

# IMPORT SUBSTITUTION INDUSTRIALIZATION AND ITS CONDITIONALITIES FOR ECONOMIC DEVELOPMENT- A COMPARATIVE ANALYSIS OF BRAZIL AND SOUTH KOREA

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## Abstract

This paper investigates on the basis of a cross-regional comparative case study under which conditions Import Substitution Industrialization (ISI) can lead to different economic and social outcomes. ISI caused several distortions that had negative impacts on state autonomy and a functioning bureaucracy, income distribution and social equality. ISI fostered rent-seeking activities in South Korea and Brazil and made institutional capacities of the state less effective and efficient. South Korea could overcome ISI distortions and shifted towards export-oriented growth due to its inherited institutional structure and social justice within the society. The other side of the coin shows higher industrial growth and a structural change in Brazil. Nevertheless, Brazil had to rely on a growth-cum-debt strategy in order to deal with the distortions of ISI.

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## Introduction

Developing countries pursue different economic strategies to catch up with developed countries. Import Substitution Industrialization (ISI) is only one industrialization strategy among others. It aimed at strengthening the domestic production of those goods that were previously imported. ISI is a state-led model of development and thus reflects internal decision-making processes.<sup>1</sup> Thus, understanding the paradigm of Import Substitution Industrialization (ISI) allows us to focus on the role of the state in the frame of different development trajectories.

ISI prevailed as Industrialization strategy in the majority of developing countries in the 1950s and 1960s. While the bulk of Latin American countries adhered to ISI also in the 1970s, the South East Asian countries shifted towards an outward-oriented strategy.<sup>2</sup>

The reason for choosing this research topic was determined by the common academic interpretation of ISI. ISI is mainly attributed to the ‘failure-thesis’ or the ‘ISI-syndrome’, which links this state-led approach with export-bias, balance-of-payments crisis and rent seeking. Even though some authors emphasize higher industrial output and increased GDP per capita and at the same time show the negative socio-economic impacts their interpretation lacks analyses of historical patterns and institutional causality. Furthermore, many research papers review ISI mainly within the borders of Latin America. The outcomes of ISI are still controversially discussed and thus justify further research.

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<sup>1</sup> Houssam-Eddine Bessam, Rainer Gadow, and Ulli Arnold. "Industrialization Strategy Based on Import Substitution Trade Policy." In *Designing Public Procurement Policy in Developing Countries*, Springer New York, 2012: 53f.

<sup>2</sup> Henry J. Bruton. "A reconsideration of import substitution." *Journal of economic literature* 36, no. 2 (1998): 903f.

The **research question** of this thesis reads as follows: Are there conditions under which ISI can lead to economic development? The independent variable is Import Substitution Industrialization. My dependent variable is economic development. Condition variables are institutional and organizational structures of the state and its macroeconomic features. Economic development is a broad term and due to the scope of this thesis the author will define indicators in order to show the ramifications of ISI in both economic and social terms. The indicators to measure economic development are industrial growth, income distribution and industrial employment.

For this purpose my methodological approach will be based on a heuristic comparative case study (cross-regional) - the aim of which is to “*inductively identify new variables, hypothesis, causal mechanisms, and causal paths*”.<sup>3</sup> The methodology of my thesis allows me to generate knowledge with technical instruments.<sup>4</sup> Donatella Della Porta and Michael Keating state: ‘Positivists...want to know what factors cause which outcomes (...), for example what is the causal relationship between...’<sup>5</sup>

The author focuses on the comparative institutional approach in order to analyse ISI conditionalities for development trajectories. As Peter Evans points out its aim “*is to ground assertions of institutional effects in the analysis of the actions of specific groups and organizations*.”<sup>6</sup> Institutions refer to social mechanisms (i.e. patronage) and its structural foundations.<sup>7</sup> Based on the institutional setting the author looks at how state actions have influenced the implementation of ISI. Nevertheless, further ISI conditions had impact on economic development.

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<sup>3</sup> Alexander L. George and Andrew Bennett. *Case studies and theory development in the social sciences*. Mit Press, 2005: 75

<sup>4</sup> Donatella Della Porta and Michael Keating. “How many approaches in the social sciences? An epistemological introduction.” In Della Porta, Donatella and Michael Keating (eds.), *Approaches and methodologies in social sciences*. Cambridge: Cambridge University Press (2008): 21

<sup>5</sup> Ibid., 29

<sup>6</sup> Peter Evans. *Embedded autonomy: states and industrial transformation*. Princeton University Press, 1995: 19

<sup>7</sup> Vinícius Rodrigues Vieira. "Invisible legacies: Brazil's and South Korea's shift from ISI towards export strategies under authoritarian rule." *Journal of International Relations and Development* (2013): 2f.

My case studies are on the one hand Brazil and on the other hand South Korea. The author chose these two countries because Brazil is the largest Latin American country and South Korea represents one of the four Asian tigers. The development paths of the NICs in South East Asia are regarded as more successful than those of the Latin American countries. Thus, the author wanted to find out when and why development trajectories took different directions. In both countries former colonial powers shaped the state apparatus and both countries experienced authoritarian rule. On the other hand both countries were affected differently by the Cold War due to their geopolitical position. Both countries inherited different structural foundations.

Korea inherited a coherent, autonomous state bureaucracy from Japanese colonial era. Due to this structural foundation Korean policy stakeholders were able to overcome the distortions of ISI and strengthen export-oriented growth. Therefore, the different motives for ISI between the two countries are not crucial. It is not bureaucracy that hampers development per se but it is the capacity of the state to deal with economic discrepancies, which effect state institutions. This thesis will show that ISI as deliberate development policy led to political and economic distortions but at the same time lay the foundation for structural change. The author refers to Patrice M. Franko: “(…), *import substitution was both unsustainable over time and produced high economic and social costs.*”<sup>8</sup> The longer ISI prolonged the more foreign borrowing was demanded. André Villela calls it growth-cum-debt strategy.<sup>9</sup>

Above all, the choice for this thesis topic is based on the author’s interest in development economics. The following statement by Henry J. Burton motivated the author to deepen his knowledge on ISI: “*Import Substitution refers to a set of ideas about why*

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<sup>8</sup> Patrice M. Franko. *The puzzle of Latin American economic development*. Rowman & Littlefield Publishers, 2007: 66

<sup>9</sup> André Villela. “A bird’s eye view of Brazilian industrialization” In Werner Baer and David Fleischer. *The Economies of Argentina and Brazil. A Comparative Perspective*. Cheltenham and Northampton: Edward Elgar, (2011): 56f.

*mass poverty has prevailed and continues to prevail in many countries while other countries have grown rich, and about a general approach to elimination of that poverty.”*<sup>10</sup>

The thesis is organized as follows: The first chapter outlines theories and concepts that relate to ISI and its conditions, which will be tested in relation to hard facts.<sup>11</sup> The author tries to find out how the state's role and its institutional settings are placed in the context of ISI according to major development paradigms. The second chapter focuses on the empirical analysis of ISI in Brazil and South Korea. The third chapter outlines the comparative research. It allows the author to elaborate on the conditions of ISI for economic development. The role of the state and its role of determining different development are thoroughly investigated. The chapter will close with looking at how ISI can be evaluated in the frame of development indicators. In the last section of this thesis the author gives an overview of his findings and draws a conclusion regarding the research question.

### *Literature Review*

The author shows that previous literature looked at diverse conditional variables for ISI. The analyses of ISI have to be put in relation to different time periods. Data of more recent academic papers are able to use more disaggregated data and thus interpret indicators of economic development differently to early academic contributions.

Stephan Haggard states: “*A rational ISI strategy demanded political and administrative capacities beyond the reach of the most developing countries.*”<sup>12</sup> This statement demonstrates the decisive role of the internal, institutional setting of developing countries in the context of ISI implementation. Furthermore, this statement supports the case selection of this thesis

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<sup>10</sup> Bruton. "A reconsideration of import substitution", 904

<sup>11</sup> Della Porta, et al., "How many approaches in the social sciences?" 26

<sup>12</sup> Stephan Haggard. *Pathways from the periphery: The politics of growth in the newly industrializing countries*. Cornell University Press, 1990: 13

due to the different inherited institutional settings and how these legacies effected ISI implementation in South Korea and Brazil.

Work done by Werner Baer and Henry J. Burton builds on the ‘failure-thesis’ of ISI. According to Bruton advances in development rest on consistent learning and knowledge acquisition. The mechanisms of ISI prevented actors to improve their skills and expertise due to a variety of rationales. Thus, ISI was meant to fail.<sup>13</sup> Baer reflects on market and structural distortions of ISI, therefore reflecting the criticism of neoclassical scholars. At the same time Baer emphasizes that industrial output has increased.<sup>14</sup>

In the 1970s it became evident that ISI did not lead to long-term economic growth. Bruton labels it ‘import substitution syndrome’ (overvalued exchange rate, neglect of agriculture, underutilization of capital, effective rates).<sup>15</sup>

Authors like Sebastian Edwards, Victor Bulmer-Thomas or Stephen Haber ascribe inefficient industries and distortions to ISI and postulate a stagnationist hypothesis of ISI.<sup>16</sup>

In contrast to the majority of scholars, Albert O. Hirschman claims that the failure-thesis of ISI is not undisputable.<sup>17</sup> He associates the failure-thesis of ISI in Latin America with the then existing expectations and its outcomes: “*Industrialization was expected to change the social order and all it did was to supply manufacture! Hence one is only too ready to read evidence of total failure into any trouble it encounters.*”<sup>18</sup> Hirschman wrote his paper “The Political Economy of Import Substitution Industrialization in Latin America” in 1968, thus the author will refer to Villela who evaluated the long-term effects of ISI.

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<sup>13</sup> Bruton, "A reconsideration of import substitution", 903

<sup>14</sup> Werner Baer, "Import Substitution and Industrialization in Latin America: Experiences and Interpretations." *Latin American Research Review* 7, no. 1 (1972)

<sup>15</sup> Ibid., 911f.

<sup>16</sup> Renato P. Colistete. "Revisiting import-substituting industrialization in Brazil: Productivity growth and technological learning in the post-war years." In *Conference on Latin America, Globalization and Economic History at UCLA (March 2009)*: 3

<sup>17</sup> Albert O. Hirschman. "The political economy of import-substituting industrialization in Latin America." *The Quarterly Journal of Economics* 82, no. 1 (1968): 3

<sup>18</sup> Ibid. 32



In a similar vein, authors like Teitel and Thoumi or Rosemary Thorp show that ISI led to increased numbers of manufactured exports and manufacturing productivity and that industrial and infrastructural change was achieved.<sup>19</sup> Franko highlights that higher growth rates in GDP per capita in Brazil illustrate ISI success. But GDP per capita gives no information on income distribution and Franko points out that industrial oligarchs benefited from ISI and not the industry as such.<sup>20</sup>

Teitel and Thoumi attribute ISI to a maturing industrial growth process and high numbers of exports in the 1970s. They also questioned the export-led growth strategy for Brazil. According to Teitel and Thoumi, who wrote their paper in 1986, natural resource endowment, a large domestic market and high skilled labour force might be not suitable for export orientation.<sup>21</sup>

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<sup>19</sup> Colistete, "Revisiting import-substituting industrialization in Brazil", 3

<sup>20</sup> Franko, "The puzzle of Latin American economic development", 64f.

<sup>21</sup> Teitel, Simon, and Francisco E. Thoumi. "From import substitution to exports: the manufacturing exports experience of Argentina and Brazil." *Economic Development and Cultural Change* 34, no. 3 (1986): 486

# 1. Chapter – Theoretical Framing

## 1.1 ISI Theory

ISI can have different origins. Albert O. Hirschman underscores: “*Clearly, there is not just one ISI process.*”<sup>22</sup> He describes four motives behind ISI: balance-of-payment difficulties, wars, growth of the domestic market and deliberate development policy.<sup>23</sup>

As deliberate development strategy the main rationale for the advocacy of ISI were secular declining terms of trade, price volatility of primary products and low-income elasticity for primary products. Raúl Prebisch, the director of the United Nations Economic Commission for Latin America (ECLA), combined his scepticism towards the international mechanisms of the world economy with the infant-industry arguments articulated by Alexander Hamilton and Friedrich List.<sup>24</sup> ISI proponents “*believed that the appropriate strategy for development was to replace imports from the rich North with their own domestic production. Large-scale planning, rather than the market, was assumed to be the appropriate instrument, (...)*”<sup>25</sup>

The structuralists Prebisch and Hans Singer highlighted that the division of labour, thus structural economic discrepancies, hindered economic development in Southern countries. While productivity growth in the North led to higher wages due to the monopolist manufactured structure, lower productivity in the South was caused by secular negative terms of trade effects (Prebisch-Singer thesis). The competition between exporters, the surplus of workforce and weak unions contributed to the downward pressure on wage rates. At the same time higher income in the North brings about lower demand for agriculture products and raw materials – income elasticity of demand

<sup>22</sup> Hirschman, “The Political Economy of Import-Substitution“, 5

<sup>23</sup> Ibid.

<sup>24</sup> Haggard, “*Pathways from the periphery*”, 9f.; Franko, “The puzzle of Latin American economic development”, 55

<sup>25</sup> Bruton, “A reconsideration of import substitution”, 907

declines – thereby reducing the demand for imports from the South (Engel-Curve arguments).<sup>26</sup> Supply for manufactured goods was more elastic, thus explaining the balance of payments problems of developing countries<sup>27</sup>. Reyes and Sawyer conclude: “*The declining terms of trade for developing countries would mean that over time more and more commodities would have to be exported to obtain any given amount of manufactured goods. Taken to another level, this argument contains an unusual conclusion: ‘trade is making developing countries of Latin America worse off.’*”<sup>28</sup> If countries in Latin America have a negative correlation between exports and growth of income, “*then import substitution of some kind must take place to protect the balance of payments, or growth would slow or stop.*”<sup>29</sup>

Bruton claims that the emphasis was put on the dual-sector model of W. Arthur Lewis. Lewis differentiated between a modern and traditional sector, the latter one the dominant one in the Southern Countries. The predominance of the traditional sector had negative effects for economic development. The marginal product was deemed to be zero, capital goods were not at the state’s disposal and hence capital formation in the modern needed to be fostered.<sup>30</sup> Nevertheless, Lewis underpinned the economic importance of agricultural development. Several agricultural economists have emphasized the importance of dynamism within the traditional sector.<sup>31</sup>

Bruton explains the implementation of ISI. When market interventions are not sufficient, structural changes in the economic system of the South need to be implemented. Instead of importing manufactured goods from the rich North, domestic production has to be enforced. The industrialization of an economy depends on capital

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<sup>26</sup> H. W. Singer: “Beyond Terms of Trade: Convergence/Divergence and Creative/Uncreative Destruction” In *Zagreb International Review of Economics & Business*, Vol.1, No.1, (1998): 13-14; Ignacio Perrotini, et.al. “Toward a New Developmental Paradigm for Latin America.” In *International Journal of Political Economy*, Vol. 37, (Fall 2008): 55; Bruton, “A reconsideration of import substitution”, 905; Engel curve named after the German statistician Ernst Engel

<sup>27</sup> Javier A. Reyes and Charles Sawyer. *Latin American Economic Development*. London and New York: Routledge, 2011: 145

<sup>28</sup> Ibid.

<sup>29</sup> Bruton, “A reconsideration of import substitution”, 905

<sup>30</sup> Ibid., 909

<sup>31</sup> Ibid.

goods and investment in heavy industry, so structuralists postulated capital formation within the country.<sup>32</sup> Hirschman effectively argues that “*industrialization via import substitution becomes highly sequential, or tightly staged, affair.*”<sup>33</sup> The first stage refers to the substitution of consumer goods, then follows the shift towards consumer durables and intermediate goods and the final stage of ISI leads to the domestic production of capital goods.<sup>34</sup> Hirschmann persuasively suggests that the industrialization process starts with the acquisition of intermediate and capital goods prior to any industrialization.<sup>35</sup> Capital goods imports by domestic and foreign firms enjoyed privileges and industrial raw materials were attracted by preferential import exchange rates.<sup>36</sup> Thus, strategic imports were preferred.<sup>37</sup> Protectionist tools to substitute consumer goods were tariffs, import quotas or import licensing.<sup>38</sup> The incremental capital-output ratio was the main instrument to assess the necessary levels of investments.<sup>39</sup> Developing countries were abundant with large numbers of unskilled labour but lacked capital for investment. The incremental capital/output ratio (ICOR) serves as an instrument to determine the additional capital required to increase a unit of output. Thus, ICOR serves as the foundation for investment decisions. The overvaluation of the exchange rate was meant to attract investment and to encourage capital formation within a state’s boundary.<sup>40</sup> Furthermore, the production of capital goods was associated with higher costs and the need for more complex technology, which the country did not possess.<sup>41</sup> Hence, combining an overvalued exchange rate (to attract investment) with the introduction of

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<sup>32</sup> Ibid., 906f.

<sup>33</sup> Hirschmann, “The political economy of Import Substitution“, 6

<sup>34</sup> Joseph L. Love. “The rise and decline of economic structuralism in Latin America. New Dimensions.“ *In Latin American Research Review* 40,3 (2005): 104

<sup>35</sup> Hirschmann, “The political economy of Import Substitution“, 6

<sup>36</sup> Baer, “Import Substitution and Industrialization in Latin America“, 98

<sup>37</sup> Bruton, “A reconsideration of import substitution“, 911

<sup>38</sup> Franko, *The puzzle of Latin American economic development*: 60. For an detailed overview of the mechanisms of protective tools see: Todaro, Michael P. and Stephen, C. Smith. *Economic Development*. Eleventh Edition. 2011: 600f.

<sup>39</sup> Bruton, “A reconsideration of import substitution“, 911

<sup>40</sup> Ibid., 907f.

<sup>41</sup> Ibid., 908

tariffs or import licenses were an instrument to limit the balance of payment pressures.<sup>42</sup>

Optimism was prevailing: *“just get the investment rate up, import capital (with its built-in technology) and soon the underdevelopment would be at the hand.”*<sup>43</sup>

Industrial development could only thrive within the country relying on protectionist tools. A strong state, spill over affects to domestic suppliers and technological change were the engine to catch up with the centre. Albert Hirschman's introduced the concept of the metaphoric bottlenecks (bottle with a thin neck) and linkages. Land, labour and capital were prohibited from expanding since there was a lack of technology, entrepreneurship and infrastructure, thus a thin neck. In order to crash the bottlenecks in the most important industries a state-led intervention – Import Substitution Industrialization - could stimulate demand for intermediate products and initiate the engine for economic development: backward and forward linkages.<sup>44</sup> Franko states: *‘Market failure to produce sustainable growth provided the rationale for state intervention.’*<sup>45</sup>

## 1.2 Institutional approach

Referring to the previous subchapter the author of this thesis follows the institutional approach since ISI is an inward-looking, state-led strategy of economic development. Moreover, it is important to outline the neoclassic theory of development and the dependency theory and analyse how those paradigms interpret state's role for economic development. The author will analyse the state's role in economic transformation process.<sup>46</sup>

<sup>42</sup> Baer, “Import Substitution and Industrialization in Latin America”, 100f.

<sup>43</sup> Bruton, “A reconsideration of import substitution”, 909

<sup>44</sup> Franko, “The puzzle of Latin American economic development”, 56; Hirschman, “The political economy of Import Substitution”, 16

<sup>45</sup> Ibid., 56

<sup>46</sup> Evans, „*Embedded Autonomy: states and industrial transformation*“, 6

Haggard states that both dependency and neoclassic theorists disregard the crucial role of politics and institutions in determining positive development indicators.<sup>47</sup> Dependistas saw the cause for the periphery's unequal development in external factors—the unequal stratification of the international economic system<sup>48</sup>. The dependency theory only reflects on the flaws and injustices of the international economic system. The theory neglects to analyse the policy choices of respective governments thus internal reason for unequal conditions.<sup>49</sup>

Tony Smith suggests alike. Dependistas neglect the responsibility of the Southern countries over their own affairs. The leverage of the international system cannot be blamed for internal misconduct and is overemphasized<sup>50</sup>. Dependistas claim that ‘the whole’ (the international system) dominates and incorporates ‘the parts’ (states).<sup>51</sup> Smith criticizes the holistic approach: *‘The error of this approach is not that it draws attention to the interconnectedness of economic and political processes and events in a global manner, but that it refuses to grant the part any autonomy, any specificity, and particularity independent of its membership of the whole.’*<sup>52</sup> Smith recognizes the complexity of systems, but argues that changes come from outside as well as inside.<sup>53</sup> According to Smith, dependency theorists fail to differentiate and are biased and ideological as the ‘bourgeois science’<sup>54</sup>. As unit of analysis Smith suggests the organization of the state.

Haggard suggests that policy choices and strategies of development are determined by political interests within the state: *‘The strategies that state pursue and the fashion in which they implemented hinge less on broad social-structural forces than on the politically*

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<sup>47</sup> Haggard, “Pathways from the periphery”, 9

<sup>48</sup> Ibid., 16

<sup>49</sup> Ibid., 9

<sup>50</sup> Tony Smith, “The Underdevelopment of Development Literature: The Case of Dependency Theory.” In Kobli, A., ed. *The State and Development in the Third World*. Princeton: Princeton University Press (1991): 27

<sup>51</sup> Ibid.; 30

<sup>52</sup> Smith, “The Underdevelopment of Development Literature”, 36

<sup>53</sup> Ibid., 37

<sup>54</sup> Ibid., 35

*driven choices of state elites.*<sup>55</sup> At the same time he argues: “ ‘The state’ is not only an actor but an set of institutions that exhibit continuity over time (...) Institutional variation is critical in understanding why some states are capable of pursuing the policies they do.”<sup>56</sup> Thus, he highlights the importance of the institutional context for the success of ISI.<sup>57</sup> Franko refers to Fernando Henrique Cardoso who argued that it was possible to overcome injustices and inequalities in the international economic system by involving an active and autonomous state.<sup>58</sup>

Autonomy of the state is a precondition of a successful development strategy.<sup>59</sup> The degree of autonomy knows different concepts. Rhys Jenkins refers to the concept of relative autonomy, which enables the state to follow the interest “*of capital as whole, even when they conflict with the interests of particular fractions of the dominant class.*” Jenkins highlights the importance of state autonomy in pursuing effective economic policy-making. State autonomy indicates that those actors who are responsible for paving the way can formulate their goals independently without considering class hierarchy or other constraints.<sup>60</sup>

Peter Evans argues that once state’s central role in structural change has been recognized the question lies on state’s capacity and its effective and durable institutions for strengthening development. Evans states: “*(...) there is a crude correlation between the state performance around and agenda of industrial transformation(...).*”<sup>61</sup> Evans refers to the institutionalist perspective of Max Weber. The German philosopher argued that states require a coherent bureaucracy and need to be isolated from its surrounding society. Meritocratic recruitment and long-term career perspectives were the basis for an

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<sup>55</sup> Haggard, “Pathway from the periphery”, 4

<sup>56</sup> Ibid.

<sup>57</sup> Ibid., 9

<sup>58</sup> Franko, “The puzzle of Latin American economic development “, 54

<sup>59</sup> Rhys, Jenkins. "The political economy of industrialization: a comparison of Latin American and East Asian newly industrializing countries." *Development and Change* 22, no. 2 (1991): 200

<sup>60</sup> Ibid., 205f.

<sup>61</sup> Peter Evans, “The State as a Problem and Solution: Predation, Embedded Autonomy, and Structural Change.” In Haggard, S. and Kaufman, R. R. eds., *The Politics of Economic Adjustment* 1992: 142

effectively working state apparatus.<sup>62</sup> Together with Joel Migdal and Robert Bates, Weber is in strong favour of an insulated bureaucracy. Weber justifies his approach with the reference to corporate coherence, Migdal emphasized the polarity between state and society and Bates links state-society ties with rent seeking.<sup>63</sup> Evans reflects on insulation: *“The problem is separating the benefits of insulation from the costs of isolation.”*<sup>64</sup>

In contrast, Alexander Gerschenkron and Albert O. Hirschmann took one step further and saw the state apparatus rather embedded in the society than insulated.<sup>65</sup> Evans points out: *“ ‘embedded autonomy’, provides the underlying structural basis for successful state involvement in industrial transformation (...) A state that was only autonomous would lack both intelligence and the ability to rely on decentralized private implementation.”*<sup>66</sup> Evans further says that transformation periods like industrialization need to rest on a strong state.<sup>67</sup> Jenkins describes strong states as being able to formulate and implement policy goals without the interference of particular groups or of the dominant class.<sup>68</sup>

### 1.3 Neoclassic Theory

Neoclassic economists associate ISI with distortions and thus propose the ‘failure-thesis’. Neoclassic economists are one major proponent in the field of development economics. Market-based policies with little or no government control are the key for economic success. State interference is seen as detrimental for the public sector. Franko outlines the concept:

*“Foreign trade and international prices should become the engine for growth...Strict neoclassical theorists therefore see a minimalist role for the state as a guarantor of rules and property rights and a provider of a limited array of public goods such as defense. The private*

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<sup>62</sup> Evans, “Embedded autonomy: states and industrial transformation”, 12

<sup>63</sup> Ibid., 36f.

<sup>64</sup> Ibid., 40

<sup>65</sup> Evans, “The State as a Problem and Solution“, 147f.

<sup>66</sup> Evans, “Embedded autonomy: states and industrial transformation”, 12

<sup>67</sup> Evans, “The State as a Problem and Solution“, 147f.

<sup>68</sup> Jenkins, “The political economy of industrialization”, 200, 203



*sector, through the profit motive and Adam Smith's invisible hand, will generate the greatest good for all.”*<sup>69</sup>

Neoclassical theorists attacked governments for misguided policy applications and interventions and outlined the distortions and costs of ISI. They emphasized the advantages of the international division of labour for developing countries and endorsed to pursue market-conforming approaches. They rejected the critique of structuralists on the international economic structure and downplayed its cause on negative terms of trade.<sup>70</sup> Free trade brought about predominantly advantages for Northern countries: *“Openness did not preclude LDC industrialization but rather encouraged technological adaption, learning and entrepreneurial maturation.”*<sup>71</sup> Trade interventions were rejected when imperfections occurred, rather reforms were advocated in order to increase efficiency. Liberal economists who favoured trade openness deemphasized the asymmetry of economic interdependence between developed and underdeveloped countries.<sup>72</sup>

The major criticism of inward-looking strategies was that the import of intermediate and capital goods and the export bias led to a long-term balance of payments deficit.<sup>73</sup> Osvaldo Sunkel states that *“the transit from the primary export model to the import substitution industrialization model does not mean that they have become less dependent on the international economy, but that the nature of dependence has changed.”*<sup>74</sup> What changed was the composition of imports.<sup>75</sup> Furthermore, domestically produced intermediate and capital goods were more expensive than the imported ones.<sup>76</sup> ISI made state governments more

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<sup>69</sup> Franko, “The puzzle of Latin American economic development”, 25

<sup>70</sup> Haggard, “Pathways from the periphery”, 9f.

<sup>71</sup> Ibid., 10

<sup>72</sup> Ibid., 11

<sup>73</sup> Haggard, “Pathways from the periphery”, 9f.

<sup>74</sup> Osvaldo Sunkel, “Past, Present and Future of the Process of Latin American Underdevelopment,” Studies on Developing Countries, No. 57 (Budapest), 1973, p.15

<sup>75</sup> Baer, “Import Substitution and Industrialization in Latin America”, 106; Franklyn A. Manu, “Import Substitution and Export Promotion: a continuing dilemma for developing countries.” *Journal of International Business and Economics* (2009): 101

<sup>76</sup> Abreu de Paiva Abreu et al. “Import Substitution and Growth in Brazil, 1890s-1970s.” (1996): 25; Elsenhans, Hartmut. *Nord-Süd-Beziehungen. Geschichte-Politik-Wirtschaft*. Kohlhammer, 1987: 76

dependent on external financial borrowing in order to fund imports. Due to the tariff walls oligopolies remained inefficient and manufactured goods lacked international required quality standards.<sup>77</sup> Furthermore, neoclassic economists argue that government officials who issued import licences or investment permits were prone to rent seeking.<sup>78</sup> Thus, ISI led to corruption and inefficient allocation and distribution of resources.<sup>79</sup> ISI failed to generate industrial jobs. Due to its capital-intensive production the industrial sector was limited in providing the long-awaited positions<sup>80</sup>.

Neoclassic economists argue that developing countries need to focus on product specialization and comparative advantage in order to maximize output and therefore emphasize the production of primary products. Hence, the disregard of any potential comparative advantage was criticized.<sup>81</sup> Inward-looking strategies were regarded as disadvantage for technological advancement.<sup>82</sup>

#### *1.4 Dependency Theory*

Smith explains the rationale of the dependency theory:

*“Probably the chief feature of the dependency school is its insistence that it is not internal characteristics of particular countries so much as the structure of the international system – particularly in its economic aspects- that is the key variable to be studied in order to understand the form that development has taken (...).”<sup>83</sup>*

Smith states that dependistas perceive development only in the frame of the global historical context. The interplay between political and economic forces is deemed to be salient<sup>84</sup>.

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<sup>77</sup> Haggard, “Pathways from the periphery”, 9f.

<sup>78</sup> Bruton, “A reconsideration of import substitution”, 923

<sup>79</sup> Haggard, “Pathways from the periphery”, 12

<sup>80</sup> Ibid., 12

<sup>81</sup> Baer, “Import Substitution and Industrialization in Latin America”, 102

<sup>82</sup> Colistete, “Revisiting import-substituting industrialization in Brazil”, 3

<sup>83</sup> Smith, “The Underdevelopment of Development Literature”, 26

<sup>84</sup> Ibid.

Both, structuralism and the dependency theory opposed the prevailing developing concepts, but structuralists put the emphasis on an inward-directed development due to the volatility of primary products. Dependistas postulated a new international economic order<sup>85</sup>. Power and politics were the pillars of the international economy. The elites in Latin America demanded sophisticated luxury goods, hence those imports did not effect economic development. Structuralists elucidated that international trade deepens the gap between the rich and wealthy countries in the Northern and the poorer countries in the Southern hemisphere. These assumptions by Prebisch and other proponents of neoclassic critiques shaped the conditions under which Import Substitution Industrialization (ISI) rose to the surface.<sup>86</sup>

Dependency theorists argue that the countries of the centre dictate the rules of the international economy and national endowments did not determine one's economic performance. Rich countries became even richer at the expense of the periphery. Dependency theorists suggest that the expansion of the manufacturing sector is neo-colonial since subsidiaries of multinational corporations extract the profits and control the leading sectors. Hence, a self-sustaining industrialization process is hardly possible<sup>87</sup>. Southern states cannot live with their dependence due to the power of multinational corporations. At the same time Tony Smith points out that Southern states cannot live without their dependence since the power basis of local elites is contingent on the international system.<sup>88</sup> Dependistas like Paul Baran highlight the dependence of local elites on the exploitive system of the division of labor. Short-term benefits are the goal of those elites, positive impacts for their own people are not taken into considerations: 'A

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<sup>85</sup> Kay Cristobal and Robert N. Gwynne. "Relevance of structuralist and dependency theories in the neoliberal period: a Latin American perspective." *INTERNATIONAL STUDIES IN SOCIOLOGY AND SOCIAL ANTHROPOLOGY*(2000): 50

<sup>86</sup> Franko, "The puzzle of Latin American economic development", 56; Hirschman, "The political economy of Import Substitution", 16

<sup>87</sup> Smith, "The Underdevelopment of Development Literature", 28

<sup>88</sup> Ibid., 29

*social glue bonding local and international elites cemented economic privilege for the upper class. Those in power had no interest in sharing it.*<sup>89</sup>

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<sup>89</sup> Franko, “The puzzle of Latin American economic development”, 54

## 2.Chapter – Case Studies

### 2.1 Case Study: ISI in Brazil

The origins of ISI differ between Brazil and South Korea. Following the analysis of Hirschman Brazil experienced different ISI motives: wars, foreign-exchange constraint and most important ISI as deliberate development strategy. After WWII Brazil wanted to break out of the division of labour - based on the declining terms of trade paradigm of Raul Prebisch and Hans Singer-, while Korea was confronted with external economic constraints after WWII.

Baer clarifies what ISI tried to achieve in Brazil after WWII: '*ISI consisted of establishing domestic production facilities to manufacture goods that were formerly imported.*'<sup>90</sup> It targeted economic growth, greater economic independence and self-sufficiency in industry.<sup>91</sup>

Brazil underwent different stages of ISI, as Hirschman described. The first stage of ISI started at the end of the 19<sup>th</sup> century and lasted until 1955. This period can be characterised by growing manufacturing activities. The second phase of Brazil inward-looking strategy lasted for a time frame of ten years and was dominated by producing consumer durables and semi-finished goods. From 1965 onwards capital goods production began and finally manufactured goods exports took place.<sup>92</sup>

#### 2.1.1 Historical context

The advent of ISI in Latin American countries took its roots long time after the European countries adhered to ISI. On the one hand European countries dictated their former colonies to pursue free trade and on the other hand the socio-economic structure served

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<sup>90</sup> Werner Baer, "Industrialization in Latin America: successes and failures." *Journal of Economic Education* (1984): 124

<sup>91</sup> Ibid., 125

<sup>92</sup> Haggard, "Pathway from the periphery", 25

domestic power interests. Domestic elites were the beneficiaries of commodity exports and thus had no incentive to implement any policy-shift towards a structural change. As a consequence Latin American countries lacked the prerequisites to launch industrialization: entrepreneurship, infrastructure, functioning bureaucracy or necessary market size.<sup>93</sup> Stanley and Barbara Stein outline why industrialization in Latin America was hindered after independence: “*We can see how the economic growth of Latin America through diversification and industrialization could not occur while colonial patterns of production, capital accumulation and investment, income distribution and expenditure survived.*”<sup>94</sup>

Import Substitution Industrialization was however not the beginning of manufacturing in Brazil. Manufacturing activities - textiles and food products - already took place at the end of the nineteenth century.<sup>95</sup> Villela states that already during the First Republic (1889-1930) unplanned, market-driven ISI was implemented.<sup>96</sup> The manufacturing sector benefited from the rubber boom but capital and intermediate goods sectors were not in place. WWI - due to the lack of imports from European countries - opened market niches for domestic producers in the non-durable consumer products sector.<sup>97</sup> The focus on the production of military goods in Europe and the dangers for shipping increased the prices for imported manufactured.<sup>98</sup> Nevertheless, the period of WWI showed the limits of ISI under supply shock due to the absence of intermediate and capital goods imports. Villela argues that exchange rate and monetary policies were deemed to protect domestic manufacturing. However, the industrialized basis of Brazil was only poorly developed, even though the light industry has expanded its operations before the Great depression. But demand for manufactured good was too

<sup>93</sup> Baer, “Import Substitution and Industrialization in Latin America”, 95

<sup>94</sup> Stanley Stein and Barbara Stein, *The colonial heritage of Latin America: essays on economic dependence in perspective*. New York: Oxford University Press, 1970: 136

<sup>95</sup> André Villela. "A bird's eye view of Brazilian industrialization" *The Economies of Argentina and Brazil: A Comparative Perspective*, Edward Elgar (2011):40

<sup>96</sup> Ibid., 38f.

<sup>97</sup> Ibid., 38f.

<sup>98</sup> Baer, “Import Substitution and Industrialization in Latin America”, 95; Ha-Joon Chang. *Kicking away the ladder: development strategy in historical perspective*. Anthem Press, 2002: 14

dependent on coffee export revenues. Simultaneously, the success of the export sector caused an appreciation of the currency and made imports cheaper.<sup>99</sup> Thus, Villela highlights that without tariff protection ‘*industry would continue to be held hostage by the up and downs of the coffee economy.*’<sup>100</sup>

The sharp decline in the terms of trade determined the government to purchase and destroy excess capacity in the coffee sector. In 1930 Getúlio Vargas became president of the Republic. Until 1937 the central power was consolidated and culminated in the proclamation of the authoritarian Estado Novo.<sup>101</sup> Haggard shows that Brazil was a patrimonial and decentralized country with powerful governors during the First Republic Brazil.<sup>102</sup> Villela argues that from the 1930s onward Brazil followed an inward-oriented development trajectory and replaced coffee exports as the main pillar of economic growth.<sup>103</sup> He also notes that the resort to ISI in the 30s was not ‘*the result of conscious industrial policy.*’<sup>104</sup> Haggard agrees with Villela that during the Great Depression and the time of WWII ISI did not rest on an industrial strategy, but that it laid the foundations for subsequent government interventions.<sup>105</sup>

### 2.1.2 ISI implementation

Haggard effectively argues that ISI as a strategy that is based on a theoretical rationale (Singer-Prebisch Thesis) did not emerge before the 1950s.<sup>106</sup> Structural challenges demanded “*strategic action by the state.*”<sup>107</sup> ISI in Brazil in the 1930s was an answer to

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<sup>99</sup> Villela, "A bird's eye view of Brazilian industrialization", 38f.

<sup>100</sup> Ibid., 44

<sup>101</sup> Haggard, "Pathways from the periphery", 165

<sup>102</sup> Ibid. 163

<sup>103</sup> Villela, "A bird's eye view of Brazilian industrialization", 44

<sup>104</sup> Ibid., 44

<sup>105</sup> Haggard, "Pathways from the periphery", 161

<sup>106</sup> Ibid., 165f.

<sup>107</sup> Ibid., 172

external shocks in form of a lack of foreign exchange. Thus, Haggard labels it ‘natural’ ISI.<sup>108</sup>

During the Dutra administration (1946-51) foreign exchange reserves were lost by an experiment of import liberalization. From 1947 onward scarce foreign exchange was only spent on intermediate and capital goods and protective measures were implemented.<sup>109</sup> Due to the long-term benefits of manufactured goods and the price volatility of primary products state-led industrialization was pursued.<sup>110</sup> With the reintroduction of democracy by General Enrico Gaspar Dutra clientelistic networks and weak political alliances re-emerged.<sup>111</sup>

In the 1950s when light industry had reached high output levels, new sectors were target for import substitution. Thus, state authorities envisaged consumer durables, intermediate and capital goods as next substitution goals. Planning and state-owned enterprises became more important and policies to attract foreign capital were enforced.<sup>112</sup> According to Haggard, Brazil’s shift towards the secondary phase of ISI also had an ‘*intellectual rationale*’.<sup>113</sup> The structuralist approach was pursued by many politicians and entrenched in the bureaucratic apparatus.<sup>114</sup> The possibility to export commodities, to receive external funding and the crucial role of foreign direct investment promoted ISI continuity.<sup>115</sup>

According to Villela ISI during the 1950s was furthered by monetary and institutional policies. Foreign exchange auctions were substituted for import licenses and foreign firms, which internalized capital goods, were not bound to exchange cover.<sup>116</sup>

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<sup>108</sup> Ibid., 26

<sup>109</sup> Villela, "A bird's eye view of Brazilian industrialization", 47f. Haggard, "Pathways from the periphery", 172.

<sup>110</sup> Ibid., 51

<sup>111</sup> Haggard, "Pathways from the periphery", 174

<sup>112</sup> Ibid., 171f.

<sup>113</sup> Ibid., 162

<sup>114</sup> Ibid., 162

<sup>115</sup> Ibid., 162

<sup>116</sup> Villela, "A bird's eye view of Brazilian industrialization", 48f.



This meant that profit remittances of TNCs received preferential exchange rates.<sup>117</sup> On the institutional level the Joint Brazil-United States Economic Development Commission and subsequently the National Development Bank (BNDE) were established. The initial idea of the commission was to receive funding for development projects. Finally, deteriorating relations between the two countries put an end to the cooperation. Nevertheless, these projects were the basis for planning models (Target Plans) under the incumbency of president Juscelino Kubitschek.<sup>118</sup> The realization of the 'Targets Program' expanded the scope of the government: *'The Kubitschek regime was a milestone in the evolution of Brazilian import substitution because of the integrated way in which it approached the task.'*<sup>119</sup> Villela claims that ISI- due to investment initiatives- was able to substitute consumer durables and even capital goods. Imports dropped during the 1950s, exemplifying a higher degree of self-sufficiency. Nonetheless, foreign indebtedness and inflation gave a different impression of the consequences of ISI adoption.<sup>120</sup>

After the military coup in 1964 the financial markets experienced a period of liberalization. Dependency theorists claim that this policy approach opened the doors for FDI. Haggard argues that foreign borrowing was at a much higher level.<sup>121</sup> The military coup introduced the PAEG (Plano de Acao Economica do Governo) Plan. Between 1968-1973 Brazil experienced its 'miracle' with high GDP growth rates. Demand for consumer durables and the construction industry were the drivers of the Brazilian economic 'miracle'. It was achieved through private sector involvement and by granting cheap credits. As a consequence the Medici government could not avoid an overheating of the economy and thus the growth-cum-debt strategy was implemented.<sup>122</sup> Moreover the 'Brazilian Miracle' rested on outward-oriented policies, but import restriction

<sup>117</sup> Haggard, "Pathways from the periphery ", 175

<sup>118</sup> Villela, "A bird's eye view of Brazilian industrialization", 48

<sup>119</sup> Haggard, "Pathways from the periphery ", 174

<sup>120</sup> Villela, "A bird's eye view of Brazilian industrialization", 48f.

<sup>121</sup> Haggard, "Pathways from the periphery ", 180f.

<sup>122</sup> Villela, "A bird's eye view of Brazilian industrialization", 49f.

continued. The state encouraged state-owned enterprises to foreign borrowing by providing incentives like tax-exemptions, suspended credit controls or favourable exchange rates.<sup>123</sup>

In December 1974 the Second National Development Plan (II PND) entered into force. Brazil intended to finish its ISI process due to investments in those underdeveloped sectors that were still highly contingent upon imports. The shift away from commodity exports towards industrial goods, and especially intermediate and capital goods, was implemented in the mid to late 1970s.<sup>124</sup> Villela suggests that Brazil's industrialization process was accomplished and in the 1980s.<sup>125</sup> He explores both sides of ISI. On the one hand the above-mentioned structural change and industrial growth, on the other hand macro and microeconomic deficiencies. In the course of the II PND foreign borrowing increased sharply and exposed Brazil to fluctuating interest rates. The growth-cum-debt strategy had severe implications for the next decades - inflation and current-account deficit. Microeconomic shortcomings included the disregard of comparative advantage which led to allocation and economic of scales disruptions. The deficiencies of ISI were specifically apparent in the 1980s. The fact that by the late 1980s Brazil did not import goods for domestic consumption was offset by the high nominal tariff rates that hampered the competitiveness of the domestically produced goods. Lower quality and overpriced products were to the detriment of local consumers.<sup>126</sup>

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<sup>123</sup> Haggard, "Pathways from the periphery", 180f.

<sup>124</sup> Villela, "A bird's eye view of Brazilian industrialization", 50f.

<sup>125</sup> Ibid., 58

<sup>126</sup> *ibid.* 52f.

## 2.2 Case Study: ISI in Korea

### 2.2.1 Historical Context

South Korea's ISI implementation can only be analysed in the context of the legacy of its former colonial power Japan, the role of the United States and with the reference to the social-political structure.<sup>127</sup> Korea was under Japanese rule from 1910 to 1945.<sup>128</sup> South Korea took the first steps in the world economy via export primary products (PPE)-food products for the traditional sector and raw materials for export.<sup>129</sup> Korea's PPE period was dominated by Japan's military-strategic understanding of the division of labour, which emphasized raw material production and infrastructural investment with the same relevance.<sup>130</sup> In this sense, Korea became supplier of Japanese' foodstuff (rice production) during the interwar period. Thus, Japan established property rights in the rural area and enabled industrial expansion. Korea gained even more importance as supplier when Japan invaded former Manchuria in 1937.<sup>131</sup> Railroads, harbors and roads facilitated Korea's agricultural exploitation.<sup>132</sup> Nevertheless, Haggard argues that Korea was more than just a colony: *"As a result of a unique conception of empire, state-directed investment led, rather than followed, industrial development."*<sup>133</sup> Therefore, Korea gained its independence in 1948 with a state apparatus marked by Japanese notions.<sup>134</sup> Political institutions are hence a crucial pillar of the Korean development path. Haggard argues: *'Postindependence politicians controlled powerful and independent bureaucracies inherited from the colonial period.'*<sup>135</sup>

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<sup>127</sup> Haggard, "Pathways from the periphery", 51

<sup>128</sup> Kay Cristóbal. "Why East Asia overtook Latin America: agrarian reform, industrialisation and development." *Third World Quarterly* 23, no. 6 (2002): 1079

<sup>129</sup> Haggard, "Pathways from the periphery", 24

<sup>130</sup> Ibid., 34

<sup>131</sup> Ibid., 51f.

<sup>132</sup> Ibid. 194

<sup>133</sup> Ibid. 197

<sup>134</sup> Ibid., 51

<sup>135</sup> Ibid., 164

After WWII the industrial bourgeoisie in South Korea lost its influence because heavy industry was located in the Northern part of the Island. During the Korean War 75 per cent of the industrial capacity was destroyed.<sup>136</sup> With the end of the Japanese colonial era trade and industrial output decreased. Manufacturing employment dropped by nearly 60 per cent.<sup>137</sup> Nevertheless, Koreans relied on structural capacities, which functioned as a solid basis for state-led industrialization processes.<sup>138</sup>

Financial support from the United States in form of foreign aid along with the inherited structural conditions from Japan were important in determining the development path of South Korea. The financial support from the United States functioned as source of capital accumulation but institutional factors are the main pillar for explaining South Korea's development impact and long-ranging trends. While Brazil was rather clientelistic in its exchange between state and the people, Korea's state structure was centralistic.<sup>139</sup>

### 2.2.2 ISI implementation

Korea pursued import substitution after WWII on grounds of balance of payments difficulties, political separation and thus the access to important markets.<sup>140</sup> The United States provided financial resources for Korea's ISI period. Thus, Korea was more or less dependent on external assistance.<sup>141</sup>

Syngman Rhee took office in 1948 based on strong institutional foundations. The American Military Government (AMG) further sophisticated the state apparatus. Constitutional amendments weakened the power of the legislation while the executive increased its power structure. Under these circumstances land reforms eliminated the

<sup>136</sup> Vinícius Rodrigues Vieira. "Invisible legacies: Brazil's and South Korea's shift from ISI towards export strategies under authoritarian rule." *Journal of International Relations and Development* (2013):15f.

<sup>137</sup> Haggard, "Pathways from the periphery", 51f.

<sup>138</sup> Vieira, "Invisible legacies", 15f.

<sup>139</sup> Ibid., 7, 25

<sup>140</sup> Haggard, "Pathways from the periphery", 51

<sup>141</sup> Ibid., 34

dominance of rural elites.<sup>142</sup> Vieira emphasizes that landlords had already lost political power during Japanese colonisation.<sup>143</sup> High government expenditures explain the strengthening of the bureaucratic power.<sup>144</sup> Haggard states that US aid funded the necessary imports during the first phase of import substitution industrialization: “*Aid financed nearly 70 percent of total imports between 1953 and 1962 and equalled 75 percent of the total fixed capital formation.*”<sup>145</sup> Kohli highlights that US aid increased Korea’s GNP by 10 per cent on a yearly basis in the 1950s. In contrast, Peter Evans argues that US foreign aid to Korea was allocated to higher degrees to military expenditures rather than economic development.<sup>146</sup>

Rhee’s incumbency was characterised by his bureaucratic authoritarian character. In order to retain political support Rhee distributed bank credits, foreign exchange or import licences. Exchange rates regimes changed randomly. Rhee’s control over imported grain allowed him to distribute resources to government officials. Domestic firms purchased imports at overvalued exchange rates and sold below average prices. Korea’s geopolitical position sustained the flow of financial resources from the U.S. and eased the pressure to conduct institutional reforms.<sup>147</sup> Haggard notes: “*The combination of the effort to maximize aid inflows and the political use of economic instruments resulted in a highly inconsistent economic program.*”<sup>148</sup> The establishment of the Ministry of Reconstruction (MOR) was an attempt to implement a planning model, but lacked support and faced competition with other ministries. A political motivated ISI policy was blamed for a stagnating economy. The industrial growth rates under ISI showed economic upturn, thus Haggard associated the generally low growth rates with economic performances in

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<sup>142</sup> Ibid., 54f.

<sup>143</sup> Vieira, "Invisible legacies", 12

<sup>144</sup> Haggard, "Pathways from the periphery", 55

<sup>145</sup> Ibid., 55

<sup>146</sup> Vieira, "Invisible legacies", 7

<sup>147</sup> Haggard, "Pathways from the periphery", 58

<sup>148</sup> Ibid., 58

the agricultural and service sector. Korean firms were quite successful in sectors like textiles or light consumer goods, even though negative attributes related to ISI outweighed light industry entrenchment: imports of intermediate goods increased, production reflected the limited size of the market and balance of payment difficulties. US influence shaped the implementation of ISI but allocations of US aid were reduced and thus the amount of investment. Political interests of the state and specifically the institutional context shaped ISI in Korea. Rational planning was blocked as a result of the enforced political instruments.<sup>149</sup> Due to its lack of any organizational autonomy, corruption and incoherence Rhee and his government were ousted from office in 1961.<sup>150</sup> Haggard states: *‘The coup was a response not only to short-term political instability but to the underlying economic strategy that spawned it.’*<sup>151</sup>

The shift to export promotion can be framed by institutional and political changes and external constraints. Under Park Chung Hee the power of the executive remained uncontested, but the power of the government spilled over to the agricultural sector and wages were kept at the same level. The absence of wage increases enabled the creation of new jobs and fostered the path of export-led growth. Labour was further weakened. The creation of the Economic Planning Board (EPB) ensured that previously fragmented sectors operated jointly and enforced a centralization of decision-making. State capacities were strengthened and the private sector lost support. The early phase of export-led growth was accompanied by high tariffs on import-competing goods like durable consumer goods<sup>152</sup>. Haggard analyses that it was not before 1967 that import liberalization became the major trade paradigm not: *‘The neoclassical case generally overlooks a wide range of discretionary controls used to limit “excessive” imports: quantitative restrictions, advance*

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<sup>149</sup> Haggard, “Pathways from the periphery “, 58f.

<sup>150</sup> Ibid., 60

<sup>151</sup> Ibid., 260

<sup>152</sup> Ibid., 61f

*import deposits (...) and the sheer administrative complexity of importing.’*<sup>153</sup> With the establishment of the Joint Export Development Committee governmental power consolidated. Export potentials were evaluated and sectoral export targets determined.<sup>154</sup> Haggard concludes: *‘Korea’s turn to export-led growth was “state-led” not only in its dirigisme but in reflecting the particular political interests and powers of the Park leadership.’*<sup>155</sup>

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<sup>153</sup> Ibid., 66

<sup>154</sup> Haggard, “Pathways from the periphery “, 70f

<sup>155</sup> Ibid., 75

### 3.Chapter- Comparative Analyses:

#### 3.1 Conditionalities

##### 3.1.1 Land reform

One major difference between Brazil and South Korea in the context of ISI was the discontinuity and transformation of class structures. The land reform in Korea diminished possible influence of large landowners on the government.<sup>156</sup> The dichotomy between landlords and tenants was no longer of importance.<sup>157</sup> Japanese colonialism further had shaped the decline of land oligarchy,<sup>158</sup> but at the same time Japan exploited Korea's agricultural sector for its purposes.

The absence of strong landowners laid the foundation for an internal market of manufactured goods. Landowners received compensation for their land. These reimbursements were invested in industrial capacities.<sup>159</sup> Landlords were not excluded but were co-opted to the institutions: *'In this sense, Brazil, even after independence, was in an opposite situation, with a strong network of clientilism and patronage in rural areas that followed the patterns inherited from the colonial period.'*<sup>160</sup>

In Brazil the agricultural sector was still divided between the powerful landed oligarchs and their control over large properties and subordinated peasants.<sup>161</sup> Agriculture was not neglected during ISI due to its importance to foreign exchange revenues. Nevertheless, the main beneficiaries of government investments and subsidies were large landholders and not the common farmer. Therefore, ISI exacerbated the cleavages between latifundio and minifundio.<sup>162</sup> In Brazil, however, small farmers were

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<sup>156</sup> Bruton. "A reconsideration of import substitution", 921f.

<sup>157</sup> Kay, "Why East Asia overtook Latin America", 1080

<sup>158</sup> Vieira, "Invisible legacies", 12

<sup>159</sup> Ibid., 16

<sup>160</sup> Ibid., 12

<sup>161</sup> Ibid., 15

<sup>162</sup> Haggard, "Pathways from the periphery", 35f



neglected and *'ISI contributed to extensive rural poverty and a skewed distribution of income.'*<sup>163</sup>

Commercial agricultural interests dominated the ISI period.<sup>164</sup> Vieira points out that the strong position of the landowners prohibited the expansion of an internal market<sup>165</sup>:

*'(...) exclusion from consumption contributed to the further development of ISI amid an ES.'*<sup>166</sup>

### 3.1.2 Bureaucracy

At the beginning of this subchapter the author refers to Peter Evans: *"States are not generic. They vary dramatically in their internal structure and relations to society. Different kinds of state structures create different capacities for action."*<sup>167</sup>

Vieira clearly states that the social political structure of both countries, thus, institutions and organisations influenced the duration of the ISI period and its ramifications. In both countries colonial history shaped the structural foundations. In the case of Brazil the Portuguese established their colonies, in Korea the Japanese exercised control over the Korean people.<sup>168</sup>

In Brazil landowners were already powerful and dominated those who were without possessions. In 1822 Brazil gained its independence but the weak state structure remained.<sup>169</sup> The revolution of 1930 did not lead to any changes in the authoritarian tradition since oligarchs and large landowners dominated it.<sup>170</sup> With the incumbency of Getúlio Vargas professional bureaucracy and federal administration was introduced, but the landed oligarchs perpetuated their influence and limited autonomous state actions.<sup>171</sup> The strong and powerful position of landowners originated in the Portuguese colonial era.

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<sup>163</sup> Ibid., 37

<sup>164</sup> Haggard, "Pathways from the periphery", 36; Kay, "Why East Asia overtook Latin America", 1093

<sup>165</sup> Vieira, "Invisible legacies", 16

<sup>166</sup> Ibid., 22

<sup>167</sup> Peter Evans, "Embedded Autonomy", 11

<sup>168</sup> Vieira, "Invisible legacies", 2f.

<sup>169</sup> Ibid., 11

<sup>170</sup> Ibid.

<sup>171</sup> Ibid.

Vieira states:

*“They worked on behalf of the Portuguese crown and acted as de facto rulers in their neighbourhoods where they were settled. Therefore, such indirect rule led an unclear boundary between the private and public arenas in Brazil (...) these are the roots of the patrimonialism – broadly, the use of the public arena for private purposes (...).”*<sup>172</sup>

Jenkins notes that successful industrialization depends to a large extent on the effectiveness of state intervention. He refers to four key factors/conditions that characterized the development path of South Korea: flexibility, selectivity, coherence and less regulation. Flexibility means to adjust one’s policy program if the circumstances require it. South Korea has favoured production only in specific industrial sectors, thus was selective in its strategy. Latin American countries have pursued the same policies of industrialization despite negative external and internal appearances. Coherence implies to a better coordination between state actors while less regulation stands market-oriented policies.<sup>173</sup>

Korea’s policy initiatives were rooted in coherent bureaucratic organization and inherited elements of embedded autonomy due to Japanese colonial period. Embedded autonomy combines Weberian bureaucratic insulation with ‘*immersion in the surrounding social structure*.’<sup>174</sup> Civil service examination guaranteed that the best candidates were chosen and interpersonal networks within the bureaucracy strengthened coherence.

During the ISI period Rhee’s dependence on private capital established a clientelistic system that effected recruitment procedures as well. Evans claims that ISI fostered rent-seeking activities and made the state more predatory than developmental.<sup>175</sup> Only Korea’s strong bureaucratic legacy made it possible that under Park’s incumbency the state regained its autonomy and meritocratic promotion after the distortions of the ISI period, as Evans points out: “*Without a deep, thoroughly elaborated, bureaucratic tradition,*

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<sup>172</sup> Vieira, "Invisible legacies", 10

<sup>173</sup> Jenkins. "The political economy of industrialization", 200

<sup>174</sup> Evans, "The State as a Problem and Solution", 154

<sup>175</sup> Ibid., 154

*neither the Park regime's reconstruction of bureaucratic career paths nor its organization of the economic policy making apparatus would have been possible.*<sup>176</sup> Park aimed to stop the dependence on private capital, which was one main characteristic of Rhee's regime. Nonetheless, Park could not disentangle the ties to private entrepreneurship.<sup>177</sup> Evans points out: "*Korea is pushing at the limit to which embeddedness can be concentrated in a few ties without degenerating into particularistic predation.*"<sup>178</sup> The implementation of ISI exceeded the limit.

The bureaucracy of Latin American countries was highly politicized.<sup>179</sup> Appointments in Brazil's bureaucracy were based on patronage rather than competence and fluctuating political leadership encouraged civil servants to capitalize on their short employment. The strategy of 'pocket of efficiency' – a step by step - was supposed to develop a modern state apparatus, but its incrementalism implied an uncoordinated expansion of state capacities. The character of Brazil's embeddedness with its dominant role of the rural elites fostered clientelistic networks. Public-private interactions were abused for personal enrichment. Evans states that in those sectors where bureaucracy was coherent, industrialization and economic growth in the ISI phase took place. Planning capacity and subsidies by the Grupo Executivo para Industria Automobilistica (GEIA) induced a thriving automobile industry. Thus, Evans labels Brazil partial embedded autonomy.<sup>180</sup> In contrast, Baer connects the establishment of an automobile industry in Brazil with price distortions and higher production costs.<sup>181</sup> Vieira refers to Kholi and states: *'Insofar as the Brazilian state lacks cohesiveness, it might be classified as a*

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<sup>176</sup> Evans, "The State as a Problem and Solution", 156

<sup>177</sup> Ibid., 156

<sup>178</sup> Ibid., 158

<sup>179</sup> Jenkins. "The political economy of industrialization", 204

<sup>180</sup> Evans, "The State as a Problem and Solution", 166f.

<sup>181</sup>

*fragmented multi-class state.*<sup>182</sup> In contrast, Korea is classified as embedded autonomy, as a cohesive capitalist state.<sup>183</sup>

In Brazil government officials who issued import licences or investment permits were prone to rent seeking. The administrative staffs were inexperienced and did not possess the skills to observe and implement programs and plans. It seemed that the government pursued its own interests, trying to maximize its own benefits.<sup>184</sup>

In Brazil old institutions prolonged within new organisations.<sup>185</sup> Haggard notes that the pursuit of the import-substituting process generated interests that were contingent upon ISI. Therefore, the state was constraint in its leeway.<sup>186</sup>

Jenkins explains the reasons for Korea's earlier successful development path:

*"The key to the superior industrial performance of East Asian NICs does not lie in the general superiority of export-orientated industrialization strategies over import substitution,(...) It is rather the ability of the state to direct the accumulation process in the direction which is required by capitalist development at particular points in time which is crucial."*<sup>187</sup>

He reiterates that this is only possible when state authorities can implement their programs without the interference of local classes. Under military rule the Brazilian state displayed more autonomy and was able to enhance its exports and was able to catch up with South Korea.<sup>188</sup>

The weak position of the industrial bourgeoisie and strong patterns of state autonomy enabled Korea to switch to exports and then return to the second stage of ISI.<sup>189</sup> The industrial bourgeoisie of Latin American countries traces its origin back to the

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<sup>182</sup> Vieira, "Invisible legacies", 9

<sup>183</sup> Ibid. 9

<sup>184</sup> Bruton, Henry J. "A reconsideration of import substitution." *Journal of economic literature* 36, no. 2 (1998): 923

<sup>185</sup> Vieira, "Invisible legacies", 25f.

<sup>186</sup> Haggard. "Pathways from the periphery", 269

<sup>187</sup> Jenkins, "The political economy of industrialization", 224

<sup>188</sup> Ibid., 216

<sup>189</sup> Ibid., 216

beginning of the twentieth century. Thus, protectionism was supported and trade openness was opposed. The transition to export-led growth started in the late 1960s.<sup>190</sup> The military regime in Brazil (1964) enjoyed more autonomy but was also confronted with opposition towards import liberalization.<sup>191</sup>

### 3.1.3 *Regime type*

The link between regime type and economic development can be analysed from two perspectives. On the one hand, if the regime type determines the chosen strategy and economic growth, and on the other if the strategy affects a change of regime type. Thus, the author also considers the affect of ISI on political development. The focus of this research lies on economic development, but political and economic development are intertwined.<sup>192</sup>

Haggard argues that in Brazil the strategy of ISI had no direct link with the emergence of an authoritarian rule and underwent different political arrangement. He argues that periods of high inflation in general cause political polarization.<sup>193</sup> Vieira argues that the transition towards import-substitution of capital goods contributed to the rise of the bureaucratic-authoritarian (BA) regime in 1964 due to its close ties to foreign capital and the increasing social tensions within the country.<sup>194</sup> Evans and O'Donnell also link later stages of ISI with the emergence of authoritarianism.<sup>195</sup> As a consequence labor was suppressed and authoritarian patterns entrenched.<sup>196</sup> Critiques highlight that the second stage of ISI was initiated before the military coup of 1964 and deny any causality

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<sup>190</sup> Ibid., 209, 217

<sup>191</sup> Jenkins, "The political economy of industrialization", 220

<sup>192</sup> Haggard, "Pathways from the periphery", 254f.

<sup>193</sup> Ibid., 257

<sup>194</sup> Vieira, "Invisible legacies", 21

<sup>195</sup> Haggard, "Pathways from the periphery", 257

<sup>196</sup> Ibid., 257

with authoritarian rule and labor control.<sup>197</sup> The second stage of ISI rested on the substitution of consumer durables. Thus, income was unequal distributed in order to establish an adequate market. The strong demand for capital goods further consolidated wage pressure.<sup>198</sup>

Haggard points out that the need to attract foreign capital during ISI did not foster authoritarianism since manufacturing multinationals were primarily interested in market access rather than lower wages.<sup>199</sup>

According to Haggard the association between the industrial approach and political regime type is more reasonable in South Korea. The shift to export-led growth and the pressure to enhance competitiveness was accompanied by the exclusion and control of labor. Thus, support for democratic policies diminished and authoritarian rule prolonged.<sup>200</sup>

### 3.1.4 *Shift towards EOI*

South Korea, like Brazil, industrialised behind protective walls but accomplished to shift to the export of manufactured exports at an earlier stage.<sup>201</sup>

Rhys Jenkins argues that postulating a dichotomy between export-oriented and import substituting industrialization leads to wrong interpretations, since Korea's development path was based on ISI. Moreover, protectionist measures for domestic producers were still in force after pursuing export promotion.<sup>202</sup>

Haggard highlights the temporary character of ISI: *'Ideally, the protection granted to import-substituting industries would be tailored to essential development purposes and ultimately phased*

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<sup>197</sup> Ibid., 258

<sup>198</sup> Haggard, "Pathways from the periphery", 257

<sup>199</sup> Ibid., 258

<sup>200</sup> Ibid., 254f.

<sup>201</sup> Ibid., 3

<sup>202</sup> Jenkins, "The political economy of industrialization", 199

out, allowing firms to graduate to competitive status. In fact, high levels of protection persisted.<sup>203</sup> He states that the export-bias of ISI and its debt-intensiveness led to debt servicing.<sup>204</sup>

The critique of Albert O. Hirschman and Raul Prebisch show the relevance of the question if it is necessary to shift timely to export-oriented growth models. In 1963 Prebisch by himself gave up: *‘As is well known, the proliferation of industries of every kind in a closed market has deprived Latin American countries of the advantages of specialization and economics of scale, and owing to the protection afforded by excessive tariff duties and restrictions, a healthy form of internal competition has failed to develop, to the detriment of efficient production.’*<sup>205</sup> Prebisch analysed that overvalued exchange rates prohibited exports and thus led to a foreign exchange gap.<sup>206</sup> Peter Burnell expounds that Prebisch advocated for preferential market access to developed countries and regional integration.<sup>207</sup>

Developing countries draw on different tools to protect their economy. Tariffs are the most common instrument to limit imports by collecting a tax. Nominal and effective tariffs have to be distinguished. Nominal tariffs show the difference between the price level of protected and international traded goods. In contrast, effective tariffs show the value added for domestic producers achieved by protection. Since there is no or only a low tariff on imported inputs the margin of value added is larger than indicated by the nominal tariff. In many Latin American countries effective tariff rates exceeded nominal rates.<sup>208</sup> Baer states: *Such high levels of effective protection eliminate incentive to increase production efficiency and make it difficult to bring cost of production to international levels.*<sup>209</sup>

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<sup>203</sup> Haggard, “Pathways from the periphery”, 13

<sup>204</sup> Ibid. 219

<sup>205</sup> Hirschman, “The Political Economy of Import-Substitution”, 2

<sup>206</sup> Franko, “The puzzle of Latin American economic development”, 67

<sup>207</sup> Peter J Burnell. *Economic nationalism in the Third World*. London: Wheatsheaf, 1986: 67

<sup>208</sup> Baer, “Import Substitution and Industrialization in Latin America”, 104

<sup>209</sup> Ibid., 104

He adds: “*It has been estimated that effective protection for manufactured products in Brazil in 1966 was 254 percent as compared with product protection of 99 percent.*”<sup>210</sup>

Hirschman states that ISI is a prerequisite for export-led growth: ‘*Prior, successful acceptance of a manufactured commodity in the home market has even been considered to be a prerequisite for successful exporting.*’<sup>211</sup> Andreas Heinrich argues in the same direction and regards ISI as foundation for export promotion. Thus ISI can foster economic development if the right policy reforms are implemented. Heinrich clearly states that ISI is no alternative to the promotion of exports. Products have to be first consumed domestically in order to analyse quality standards and to compensate any possible product failures.<sup>212</sup> Hirschman elucidates why exporting industrial processed products is crucial for developing countries. Through exports smaller domestic consumer markets do not pose any limitations for economic growth. The balance of payments deficit will be reduced and facilitate the establishment of new industrial enterprises. Hirschman says that participating through exports in global markets requires countries to be more efficient in the production process and demands higher quality standards for products. Tariff walls prevent local producers to take care of higher standards of production processes.<sup>213</sup> He analyses why governments in Latin American countries were not supporting a timely shift towards encouraging exports: ‘*The new industries have been set up exclusively to substitute import, without any export horizon on the part of either the industrialists themselves or the government.*’<sup>214</sup>

How does the comparative advantage of resource-rich countries in commodities affect ISI? Natural resource export is a mean to prolong ISI.<sup>215</sup>

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<sup>210</sup> Ibid., 115, footnote 24

<sup>211</sup> Hirschman, "The political economy of import-substituting industrialization", 25

<sup>212</sup> Heinrich, Andreas. "Die Importsubstitution als Entwicklungsstrategie in Lateinamerika. Das Fallbeispiel Mexiko." *Wirtschaft und Gesellschaft-WuG* 24, no. 1 (1998): 102

<sup>213</sup> Hirschman, Albert O. "The political economy of import-substituting industrialization 24

<sup>214</sup> Ibid., 25

<sup>215</sup> Haggard, "Pathways from the periphery", 34



Haggard describes how factor endowment and the size of the country affect the adherence to ISI:

*“In relatively small, import-substituting countries and in those with few resources the plausibility of continuing import substitution is lower and need to generate nontraditional exports more pressing. In large or resource-rich economies, by contrast, external shocks and balance-of-payment crises may plausibly be met by “deepening” import-substitution policies, while the country relies on commodity exports for the requisite foreign exchange.”*<sup>216</sup>

Haggard states that ISI like other policies had distributional effects on societal groups.<sup>217</sup>

In this context, Michael L. Ross further elaborates on resource endowment and the prolongation of ISI even if it was not economical rationale. He states that too many non-state actors – manufactures and workers – benefited from the subsidies allocated in the resource sector and thus were supportive of ISI.<sup>218</sup> Labor seems to have extended the continuation of ISI. While organized labour in Korea was suppressed, labour organisations in Brazil – they had a stronger basis due to its longer industrial history – were in favour of ISI.<sup>219</sup> When ISI extended its protective measures towards industries in the upstream sector (ISI 2) the coalition benefiting from ISI increased.<sup>220</sup>

The size of the domestic market influences and determines the length of time of ISI. Larger domestic markets enable the possibility of economics of scale and therefore the production of intermediate and capital goods. Furthermore, smaller markets reveal the difficulties of ISI at an earlier stage.<sup>221</sup> Once consumer goods industries had been established the demand was confined by the growth rates of Brazil’s domestic market. South Korea’s export strategy responded to the composition of its industrial output, hence strengthened specific sectors, while Brazil lagged behind and opponents against export promotion further consolidated.<sup>222</sup>

<sup>216</sup> Haggard, “Pathways from the periphery”, 30

<sup>217</sup> Ibid. 34

<sup>218</sup> M. L. Ross. “The Political Economy of the Resource Curse.” *World Politics* 51 (January 1999): 311

<sup>219</sup> Haggard “Pathways from the periphery”, 38

<sup>220</sup> Ibid., 38

<sup>221</sup> Ibid., 26, 39

<sup>222</sup> Jenkins, “The political economy of industrialization”, 220f

Neoclassic theorists referred the more successful path of the East Asian NICs to market-oriented policies. But the reference to market-oriented policies disguises industrial planning by South Korea. Haggard states: “(...) *the shift to export led-growth was also accompanied by economic, legal, and institutional reforms that the neoclassical interpretation has generally ignored.*”<sup>223</sup> Market-oriented policies were supplemented by sector specific financial incentives as well as protection.<sup>224</sup> In this context, Jenkins argues that South Korea continued with import substitution in intermediate and capital goods in the early 1970s.<sup>225</sup> Korean government and the private sector cooperated and were intertwined. The government approached different tasks with different strategies and proved to be flexible in decision-making.<sup>226</sup> In South Korea export led-growth was supplemented by ISI: ‘*While the first stage, import substitution industrialization (ISI), can be regarded as pure import substitution industrialization, in the Korean case, the subsequent ISI was aimed at raising infant industries, which would become export industries in the future.*’<sup>227</sup> State action was crucial in both countries.<sup>228</sup> Therefore, Korea’s industrial policy was crucial for its success in development.<sup>229</sup>

David Felix outlines the strong-weak state perspective. Rhee’s incumbency can be characterised as weak state, while Park’s provides an example of a strong state. Felix points out that Park suppressed businessman and workers and delegated industrial planning to technocrats.<sup>230</sup> He underscores that not market liberalization and depreciation

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<sup>223</sup> Haggard, “Pathways from the periphery”, 15

<sup>224</sup> Ibid.13f

<sup>225</sup> Jenkins, “The political economy of industrialization”, 216

<sup>226</sup> Bruton, “A reconsideration of import substitution”, 924f.

<sup>227</sup> Kim, Junmo. *The South Korean Economy: Towards a New Explanation of an Economic Miracle*, Aldershot: Ashgate, 2002: 31f.

<sup>228</sup> Vieira, “Invisible legacies”, 25

<sup>229</sup> Haggard, “Pathways from the periphery”, 13f.

<sup>230</sup> David Felix. “Import substitution and late industrialization: Latin America and Asia compared.” *World Development* 17, no. 9 (1989): 1459

of the exchange rate were the reason for the shift towards export strategies: “*Better targeting and less capricious implementation were the crucial improvements under Park.*”<sup>231</sup>

Moreover, the rationale of the neoclassic concept of developing countries pursuing export-led growth did not want to anticipate the consequences of a bulk of manufactured goods entering the markets of developed countries.<sup>232</sup>

Export promotion in Brazil was further hampered due to unfavourable exchange rates. A devaluation of a currency would have hit the poorest of the poor, considering the high degree of income inequality.<sup>233</sup> Key analyses the role of exports for economic development:

*“The key obstacle to Latin America’s industrialization was less the lack of capital than the lack of foreign exchange. Thus the neglect of agricultural exports together with the failure to shift at an earlier stage to an export-orientated industry (EOI) strategy are some of the key reasons why Latin America fell behind the East Asian NICs.”*<sup>234</sup>

The Brazilian BEFLEX (Special Fiscal Benefits for Exports) created export incentives successfully but was limited due to the lack of competitive products. Regional cooperation was hindered by the obstruction of protected TNC subsidiaries, interregional political discrepancies and different economic operating numbers between the countries.<sup>235</sup>

Korea’s growth rates increased in the 60s relative to the 50s by 4,7 per cent. At the beginning of the 60s Korea depreciated its exchange rate and reduced taxes on exports to enable an outward-oriented strategy. Thereby, Korea could reduce the existing distortions of ISI of the 50s. Furthermore, an institutional development framework was

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<sup>231</sup> Ibid., 1459

<sup>232</sup> Haggard, “Pathways from the periphery”, 12f.

<sup>233</sup> Franko, “The puzzle of Latin American economic development”, 66

<sup>234</sup> Kay, “Why East Asia overtook Latin America”, 1095

<sup>235</sup> Franko, “The puzzle of Latin American economic development”, 66

in existence. The Bank of Korea or R&D establishments in agriculture were further parameters that fostered a change in the development strategy.<sup>236</sup>

### *3.1.5 Foreign Direct Investment*

During the ISI period Korea did not rely on foreign direct investment - its external capital came in the form of aid. Korea also remained a borrower during export-led growth since domestic savings did not reach substantial levels.<sup>237</sup> Haggard shows that in Korea export-led growth fostered the establishment of local firms. Brazil with its shift to the secondary phase of ISI had to rely on the input of foreign firms. This was due to the limits of local investors in terms of capital and technology. Nevertheless, as Haggard points out by 1973 commercial loans became the main source of external capital and limited the role of FDI.<sup>238</sup> In Korea closer ties between business and labour fostered joint actions against foreign investment. In Brazil after the military coup in 1964 government's demand for capital shifted towards the recourse to foreign capital since institutional links to the domestic private sector were less intensive.<sup>239</sup> The substitution of consumer durables and intermediate goods was affiliated to the provision of favourable treatment to foreign firms.<sup>240</sup>

Vieira highlights the dominant role played by Foreign Direct Investment in Brazil by exemplifying that in the timeframe of 1953 to 1960 21,2 per cent of Brazil's whole gross domestic fixed capital formation stem from FDI.<sup>241</sup>

Foreign investment during the second stage of ISI in Brazil was accelerated after the military coup in 1964.<sup>242</sup> As a consequence state elites, local capital and foreign-owned

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<sup>236</sup> Bruton, "A reconsideration of import substitution", 921f.

<sup>237</sup> Haggard, "Pathways from the periphery", 196

<sup>238</sup> Ibid., 191f., Aregbeshola R. Adewale, "Does import substitution industrialization strategy hurt growth?: new evidence from Brazil and South Africa" *In African and Asian Studies*, 17, no 3 (2012): 296

<sup>239</sup> Ibid., 194

<sup>240</sup> Ibid., 213

<sup>241</sup> Vieira, "Invisible legacies", 25f.

firms forged an alliance. Dependistas clearly emphasized the dominant role of TNCs among those partners with negative consequences for manoeuvres of the other actors. Haggard claims: “*The strategy of “dependent development”-essentially the phase of import substitution in which multinationals come to play an expanded role-resulted from a particular transnational class coalition.*” Evans argues that ‘*instead of being connected to the centre primarily in terms of the exchange of commodities, the periphery became part of an integrated system of industrial production whose ownership continued to remain in substantial measure in the centre.*’<sup>243</sup>

In contrast, South Korea applied more restrictive measures and technological knowledge entered domestic markets, while in Brazil technological development took place behind the walls of TNC subsidiaries.<sup>244</sup> The export of manufactured goods with low to medium technological content significantly surged in the late 1970s. Primary exports remained Brazil’s main pillar until 1979.<sup>245</sup>

The dominance of TNCs at the second stage of ISI in Brazil was to the detriment of the urban popular sector. This strategy, which is called dependent development, tried to suppress the policy choices of the popular class in Brazil. Thus, Haggard argues, by referring to Peter Evans, that the second stage of ISI, which was dominated by the influence of foreign investment, strengthened authoritarianism and inequality.<sup>246</sup> Moreover, Guillermo O’Donnell associated military intervention with the time period when TNCs controlled import-substituting policies to the largest extent. Dependency scholars focused on the consequences of dependent development on inequality. The focus on capital-intensive manufacturing favoured high-skilled labor forces, which were rare, and thus the bulk of unskilled workers were neglected. The consumption of

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<sup>242</sup> Jenkins, “The political economy of industrialization”, 222f.

<sup>243</sup> Peter Evans. *Dependent Development: Alliance of Multinational, State and Local Capital in Brazil*, Princeton, NJ: Princeton University Press, 1979: 74

<sup>244</sup> Jenkins, “The political economy of industrialization”, 222f.

<sup>245</sup> Renato P. Colistete. “Revisiting import-substituting industrialization in Brazil: Productivity growth and technological learning in the post-war years.” In *Conference on Latin America, Globalization and Economic History at UCLA (March 2009)*. 2009: 9

<sup>246</sup> Haggard, “Pathways from the periphery”, 16f.

consumer durables was beyond the means of most of the people.<sup>247</sup> Haggard highlights that TNCs prolonged the dependence on technology also after the end of ISI. Nevertheless, by classifying the operations of TNCs as intervening variable he shows that TNCs policy was ISI induced. The question of bargaining power between host countries and TNCs is beyond the scope of this thesis and cannot be further investigated<sup>248</sup>

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<sup>247</sup> Ibid. 16f.

<sup>248</sup> Haggard, "Pathways from the periphery", p.16f.

## 3.2 Economic Development

### 3.2.1 Industrial growth

The author provides data to industrial growth only to Brazil since in South Korea ISI was not introduced to break out of the division of labour. South Korea already had a more sophisticated industrial basis before the 1950s.

*Changes in the Structure of the Economies of Selected Countries*  
(Percentage Distribution of Gross Domestic Product According to Principal Sectors)

	BRAZIL									
	Current Prices					1953 Prices				
	1939	1947	1953	1960	1968	1947	1953	1960	1968	
Agriculture	25.8	27.6	26.1	22.6	17.9	30.0	26.1	22.2	20.5	
Industry	19.4	19.8	23.7	25.2	28.0	20.6	23.7	28.0	29.3	
Other	54.8	52.6	50.2	52.2	54.1	49.4	50.2	49.8	50.2	

Source: Fundação Getulio Vargas, Centro de Contas Nacionais.

Source: Baer, "Import Substitution and Industrialization in Latin America", 99

Baer shows through empiric data that ISI led to significant in Brazil. The manufacturing sector increased its share of GDP in the economy from 19.8 percent in 1947 to 28 percent in 1968.<sup>249</sup> Thus, the industrial share of GDP grew in relation to the agricultural sector. According to Villela, industrial production increased on average by 9 per cent throughout the beginnings of the 1950s.<sup>250</sup>

The author refers to Villela who questions the sustainability of industrial growth under ISI in Brazil. Villela argues that the industrial sector and its importance to GDP were declining incrementally: ‘ (...) *having grown ‘too much’ under cover from foreign competition, Brazil’s manufacturing sector was forced to adopt to a situation of greater contestability, which inevitably*

<sup>249</sup> Baer, "Import Substitution and Industrialization in Latin America", 99

<sup>250</sup> Villela, "Invisible legacies", 48f.

(...) led to the survival of only the fittest.<sup>251</sup> He adds that ‘the industrial sector at its peak in the late 1970s (a third of total output) was clearly ‘bloated’ and therefore untenable in a competitive environment (...)’<sup>252</sup>

**a) Distribution of Economically Active Population  
(per cent distribution)**

	BRAZIL		
	1940	1950	1960
Primary	71.0	64.4	58.5
Secondary	8.9	12.9	12.7
Tertiary	20.1	22.7	28.8
Total	100.0	100.0	100.0

Source: Various Brazilian Demographic Censuses.

Source: Baer, "Import Substitution and Industrialization in Latin America", 100

This table relates to the proportion of active labour population in different employment sectors. The percentage of people employed in manufacturing industries rose in Brazil. Baer criticizes that the proportion of labor force engaged with the manufacturing industry was rather low in correlation with the contribution of industry to GDP. The low labor absorption rates and the high capital/labor ratio implied regional concentration of income in Brazil. Moreover, many people migrated from the rural areas to the urban areas. As a consequence, the urban population grew faster than vacancies in the industry. Baer argues that if a state wants to achieve a higher degree of social equality the state needs to apply more flexibility in its productive structure.<sup>253</sup>

### 3.2.2 Industrial employment

The industrialization process failed to create large numbers of new employment opportunities. The employment in industry could never match up to the high growth

<sup>251</sup> *ibid.*, 55

<sup>252</sup> *Ibid.*, 57

<sup>253</sup> Baer, "Import Substitution and Industrialization in Latin America", 102, 108



rates of industrial production. An increasingly growing urban sector and population growth exacerbated the density on the labour market. Baer explains what further contributed to job scarcity: *“One of the major reasons for the low employment impact of industry is its capital-intensive technology. Little effort was made to adapt imported technology to local factor supply conditions.”*<sup>254</sup> Import Substitution Industrialization was seen as the engine of economic development. Once a strong industrial bases had been established the size of the domestic market could increase through backward and forward linkages. Backward linkage refers to the production of inputs for the initial industry, hence stimulating the growth of domestic supplier industries.<sup>255</sup> As Hirschman clarified: *“With increasing market size, an additional number of industries, all of larger size than could be accommodated previously, become possible.”*<sup>256</sup> Thus, ISI was deemed to generate jobs. But firms, which emerged during the first stage of ISI opposed against backward linkage investment because of the fear of higher prices and lower quality than the imported inputs.<sup>257</sup>

Haggard underpins that high industrial output growth in Brazil during the 1950s was based on capital-intensive production and thus ISI policies did not foster the creation of new jobs. Work was provided in the low-paid tertiary sector. In the 1960s and 1970s the number of manufacturing jobs increased due to the export-oriented approach.<sup>258</sup> Teitel and Thoumi point out that Brazil managed to increase its supply of skilled workers by the 1970s by the establishment of training systems.<sup>259</sup>

Labour absorption in the manufacturing sector in South Korea grew faster than in Brazil in context to the promotion of the export sector.<sup>260</sup> Korea’s manufacturing was

<sup>254</sup> Baer, "Industrialization in Latin America: successes and failures": 129

<sup>255</sup> Hirschman, "The political economy of import-substituting industrialization in Latin America", 117; Franko, "The puzzle of Latin American economic development", 56

<sup>256</sup> Hirschman, "The political economy of import-substituting industrialization in Latin America", 16

<sup>257</sup> Ibid., 17; Baer, "Import Substitution and industrialization in Latin America", 98

<sup>258</sup> Haggard, "Pathways from the periphery", 241

<sup>259</sup> Simon Teitel and Francisco E. Thoumi. "From import substitution to exports: the manufacturing exports experience of Argentina and Brazil." *Economic Development and Cultural Change* 34, no. 3 (1986): 464

<sup>260</sup> Haggard, "Pathways from the periphery", 241

labor-intensive and thus unemployment decreases.<sup>261</sup> Kay demonstrates that the land reform in Korea with its deconstruction of class cleavages enabled the absorption of many former farmers in the labour-intensive industry.<sup>262</sup>

**b) *Growth of Employment by Sectors and Population Growth***  
(yearly rates of growth)

	Employment Growth			Population Growth	
	1950–60	1960–69		1950–60	1960–69
Agriculture	1.3	1.5	Total	2.8	2.9
Manufacturing	2.6	2.3	Urban	4.8	4.4
(artisan)	(1.5)	(1.6)	Rural	1.4	1.4
Mining	2.0	2.2			
Construction	3.2	4.0			
Basic Services	4.6	3.4			
Other Services	4.7	4.6			

Source: CEPAL, 1968.

Source: Baer, "Import Substitution and Industrialization in Latin America", 100

This table illustrates that the demand for labor in Latin American countries was smaller than the growing number of the population. Baer interprets this numbers as a clear failure of ISI to create employment and that high wages in the industry have prevented labour-intensive techniques of production.<sup>263</sup> In Brazil the average population growth between 1965-1980 was 2.4 percent, while only 1.9 percent in South Korea.<sup>264</sup> Haggard states: *'In Latin America population growth places much greater strain on labour markets than in East Asia.'*<sup>265</sup>

In Korea the colonial legacy of Japan left large amounts of human capital capacities. The manufacturing sector was highly supported by the colonial power and Koreans received training as industrial workers at different layers of management hierarchy. Collective learning was transferred to the following generation. Koreans also

<sup>261</sup> Bela Balassa and Gerardo M. Bueno et al. *Toward Renewed Economic Growth in Latin America*. Mexico City, Rio de Janeiro: Institute for International Economics, 1986: 71

<sup>262</sup> Kay, "Why East Asia overtook Latin America", 1080

<sup>263</sup> Baer, "Import Substitution and Industrialization in Latin America", 100

<sup>264</sup> Haggard, "Pathways from the periphery", 241

<sup>265</sup> Haggard, "Pathways from the periphery", 241

improved its skills in construction work due to American assistance.<sup>266</sup> Hence, Bruton argues that the quality of labor in South Korea “*was very different from that in other developing countries at the time, and, in particular, unskilled labor was much more effective than (...) in most of Latin America.*”<sup>267</sup>

### 3.2.3 Income distribution

Haggard refers to wage differentials between the manufacturing and other economic sectors in order to analyse the distribution of income. In the first years of ISI manufacturing was a high-paying sector in Brazil but with the end of the 1970s wage differentials diminished. This was due to the establishment of minimum wages and the higher numbers of exports, which increased the demand for agricultural labour.<sup>268</sup> Haggard points out that ‘labour aristocracy’, a growing informal sector and large wage differentials between the manufacturing and the agricultural sector in Brazil created a labour market characterized by inequality.<sup>269</sup> Haggard emphasizes the role of state in widening unequal income distribution: ‘*Protection, subsidies, and tax a increase capital and skill intensity over the long run.*’<sup>270</sup> Subsidies were provided for large landowners, small-scale farmers were neglected. This accentuates the importance of government interventions in shaping more equal conditions.<sup>271</sup>

Reyes and Sawyer argue that industrial oligarchs and business groups in Latin America benefited from the protectionist tools under ISI. Private sector firms and SOE received subsidies from the government and behind the tariff wall competition was generally low.<sup>272</sup> Thus, factory owners made high profits while the consumers paid relative high prices for lower-quality products: “*The vast majority are being made worse off while*

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<sup>266</sup> Bruton, "A reconsideration of import substitution", 922

<sup>267</sup> Ibid.

<sup>268</sup> Ibid., 244

<sup>269</sup> Haggard, "Pathways from the periphery", 241

<sup>270</sup> Ibid., 250

<sup>271</sup> Haggard, "Pathways from the periphery", 236f.

<sup>272</sup> Reyes, "Latin American Economic Development", 299f.

*the gains from this arrangement are concentrated.*"<sup>273</sup> ISI fostered the development of capital-intensive industrial firms: *"The policy favoured the relatively well off at the expense of the larger group of semi-skilled workers."*<sup>274</sup> Thus, dualistic labor markets were the result.<sup>275</sup> Income concentration and thus unfair income distribution prevented most people from purchasing domestically produced industrial products.<sup>276</sup>

Income inequality limited domestic demand for products and the high number of producers prohibited economic of scales.<sup>277</sup> ISI solidified unequal income distribution due to the capital-intensity of the emerging industries. The adoption of technology to Latin American supply conditions failed.<sup>278</sup>

Korea's income distribution was already more equal during ISI due to the implemented land reform and the commitment to education.<sup>279</sup> Haggard highlights the crucial role of the land reform in South Korea in contrast to the situation in Brazil: *'One major factor is the persistence in Brazil (...) of high levels of inequality and extensive poverty in the countryside and high inequality between the rural and the urban areas.'*<sup>280</sup> The shift towards export-led growth model further contributed to an improvement of Korea's equal income distribution.<sup>281</sup> In contrast to Brazil, South Korea's wage dispersion across industrial sectors was less pronounced.<sup>282</sup>

The land reform, the absence of low-income agricultural sector and the labor-absorbing outward-looking strategy led to a more egalitarian income distribution in

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<sup>273</sup> Ibid., 299

<sup>274</sup> Ibid., 300

<sup>275</sup> Haggard, "Pathways from the periphery", 12

<sup>276</sup> Jaleel Ahmad. "Import Substitution—A Survey of Policy Issues." *The Developing Economies* 16, no. 4 (1978): 365

<sup>277</sup> John Peter Tuman and John T. Morris. *Transforming the Latin American Automobile Industry: Union, Workers, and the Politics of Restructuring*. ME Sharpe Inc, 1998: 7

<sup>278</sup> Baer, "Industrialization in Latin America: successes and failures", 128f.

<sup>279</sup> Haggard, "Pathways from the periphery", 227, 238

<sup>280</sup> Haggard, "Pathways from the periphery", 236

<sup>281</sup> Ibid. 227

<sup>282</sup> Ibid. 244f.

Korea.<sup>283</sup> Nevertheless, peasants who migrated to urban areas were deployed as cheap workforce and thus some form of exploitation took place.<sup>284</sup> Cristóbal Kay argues: “ *It could be argued that South Korea’s phenomenal economic success was achieved on the back of the peasantry.*”<sup>285</sup>

According to Bruton, Korea was able to increase employment and alleviate poverty after shifting towards an open economy due to its initial conditions, like accumulation of human capital, strong government, social cohesion and the incorporation of foreign technology to local standards.<sup>286</sup>

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<sup>283</sup> Haggard, “Pathways from the periphery”, 13

<sup>284</sup> Vieira, “Invisible legacies”, 16

<sup>285</sup> Cristóbal, “Why East Asia overtook Latin America”, 1081

<sup>286</sup> Bruton, “A reconsideration of import substitution”, 931

## Conclusion

Import Substitution Industrialization (ISI) caused several distortions that had negative impacts on state autonomy and a functioning bureaucracy, income distribution and social equality. ISI fostered rent-seeking activities in both Brazil and South Korea and made institutional capacities of the state less effective and efficient.

South Korea could overcome ISI distortions due to its inherited institutional structure. The land reform dissolved class cleavages and made income distribution more equal. The negative impacts of ISI were mitigated by large amounts of US aid. South Korea managed to shift towards export-oriented industrialization because of its state cohesiveness and structural basis. Brazil continued to adhere to ISI since to many interests hinged upon ISI policies like the allocation of import licenses or state subsidies for the manufacturing sector. Industrialists were better off behind tariff walls. Landowners further received government subsidies due to the importance of the agricultural sector for foreign exchange revenues.

Brazil, by the early 1980s became heavily industrialized, but at the same time was highly indebted. Local products were hardly competitive on the international market and ISI led to a growth-cum-debt strategy.<sup>287</sup> The local technological content of manufactured exports only surged in the beginning of the 1980s. The second stage of ISI relied heavily on FDI and thus contributed to income inequality.

The author agrees with Santiago Macario from the Economic Commission for Latin America (ECLA) who pointed out that the problem is not trade protection as such but the indiscriminate protectionist policies of ISI that were to the detriment of export

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<sup>287</sup> Villela, "A bird's eye view of Brazilian industrialization", 58

promotion.<sup>288</sup> South Korea implemented protectionist measures even after its shift towards export promotion.

Thus, the author wants to conduct further research on export-led growth and the impacts of the Washington Consensus in the last two decades.

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<sup>288</sup> Colistete, “Revisiting import-substituting industrialization in Brazil”, 4

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