase in the quality of workers' skills and living standards was noted (Molchanova, 2015). However, the lack of competition and the introduction of import substitution policies in all areas of production resulted in the inefficient implementation of the industrial policy and, accordingly, the price increase. The inflation during the period of the import substitution program was very high and was measured in the 1980s in triplicate figures. The creation of new plants could not be compensated due to the uncompetitiveness of the products manufactured. This led to a decrease in the competitiveness of the national production.

The policy of import substitution in the countries of South-East Asia combined the protectionism and the policy of export diversification. The Asian countries apply the doctrine, defined as the “flying geese” model by the Japanese economist Kaname Akamatsu. In accordance with this doctrine, the states are gradually moving towards their technological development, in accordance with the example of the states, which are directly before them in the course of their development. The purpose of this policy is to carry out the industrialization of the economy. This purpose can be achieved not by the substitution of the imports with the national production through the foreign trade restrictions, but also by the discrimination of the imports, and by the improvement of the export potential of the state. The export platform is required for the execution of this model. The idea of working out an export platform includes the creation of an enclave in the economy, open to foreign investors and embedded in a global economy, free from any infrastructure, security, rule of law and trade policy problems, burdening the rest of the economy.

Taiwan has achieved the impressive results due to the implementation of the combined strategy to increase the competitive advantages of the national production. The strategy, implemented in Taiwan, was called "export-oriented import substitution". At that time, when GDP growth in China and India amounted to 5-8% due to the export expansion, the domestic demand in Taiwan increased by 43-45%, and the export growth (half of which consists of various high-tech products) was equal to 55-57% of GDP growth. When implementing the policy of import substitution, the authorities of Taiwan initially introduced a set of protectionist measures to incite the light industry enterprises. At the same time, the state-owned industrial corporations were created, covering more "complex" industries: shipbuilding, petrochemistry, etc. The state directed the resources to the areas, most dependent on imports, with a view to reduce the import dependence of the industries.

In Taiwan, high import duties were imposed to incite the local economy to produce more goods. Initially, the costs and, accordingly, the price of domestic goods turned out to be higher than the price of the imported goods, but then, due to the state support, the acceptable for the population level of prices was reached. The policy of patching-up of the standard of living of the population was also carried out: in 1950, the income gap of 20% of the richest people in the country was 15 times higher than the income of 20% of the poorest people, but in the late 1970s this difference was reduced 4.2 times (Zykin, 2014).

In Japan, in the 1960s, the state jointly with the business developed an economic policy of modernization. Several industries were selected as the priority ones to be specially supported by the state. Thus, the industry and the agrarian sector were protected by the protectionist barriers for a long period of time (Zykin, 2015). The financing of the scientific and technical projects was also carried out mostly at the expense of the state.

At the same time, the banking sector was strictly controlled by the state there, which allowed establishing the effective system of crediting for the enterprises, and low taxation was also applied to incite the business development at all levels of activity. As a result of successfully implemented import substitution policy, the so-called "Japanese economic miracle" worked in practice in this country. This phenomenon is characterized by an increase in the welfare of the population and the state, which amounted to about 10% annually in the period from 1950 to 1973 (Akaev, 2013). A number of states, such as Kenya, have initiated the import substitution policy not on their own. So, it was initiated in Kenya by the British colonialists, since the metropolis could not provide its own colony with foreign goods. In the middle of the twentieth century, a "theory of dependence" developed in the economic science, which justifies the need for import substitution. The adherents of this theory believed that the trade relations between the West and the developing states were dominated by the unequal exchange that had been formed since the colonial times.

In Cuba, the strategy of import substitution considered was realized after the victory of the revolution accompanied by the nationalization of private enterprises. To reduce the dependence of Cuba on Western states, it was important to ensure the production of a variety of consumer goods. At the same time, as far as integration with the CMEA member states, by 1968 the implementation of this plan was terminated. The main principles of the new policy were the increase in production, as well as the export of sugar and the formation of foreign trade relations with various socialist countries (Minaev, 2009).

In Europe, where the import substitution was initiated relatively late, in the 1990s, the experience of Poland, which produces 5.2% of all crop production, and 6.4% in livestock, being the leading exporter of vegetables, fruits, pork and poultry meat in the EU, is of great interest.

After the accession to the EU, the agrarian sector of Poland has gradually adapted to the new conditions. This process intensified especially after the country joined the EU (2004). Undoubtedly, this was mainly due to a significant increase in subsidies to the industry from the EU budget. Farming is the main form of organization of the agricultural production in Poland. The average size of agricultural enterprises (farms and other industry groups) is 9.8 ha. At the same time, over 1.5 ha (83%) of farms have more than 1 hectare. At the national and supranational levels, the regulation of the activity of the agricultural sector of Poland is performed in accordance with the common agricultural policy (CAP). The aggregate of measures taken in the European Union resulted in the increase in the agricultural production by 1.7 times over the period from 1995 to 2012 (per capita, USD), and by 1.8 times in the added value. The similar measures for the improvement of the agrarian economy were also taken in the territory of East Germany, which also proved to be quite effective (Adukov, 2013).

Results

The analysis of application of the import substitution policy in other countries has shown that it often brings benefits to the country. However, according to Semenov, with whose opinion the authors hereof agree, in the case of state support for the policy of import substitution, it is necessary to create the artificial incentives (foreign trade, currency, technical, administrative, etc.) for the development of individual industries and regions in order to increase their competitiveness in the domestic market. These activities should be carried out along with the support of specific industries or groups of enterprises and the development and implementation of such universal measures as monitoring of the exchange rate, assistance in the creation of infrastructure and universal financial mechanisms (Semenov, 2014).

Summing up the historical escourse, the following key conclusions can be worded:

Conclusion 1. The implementation of the exclusively intra-oriented strategy of import substitution may result in not merely the increase in industrial production, but also in the protracted crisis.
According to the experience of Latin America, the import restrictions make it possible to achieve a positive effect only for a short period of time. However, in the absence of competition, the industrial production gradually becomes ineffective, causing a rise in prices. The construction of new plants and factories does not change the situation as uncompetitive products prevent the investment from recovering. The result of import restriction is the decline in the competitiveness of national production.

Conclusion 2. The cooperation between the state and the business is necessary when choosing a strategy, but its implementation must be strictly controlled by the government of the country.
The pluralism in the choice of the import substitution strategy between the two fundamental institutions allows maintaining a competitive environment, ensures free development of the personality, makes it possible to get the maximum profit. At the same time, the concept, in which the state takes the supreme position in disputable issues, and, being a political regulator, takes the initiative in negotiations, enables the authorities to play the role of arbitrator and to take proactive decisions.

Conclusion 3. The sequence of implementation of the import substitution strategy by the sectors is important; at the same time, the systemic state control over the non-productive spheres (the incentive tax policy, the control over the banking sector, etc.) is necessary.

The experience of Japan shows that initially the state together with the business selected several priority industries, which allowed to achieve the competitive advantages. In turn, the strict state control over banks allowed to establish an effective system of lending for the companies in all sectors, and the low taxation incited the development of business at all levels. Table 1 shows the classification of the main measures of the policy of import substitution implemented in various countries, which confirms the conclusions made by the authors. The generalized analysis of the best practices in the implementation of the measures of the import substitution policy allows drawing the following conclusions about the advantages, disadvantages and conditions required for the successful implementation of the import substitution (recognized as a form of protectionist policies aimed at the domestic market) and the export promotion strategy (Table 2).

Summing up the review of the best practices of the policy of import substitution, the authors are inclined to agree with the opinion of N.Y. Mukhin, who, commenting on the advantages and disadvantages of these policies, comes to the conclusion that the strategy of import substitution “can work mainly in the short and medium term” (Mukhin, 2016).

Discussion

The list of measures required for the implementation of the import substitution policy is similar to the instruments of foreign trade regulation in terms of restriction of the import and protection of the national producer. However, there is an explicit margin between the import substitution and the protectionism, expressed in the performance criteria for the implementation of the chosen policy in the long term. The state plays a key role in promotion of the policy of import substitution. The support provided by the state allows to achieve the success in a fairly short period of time. It is also necessary to pay attention to the best practices, where the import substitution relies on a private initiative, but is supported by the state. Therefore, the symbiosis of the state and the private sector is very important in the implementation of the strategy. Import substitution will be effective only in case of close interaction between the state administration of all levels with private business.

The mechanism for implementation of the import substitution policy should be supplemented with the tools for assessment of the investment efficiency and the tools for monitoring of the expenditure of the state funds. The following factors can serve as the performance criteria for the import substitution policy: at the general economic and industrial levels – the increase in the share of products produced by domestic producers, characterized by a high degree of localization of production in the territory of the Russian Federation in the total volume of procurement, the increase in the volume of exports and the decrease in the volume of imports, the increase in the number of innovative products, the expansion of production capacities, the increase in the level of localization of production in the territory of the Russian Federation, the increase in the number of innovative products and technologies introduced into production; at the level of enterprises – the minimization of prime cost at equal other conditions.

When implementing the policy of import substitution, there are some risks that can ultimately lead to a rise in the cost of products with a decrease in their quality (Fyodorov, & Kuzmin, 2013). The examples of these risks are the following:

- the decrease in competitiveness of national producers;
- the monopolization of production, strengthening of market power of the regional companies and state monopolies;
- the threat of corruption due to the targeting of the state support;

– the decrease in the efficiency of the economy of the state as a whole if the solutions of the national manufacturers are inferior in quality to the solutions of the foreign analogues;

– the growth of burden on the budget, the growth of defense costs and expenditures on national security;

– the relative decrease in income and welfare of the population;

– the resistance of the participants of import substitution programs to cessation of support measures.

To implement successfully the policy of import substitution in Russia, it is required to use the best practices and to avoid the mistakes that could aggravate the emerging economy crisis. The study of the best practices makes it possible to formulate the following principles of the state approach to import substitution:

– a gradual transition from intra-oriented model to externally oriented (export) model or the use of the combined import substitution model is required;

– the import-substituting policy should be implemented mainly with the application of incentive measures as against the restrictive ones;

– the main criterion for import substitution should be the evaluation of the result of the total economic consequences of the decision on the work in a particular direction. The main direction of import substitution should be the creation of the productions of the goods with high added value, the costs of production of which will yield the greatest return in comparison with the production of other goods, oriented to domestic and foreign markets;

– it is important to combine the direct and indirect import substitution. The direct import substitution means the creation of own production of goods instead of imported products. The indirect import substitution envisages a reduction in imports and consumption of imported products through the introduction of savings and the use of new technologies and innovations (Zaryankin, 2010);

– R & D funds for the implementation of import substitution goals and tasks should be provided on the basis of compensation received from the state budget. The compensation at the same time should be formed at the expense of the proceeds from the sale of products produced under the policy of import substitution, and even exported in some cases;

– the development and support of domestic production should not exclude the possibility of foreign technology transfer, the creation and localization of production with the attraction of foreign investment;

– the effective use of territorial advantages of specific regions in order to increase the efficiency of import substituting projects.

Conclusion

A number of measures taken from the best practices of other countries, which achieved high results in the course of implementation of this strategy, will contribute to the import substitution in Russia. The analysis shows that the greatest results for all classification criteria were achieved by the countries of East Asia. Thus, according to their experience, the improvement of the competitiveness of the national industry is possible due to their own initiative to initiate the import substitution policy, as well as the transfer and further development of the advanced scientific and technical developments, the state financial support for the creation and modernization of the production infrastructure, but, above all, due to orientation to the foreign markets and the improvement of the export potential of the industry. Particular attention should be paid to the mechanisms for attraction of the foreign investment into the economy, used by China, India, Malaysia, the Philippines, Indonesia, Thailand and Belarus. Then, despite all the difficulties related to the policy of import substitution, with a proper approach to the implementation of the plan, Russia will be able to show the rapid economic growth in the long term.

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Table 1. *Classification of the main measures of import substitution policy*

Criterion of classification		Countries	Example	Result
The time of initiation of the import substitution policy	1950s	Latin American Countries	Protectionist import duties, various exchange rates for imports of different categories of goods, cheap state loans for industrial enterprises, direct state participation in certain sectors	Insignificant
	1960s-1970s	The countries of South-East Asia (the Republic of Korea, Taiwan, Singapore)	Establishment of a realistic exchange rate, incitement of the exports: subsidizing and lending on favorable terms for the enterprises exporting products with high added value of at least a certain volume, reduction or exemption from import duties on intermediate resources	Significant
	1980s-1990s	European countries	Lending rates, compensation, tariff policy	Average
The initiator of the introduction of the policy of import substitution	Domestic initiative of the states	Latin American Countries, the countries of South-East Asia (the Republic of Korea, Taiwan, Singapore), European countries	-	Significant in some states
	Foreign initiative	Kenya, the colonial states	-	Insignificant
The nature of the target market	Domestic	Latin American Countries	Focused on the domestic market only with no combination of the import substitution policy with the policy for goods promotion to the foreign market	Led to a decrease in the competitive ness of national industries

Criterion of classification		Countries	Example	Result
	Foreign	The countries of South-East Asia	Improvement of the export potential of the state	Led to a significant increase in the economies of the states
The variants of implementation policy	Administrative and tariff barriers	Brazil, Argentina, Mexico, Chile, the USSR	The maximum amount of own products are produced by the state. Only goods with no analogues, or if the cost of analogues is much higher are imported.	Insignificant
	Gradual reduction and the subsequent termination of state support of new industries	The countries of East Asia	The state is focused on supporting the new promising market segments. When the enterprises enter these markets, the state provides them with preferences in order to support the competitiveness of national producers at the initial stage.	Significant
	Based on the “flying geese” paradigm	USA, Japan, Taiwan, India, China, South Korea, Thailand, Malaysia, Philippines	The state supports only the competitive industries with the enterprises, engaged in active export activities.	Significant

Table 2. *Advantages and disadvantages of the economic development policies*

Policy	Advantages	Disadvantages	Conditions required for implementation	Results
Import substitution	Less risky than the export promotion strategy; It is easier to track the success of implementation based on the changes in the volume of imports	Ineffectiveness of state-protected industries and high costs for the economy; When the saturation of the market is achieved, the strategy ceases to work	Strong domestic market with high demand; A significant amount of foreign currency to finance the import of equipment; Effective tariff and non-tariff measures to protect young industries from global competition	Less significant
Export incentives	Development of competitive productions; Savings due to the scale of production; The possibility of more effective regulation of the balance of payments and the process of economic development of the country	Low net income of the exporters, subject to the import of components; High dependence on market conditions; Damage to the economy of the exporting country in case of changes in the foreign trade policy	Achievement of a competitive price level and high quality of the products; Constant increase in the level of production technology to ensure the competitiveness in the world markets	More significant in most countries

Source*: (Mukhin, 2016).*