CHAPTER 1

INTRODUCTION

1.1 Statement of the Problem

The experience of Thailand, as a developing country, in promoting industrialization through trade strategies is not different from the others. It started with trade restriction and control after the end of the Second World War (1944-1955) followed by liberalization during 1955 to 1966, modernization and import substitution during 1961 to 1971 and export promotion from 1972 onwards.

It is widely accepted that modern industrialization in Thailand began in around 1960. A policy of import substitution facilitated by protection tariffs and investment incentives under the industrial investment promotion scheme was adopted in early 1960s. The intention is to promote private industrial investment particularly in industrial using raw domestic materials and producing products for import substitute. The strategy was encouraged mainly in order to reduce Thailand's dependence on import of foreign goods, to save foreign exchange on import expenditure and to raise the level of income through an increasing in the value added.

However it was found by the late of 1960s that the import substitution policy could not achieve its major objective i.e. it could not improve the balance of trade deficits. In contrast, the country relied more on imported machinery and raw materials since the import-competing policy did not create any forward and backward linkage. Therefore Thailand, by the third National Economic and Social Development Plan (1972-1977) shifted the emphasis to promote manufactured exports as an industrial strategy.

The Export Promotion Act (1972) provided a full tax exemption on imported inputs used in export activities, a refund of all taxes on the production process, a discount facility an short term loan from the Bank of Thailand and an exemption of business tax on product exported.

Although the period after 1972 is referred to be export promotion industrialization. Import-substitution was still encouraged which is shown by the positive value of effective tariffs. The change was only the structure of protected industry from light and heavy industries producing consumer products to heavy industries producing intermediate and capital goods. Thus the period 1977-1982 is sometime called as the second import substitution period.[1]

It was the fifth plan (1982-1986) which policy makers actually realized that industrial development

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[1]Paitoon Wiboonchutikula, "Second Phase Import Substitution in Thailand," a paper presented to Asian and Pacific Development Centre, TDRI, Bangkok, 1987, p.2.

through import substitution in the past two decades generally did not generate satisfactory results. The provision of high protection to import-substituting investments had created inefficient.[2] In addition it is found that. These high levels of protection continued to discriminate against the development of export activities.[3]

There are many studies which attempted to calculate effective rate of protection and domestic resource cost ratio.[4] Their results also highlighted that the tariff structure of Thailand has still been biased toward production of import-substitute products for domestic used rather export markets. Hence Thailand could not achieve her goal of promoting export industries as explicitly pointed out by Atchaka Sibunruang (1986) that

> ...the major impediment to export growth remains the very high level of protection provides to activities producing for domestic market. Indeed, these high levels of protection indicate that the transition from import substitute to export promotion is far from complete...

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[2]Atchaka Sibunruang, "Industrial Development Policies in Thailand," A report prepared for the World Bank, September, 1986, pp.127.

[3]IBRD, "Thailand's Manufactured Exports: Key Issues and Policy Options", Report No.5670-TH, Washington D.C., 1985.

[4]See the review of all these empirical studies in Sukrita Sachchamarge, "Industrial Protection in Thailand," Research Report Services, No.58, Faculty of Economics, Thammasat University, 1986. (in Thai).

Theoretically, there are two conceptually distinct aspects of protection.[5] The first one is analysis of the costs of protection which consider the loss in potential national income. Since protection alters the pattern of production and consumption in an inefficient manner i.e. on the production side, for example, the supply of efficient export reduces and that of protected import-substitutes flourishes, therefore total national income is smaller than it would be otherwise.

The criteria used to measure the costs of protection such as effective rate of protection (ERP) and domestic resource cost (DRC) approaches. The former which was first developed by Johnson and Corden emphasizes the protection of value added rather than the value of the final product. The ERP analysis attempts to summarize the net effects of the entire tariff structure on a particular production process by providing a summary statistic or the ERP rate. It takes into account tariffs on inputs into the relevant production process as well as on inputs. It gives as idea about how much a particular industry has actually been protected. Analysts tend to be interested in the ranking of ERPs, the average ERP and their range.

The average ERP conveys information about the extent to which value added can be raised relative to a

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[5]Clements K.W. and Sjaastad, L.A. <u>How Protection Taxes Exports</u>, Thames Essay (London: Trevor-Hobbs, 1984), pp.5-6.

situation where distortion are absent. The rank of ERPs provides some indication about resource movement associated with protection structure. That is domestic production will shift from low to high protective activity and consumption may shift from high to low protective activity.[6]

DRC is the other approach which is used to measure something about relative resource pulls between protected industries. The theory which is behind DRC is very similar is that of ERP. The analysis focuses on value added in a given domestic activity compared with value added at world prices. The domestic factor inputs are however valued at shadow prices. It is common to view DRC ratio as the cost of acquiring a unit of foreign exchange.[7]

However ERP and DRC are a partial equilibrium approach to evaluation trade policy which do not capture the production, consumption and price effect of the import tariff outside the protected sector. They are generally applied at the "industry" or activity level. But if we would like to focus on broad sectors of economic activity to comment on the way in which protection of one sector

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[6]Corden, W.M., The Theory of Protection (Oxford: Clarendon Press, 1971).

[7]Greenaway, D. "Commercial Policy and Policy Conflict: An Evaluation of the Incidence of Protection in a Non-Industrialized Economy," Manchester School 2(June 1989), pp.125-127.

may impact upon the other, they can not provide us. Thus it may be of interest to tract the effects of trade policy at a more aggregate level so we have to focus on analysis of the incidence of protection which is the second concept of protection.

The incidence of protection is general equilibrium analysis which will highlight whether there is any conflict of simultaneously attempting to provide protection to both the import substitute and export sectors. Protection of this activity will tend however to disprotect another. Equivalently export sector may expand with a higher rate if there is no import protection. In the general equilibrium basis, protection on imports not only rises absolute prices of importables but also changes their relative prices to others if we assume the substitution in production and consumption is possible to and from importables. Then the focus as normally perceived by policy makers on partial equilibrium framework is mistaken. The protection on importables can be achieved not by a tax normally paid by domestic consumers of imports but by the implicit taxing of other domestic activities besides imports.

Therefore, it is worthwhile to estimate the incidences or burdens of protection which may be shifted onto other groups of producers and consumers by applying a general equilibrium framework of the incidence of protection developed by Clements & Sjaastad (1980). The result will be a useful complement to the empirical studies on effective protection rate and domestic resource cost ratio to evaluate the industrialization policy in Thailand.

The framework of the incidence analysis is general equilibrium, and it considers substitution effects among sectors in the economy. On the other hand the analysis emphasizes on **"the relative price effects"** of commercial policy interventions. It permits us to identify how the incidence of protection may be shifted via changes in relative price. Moreover by considering the changes in relative prices, we will observe that true protection is different from nominal protection. Finally the model also allows us to examine who actually pays for protection by measuring income transfers among various economic agents.

1.2 The Objective and Scope of the Study

This study intends to evaluate the effects of trade policies in the process of industrialization in Thailand by applying the incidence analysis. Within this framework, the study concentrates on 3 main objectives as follows.

1. To estimate the shifting of protection from import to export sector in Thailand from 1962-1987. The export sector will be decomposed into traditional, non-traditional or manufacturing exports and export sector as a whole. Since they are different in factors used intensively in production, the proportion of protection

which is shifted may not be the same. Therefore it is worth examining the incidence of protection on them separately.

2. To indicate the possible values of the true tariffs and true subsidies in 1982 by employing the information from the former objective. Any initial incentives provided to export sector or to import competing firms may be offset, in the face of relative price effects associated with import protection. The results will serve us to emphasize the limitation of simultaneously pursuing import substitution and export promotion policies.

3. To observe income transfer occurring from import protection policy to each group of people in the economy in a political economy context. Quantifying who gains and who losses from protection provides us with understanding of why the protection in Thailand still occurs even though the government intended to change the industrialization strategy to export orientation since 1972.

1.3 Hypotheses

The null hypotheses are set in accordance with the objectives as

1. There is no incidence or burden of protection shifted from import onto export sector.

2. There is no difference between true tariff, true subsidy and nominal tariff, nominal subsidy.

3. Nobody gains or losses from protection so that there is no incentive for anyone to support the protection.

1.4 Plan of the study

The study is organized into 7 chapters. Chapter 1 opens with a section focused on describing statement of the problem and its significance. The objectives and hypotheses of the proposed study are also discussed here. Chapter 2 explains an industrialization experience in Thailand. Chapter 3 reviews the analytical framework of incidence of protection, developed by Sjaastad in 1980 and Sjaastad and Clements (1984) and further extended by Greenaway and Milner (1986,1987,1988). This general equilibrium framework will be applied in this study.

Since the major data inputs are price indices on importables, exportables and non-tradeables, thus chapter 4 explains the data sample in detail. The ways to construct all the price indices are also clearly described. Chapters 5 and 6 are the core of the present study. Chapter 5 provides empirical evidences of the incidence of protection. The hypothesis that there is no changing of the shifting of protection over time will be tested by using dummy variables. The survey of estimates of the proportion of protection paid by exporters in 10 countries is also presented.

Chapter 6 demonstrates the methodology of the true tariff and the true export tax and the criterion to measure income transfers arising from protection. The calculations of true tariffs and true export tax by using various guesstimate values of true subsidy rate are presented. The chapter also provides the income transfer matrix in 1982. The matrix tells us who indeed bears the burden of protection. Other studies related the income transfers are also summarized here.

The last section, chapter 7 provides the summary, conclusion, policy implications, and limitations and suggestions for any further study.