

The “neutralisation of the Dutch disease argument” legitimising import tariffs

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Abstract. In economics, there is just one argument legitimising import tariffs – the infant industry argument – but it ceases to be valid as the required learning time ends. This note offers a second argument: the neutralisation of the Dutch disease argument. If the country faces this competitive disadvantage, import tariffs and export subsidies may be a way of circumventing the problem. Many countries that industrialised were only successful because they pragmatically neutralised the disease with import tariffs.

Resumo. Em teoria econômica, há apenas um argumento que legitima as tarifas de importação – o argumento da indústria nascente – mas ele deixa de ser válido quando o tempo de aprendizado necessário termina. Esta nota oferece um segundo argumento: o argumento da neutralização da doença holandesa. Se o país enfrentar essa desvantagem competitiva, tarifas de importação e subsídios à exportação podem ser uma forma de contornar o problema. Muitos países que se industrializaram só tiveram sucesso porque neutralizaram pragmaticamente a doença com tarifas de importação.

Keywords: infant industry, Dutch disease, import tariffs, neutralisation

JEL classification: F10, F43

In this short text, I propose a second argument in the history of economics that legitimises import tariffs – that demonstrate that import tariffs and export subsidies on manufactured goods are not necessarily “protectionist” policies, this word understood here in its pejorative sense as policies that protect unduly inefficient companies and hinder instead of fostering growth. The first argument is the well-known infant industry argument, and the second is the “neutralisation of the Dutch disease argument”.

The Dutch disease model

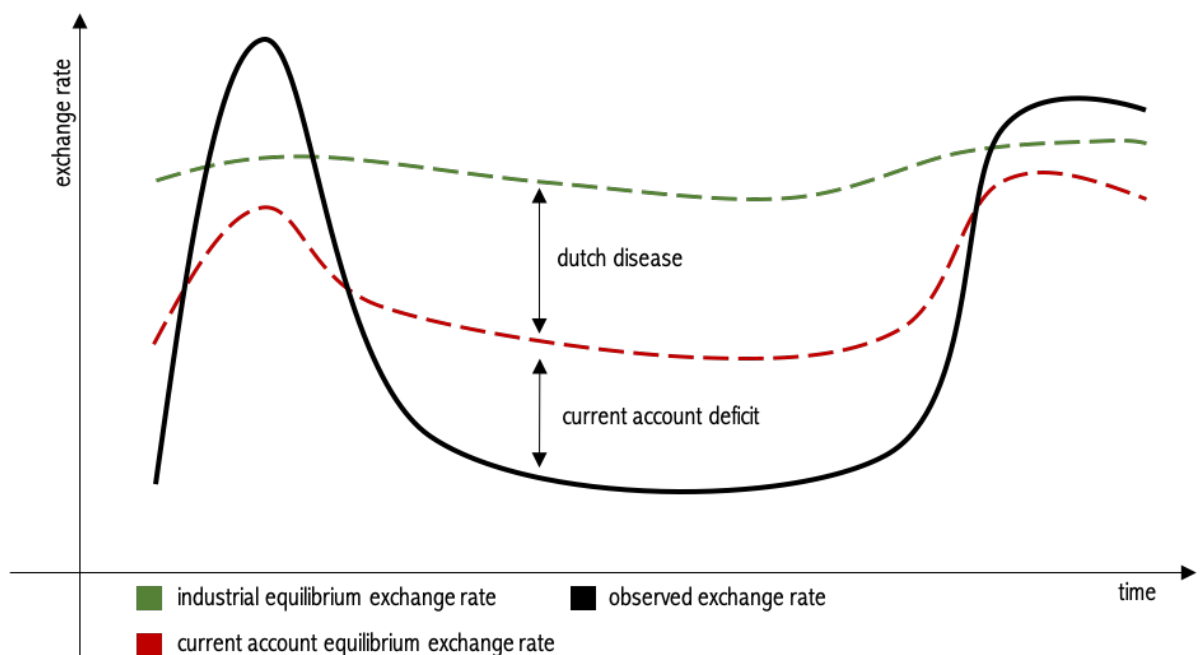
Only after, in 2008, I formulated the second model of Dutch disease that a method of neutralising it became available: a variable tax on the commodities exports.¹ In the paper “The Dutch disease, a Ricardian approach”, I formulated a new model of the major competitive disadvantage that export commodities. In this model, which is central to the new-developmental theory, I defined two equilibrium exchange rates: the “current equilibrium”, which balances intertemporally the country’s current account and the “industrial equilibrium”, which makes competitive the industrial projects that utilise the best technology available in the world. The Dutch disease corresponds to the difference in these

two equilibriums, which change in time following a cyclical behaviour. Countries with the disease don't industrialise or deindustrialise when they had previously neutralised the disease pragmatically. If these countries try to grow with foreign finance, abrupt changes in the prices of commodities and indebtedness to foreign money will easily lead them to currency crises in which a sharp depreciation of the national currency.

The industrial equilibrium changes little because it depends on the unit labour cost. The current equilibrium changes fast because it depends mostly on the variation in the prices of commodities. But, against the belief of conventional economics, the exchange rate is not simply volatile: it changes following a tendency or a cycle, which is proper for commodities. After the sharp depreciation, the exchange rate appreciates over time, the country incurs current-account deficits again, the exchange rate appreciates in the long-term within the cycle, and the foreign debt increases until foreign creditors lose confidence, and the rollover of the debt stops. A new sharp depreciation closes the currency cycle.

It is a developmental model because it assumes that a country's growth requires industrialisation. It models a market failure because the Dutch disease is a market problem. It adopts a Ricardian approach because the countries in which the Dutch disease is very severe (usually countries that produce oil at a low cost) "benefit" not only from commodity price booms but also from differential rents that continue to cause the disease even when the price of the exported commodity is relatively low. The severity of the disease (the distance between the current and the industrial equilibrium curves) depends on the commodities prices and the production cost. See the figure with the industrial equilibrium, the current equilibrium, and the real exchange rate.

Exchange rate and two equilibriums in countries with Dutch disease



In the 2020 paper, “Neutralising the Dutch disease”, I distinguished more clearly the Dutch disease, which is an economic problem, from the natural resource curse, which is a political and moral problem involving rent-seeking or corruption. Orthodox economists prefer to speak on the curse and put the responsibility for underdevelopment on the local economic and political elites.

And I proposed a second way of neutralising the disease. The first was a variable export tax on commodities; the second, a more obvious method that I viewed as the second-best: adopting an import tax on manufactured goods to neutralise the disease in the domestic market and an export subsidy on manufactured goods to neutralise it in the international market and allow the competent manufacturing companies (which use the best technology available) to export. The second method requires that the country makes a tariff reform establishing two tariffs for each good. One is the standard tariff following the industrial policy, and, in principle, it should be small. The manufacturing industry is supposed to be efficient. The other is a single tariff for all goods, which will vary according to the price of the main commodity exported.

A second argument for import tariffs

A consequence of great importance for development economics may be derived from this model. In the framework of New Developmentalism, I am proposing a second legitimate argument for adopting import taxes – the *neutralisation of the Dutch disease argument*. Many countries, particularly in Latin America, industrialised after the Second World War using import tariffs and, in the case of Brazil, also with export subsidies since the late 1960s. Liberal economists and the industrialised countries immediately criticised the policy, but these countries resisted using the infant industry argument. Around 1990, however, after the Global North made the Neoliberal Turn and increased their pressure, many countries, lacking a good argument, opened their economies, although the tariffs remained a condition to avoid deindustrialisation essentially because they have the Dutch disease and will only be able to industrialise and further grow if they continue to neutralise it as they have done before with import tariffs and export subsidies on manufactured goods.

The classical argument legitimising import taxes was the *infant industry argument*, proposed by Alexander Hamilton (1792) and Friedrich List (1844). It was an excellent argument, but with a problem: it was a conditional argument: it was valid while each industry in a country was an infant industry. After this, the argument lost validity, but many countries continued to require import tax to avoid deindustrialisation. Now, we have a new and good argument – the neutralisation of the Dutch disease argument – which countries should adopt.

The United States had a severe Dutch disease since it began to export oil from Texas. For that reason, their policymakers kept high import tariffs until 1939. They didn't have the theory, but they knew that in the past, import tariffs had had a key role in the industrialisation of their country and, pragmatically, continued to neutralise the Dutch disease. In 1939 they lowered the tariffs because the US's competitors – the European countries – were at war. And because import tariffs are not so important in rich countries, which may, to a certain extent, deindustrialise healthily, not prematurely, as in Latin America.

Subsidies to export manufactured goods subsidy were used in Brazil between 1969 and 1990. It caused an enormous increase in exports, and Brazil became a great exporter of these goods. Since 1990, when the subsidy was stopped, exports of manufactured goods as a percentage of total exports fell to half of what they were, and the technological sophistication of its remaining industry fell.

In 2020, Carmem Feijó, Eliane Cristina Araújo and I published the paper “An alternative to the middle-income trap” and called this alternative the “liberalisation trap”. Our argument in this paper, which included an econometric study sustaining it, was that the main reason the Latin-American economies have been quasi-stagnant since 1990 was the trade liberalisation reforms these countries adopted around this year. The neutralisation of the Dutch disease argument was not available to their economists and politicians, and trade liberalisation proved disastrous to them.

Summing up, the American and Latin American governments didn't know what the Dutch disease was, but the American policymakers were relatively developmental, and the Latin American policymakers were definitively developmental. They understood that economic development requires industrialisation, knew that the tariffs were a condition for the industrialisation of their countries, and adopted intuitively high import tariffs (and export subsidies in the case of Brazil) because they believed industrialisation would stop if the tariffs were cancelled. The Latin American policymakers justified the tariffs with the infant industry argument, but this argument had been overcome over time. If they had known and adopted the Dutch disease argument, they would have been stronger in defending the industrialisation of their countries.

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¹ After the publication of the Corden and Neary paper some economists worked on the Dutch disease, but none built a model that we can call new.