# AGENCY FOR INTERNATIONAL DEVELOPMENT
# POL/CDIE/DI REPORT PROCESSING FORM

**ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT**

| 1. Project/Subproject Number | 2. Contract/Grant Number | 3. Publication Date |
|---|---|---|
| 940-0405* | PDC-0095-Z-00-9053-00 | October 1993 |

**4. Document Title/Translated Title**

Strategies of Industrialization: Lessons for the Gambia

**5. Author(s)**

1. Roemer, Michael
2.
3.

**6. Contributing Organization(s)**

Harvard Institute for International Development

| 7. Pagination | 8. Report Number | 9. Sponsoring A.I.D. Office |
|---|---|---|
| 29 | CAER Disc Paper #16 | G/EG/SMIE |

**10. Abstract (optional - 250 word limit)**

Attached

**11. Subject Keywords (optional)**

1. Economic Policy Reform
2. Industrial Development
3. Import Substitution
4. Export Development
5. Trade and Development
6. The Gambia

**12. Supplementary Notes**

*Project No. was 930-0095 before FY1993.

| 13. Submitting Official | 14. Telephone Number | 15. Date Submitted to CDIE |
|---|---|---|
| FOREST DUNCAN | (202)663-2338 | 1/26/94 |

DO NOT write below this line

| 16. DOCID | 17. Document Disposition |
|---|---|
| | DOCRD [ ] INV [ ] DUPLICATE [ ] |

AID 590-7 (10/91 rev)

ABSTRACT

Strategies for Industrialization:
Lessons for The Gambia

by

Michael Roemer

September 1993

Following the implementation of a structural adjustment program that renewed economic growth in The Gambia, The Government of The Gambia requested this paper to suggest additional measures it might take to promote industrialization. The paper explores the lessons of industrial development from other countries, primarily the successful industrializers in East and Southeast Asia, and attempts to apply those lessons to the special circumstances of The Gambia.

Three broad industrialization strategies are examined:

- resource-based industrialization;
- import substitution; and
- outward-looking industrialization.

Given its tiny domestic size, the analysis suggests that The Gambia's only alternative is to remain a completely open economy, producing for export and reexporting goods to neighboring countries. Specifically, the paper recommends that The Gambia pursue its goal of becoming an *export enterprise* by:

- exporting principally the products of its natural resource base, especially groundnuts, horticulturals, fish and tourism;
- moving cautiously into manufacturing goods that could substitute for the existing reexports of imported goods such as candy, footwear, and clothing; and
- attracting foreign investors, especially from East Asia, to utilize The Gambia as an export platform for selling textiles, clothing, and other light manufactures to Europe.

The report finds that the government has already taken important steps on the road to export-led development, but lists several additional steps that should be taken; e.g. maintaining macroeconomic stability, reducing profit taxes, lowering the premium on domestic bank loans, imposing only modest export

surcharges if infant industry protection is to be granted, and attracting investors from East and Southeast Asia.

G/EG/SMIE:FDuncan:1/21/94:GAMIND.B51

Consulting
Assistance on
Economic Reform

# CAER Discussion Papers

The aim of the Consulting Assistance on Economic Reform (CAER) project is to help developing nations design, implement, monitor, and evaluate economic policy reforms. The contract is with a consortium led by Harvard Institute for International Development (HIID). Funded by the U.S. Agency for International Development (Contract PDC-0095-Z-00-9053-00), it gives A.I.D.'s missions and Washington offices access to economists and other social scientists with extensive practical experience who are highly regarded within their professional disciplines. Some of the CAER work generates results of interest to a broad audience. The CAER Discussion Papers series provides a convenient and consistent form in which to share these results.

## Strategies of Industrialization: Lessons for The Gambia

Michael Roemer

HIID

CAER Discussion Paper No. 16, October 1993



***For information contact:***
CAER Project Administrator
Harvard Institute for International Development
One Eliot Street
Cambridge, MA 02138, USA
Tel: (617) 495-9776 FAX: (617) 495-0527

/ /

# STRATEGIES OF INDUSTRIALIZATION: LESSONS FOR THE GAMBIA

**Michael Roemer**

**Harvard Institute for International Development**

17 September 1993[1]

## SUMMARY

The Government of The Gambia, having undertaken a major structural adjustment program that has restored economic balance and renewed economic growth, is considering additional measures to promote industrialization. This paper explores the lessons of industrial development from other countries, primarily the successful industrializers of East and Southeast Asia, and attempts to apply those lessons to the special circumstances of The Gambia.

The Gambia's size is its destiny. Unable to base industrialization on its tiny domestic market, its only alternative is to remain a completely open economy, exporting principally the products of its natural resource base, especially groundnuts, horticulturals, fish, and tourism; moving cautiously into manufacturing goods that could substitute for the existing reexports of imported goods such as candy, footwear, and clothing; and attracting foreign investors, especially from East Asia, to utilize The Gambia as an export platform for selling textiles, clothing, and other light manufactures to Europe.

If The Gambia is to achieve and sustain rapid development, it will have to become an ***export enterprise***. All producers, even those removed from export markets, and the government itself will have to provide high quality goods and services at competitive costs. Import substitution, inefficiency, and rent-seeking are incompatible with export-led growth. The government has already taken important steps on the road to export-led development, but more can be done:

- Since stabilizing the economy in the mid-1980s, the government has avoided large fiscal deficits and rapid money growth; has allowed the *dalasi* to adjust readily against other currencies; and made the *dalasi* a convertible currency.

---

[1] This paper was prepared for the Government of The Gambia during a visit from May 25 through June 6, 1992, with funding from the United States Agency for International Development under a contract with the Harvard Institute for International Development. The paper was presented at a conference in Banjul in January 1993.

- Tax revenues, at 21% of GDP, are not excessive. With two-thirds of these coming from taxes on trade, exporters are going to have to bear some direct tax burden, contrary to the usual practice. In turn, government must deliver essential services to producers as efficiently as possible.

- Tariff reform has reduced duties and moved them towards more uniform rates. Even if rates become uniform, revenue needs will dictate duties in the range of 12 to 15% in addition to the 10% sales tax, rates that even exporters will have to pay. If infant industry protection is to be granted to potential exporters, it should be based on modest surcharges, perhaps at 10%, and relief from import duties, both of which should automatically expired after 3 to 5 years. Duty-free access to neighboring countries, through the effective implementation of ECOWAS, should be high on the diplomatic agenda of The Gambia.

- Profit taxes need to be reduced to 35% or less to make The Gambia competitive, but at these lower rates, tax holidays may not be essential. Turnover taxes, a severe disincentive to trade and investment, should be eliminated or used only as a punitive tax for enterprises not filing verifiable tax returns.

- Producers and traders do not complain about poor infrastructure, but that is partly because they have learned to make costly accommodations to poor water and power supplies. Government does need to improve transport and other infrastructure over time. It is not evident that industrial estates or duty-free zones would be a cost-effective way of doing this, however.

- Interest rates on domestic bank loans have borne a 9% premium over both the parity based on LIBOR and the rate on government paper. These rates can be brought down over time as prudent macroeconomic policies reduce instability and risk; and if government encourages new financial institutions to provide competition for the dominant Gambian bank. Subsidized credit is not likely to be a solution to high-cost credit and should be avoided.

- Foreign investors have been attracted to The Gambia by profitable opportunities, political openness and stability, macroeconomic stability, currency convertibility, and open trade. The government should attempt to attract more investors from East and Southeast Asia, who are seeking export platforms.

## INDUSTRIALIZATION STRATEGIES

Over the past forty years developing countries have employed three broad strategies to promote accelerated development through industrialization:

>> *Resource-based industrialization (RBI)* attempts to exploit the linkages to manufacturing industry that arise from natural resource-based exports, including minerals, timber, and export crops.

>> *Import substitution (IS)* attempts to replace imported consumer goods, and then imported intermediate goods, with domestically manufactured products, progressively over several decades, principally by protecting domestic manufacturing.

>> *Outward-looking industrialization (OLI)* attempts to diversify and expand exports, moving from primary to manufactured exports by exposing the domestic economy to the competitive forces of world markets.

The next three sections explore each of these strategies in turn, drawing lessons from countries that have employed them.

**Resource-based Industrialization (RBI)**

The majority of developing countries--and virtually all those in Africa--have a strong comparative advantage in the export of primary products from mining, agriculture, or forestry. Resource-based strategies attempt to build on this primary base in two ways.

First, the <u>primary export base</u> itself is intensified, expanded, or diversified. Investments are made or encouraged by government in the infrastructure supporting primary exports; in research to improve productivity and thus reduce the costs of production; in the dissemination of that research, e.g. through new seed varieties; and in incentives to use modern inputs, especially in agriculture.

Three Southeast Asian countries--Malaysia, Thailand, and Indonesia--were particularly effective in this approach. Malaysia, for example, decided in the 1950s to invest in research into new varieties of rubber and palm oil, its two major exports, despite indications of shrinking markets and falling prices. Indonesia in the 1970s invested its oil revenues substantially in new rice varieties, irrigation, and subsidized inputs to keep food prices low and stable, while Thailand encouraged the export of its rice surpluses. Indonesia and Malaysia also promoted new export crops and maintained a welcoming investment climate for mining and oil exploration. In Africa, Kenya, Zimbabwe, and Botswana similarly invested in food and export agriculture and mining. Horticulture is one kind of primary export diversification that has worked extremely well in Asia, Africa, and Latin America.

These strategies paid handsomely, as primary exports grew much faster in Southeast Asia than in most of Africa. In fact, many African countries have declining shares in the world trade of primary exports in which they once had a comparative advantage. The Southeast Asian nations never faced the kind of foreign exchange shortages that forced many

African governments to limit imports, which in turn doomed industrialization in much of the continent. Moreover, because export producers were often small farmers in Southeast Asia, as in most of Africa, the incomes generated by growing primary exports contributed directly to the reduction of rural poverty and thus to a more equal income distribution.

The second avenue for resource-based strategies is to build new industries on the primary export base, generally through the further processing of mining, farm, and forest products. Despite its appeal, this RBI approach has limited usefulness. In some cases, a primary exporter may have an obvious cost advantage in processing its exports, as in refining some ores and decorticating and crushing nuts and palm kernels to save transport costs. In other industries, such as sawmilling and plywood or the preserving and canning of fruits and vegetables, comparative advantage in processing depends on the efficiency of the industry. Indonesia's plywood industry, despite its vigorous growth, has incurred a net economic cost to the country because value added in plywood has not surpassed the rents lost from former log exports. For still other processes, such as aluminum smelting, steelmaking, and the final refining of vegetable oils and chocolate, the cost of raw materials is not the only determinant of comparative advantage, and these industries are seldom located economically in the country that exports the primary product.

A number of countries have extended primary export growth through RBI. Many major oil exporters have export refineries; all vegetable oil exporters do some refining; some partial reduction of ores is common in countries mining tin and copper; Venezuela has remarkable combinations of ores and energy resources that make it an exporter of steel and aluminum; Kenya and Indonesia export canned pineapples and Kenya aspires to produce jams for export. Even Taiwan, now noted as an exporter of increasingly sophisticated manufactured products, began its export-led era by canning and exporting mushrooms and other horticultural crops.

Typically, these export industries reproduce the characteristics of the primary resource itself: petroleum and metal ore refining are done in capital-intensive enclaves, like the extractive industries themselves; while wood industries and food processing are rural, generally labor-intensive, small- to medium-scale industries. Thus RBI alone is never a complete strategy for industrialization. It extends the primary export base, sometimes to the country's advantage, but cannot result in a broad industrial base for sustained development.

Tourism is closely related to RBI. It is a service industry that is also based on a natural resource, climate and terrain; is also an export; and also extends the country's productive capacity beyond extraction or growing. Like farm exports, tourism is a labor-intensive industry that tends to employ low-income workers in large numbers. Tourism can reinforce other aspects of a country's development, as foreign tourists become aware of the country's attractions and products, stimulating foreign investment and exports. Thailand, Indonesia, Kenya, Spain, Mexico, and other countries have all promoted tourism vigorously both to earn foreign exchange and to enhance the country's appeal to importers and investors.

For countries pursuing resource-based strategies, it has been important to observe certain rules of macroeconomic management. All sound strategies of industrialization must be supported by the normal strictures of macroeconomics: government budgets that are balanced or can sustain noninflationary deficits; money creation no faster than the growth in demand for money balances; and an exchange rate that is attractive to exporters and maintains its real value (i.e., is devalued to compensate for inflation) over long periods. RBI countries face the additional burden of compensating for the fluctuations in export earnings that are characteristic of primary exports.

In boom times, foreign earnings increase reserves and hence the money supply, as well as domestic incomes, thus stimulating demand and inflation. This in turn causes an appreciation of the real exchange rate (the nominal rate relative to prices at home and abroad), which reduces the incentives for exporters in non-boom industries. This is the classic Dutch disease, in which primary export booms raise incomes and investment but, paradoxically, weaken or destroy agricultural and manufacturing industries. When the boom is reversed, there is a painful adjustment as incomes fall. However, the non-boom industries are not always able to reverse their decline despite exchange rate depreciation.

The contrast between Nigeria and Indonesia during the oil boom illustrates the importance of countercyclical macroeconomic policies in resource-based economies. In Nigeria the boom was unchecked by government, which permitted a sharp appreciation of the currency after the second oil shock in 1979-80. Much manufacturing industry was protected behind high tariff walls and did not suffer, but neither was it efficient enough to contribute to exports when oil revenues fell. Agricultural exports were destroyed by the appreciation, so also could not respond when oil prices fell during the middle 1980s. Moreover, oil revenues were invested, not in export industries, but in often wasteful construction projects. When the oil boom ended, Nigeria had little of lasting value to show for its temporary wealth.

Indonesia, on the other hand, underwent three sharp currency devaluations during and just after the oil boom, then in 1986 instituted a crawling peg that has maintained the real value of the currency. It also invested its boom revenues in agriculture, industry, and education, laying the foundations for continued growth after the boom. Consequently, Indonesia has sustained economic growth of over 6% a year, with only a slight hesitation when oil prices collapsed during the mid-1980s. Its growth is now based on both primary and manufactured exports, with the latter growing at over 25% a year since oil prices fell. In 1970, Indonesia forced on itself the discipline of a convertible currency, with only minor exchange controls that were later lifted. Also, by law the government cannot borrow domestically to finance its deficits. Consequently, to avoid wide swings in its reserves, Indonesia has had to maintain sound fiscal and monetary policy throughout the oil boom-bust cycle. These disciplines were the foundation for Indonesia's ability to capitalize on the oil boom.

For countries undergoing shorter booms, as is true for most agricultural exporters, the appropriate policy is to increase savings, either public or private, during the booms, accumulate foreign reserves, and avoid exchange rate appreciation. Then, when the boom is over, these policies can be reversed: accumulated reserves are used to compensate for lower saving and to avoid unnecessary devaluation of the currency.

**Import Substitution (IS)**

Throughout the nineteenth and twentieth centuries, from the United States and Germany to Japan, Argentina, and India, the dominant mode of industrialization has been import substitution. After the second world war, however, with the independence of Asian and African countries, the strategy evolved into an extreme form that, despite its early successes, has generally been counterproductive and unsustainable.

The strategy is widely understood. Countries erect protective barriers--tariffs or import quotas or both--to enable one industry after another to compete in the home market against more efficient producers in more industrialized countries. Consumer good industries are generally protected first, because in the early stages of industrialization consumer imports are large. Eventually producer good industries are brought behind the protective wall, in an attempt to create backward linkages and a more fully articulated industrial structure.

Protection comes, not only from high tariffs or restrictive quotas on competing imports, but also from lower tariffs on imported inputs. Thus effective protection is higher than the nominal duty rate if duties on inputs are lower than duties on competing imports. The *effective rate of protection (ERP)* measures the protection given to value added in the country. If, for example, clothing imports bear a 20% duty, but textile imports only a 10% duty, and if the clothing industry adds 25% of value to the cost of a competing import, then the ERP is 50%.[2] An inherent conflict arises, however, when protection is used to promote investment in intermediate and capital goods industries. Then the original import substituters are forced to pay higher prices for the newly protected inputs that they had previously imported at low cost with low duties. As the ERP for the intermediate good producer rises, the ERP for the final goods producer falls and the latter becomes less profitable.

The one sound rationale for import substitution is the infant industry argument. Economists recognize that new industries need time to become productive enough to compete with established producers in other countries, a concept called *learning by doing*. Protective

[2] The formula is ERP = [Tm - aTi]/[1-a], where Tm and Ti are the tariff rates on competing imports and on imported inputs, respectively, and a is the share of imported inputs in the total value of production. Thus, ERP = [.20 -.10(.75)]/[1 -.75] = .125/.25 = .50 or 50%.

tariffs provide the margin that give new industries the necessary time to reduce their costs to world standards. However, this rationale implies two strong conditions:

(1) The benefits to the economy as a whole from having a new, low-cost industry once it has "learned by doing" must be sufficient to repay the costs of protection during the early years of production. The costs of protection are the higher prices--and lower well-being--borne by consumers of the former import. Moreover, the benefits must be high enough to repay the costs when discounted over time at the nation's cost of capital.

(2) Protection should be temporary, confined only to the period of learning by doing. If the firm becomes competitive in its home market against imports, it does not require further protection. If the firm does not become competitive, the nation will be worse off, because it will lose resources continuously by protecting the firm. Thus any protective duties should be moderate, so as not to encourage very inefficient firms; and should be limited by law to a period of a few years at most, to ensure that the firm either becomes competitive or goes out of business.

Import substitution is most likely to meet these conditions under two circumstances. First, in large countries with moderate incomes and therefore large markets for some goods, new industries can achieve *economies of scale* and reduce their costs. The scale varies with industries. A country as small as Kenya (20? million) can achieve economies of scale in clothing, footwear and a few other industries, but even the Indian market may be too small for heavy industries such as synthetic rubber or a range of automobiles. Most developing countries provide markets that are too small in most industries.

The second favorable circumstance is dynamic management that responds to market conditions by finding ways to produce better quality products at lower cost. The East Asian exporters, Japan, Korea, and Taiwan, used import substitution as a step towards developing export industries. At first this was accidental: protection was provided primarily to encourage domestic industry, some of which--notably in clothing, textiles, and footwear--became efficient enough to export. Competitive internal markets may have played a role in inducing productivity growth in these industries. Later, import substitution was seen as a temporary way-station towards new export industries, as in steel, cars, and fertilizer in Korea. The ultimate test of import substitution in East Asia, and a strong indication that the infant industry conditions have been satisfied, is the eventual ability of the protected industry to export without subsidies. If this test is enforced, as it has been in East Asia and increasingly in Southeast Asia, import substitution can be a sustainable strategy.

The great majority of countries industrializing after World War II did not adhere to the infant industry conditions. Pick from a long list of industrializers--Argentina, Chile, Mexico, Philippines, Bangladesh, India, Pakistan, South Africa, Zimbabwe, Kenya, Nigeria, and Ghana, not to mention the former Soviet Union and its satellites--all protected their industries at any cost and regulated their economies in a myriad of ways. At first these countries were successful in generating new industries and rapid growth of manufacturing. But eventually the inherent costs and contradictions of import substitution became evident and industry stagnated, even declined in some countries.

What were these contradictions? Because infant industry strictures were ignored and firms were protected at all costs, their high costs persisted. With economies closed to foreign competition, and often with little domestic competition, firms had little incentive to become more efficient. Government was always ready to extend or even increase protection if costs rose for any reason. And costs did rise, as progressive import substitution required protection for new firms producing inputs to the first import substituters. Because costs were high throughout the economy, and because profits were highest in the protected industries by design, exporters had little incentive to invest and expand, so exports stagnated, foreign exchange became scarce, and domestic industry was rationed in its purchases of needed imports.

In IS regimes, controls were used for many purposes: to restrain imports, to keep interest rates low and then to allocate cheap credit, to license investment, often to reduce "wasteful" competition, and to protect workers' jobs and incomes. Controls also protected the well-connected few with privileged market positions, entrenched ruling parties in power, and enriched politicians and civil servants who had the power to grant licenses. The entire IS regime discriminated most heavily against farmers, whether producing food or exports, and against small firms and workers in the informal sector. Because these generally poor groups fared badly, IS concentrated income and did little to reduce poverty.

Import substitution created stagnant, rigid economies that had great difficulty in adjusting to external shocks. The "Reagan recession" of the early 1980s, followed closely by the debt crisis in Latin America, and then the collapse of the Soviet bloc economy, exposed the bankruptcy of IS regimes. Economies needed to adjust rapidly, but could not. Stabilization of prices and balance of foreign accounts imposed great hardships on rigid economies. Structural adjustment programs were designed to dismantle the import substitution regimes and replace them with more outward-looking economies that promised greater productivity and growth. In the past 10 to 15 years, opinions have shifted so much that export-oriented, market-based, open economies are now fundamental to the development strategies of most, though not yet all, developing countries.

**Outward-looking Industrialization (OLI)**

There are at least three versions of the outward-looking strategy. At one extreme is the <u>neoclassical, market-based, open economy strategy</u> exemplified by Hong Kong and Singapore and advocated by the World Bank and IMF. In this variant of OLI, world market prices rule in the home economy. Tariffs are low, preferably uniform, and imposed for revenue only;

there are no controls over trade or investment and preferably none over foreign capital flows; the currency is convertible; capital markets are deregulated, allowing only for prudential regulation to prevent fraud and gross mismanagement, and becoming increasingly sophisticated; labor markets are flexible enough to let wages adjust to market conditions; prices are either set by the market or, as with utilities, are regulated to reflect market conditions. In short, markets are free to work and prices are set, mostly by markets, to reflect world market conditions and the economic scarcities of nontraded goods and services in the home market.

The other extreme version of OLI is the pro-market interventionist strategy practiced by Japan, (South) Korea, and to a lesser extent Taiwan. In this version, government does protect, control, and otherwise intervene in the economy, but does so with the single-minded intent of promoting the growth of new exports, especially manufactured exports. The aim is to enhance market forces, not to work against them.

Japan and Korea protected their domestic markets for new industries, but tied protection to export performance. In some cases high profits earned on domestic sales were intended to subsidize losses incurred in seeking new markets abroad. In Korea the large banks, at government's bidding, offered loans at low interest rates (frequently at rates below the rate of inflation) to the largest firms. However, to continue borrowing at subsidized rates, these firms had to meet increasingly ambitious export targets. Other firms were forced onto the curb or informal credit market, where rates were very high. Tax authorities were notably more lax in their enforcement of payments from firms that met export targets. Government invested heavily in infrastructure to reduce the costs of exporting. And moral suasion, sometimes to the point of naked coercion, was used to reinforce the message: export or else... Underlying all these price incentives was a policy to devalue the *won* sufficiently to keep the real exchange rate reasonably constant over many years, giving exporters confidence that their long-term investment would not be jeopardized by an overvalued currency. All these policies created an incentive to export that was at least as high as the incentive to produce import substitutes for the home market.

The remarkable feature of Japanese and Korean industrialization was that government exercised so much power so strictly in favor of a national economic goal. The bureaucracy was generally honest, energetic, and disciplined to pursue government policy. Governments in India, Kenya, Argentina, and many other countries have exerted equal power over firms in their economies, but almost never so strictly in pursuit of national goals. Outside of East Asia, the result has generally been inefficiency, stagnation, rent-seeking, and corruption. Pro-market intervention can work better than the market alone to accelerate exports and economic development, but only if government and its agents are dedicated and strictly disciplined. If they are not, the outcome is likely to be worse than that of the more purely market approach exemplified by Hong Kong and advocated by the World Bank and IMF.

## COMPARATIVE ECONOMIC PERFORMANCE, 1965 - 1989: EAST/SOUTHEAST ASIA AND AFRICA

### A. GROWTH RATES: 1965 - 1989

| Country | Income per capita | Exports | Manufacturing | Total factor prod'y |
|---|---|---|---|---|
| South Korea | 7.0 | 22.0 | 16.6 | 4.3 |
| Taiwan | 7.3 | 15.5 | 12.0 | 5.3 |
| Hong Kong | 6.3 | 8.0 | n.a. | 3.9 |
| Singapore | 7.0 | 6.0 | 10.4 | 2.7 |
| | | | | |
| Indonesia | 4.4 | 6.8 | 12.3 | 2.6 |
| Malaysia | 4.0 | 6.5 | n.a. | 1.7 |
| Thailand | 4.2 | 10.2 | 10.0 | 2.2 |
| | | | | |
| Africa (SSA) | 0.3 | 3.9 | n.a. | -0.6 |
| All dev'g ctry | 2.5 | 4.1 | 7.2 | 0.5 |

### B. RATIOS TO GDP, IN PERCENT: 1989

| Country | Exports | Primary exports[a] | Manufacturing | Gross domestic invest.[b] | Gov't revenues | Broad money |
|---|---|---|---|---|---|---|
| South Korea | 34 | 2 | 26 | 28 | 18 | 41 |
| Taiwan | 59 | 5[c] | n.a. | 23 | 37 | 147 |
| Hong Kong | 135 | 4 | 21 | 26 | n.a. | n.a. |
| Singapore | 191 | 40 | 26 | 41 | 28 | 93 |
| | | | | | | |
| Indonesia | 26 | 18 | 17 | 23 | 18 | 42 |
| Malaysia | 74 | 41 | n.a. | 27 | 26 | 68 |
| Thailand | 36 | 17 | 21 | 25 | 18 | 65 |
| | | | | | | |
| Africa (SSA) | 25 | 22 | 11 | 18 | n.a. | n.a. |
| All dev'g ctry | 21 | 10 | 20+ | 24 | n.a | n.a. |

[a] Share of total exports.
[b] Average over 1968-88.
[c] 90% in 1955; 54% in 1965.
[d] 16% in 1989.

The intermediate OLI strategies of Asia are perhaps more relevant to Africa. Taiwan did use some market intervention, especially in promoting large-scale industries, many of them owned by the government or Kuomintang party. But interventions were never as pervasive as those in Korea. Where Korea encouraged large export conglomerates and tried to control them through the bureaucracy, Taiwan encouraged small and medium export-oriented firms and left their guidance to market forces. Entry of new firms and exit of old ones were easy; small firms prospered, many in rural areas; employment grew rapidly; and technological change continually transformed the export industries. While the larger firms, mostly in heavy industries, got subsidized credit, the informal market kept small exporters adequately financed.

A similarly mixed picture emerges from Southeast Asia. Governments in Malaysia, Thailand, and Indonesia have intervened substantially in their economies, investing in public enterprises, creating lucrative monopolies for the military and other political favorites, protecting inefficient industries, allocating subsidized credit, and so forth. Since the mid-1980s, many of these interventions have been dismantled through sustained programs of structural adjustment, including in the case of Indonesia, for example: exchange rate devaluation and then flexible management; deregulation of imports and tariff reform; decontrol of domestic and foreign investment; and deregulation and development of financial markets. The result in all three countries has been a dramatic inflow of foreign investment; rapid diversification and growth of exports, especially of manufactures; sustained growth of income despite the economic shocks of the 1980s; and, in Indonesia and Malaysia at least, a marked reduction in the incidence of poverty.

None of these three economies is a model of market-based development. Protected firms persist and even expand their domain; old-style interventionist policies remain and new ones are continually proposed; influence, rent-seeking, and corruption sometimes get in the way of improved policies. Despite these interferences, the crucial manufactured export sectors are left pretty much to market forces.[3] Indonesia has successfully provided exporters with duty-free access to imported inputs, the kind of intervention favored by Korea, but has confined itself to this one pro-market initiative. The overall picture is an untidy market economy, with market forces impinging most directly on labor-intensive exports, which thrive.

The results of these three versions of OLI can be seen for seven Asian countries in Table 1. Although the East Asian countries have done substantially better than the Southeast Asian ones, all seven have performed dramatically better than the average for all developing countries, while Africa lags far behind. The keys to rapid income growth (and reduction in

---

[3] An exception is textiles and clothing, where the Multifibre Agreement forces exporting countries to issue quotas to their exporters.

poverty) have been rapid and sustained growth of exports, especially of manufactures, and of productivity, together with high saving and investment ratios.

African countries have much to gain from emulating the OLI strategies of Southeast Asia, especially. Administrative capacity and discipline are unlikely to be sufficient to follow Korea's approach, nor is it likely that the purely market-based, open economy of Hong Kong is politically feasible in most of Africa, though The Gambia might be an exception. The next paragraphs describe some of the specific policies that have contributed to the export successes of Asian countries.

Macroeconomic policy has been the foundation on which export-oriented policies have been erected. Two aspects of macroeconomic management were crucial in East and Southeast Asia. First, the real exchange rate was maintained at a level that made it attractive for investors to take risks by investing in production for new export markets. In the face of moderate inflation, this required a crawling peg in most of the Asian countries. Second, fiscal deficits and growth in the money supply were kept moderate, both to restrain inflation (a necessary complement to exchange rate management) and to contain aggregate demand for tradables. Thus East and Southeast Asian economies were much more stable during the 1970s and 1980s than were Latin American and African countries. When economies lose their internal or external balance, the required corrective policies inevitably disturb export incentives and are likely to inhibit export diversification and growth.

Infant industry protection has been used in all these Asian countries except Hong Kong. Asian exporters were not as assiduous in following the infant industry rules--moderate and temporary protection through tariffs and not quotas--as many economists would recommend. But where protection was used, it was either (1) tied to ambitious export targets, as in Korea, or (2) isolated from export sectors through duty drawbacks, export promotion zones, and other devices discussed below.

Privileged access to imports was an important feature in economies, like Indonesia, where import and production monopolies were used to promote import substitution. In 1986, Indonesia established an export promotion organization (EPO) within the Ministry of Finance with two aims: (1) permit exporters to import their own inputs freely despite import controls and monopolies to the contrary and (2) provide duty exemptions or drawbacks to exporters (see next paragraph). These measures freed exporters from the disincentives of Indonesia's "high-cost economy" and proved to be a crucial ingredient for the successful export drive. The EPO was, unusually in Indonesia, efficiently and honestly administered. Rules of participation were clear and fairly administered, and access was automatic for qualifying firms. Needless to say, corruption in the EPO would be a death knell to any export drive. In other countries, Kenya for example, incentives to exporters get so tied up in bureaucratic procedures that no investor is wise to depend on such incentives, which become ineffectual. In countries like Indonesia, with limited capacity for administrative reform, it is important to target programs narrowly and carefully on one or two crucial factors, such as exporters' access to imports and duty drawbacks.

Duty exemptions or drawbacks are a common feature of export promotion programs. As countries move towards lower tariffs and freer trade, these programs become less essential and may be eliminated. But if a country starts from a high tariff situation, exporters can be severely penalized in world markets if they must either pay import duties or purchase from protected domestic firms. Hence privileged access and duty exemptions or drawbacks are both necessary in many countries.

Export processing zones (EPZ) combine privileged access and duty exemptions with some physical infrastructure and provision of some services, especially water and power, to attract mainly foreign investors into export industries. Income tax holidays are often part of the package, but this may not be essential (see below). EPZ have been used in Malaysia to attract electronics firms, in Korea, China, and many other countries. They can be helpful as ways of physically isolating exporters, enabling them to import easily with minimal risk of leakage to the protected domestic market. Thus EPZ can be most attractive to countries that have done the least to dismantle their protective, interventionist policies. The difficulty with EPZ is the very narrow margin between net benefits and costs to the country. If no duties or sales taxes are paid and if firms have tax holidays, then the only benefits to the country are (1) the foreign exchange earned to pay wages and (2) profits earned by local investors. Against these often small benefits are the costs to the country of supplying infrastructure that is not compensated by the firms and of providing utilities at subsidized rates, as often happens. In the competition to attract foot-loose exporters into EPZ, countries often suffer net losses from these exports. In any case, as trade reform proceeds to eliminate import restrictions and lower tariffs, EPZ become less necessary. Hong Kong and Singapore are cities with many aspects of EPZ, even if no special zones are declared.

Manufacturing in bond in effect makes each designated factory a duty-free EPZ. Imported inputs are under customs bond until the bond is canceled when the final product is exported. This approach eliminates the need to establish a zone with its infrastructure. However, it requires close cooperation with customs officials, who must be in regular attendance at the bonded factory. The device has been tried in Kenya with limited success.

Customs reform may be essential to make any of these export promotion devices effective. If customs officials are corrupt or otherwise obstructive, they can thwart the good intentions of the EPO or EPZ. Indonesia preceded its export reforms with a draconian reform of customs: the president declared in 1985 that the Swiss firm, SGS, would immediately take over the inspection and certification of imports and assessment of duties; while importers would pay duties to their banks, which in turn certified the payment to customs. In effect, customs officials were cut out of all but the most perfunctory duties. Delays at the port were cut dramatically, imports flowed in, and revenues rose. It was on the foundation of this reformed customs system, which remains substantially in place, that the EPO reforms were able to stimulate exports. Experience with more gradual reforms, based on existing customs organizations, has been less promising.

Industrial estates are EPZs without the free trade features. They can be a useful tool for providing infrastructure efficiently in a single location, especially in countries that lack broadly available infrastructure services. Estates can ease problems of land acquisition, licensing, and other bureaucratic obstructions to implementing investments. In establishing an estate, however, government takes a risk that firms may not want to use that location. And if water, power, and other services provided by government are not fully compensated by the using firms, the country may suffer a net loss. Estates have been widely used in Asia and elsewhere. Indonesia has been encouraging private firms to establish them in preference to public corporations.

Directed, subsidized credit has been used successfully by Japan and Korea to promote OLI. Indeed, targeted credit has been boosted by Japanese officials and by some economists elsewhere as a central feature of industrial policy. Indonesia, on the contrary, has moved away from subsidized credit. A danger with directed credit is that it can easily become a tool to help political favorites and inefficient enterprises, unless bankers and officials exercise the kind of discipline that Japanese and Korean officials have shown. Nor is it clear how bankers and officials can predict better than industrialists where the profitable ventures lie. Subsidized credit undermines the development of a deregulated, competitive financial system that channels savings into investment at market-determined prices. Indonesia has found that the benefits of a more efficient financial system outweigh the benefits of subsidized credit. In fact, they have even developed a highly effective program for small loans to rural traders and producers at commercial rates of interest, based on attracting saving from rural households at remunerative interest rates.

Tax holidays are widely used in Asia to promote investment. Malaysia has a long-established system of holidays and most countries have used them at one time. It has been argued that, in a competitive world where investors have access to any number of countries, any host government wanting to attract investment needs to offer tax holidays. But these can be costly. Surveys of multinational company executives have consistently shown that tax holidays always rank far down the list of considerations in investment decisions. Profitable opportunities, good locations, stable governments, transparent and fair treatment of investors, and other strategic considerations loom much larger in these decisions. Also, in the absence of tax sparing treaties, host governments may only be surrendering tax revenues to the country of the investor's origin. Many holidays are therefore redundant, simply a loss of revenue on investments that would take place in any event. A better approach is to establish a healthy investment climate through an open, deregulated economy and to lower profits taxes to competitive levels. Indonesia has done this, and also done away with tax holidays. The result has been an investment boom of unexpected proportions over the past six years, even though Malaysia and other competing neighbors still offer tax holidays.

## APPLICATIONS TO THE GAMBIA

The Gambia's size is its destiny. With less than one million people, The Gambia must rule out the home market, and therefore import substitution, as a path to industrialization. With income of just over $300 per capita, The Gambia is also poor. But even Brunei, with 50 times the average income of The Gambia, is too small to base its development on import substitution. There will be a few industries with "natural protection," whose locally available raw materials would be too costly to import, that might be profitably based on the domestic market; ceramic tiles appears to be one such industry. But these will be the exception, even as incomes rise. Nor can The Gambia (or Brunei) emulate Korea and use a protected home market as an effective incentive for export industries, because the rewards for manufacturers in the home market would be too small.

The Gambia has already chosen the only available alternative: become an open economy, producing for export and reexporting goods to neighboring countries. The gross value of all exports was equivalent to 37% of gross domestic product in 1990/91; reexports alone accounted for 31% of GDP. Value added directly in all export activity might account for as much as 18% of GDP. Many of the country's exports are now, and presumably will continue to be, based on natural resources, especially farm products and tourism. So resource-based industrialization will presumably play an important role in development. However, The Gambia should also consider ways to promote outward-looking manufacturing activities.

Accepting the role of a small open economy, what are the appropriate goals and policies for The Gambia? In what products is it likely to have comparative advantage? What are the appropriate macroeconomic policies for a very small, open economy? How will the export orientation affect tariff and tax policies? Is there a role for industrial estates or even a duty free zone? What are the infrastructure needs of an entrepot economy? Should The Gambia try to attract foreign investors and how could it do so? Each of these topics is explored in the following sections.

It is worth emphasizing in advance, however, that there are no ready models for The Gambia, which borders on being a unique country. Some of the lessons from Asia can be applied to The Gambia. But all the economies there, even the city-states of Hong Kong and Singapore, are at least 100 times the size of The Gambia. Many policies that worked in those countries cannot be translated across size differences of this scale. And both Hong Kong and Singapore began their rapid growth at a far more advanced stage of development than The Gambia. States that are more like The Gambia in size and income are either small islands without The Gambia's potential for entrepot trade; or similar countries, such as Togo, Guyana, or Belize, whose development performance has not been outstanding. Nevertheless, some effort should be made to find out how these latter countries are industrializing.

One further *caveat*: the term *industrialization* needs to be used quite flexibly in this context. Generally when this term is used, it means the development of manufacturing: first light, consumer goods industries and then heavy, intermediate goods industries. Here, however, *industrialization* is taken to mean the development and modernization of industries in the broadest sense, including primary industries (agriculture and fishing) and services (tourism and finance). The aim of development should not, in any case, be the expansion of manufacturing as such, but rather the modernization and increased productivity of all economic activity, with the aim of improving the well-being of the country's population. This is the sense in which The Gambia's industrialization is being considered in this paper.

**Comparative Advantage**

Comparative advantage is an economist's term for the competitiveness of a country's products in world markets. It is a concept involving *relative* costs: given the array of possible exports, which ones can The Gambia produce at low cost relative to other countries. Every country, no matter how poorly endowed, has a comparative advantage in--can export--something.

Six factors determine comparative advantage in The Gambia: size, land, water, climate, location, and low-cost labor. In this it is not very different from many other developing countries. In The Gambia, these factors have determined three different types of export: (1) primary exports, notably groundnuts, horticulturals, fish, and tourism; (2) reexporting and other entrepot activities; and (3) simple, labor-intensive manufactures.

<u>Groundnut</u> production and processing is an old, perhaps declining, industry. The new owners of the GPMB may well use it as a vehicle to diversify away from groundnuts, possibly to sesame seed or other crops. Such a restructuring of small-scale farming is likely to require more direct involvement of the reformed GPMB in assisting farmers with new crops, techniques, and inputs. This could be an important contribution to the resuscitation of small-scale export farming, with its favorable impacts on rural employment and income distribution.

<u>Horticulture</u>, based on climate, water availability, and low-cost labor, appears to be a dynamic industry. Gambian growing conditions are excellent, labor is available, the country is close to the European market, and investors appear to be interested in expansion. This will always be a highly competitive industry, but The Gambia's supply will always be very small and its low costs should enable it to penetrate markets.

<u>Fishing</u>, including shrimping and shrimp farming, have also attracted interest and seem to have potential. The demand for fish products is, like that for horticultural crops, likely to grow at least as fast as incomes in the industrial countries. As with horticulturals, The Gambia should be able to maintain a position in northern markets.

Tourism, based on climate and location, is much like a primary export. The Gambia already attracts about half the tourists per capita that visit Kenya, whose industry is far advanced. Kenya has outstanding tourist attractions and a well developed infrastructure that The Gambia is unlikely to match. However, development will bring improved facilities in The Gambia and its political stability is an important advantage for tourism.

Petroleum deserves mention if only because talks are going on with a major oil company to being offshore exploration. Discovery of an exportable deposit would be a boon to The Gambia, but many other small countries have found oil exports to be a mixed blessing. It is premature to worry about the proper policies for exploiting oil reserves, but if that time comes, policymakers should study the instructive contrast between approaches of Nigeria and Indonesia.

This is a promising menu of primary exports for a country of this size. The experience of Malaysia, Thailand, Indonesia, and Kenya suggests that The Gambia should invest aggressively in these primary industries, and also in related processing, handling, transportation, and trading activities. Fortunately, it appears that much of the investment could come from private firms, with the government focusing on basic infrastructure.

Reexporting, transport, and other entrepot activities are efficient because of The Gambia's size, its location, its low-cost labor, and the protective policies of its neighbors. However, the bulk of this trade is vulnerable to deregulation of trade policy, tariff reform, and exchange rate reform in neighboring countries, changes that these countries are being strongly advised to make in the foreseeable future. Some of the reexport trade could survive such liberalization, if the low costs of shipping through Banjul port are competitive, transport facilities in The Gambia are efficient, and the nearby neighboring populations enjoy rising incomes. Furthermore, there may be some potential to further develop road and river transport and other activities related to entrepot trade.

However, even if the reexport trade remains advantageous in the near term, this industry is too fragile a foundation on which to base a national development policy. The Gambia's vulnerability to change is intensified because very little is known about the costs and other conditions of this trade. Local traders (and manufacturers) sell locally to traders from the importing countries, who may well be involved in smuggling. Local suppliers are content with this arrangement and sensibly avoid knowing too much about this trade. However, ignorance of market conditions makes it more difficult to formulate a policy for the reexport trade.

Light manufacturing, based on good location and a low-cost labor force, has gotten a small start in The Gambia in such lines as groundnut processing, baking and confectionery, beer and soft drinks, soap, petroleum jelly, clothing, plastic sandals, nails, wheelbarrows, ceramic tiles, window assembly, and printing. (It appears, however, that the cost of production in two or three of these products is very high by international standards.) There are suggestions of investments in plastic sheet and carton paper for packaging. Unlike horticulture, fishing, and tourism, however, light manufacturing does not seem poised for major expansion.

Two kinds of manufacturing development might be expected. First, light manufacturing might replace some of the reexport trade, as has already happened in candy and sandals. In The Gambia, this kind of industrialization might be called export substitution, a precise analogy to import substitution as manufactured exports replace reexports. Export substitutes will have to demonstrate real cost advantages to assembling or manufacturing in The Gambia, rather than just a response to a tariff anomaly. And the country's success in export substitution may depend on the effective implementation of ECOWAS agreements, negotiation of which should be an important aspect of industrial policy. Second, foreign investors might find The Gambia attractive as an export platform for textiles, clothing, and other simple manufactures, given the country's location, preferential access to the European market, and low-cost labor. In all probability, such investors would come from East Asia.

Heavy industry appears to have no prospects in The Gambia, which has no mineral resources and is not sufficiently close to large industrial markets. The only possible opportunity might be to permit polluting industries to operate without incurring the costs of abatement. However, it is not clear that would be a sufficient inducement, nor is it obvious that the country would gain sufficiently to make the costs of pollution worthwhile. If groundwater supplies and waterways were to become fouled by such industry, other promising industries such as horticulture, fishing, and tourism could be jeopardized.

International service center. Could Banjul become a regional home to offshore banks, a tax haven and nominal headquarters for international corporations, a data processing, communications, and publishing center? These seem to be very distant prospects. The places that have these industries--Hong Kong, Singapore, The Bahamas, Luxembourg--are better located and far more developed. It would take major investments in infrastructure of all kinds, new buildings, far better air services, access to international newspapers, modern communications facilities, a better educated work force, in short a thorough transformation of Banjul to a modern city, to attract such service industries. One of the attractions would have to be negligible taxes on firms' profits and on the incomes of their foreign personnel, so it would be difficult to recoup directly the massive investment that such a development would require.

Thus The Gambia's industrial future appears to lie in agricultural exports, export fishing, tourism, and light manufacturing for export. The remainder of this paper discusses policies that might be adapted from Asia and elsewhere to improve the prospects that such industries will develop.

**Macroeconomic Policies**

The Gambia has already absorbed the major lesson of Asian export-led development: sound macroeconomic management. The *dalasi* is convertible and there are no restrictions on capital flows. Like Indonesia, The Gambia has thus imposed on itself the discipline of protecting its reserves by avoiding large budget deficits and rapid growth of the money supply; and by continuing to allow its exchange rate to adjust against the currencies of major trading partners as needed to accommodate inflation. This is the only appropriate policy mix for a small, open economy, indeed for economies much larger than The Gambia.

The main task now is continual vigilance to ensure that major fluctuations in export earnings are compensated by monetary, fiscal, and exchange rate policies. With its economy so open to trade, conditions in neighboring countries and in more distant export markets will be transmitted rapidly to The Gambia. These changes may call for quick, decisive policy adjustments, within the framework already established. Investors in export industries will be sensitive to these adjustments, because destabilizing macroeconomic policies can threaten the viability of their industries. And if oil revenues come into play, macroeconomic management will have to cope with Dutch disease.

**Government Revenues and Exports**

Tax revenues in 1990/91 were 21% of GDP. Although this is higher than in some Asian and African countries, it is not excessive by world standards. The Gambia's need for development finance probably leaves little room for a reduction of tax revenues.

Much of this revenue comes from taxes on trade. Import duties alone yielded almost half of tax revenue in 1990/91 and the sales tax, much of it levied on imports, contributed 28%. Thus as much as two-thirds of revenues may have been due to taxes on trade. Because 38% of imports were reexported in 1990/91, a large share of the taxes on trade are actually a charge on exports.

These observations suggest that exports probably must bear some direct tax burden, whether through duties and sales taxes on imported inputs or through a sales tax on exported production. This is contrary to the usual practice in other countries, which attempt to reduce the tax burden of exporters as much as possible. Duty exemptions and drawbacks are common, as already noted. Countries using the value added tax typically exempt exporters from paying it and refund taxes paid on inputs. Some countries, Colombia for one, have issued export subsidies in the form of marketable certificates that can be used to pay profits taxes. To replace these revenues, governments levy higher taxes on income, profits, property, and imports for use by non-exporters.

The Gambian economy is not developed enough to easily replace trade taxes with income, sales, property, or other taxes, though it should gradually become possible to do so. For the next decade or so, exporters and reexporters will probably to have to bear some taxes directly on their trade. This reality severely limits the role of tax policy in promoting industrialization, as discussed in the next two sections.

**The Gambia as an Export Enterprise**

These circumstances point to another conclusion: like Hong Kong and Singapore, or Korea and Taiwan for that matter, The Gambia's future lies in the entire country becoming an export enterprise. Every feature of the economy will bear directly on its ability to export. Even sectors removed from export markets, such as utilities, internal transport, accounting, health, and education, will have to provide good quality services efficiently, or else the high cost of these services will be reflected in the cost of producing for export. This is true to some extent in all economies, but especially so in very small, export-oriented ones. It will not be possible, as in larger countries like Thailand, Indonesia, India, or Brazil, to isolate and tolerate sectors of inefficiency and rent-seeking. In The Gambia, as in Hong Kong or Singapore, inefficient, import-substituting firms cannot easily coexist with a thriving export sector.

This bears especially on government's own operations. The cost of government services is borne by the producers and income earners who pay taxes. In The Gambia, exporters must also pay taxes. Thus the cost of government's ineffectiveness, inefficiency, or corruption will bear directly on the country's ability to export and thus on its ability to industrialize. If The Gambia is to succeed as an export enterprise, its government is going to have to deliver the appropriate services at a low cost. In this sense, the size and shape government, and of its budget, become issues of industrial and export policy. And in this regard, the East Asian countries are good models to emulate, though their standards are among the highest in the world.

**Taxes on Trade**

The current trade tax structure of The Gambia appears to be typical of many developing countries. Duties are highest on consumer goods and lowest on intermediate goods and raw materials. Imports for reexport bear moderate duties, which can be reduced if competitive market conditions require it, as in the case of rice.[4] Sales taxes are charged on all imports

---

[4] National accounts data suggest that, for reexports as a whole, there is a spread between the cif cost of imports and the fob value of reexports equal to 60% of the cif costs of imports. Within this margin, tariffs and sales taxes account for about 25% of the cif import value of

and on the ex factory value of production (with credit for sales tax paid on imported inputs), but evidently not on exported production. New industries can obtain development certificates that exempt payment of duties (but not sales taxes) on capital equipment and intermediate inputs for a specified period; and some firms also obtain higher duties on imports that compete with their output. However, not all manufacturers have obtain such favorable protection and some firms have gone into production without being certain whether they will obtain a certificate and on what terms.

Is this an appropriate tax structure for The Gambia? One aim is to maximize the revenue yield from taxes on trade. This would require a differentiated tax structure (*optimal tax*) in which goods with the least price-elastic demand bear the highest tax rates. Something like this approach may have been behind the decision to reduce duties on reexported rice while keeping duties high on other reexported imports. However, the prevailing opinion among economists is that governments lack the information and response capacity to adjust taxes according to price elasticities. Moreover, differentiated tax structures create administrative complexity and invite corruption.

A second aim in determining tax structure is to encourage investment in new industries. Under import substitution regimes, discussed earlier, this criterion led to the kind of cascaded tariff structures, not unlike that in The Gambia today, with higher duties on finished products, moderate duties on intermediate goods, and lower or zero duties on non-competitive intermediates and raw materials. The consequence of this approach has been a chaotic pattern of incentives (*effective protection*) that has, eventually, discouraged investment, the opposite of the intended result.

An outward-looking strategy of industrialization requires uniform incentives across all industries, so that new investment flows to the most productive activities, as determined by market forces. With this aim in mind, economists have recommended a policy of uniform tariffs, so that effective rates of protection are the same for all industries. Uniform tariffs also have the advantage of being administratively simple to enforce, minimizing the opportunity for corruption. Although the East Asian exporters did not have uniform tariffs, on the whole their complex systems of tax and subsidy did lead to fairly uniform incentives across industries, with a slight edge if any going to export industries. Tariff reform in many developing countries, including Indonesia, appears to be heading towards more uniform tariff rates; Chile adopted a uniform 10% rate in the 1970s.

In recent years, the pattern of tax reform in The Gambia has been to reduce all duties, which has moved the country towards more uniform rates. How far should this process go? If import duty revenue cannot easily be replaced by other taxes in the near term, then tariff reform is constrained by the need to maintain revenues at current yields. A

---

reexports.

recent estimate is that, with rough allowances for varying price elasticities of demand, a uniform tariff with no exemptions would have to be somewhere in the range of 12% to 15% to maintain tariff revenue.[5] Assuming the 10% sales tax is retained, indirect taxes on imports would be 22% to 25%. This was roughly the average tax on imports for reexport in 1990/91.

Contrary to popular belief, a uniform tariff does provide some protection to domestic industries. Assume importers and local manufacturers both pay a 15% import duty and a 10% sales tax on imports, while the manufacturer pays a 10% sales tax on output with a deduction for the sales tax paid on imports. In that case, the local manufacturer enjoys effective protection of 15% on the value added in the country. This protection arises because, while the manufacturer pays the 15% duty only on his inputs, the importer pays 15% on the total value of the finished good, which ought to be higher.[6] Fifteen percent is not considered to be much protection by the standards of most countries and most investors. It does, however, ensure that any local industries will be competitive in world markets, which is the condition needed for small, open economies and especially for entrepot economies such as The Gambia.

Should The Gambia provide more than 15% effective protection to promote industrialization? There are two arguments in favor of doing so. The first is the <u>infant industry argument</u> discussed earlier, which says that firms may need <u>temporary</u> protection during a period of learning by doing. The Gambia's development certificates are designed to provide just such temporary protection.[7] If a certificate exempts a firm from paying a 15% duty for, say, three to five years, then during that period the firm enjoys protection on value added (effective protection) of anything from 40% to over 100%, depending on the share of value added in total value.[8]

The second argument for higher protection deals with <u>dumping</u>. Manufacturers, especially those who compete with reexported imports in nearby markets, complain that

---

[5] Clive Gray, Malcolm McPherson, James Owens, and Clifford Zinnes, *Taxes and Private Sector Activity in The Gambia*, draft, Harvard Institute for International Development, February 1992.

[6] The calculation, using the formula in footnote 2, is ERP = [15% - a(15%)]/[1-a] = 15%.

[7] Unfortunately, the administration of development certificates has not always matched this ideal. In at least one case, a certificate has been extended to protect a highly inefficient firm over a much longer period.

[8] If value added is 40% of the cif cost of competing imports, the calculation is ERP = [15% - 0%]/.40 = 37.5%.

competing imports are priced well below the cost of production by China, Brazil, and Eastern European countries. This is an argument frequently used all over the world to justify permanent protection. The correct response to a claim of dumping is to investigate the charge that goods are being sold abroad at prices below those in the home market. If the charge is true, then the appropriate remedy is a countervailing duty against the exports of that country for a period until dumping is corrected. Small countries may, however, find it difficult to carry out such investigations.

If it is felt that infant industries should receive more protection than provided by duty exemptions; or if The Gambia is felt not to have the resources to undertake proper anti-dumping procedures; then additional protection could be given via a temporary duty surcharge that could raise the duty on competing imports by a modest amount over a limited period. For example, a new industry might get a surcharge of 10 percentage points over the uniform duty rate, for a total duty of 25%, and this might last for 3 to 5 years; the surcharge rate might decline automatically in the last two years of the surcharge. This would convey an effective rate of protection of 62.5% to a firm with 40% value added that also paid no duties on imported inputs.[9] But the firm would be on notice that eventually it will have to compete with only the uniform duty rate for protection.

Who should get this protection? In principle, higher temporary protection should go only to firms that cannot compete with imports in the near term, but should be able to do so in a few years. To be consistent with the OLI strategy, tax incentives should go to export-oriented firms in preference to import-substituting firms. In practice, however, trade tax incentives are likely to be awarded to most if not all new firms. That is not a serious problem if--and only if--the "temporary" protection really is temporary and the development certificate is allowed to expire after 3 or 5 years. There should be no exceptions to this rule. If inefficient firms are allowed to linger behind high protection, The Gambia will have difficulty succeeding as an export enterprise.

Why, if The Gambia is going to promote export-based industrialization, should it award any protection, because it is impossible to "protect" exporters who must sell at world prices? First, the presumption in The Gambia is that exporters will pay at least sales tax and perhaps duties on imports. Some temporary relief from these taxes may be necessary on infant industry grounds, even if exporters will be expected to pay them eventually.

Second, in The Gambia exporters face the unusual situation of having to compete with the country's own traders in reexport markets. It is clearly advantageous for The Gambia to substitute manufactured exports for transshipped imports if it can do so without incurring such high costs that it loses the export market. Where fledgling manufacturers cannot compete until they have gained experience in production, temporary protection against

[9] The calculation is $[(15\% + 10\%) - 0\%]/.4 = 62.5\%$.

reexporters may be warranted. The level of this protection is severely constrained, however: if the local manufacturer cannot sell profitably at the reexport price faced by traders, The Gambia is likely to lose the trade altogether by protecting the new industry.

The level and extent of protection is also constrained by revenue considerations. Protection requires some combination of a reduction in duties and sales taxes on imported inputs, an increase in duties on competing imports, and relief from the sales tax on production. If the protective package is successful, tax revenues will necessarily fall, because more highly taxed import business declines in favor of less taxed production. Some of the fall could be made up by taxes on profits of the protected companies and on incomes of their employees, but of course that would also raise the cost burden to these firms.

One additional item on the agenda for trade taxes is the implementation of agreements under ECOWAS. It will be crucial for The Gambia's export-substituting manufacturers to have duty-free access to neighboring countries' markets. In effect, traders and some manufacturers have this access now through the smuggling of transshipped goods. If duty rates fall and currencies are devalued, Gambian exporters will lose their advantage. ECOWAS would help them regain some of it. This is a two-edged sword, of course, because neighboring country firms will also have access to The Gambia's markets. Agreement with neighboring countries on ECOWAS measures should be a high priority for industrial policymakers.

In summary, a trade tax policy to encourage outward-looking industrialization in The Gambia could include:

>> a uniform tariff of 12% to 15%;
>> a sales tax on imports and production of 10%;
>> temporary relief of duties on inputs to infant industries, especially export industries;
>> temporary import duty surcharges of 10% against competing imports;
>> implementation of ECOWAS agreements.

**Other Taxes**

The severe limitations on tax policy as a tool of industrialization can be overcome in time through reforms to broaden the revenue base and gradually to reduce its reliance on trade taxes. A recent report recommends a strategy for tax reform that would begin this process.[10] This section merely highlights some of the reforms that might have the most impact on industrialization, in light of experience in other developing countries.

---

[10] Gray, *et al.*, 1992.

Sales taxes have already been discussed in the context of taxes on trade. As applied in The Gambia, the sales tax approximates a value added tax in that manufacturers get credit for sales taxes paid on imported inputs. Although sales taxes are not charged on exports, exporters do pay sales taxes on inputs. Over time, it may become possible to broaden the base of the sales tax to collect more revenue and make it possible to relieve exporters of paying sales taxes on their inputs.

Profits taxes are too high by world standards. A rate of 35% would be more competitive. Over a longer period, it may be desirable to reduce the profit tax rate below 35% to attract foreign investment.

Turnover taxes can be a severe disincentive to trade and investment. In the reexport trade, where turnover is high and margins are low, the 3% turnover tax may amount to a 60% tax on profits. A lower profit tax rate, combined with improved enforcement, should make it possible either to eliminate the turnover tax; to lower its rate; or to use it only as a punitive tax for those who do not file verifiable returns. Enterprises earning low profits on turnover should not be penalized by a turnover tax.

Tax holidays are provided as part of the development certificate. As explained earlier, there is little evidence that tax holidays are necessary to attract investors in other countries; and it is likely that they are costly in lost revenue. By narrowing the profit tax base, holidays also place a greater revenue burden on trade taxes. If The Gambia reduces its profit tax rate, it should be able to eliminate the profit tax holiday from its incentive package, as Indonesia has done.

### Duty-free Zone

Experience elsewhere shows that a DFZ can be a very marginal investment for a country. The government of The Gambia cannot afford to have many industries enter a DFZ because of its dependence on trade taxes for revenue. In any event, it could achieve much of the benefit of a DFZ by long-term tax reforms that permit a reduction in duty rates.

### Infrastructure

Industrialists voice surprisingly few complaints about the infrastructure available in The Gambia. The most frequent concern is about the power supply, but it is so inadequate that virtually all firms accept the need to provide their own generator, either as the sole power source or on standby. Water is generally available through boreholes and the supply is considered good. Despite the poor condition of the road system, it does not seem to be a major hindrance to transportation of goods. Banjul port seems adequate, is reputed to be efficient, and has plans for expansion. Concern is expressed about the deterioration of river traffic and the need to revive the river transport industry, but it should be done by private firms. Telephone service is excellent.

The picture would be very different if Banjul were to aspire to become an international service center, as discussed earlier. The investment requirements would be huge and probably not financeable. Infrastructure needs would also be greater if government wants firms to decentralize industry away from Banjul. For the normal development of export trade, however, there do not seem to be any glaring needs for immediate investment, beyond the normal improvement in infrastructure with development.

## Industrial Estates

Although complaints about infrastructure are not rife, there may be some merit in organizing industrial estates to provide investors with basic permits and services: a title to or lease of land, road access to the plot, basic utility hook-ups (electricity, water, sewage), and a set of permits needed to start operations. These are services that governments normally provide and there need be no charge for them. However, the actual provision of utilities should be at rates that fully cover costs. The estate should not provide buildings for investors, who are in the best position to know what they need and to finance their own projects.

A determined effort to have manufacturing locate away from Banjul would probably require the establishment of industrial estates, but the cost is likely to be high and the chances of success are not great. Indonesia has used estates, together with good transport facilities, to accommodate an investment boom in East Java. However, most countries have failed to induce investors to locate far from the largest cities. The estate at Kanifing is relatively successful, but also relatively close to Banjul.

## Financial Markets

The high cost or lack of credit is a problem widely perceived by investors. Development of the financial system is too large a topic for this paper, and in any case has been the subject of earlier studies.[11] Some points bear directly on industrial policy, however.

The banking system is rudimentary and operates at very high cost. Investors with access to foreign credit, through banks or, more likely, through their suppliers, prefer it to

---

[11] Professor James Duesenberry of Harvard University conferred with officials of the Government of The Gambia in April 1992. The suggestions in this section are consistent with those in his report.

local credit. Much trade is apparently self-financed. Those who do borrow from local banks complain of excessive borrowing rates.

One industrialist is able to borrow from supplier-related banks in London at about 12% a year. If that rate represents a reasonable premium over LIBOR for the riskiness of lending to a small firm in The Gambia, then local banks should be able to lend at a premium over 12% reflecting some expectation of annual depreciation of the dalasi. With inflation in The Gambia at about 10% a year and in the United Kingdom at around 4%, the dalasi might be expected to depreciate by the difference, 6% a year. Then local banks would be able to lend at 18%. However, government paper yields this rate, so private borrowers might be expected to pay something more. Still, it is hard to justify lending rates 9% or 10% above the rate on government paper.

Larger foreign investors, whose credit is likely to come from abroad, are not necessarily disadvantaged by the high costs of Gambian banks. But smaller foreign investors and Gambian investors are at a serious disadvantage, especially those who export and must compete with exporters who have access to cheaper credit.

Why should lending rates be so much higher that those prevailing in the London market? First, there is little real competition among banks in The Gambia; in recent years, only one of the three major banks has been actively lending in the country. Second, the government's monetary ceilings, negotiated with the IMF, permit little expansion of domestic credit, hence allow no room for an expansionary policy to force lending rates down. This appears to be an appropriate monetary policy for a small, open economy like The Gambia. Third, foreign banks evidently find it too risky to enter The Gambian market with loans denominated in *dalasi*. Fourth, domestic savers have a strong preference for offshore deposits, which exceed the value of the entire Gambian money supply; this preference reduces domestic liquidity and drives up interest rates.

These conditions pose a dilemma for industrial policy. On the one hand, it would be advantageous for investment if domestic credit were available at lower interest rates. On the other hand, tight money and high interest rates are necessary components of a macroeconomic policy that restrains inflation, stabilizes the real value of the exchange rate, protects the balance of payments, and thus provides an attractive climate for investors.

The solution to this dilemma is two-fold. Over the long run prudent macroeconomic policies should establish the stability of the economy and begin to attract offshore deposits back to the country to finance more investment at lower interest rates. Government should simultaneously encourage new banks to enter the market to compete with existing ones both for loan customers and for depositors, especially those with offshore deposits.

One kind of institution that might be especially helpful would be a <u>leasing company</u>, which combines the purchase of equipment with loans to finance such investments. Leasing company loans are secured by the equipment purchased. These institutions need not accept domestic deposits, but can attract capital from abroad and might be a vehicle for channeling offshore deposits of Gambian citizens into financing industrialization.[12]

The solution to high-cost credit does *not* lie in special government programs of directed, subsidized credit. However well this approach worked in Japan and Korea, it has been a failure elsewhere and is being abandoned around the world. Experience in other countries has shown that subsidized credit goes to well connected rent-seekers rather than to the most productive borrowers; stimulates excessive indebtedness by those who can borrow; creates bureaucratic rather than profit-maximizing behavior by both bankers and borrowers; is not sustainable because it is not repaid; removes banks' incentives for seeking saving deposits; and thus retards the development of the financial system. If donors wish to provide capital to support industrial investment, it should be provided on commercial terms through the banking system. Such lending could make a contribution if it were conditioned on improvements in the banking system.

If donors are interested in lending at concessional rates to establish an industrial development bank or program, such funds should be channeled through the commercial banking system. Government could borrow at the concessional rate, then onlend to financial institutions at rates approximating the return on saving deposits. Such a program could help to attract new financial institutions, such as the leasing company mentioned above; or a merchant bank that can accept deposits and compete with the existing banks over some range of loans, but would primarily lend at longer term.

**Attracting Foreign Investors**

The Gambia appears to be quite open to foreign investors, indeed seeks them. This is an appropriate policy for a small, open economy. Several of The Gambia's most promising export industries are natural investments for foreign firms, including horticulture, fishing, tourism, and light manufacturing for export.

Investors are, and will be, attracted by profitable opportunities in these industries based on land, climate, and location; by The Gambia's political openness and stability; by its macroeconomic stability, including sound fiscal, monetary, and exchange rate policies; by the convertibility of the *dalasi* and the absence of exchange controls; and by the country's open trade policies.

The problems for investors, foreign and domestic, lie in the implementation of rules. There is considerable frustration with lax implementation, with the need to go beyond legal

[12] Professor Duesenberry drew attention to this possibility in his report.

compliance to get things done, and generally with the uncertainty of knowing whether an investment can be implemented or not. Foreign investors have a world of countries from which to choose. Transparent rules, automaticity, and dependability are important considerations to them. Development of a reliable government response to foreign investors is more important than a set of fiscal incentives to attract them.

One source of foreign investors that has not been emphasized in The Gambia's promotion efforts is East Asia. Investors from Korea, Taiwan, Hong Kong, and Singapore have virtually swarmed to Thailand, Malaysia, and Indonesia in the face of rising labor costs in their own countries. The flow of investment has moved towards Bangladesh, Sri Lanka, and Mauritius. With good policies, African countries may be able to attract East Asian investors as well. The most likely industries for The Gambia would be labor-intensive, light manufacturing firms seeking access to the European Community for clothing, textiles, footwear, sportswear, and other consumer goods. The NIB should target Seoul, Taipei, Hong Kong, and Singapore for attention.