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APPROACHES TO STATE INTERVENTION

In 1956, the Brazilian government banned all car imports. Foreign automobile companies faced an official ultimatum: Either they abandon the lucrative Brazilian market or they invest to manufacture vehicles with 90–95 percent Brazilian-made content within five years. The timing for such an initiative did not appear propitious. Brazil had only the beginnings of an industrial base, and until that point, virtually all vehicles had been imported as knocked-down kits and assembled locally. Steel production had begun only nine years earlier, and coffee still accounted for more than 50 percent of the country’s exports. Indeed, the auto plan was part of a general import-substituting development strategy to shift the economy’s focus from raw material exports to domestic industrialization. Moreover, as the first country in Latin America to insist upon domestic auto production, Brazil was entering uncharted territory. There was little precedent in Brazil or in the region for negotiating with transnational firms in any manufacturing activity. Foreign investment had been largely restricted to public utilities, railroads, and raw materials. Despite the intensification of international competition among the large auto manufacturers, cross-national investment in production facilities was occurring primarily within Europe. In the 1950s, firms competed for peripheral markets such as Brazil through exports.

In addition to these challenges, the Brazilian state’s industrialization effort was constrained by chronic balance-of-payments difficulties, limited fiscal capacity, and internal divisions. The executive branch, the agent of the industrialization drive, was not hegemonic within the government apparatus and lacked full autonomy over existing resources. Congress had budgetary control, and much of the executive’s revenues came in the form of “earmarked funds,” the allocation of which was predetermined. As president, Juscelino Kubitschek (1956–61) was able to unite different sectors and classes around an ideology of “national developmentalism,” but the industrial elite was by no means in firm control. Both corporatist and clientelistic tactics were
used to consolidate political support and to mute opposition. The broad political coalition that supported Kubitschek precluded a direct squeeze on consumption to finance industrial investment.

These attributes of the Brazilian state molded its intervention. In general, the lack of direct access to resources caused the state to resort to indirect financing methods. Because of the executive branch’s control over access to scarce foreign exchange, trade policy played a developmental role in Brazil. Moreover, the economic and political power of the agro-export sector precluded the use of direct export taxes. As a result, the state relied on the “second-best” alternative to transfer resources from agriculture to industry, that is, differential exchange rates on imports and exports. In addition to protection from imports, therefore, the government offered the auto companies incentives and subsidies, largely in the form of beneficial exchange rates on investment and foreign financing, as well as exemptions from various duties and taxes.

Neither of the currently contending approaches to economic development would suggest that this type of import-substitution program would succeed in the context of Brazil’s political economy. On the one hand, neoclassical, market-oriented explanations of economic development challenge both the necessity and the efficacy of state intervention. Traditional orthodox trade theory predicts that such deviation from free-trade policies is likely to lead to suboptimal results; reliance on “second-best” trade policies as indirect instruments of industrial policy is especially suspect. According to a more recent neoclassical political economy literature that focuses on the dynamics of state intervention, import-substitution policies of protective tariffs and subsidies are more likely than externally oriented strategies to induce nonproductive, rent-seeking activity by private actors. On the other hand, state-centered approaches that emphasize the importance of institution building over market forces typically assume that effective state policy requires a highly autonomous state to insulate economic decision making and implementation from clientelistic politics. However, the Brazilian state had neither the fiscal authority nor the disciplinary power over the private sector associated with late developers such as Japan, South Korea, and other East Asian newly industrializing countries (NICs), which are often the models for this type of approach.

This book will show that, despite these constraints, the Brazilian strategy to install a domestic automotive industry successfully forced transnational firms to invest rapidly and allowed the country to capture the economic rents and positive externalities associated with the
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industry. Most production targets were achieved. By 1961, only six years after the plan’s initiation, eleven firms were producing over 145,000 vehicles with an average domestic-content share of 93 percent by weight and 87 percent by value. Most of the major players in the international auto industry, including Ford, General Motors, Volkswagen, and Mercedes-Benz, participated. Production reached 280,000 by 1968, and eight firms, all foreign controlled, remained, although only three were responsible for 89 percent of all vehicles produced. This consolidation allowed some firms to attain economies of scale, and production costs declined. Subsequently, the industry entered a second phase of growth, leading the Brazilian economic “miracle” of 1968–73 with annual growth rates topping 20 percent. By 1975, annual production approached one million vehicles, making Brazil’s industry the largest in the periphery and the ninth largest in the world.

More surprising are the results with respect to state financing of the auto plan. The state’s subsidies, though substantial, were smaller than other analysts have previously assumed. Moreover, in contrast to many contemporary Latin American experiences that better fit the rent-seeking paradigm, the initial subsidies did not lead to ongoing resource transfers to the sector. The taxes paid by the vehicle assemblers more than compensated for the indirect subsidies they received, even within the industry’s first five years. A circular self-financing program can be observed from the data: Firms were given indirect subsidies, and consumers reimbursed the government through production and sales taxes. The share of oligopolistic rents accruing to the firms decreased over time, as companies were forced to lower prices and as an increasing tax bite was taken by the state. The sector thus became a significant source of revenue for a state with limited sources of fiscal income. The data reveal a form of rent redistribution usually found between peripheral states and transnational firms exporting raw materials. The evidence also shows that the automotive industry had relatively high linkage effects. It generated the development of new sectors to produce parts and intermediate inputs. Brazil’s policy was successful in generating the production externalities of the industry and in increasing the capacity of the state to capture rents accruing to the firms, benefits it would have sacrificed had it continued to import from the oligopolized firms.

Historical evidence also shows that transnational automotive firms would not have invested in manufacturing capacity or complied with domestic-content requirements in the absence of government policies. Even if the auto program may have “anticipated an existing trend”
in foreign direct investment, as some claim, firms were compelled to invest according to a Brazilian-imposed schedule, which greatly accelerated the speed and diffusion of industrialization more generally.

Brazil’s success in establishing an automotive industry was determined by a favorable combination of market and institutional variables. It was dependent on the capacity of a segment of the state apparatus to formulate and implement a sectoral policy consistent with the country’s underlying economic structure and to bargain effectively with transnational firms. The Brazilian case demonstrates that, while the institutional actors and the environment are critical to success, strongly compatible underlying economic conditions provide crucial leeway for policy manipulation. It also suggests that the effectiveness of state policy can vary greatly across sectors and over time depending on demand conditions, the nature of technological change, transnational firm strategy, and the domestic and international macroeconomic environment.

Contending Paradigms

The fact that Brazil’s successful experience with automobiles cannot be fully accounted for by either of the dominant contending paradigms of economic development reflects their failure to articulate fully the interaction between the economic and political spheres. Although the terms of the debate on economic development have shifted over the years from the capacity of markets to the capacity of states, the essence of the controversy still centers on the relative importance of market versus institutional factors in determining economic performance. Currently, two contending paradigms dominate social science, one that ultimately argues for removing the state from the development process, and another that argues for putting it “back in.”¹ Although each offers important insights, the debate over state intervention and industrial policy remains polarized between “all or nothing” theories and caricatured portrayals of both states and markets. As a result, neither paradigm alone can account for Brazil’s experience with automobiles or, more generally, why some cases of intervention by particular states succeed while others fail.

The Neoclassical, Market-Oriented Approach

In the 1960s, development economists highlighted the greater scope of market failure in less-developed as compared with developed econ-

¹ The term is borrowed from Peter Evans, Dietrich Rueschemeyer, and Theda Skocpol, eds., Bringing the State Back In (Cambridge: Cambridge University Press, 1985).
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omies, thereby providing a rationale for enlarging the scope of state intervention. Although distinct viewpoints were evident in the literature, these theorists all saw development as a process of dynamic, nonmarginal change. The price mechanism alone was deemed insufficient to induce the resource transfer necessary for industrialization to occur.

This paradigm of economic development provoked two waves of neoclassical dissent. The thrust of the first wave was aimed at the state’s capacity to guide structural change. Using new analytical tools from trade theory such as effective rates of protection and domestic resource costs, Ian M. D. Little, Tibor Scitovsky, and Maurice Scott showed that national industrial strategies were inefficient – the incentives they created were highly unequal for different economic actors. Based on the neoclassical assumption that allocational inefficiencies always lead to production inefficiencies, this approach sought to correlate “distorted” policy regimes with poor economic performance, advocating domestic laissez-faire and free trade as the only viable alternatives.

This neoclassical critique was bolstered by the success of export-oriented countries such as South Korea and Taiwan. Their rapid growth in comparison to economies that followed import-substitution strategies seemed to provide empirical validation for Harry Johnson’s earlier claims, which many development economists had denied, that dynamic gains could be had from free trade. An avid supporter,
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Anne Krueger, later explained that: “From a theory without any evidence in the early 1960s suggesting departures from free trade for dynamic reasons, the tables are turned: empirical evidence strongly suggests dynamic factors that may be associated with export-led growth."5 Export expansion spurred by market liberalization became the industrialization strategy of choice.

Work in the 1970s by Krueger, Bela Balassa,6 and others was not so much anti-interventionist as anti–import substitution. The debate between old-style development economists and more orthodox theorists still centered on market failure. It focused on whether to intervene and, with few exceptions,7 the protagonists stopped well short of denying the state’s institutional capacity to promote economic development. That more radical claim came with the second phase of neoclassical counterrevolution against heterodoxy.

The neoclassical political economy literature of the 1980s explicitly attacks the early development economists’ implicit belief in the efficacy of government intervention. It argues that the existence of market failure is not sufficient to justify state intervention. Formal models of the interaction between state and economy have been devised to show theoretically and not just empirically how government intervention is likely to produce inefficiencies. State policy is endogenized to the general equilibrium system by depicting it as the outcome of individual optimizing behavior in the political realm. In contrast to traditional

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arguments of administrative incompetence and corruption, recent theorists argue that state policies such as subsidies and quotas distort incentives to the private sector and generate competition for the excess returns that accrue to the winners of government largesse. Because almost any state intervention opens space for a “rent,” seeking government favors will divert resources away from productive market activity. Firms will engage instead in activities such as lobbying and bribery to garner and maintain these rents. The rational pursuit of these favors on an individual level produces a nonoptimal result for the economy as a whole.9

These arguments suggest that industrialization strategies oriented to the national market, which, by definition, rely upon market restrictions and government intervention, create a more conducive climate for rent-seeking activity than the more open, export-promoting strategies. This presents a different explanation for the relative success of export-promoting countries: The state is less involved, so the economy is less prone to rent-seeking activity. The pressures of international competition are supposed to mitigate the worst sort of rent seeking observed in countries practicing pure import-substituting industrialization. Free trade and factor mobility reduce rent seeking by restraining special interests and making cartels harder to maintain.

9 In this context, a rent is earned on a given resource when its return is higher than its opportunity cost, that is, the return it would generate in an alternative activity.

8 If one follows the categorization used by T. N. Srinivasan in “Neoclassical Political Economy: The State and Economic Development,” Yale University, Economic Growth Center Paper no. 375 (New Haven, 1983), three different strands can be discerned in the neoclassical political economy literature: Mancur Olson’s collective action framework, James Buchanan’s public choice school, and Jagdish N. Bhagwati’s and Anne O. Krueger’s related work on trade and development. In The Rise and Decline of Nations (New Haven: Yale University Press, 1989), Olson argues that because of bargaining costs and the problem of free riders, individuals are unlikely to organize in their collective interest unless they are in small groups and/or can impose selective incentives on group members. Such coalitions of self-interested persons are likely to try to redistribute income toward themselves instead of working to raise efficiency and national income, the full benefits of which they would not receive. In “Rent Seeking and Profit Seeking,” in J. M. Buchanan, R. D. Tollison, and G. Tullock, eds., Toward a Theory of Rent-Seeking Society (College Station: Texas A & M University Press, 1980), pp. 3–15, Buchanan argues that the emergence of monopoly and other distortions created by public policy does more than impose a deadweight loss on the economy, because it directs resources into what Bhagwati referred to as “directly unproductive profit-seeking activities” (in “Directly Unproductive Profit Seeking [DUP] Activities,” Journal of Political Economy 90 (1982):988–1002). In “The Political Economy of the Rent-Seeking Society,” in American Economic Review 64 (1974):291–303, Krueger emphasized the consequences of quantitative import restrictions.
In development economics, therefore, the operating assumption of imperfect markets has been replaced by the presumed inevitability of imperfect states, lacking the wherewithal to counteract rent-seeking behavior. The neoclassical political economy literature has concluded that the former is the lesser of two evils. From this perspective, even if markets are imperfect, state intervention — due to its market-distorting, growth-inhibiting character — only makes things worse. As Deepak Lal contends, “bureaucratic failure” may be worse than “market failure.”

*The State-Centric, Institutional Approach*

Proponents of a statist approach to development are as impressed with East Asia’s success as are market-oriented theorists, but they derive different conclusions from the experiences of these late industrializers. In the tradition of Alexander Gerschenkron, this eclectic group, drawn mostly from social science disciplines outside economics, sees effective institution building as the critical explanatory variable for relative growth rates among latecomers. According to its reading of history, what has distinguished countries such as Japan, South Korea, and even Taiwan from other twentieth-century industrializers has not been an unwillingness to subsidize and protect, but underlying productive structures and states with the fiscal and institutional capacity to discipline firms and to formulate coherent and strategic economic policy.

A unifying theme among these theorists is that market forces alone will not lead to successful economic outcomes. There are differences among them, however, about the importance of using unfettered markets to set relative prices. Some argue that strong governments are required both to usurp the market’s role in resource allocation

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and to ignore standard indicators of static comparative advantage and inefficiency. Chalmers Johnson, for example, credits Japan’s success to its “plan-rational” state, which took an active role in industrialization and was concerned with strategic outcomes, in contrast to a “market-rational” state’s concern with rules of the game and traditional notions of efficient resource allocation.12 Based on her study of South Korea, Alice Amsden even argues that late industrializers should get important prices “wrong” in order to direct resources into targeted activities that reflect a country’s dynamic comparative advantage.13 Others such as Stephan Haggard have supported the neoclassical contention that the success of East Asia’s NICs resulted from economic liberalization and their quick adoption of export-oriented development strategies that were relatively less price-distorting than Latin American import-substitution schemes.14

Regardless of their attitude to market signals, these theorists are distinguished from their neoclassical adversaries by the contention that differences in state capacity largely explain variation in economic performance among latecomers. Although they acknowledge that “where there are rents, there are rent-seekers,” their solution is not to remove the state but to build a competent bureaucracy to block rent-seeking behavior.15 For those who defend price-distorting interventions, a state with enough countervailing power over the private sector is required to impose performance standards on firms receiving support.

Amsden, for example, argues that the source of South Korea’s success, and what distinguishes it from other late-industrializing countries with similar strategies, is the state’s power and willingness to discipline private firms. It rewarded firms with low-cost financing and access to foreign currency in exchange for increasingly stringent export requirements. It had a broad array of instruments at its disposal, including control of the banking system and prices, to curb monopoly power. It also had the fiscal authority to tax the middle class and the political leeway to keep social expenditures relatively low, which freed government funds for long-run investment. As a result, South Korea

13 Alice Amsden, Asia’s Next Giant: South Korea and Late Industrialization (Oxford: Oxford University Press, 1989).
15 See Evans, “Predatory, Developmental and Other Apparatuses: A Comparative Political Economy Perspective on the Third World State.”
did not degenerate into a pure rent-seeking society where the government distributed spoils only to politically favored groups. Despite a concentrated and protected industrial structure, government policies generated intense competition that forced firms to “learn” and become ever more productive.\(^\text{16}\) Other countries have been less successful in creating this type of reciprocity between the state and private firms. Those who support the adoption of export-led industrial policies argue that this strategy, too, must be accompanied by economic and institutional reforms. Most less-developed country (LDC) states, for historical and political reasons, have not had the capacity with which to implement these reforms and to make hard policy choices.

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The neoclassical political economy literature has correctly pinpointed the implicit assumption that the state has unlimited capacity to intervene effectively in the economic system as the major weakness of 1960s-era development economists. Those theorists had focused on whether to intervene, but they stopped short of explicitly considering the state’s political and institutional capacity to meet its prescribed role. In so doing, much of development economics reproduced the neoclassical separation of the economic and political spheres, neglecting to incorporate a theory of the state. Traditional neoclassical theory at least assumed that markets function, presupposing a minimal role for the government. In contrast, the omission of the state as an explicit actor was a fundamental flaw in the development theorists’ argument, because they relied on it as an agent of change and presumed that it had the requisite political autonomy and administrative tools to carry out the task. Because the academic debate concentrated only on the existence of market imperfections, the superior capacity of the state to allocate resources remained an article of faith.\(^\text{17}\)

\(^{16}\) Ha-Joon Chang makes the interesting argument that the dominance of large, industrial conglomerates, or chaebols, may have helped minimize the extent to which government subsidies turned into pure rents for the private sector. Given the chaebols’ exclusive status, smaller players were unlikely to compete with them. Their involvement in multiple activities reduced the costs associated with start-up and with finding information about competitors. Furthermore, each chaebol’s ability to move into almost any line of business generated competitive pressures to remain efficient. See Ha-Joon Chang, “Interpreting the Korean Experience – Heaven or Hell?” Faculty of Economics and Politics, University of Cambridge, Research Paper Series no. 42 (Cambridge, 1999).

\(^{17}\) Implicit assumptions associated with early development frameworks increase the probability of efficient intervention. For a discussion of the political and technological