The Dutch disease, extractivism, and the second argument for tariffs on the import of manufactured goods

Luiz Carlos Bresser-Pereira

> Notes for “Bringing Structural Analysis Back in a World of Pessimism”, May 11, 2022. An online Extractivism-Talk organized by the Extractivism Project of Kassel University. Panel 1, “Revisiting Development: State, Class, and Structure”. Moderator Hannes Warnecke-Berger. Panellists: Hartmut Elsenhans, Mushtaq Khan, and myself.

A research project on extractivism is being conducted by Kassel University. The organizers invited me to participate and asked which has been my contribution to the theme associated with economic development. Extractivism may be defined as the abusive use of human, or natural resources in benefits to certain groups, or countries. My contribution to this problem is in the two papers I wrote on Dutch disease. In this note, I will resume them and present a second argument justifying the adoption of import tariffs on manufactured goods.

In the 2008 paper, “The Dutch disease and its neutralization: a Ricardian approach”, I defined the Dutch disease as a major market failure that characterizes countries exporting mostly commodities that can be exported with a profit at an exchange rate substantially more appreciated than the one that the manufacturing companies or projects utilizing the best technology available in the world require.

The Dutch disease blocks industrialization, thus, from the developmental point of view, blocks economic growth. A country with the disease will only grow and catch-ups if the government neutralizes it. This neutralization does not need to be deliberate. It was only in 1982 that Max Corden and Peter Neary formulated the first model of Dutch disease in the history of economics. It was a neoclassical model, the disease only happened when booms of commodities broke up, and no method to neutralize it was proposed. Nevertheless, many countries that had the Dutch disease industrialized because their governments pragmatically neutralized it. I will return to this issue ahead.

The Dutch disease model

Only after, in 2008, I formulated the second model of Dutch disease that a method of neutralizing it became available: a variable tax on the exports of the commodities.[1] This paper was published in the *Brazilian Journal of Political Economy* and economists at the world level likely didn’t read and certainly didn’t discuss it. In this model, 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 utilizing the best technology available in the world. The Dutch disease

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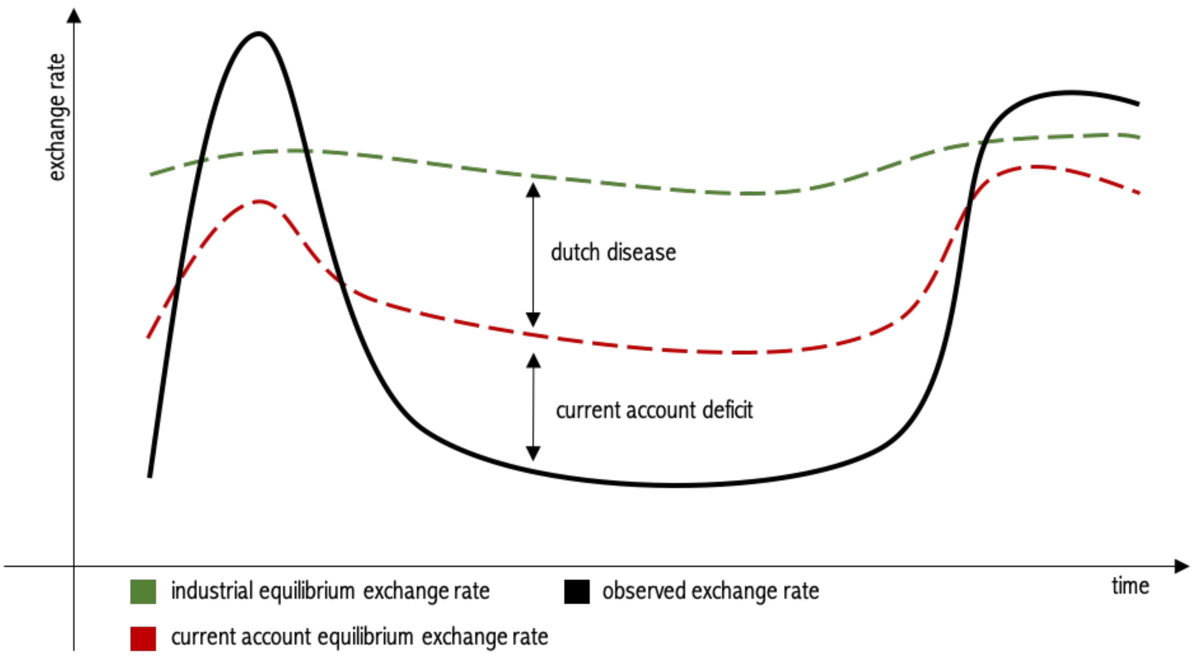
Luiz Carlos Bresser-Pereira is emeritus professor of Getúlio Vargas Foundation and editor of the Brazilian Journal of Political Economy. bresserpereira@gmail.com, www.bresserpereira.org.br.

corresponds to the difference in these two equilibriums which change in time following a cyclical behaviour. Countries with the disease don't industrialize or deindustrialize when they had previously neutralized in a pragmatic way the disease. 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 through time, the country incurs again current-account deficits, the exchange rate appreciates in the long-term within the cycle, and the foreign debt increases until foreign creditors lose confidence, the rollover of the debt stops, and a new sharp depreciation closes the currency cycle.

It is a developmental model because it assumes that industrialization is required for a country to grow. It models a market failure because the Dutch disease is a market problem. It adopts a Ricardian approach because in the countries in which the Dutch disease is very severe (usually countries that produce oil at a low cost) "benefits" 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 curves of the current and the industrial equilibriums) depends on the prices of the commodities and on the cost of production of the commodity. 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, "Neutralizing 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 a 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 neutralizing 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 neutralize the disease in the domestic market and an export subsidy on manufactured goods to neutralize it in the international market and allow the competent manufacturing companies (which the 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 traditional tariff following the industrial policy, and, in principle, should be small. The manufacturing industry is supposed to be efficient. The other is a single tariff to all goods which will vary according to the variation in the price of the main commodity exported.

A second argument for import tariffs

A non-intended consequence of great importance for development economics is derived from this model. In the framework of New Developmentalism, I was proposing a second legitimate argument to import taxes – a tax that was essential for many countries to industrialize and continues to be essential today. Yet, the sharp and insistent criticism of liberal economists led most developmental policymakers to give up adopting them.

The classical argument legitimizing 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 point in time, many countries continued to require import tax to continue to industrialize or avoid deindustrialization, but policymakers lacked a good argument. Now, we have this argument, which I propose to call *"the neutralization of the Dutch disease argument".*

For instance, the United States had a severe Dutch disease since it began to export oil from Texas and the Latin American countries were always exporters of commodities. They kept high import tariffs, the US until 1939, the Latin American countries until around 1990 and continued to industrialize although the infant industry argument had already lost validity. Thus, many countries adopted pragmatically the neutralization of the Dutch disease argument. The export of manufactured goods subsidy was 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, the exports of manufactured goods and their technological sophistication fell to half of what they were as a percentage of total exports.

The American and the Latin American governments didn't know what the Dutch disease was, but they were developmental and counted on policymakers who

- understood that economic development requires industrialization,
- knew that the tariffs were a condition for the industrialization of their countries,
- and adopted pragmatically and intuitively high import tariffs (and export subsidies in the case of Brazil) because they believed industrialization would stop if the tariffs were cancelled.

They justified the tariffs with the infant industry argument, but this argument had overcome over time. If they knew and adopted the Dutch disease argument, they would have been stronger in defending the industrialization of their countries. In Latin America, developmental economists who argue for industrial policy would have continued to defend import tariffs which are the more important industrial policy in the history of economic development.

Extractivism

I was invited to participate in a webinar promoted by Kassel University together with some outstanding developmental economists. The theme is extractivism, which is the object of the research project "Natural Resource Extractivism in Latin America and the Maghreb". The organizers asked which had been the contribution of the participants to this problem. My contribution was the two papers on Dutch disease. Extractivism is a consequence of a non-neutralized Dutch disease, which manifests itself through economic rents that benefit the domestic and foreign consumers of commodities and may make unfeasible industrialization if the country didn't neutralise it. In the case of the natural resource curse, the rent-seekers act alone or in groups controlling the government.

My 2008 paper had some repercussions in Brazil, but the academic discussion was poor, and the Brazilian government didn't act to neutralize the disease even when the finance minister was a developmental economist. Internationally, it had practically no academic impact. The 2020 paper on the neutralization of the Dutch disease didn't have any repercussions. The model remains poorly known abroad. In 2021 I and an agency of the United Nations organized an international seminar with the participation of the Jeffrey Sachs, which, again had no impact.

I understand that the neutralization of the Dutch disease interests almost all developing countries – all the ones that export commodities. The problem interests the Latin American countries that are prematurely deindustrializing and experiencing quasi-stagnation since around 1990 when they opened their economies and stopped neutralizing the Dutch disease. It should also interest the US because the dollar is overvalued since the war, and they face chronic current-account deficits since the Second World War, but the interest the global North have is limited because they fear the competition from the global South. It does not interest the East Asian countries because they are not exporters of commodities. The fact they don't have the Dutch disease is one of the reasons why they have been so successful.

What keeps lacking, and what should be done is the involvement and commitment of important and acknowledged developmental economists who reject economic liberalism and are critical of imperialism and dependency of local elites. In the countries having the Dutch disease, extractivism and the pessimism it causes will only be overcome with the adoption of policies that neutralize the disease. The abusive use of human resources is a central and well-known problem that is not object of this note.

References

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[1] After the publication of the Corden and Neary paper some economists work on the Dutch disease but build a different model.