

The Role of Demand in Provincial Industry*

Somluckrat W. Grandstaff

Background and Scope

Domestic demand was the most important source of growth for Thailand's industrial sector in recent years. However, more than 75 percent of all industrial production (measured in manufacturing value added) has taken place in the Bangkok Metropolitan Region (BMR). It is obvious that products from the BMR have met much of the provincial population's demand for domestic industrial products. Meanwhile, population pressure on agricultural land in the provinces has forced many to seek employment in cities—particularly in the BMR, which has not been able to generate enough employment for the influx of rural labor despite its scope and complexity of economic activities. There is increasing interest among international development organizations and among Thai government agencies to encourage industrial expansion into the provinces to provide more employment for the country's growing labor force. Most of the effort has been focused on providing supply incentives such as tax privileges to attract industrial enterprises to the provinces; however, the response has been disappointing. The principle of wealth maximization states that, if the effective demand for an investor's product is known to be inadequate or uncertain, no amount of incentive will be sufficient for an investor to establish the industry in the provinces.

This paper addresses the issue of provincial industrialization from the aspect of demand. Its purpose is to analyze the current and potential situation concerning effective demand for provincial industry products, then to identify ways to increase and sustain the existing demand, if it is currently limited. Four primary demand sources for provincial industry products were analyzed: (1) household consumers; (2) producers; (3) the domestic government; and (4) foreign markets. The analysis focused more strongly on the role of domestic demand rather than foreign demand, since the government's intended influence through manipulation of policy measures on domestic demand are expected to be more controllable and thus more effective in initiating the process of provincial industrialization.

Findings

Existing information and analysis in the present study concur that the demand for rural/provincial industry products faces limited markets and, in a few cases, product inferiority. The more serious issue, however, is market limitation due to low purchasing power caused by widespread poverty in provincial rural households. The expenditure elasticity analysis—based on data from the Household Socioeconomic Surveys—reveals that the values of expenditure elasticity of demand for industrial products are generally positive and are often greater than unity ([Table 1](#)). The change in the direction of expenditure elasticities of demand by twelve major categories of commodities purchased by provincial households is also consistent with studies carried out in other countries ([Table 2](#)).

Further review of studies on factor intensity of industrial products purchased by households of different income levels indicates that as household income begins to rise, the very poor households tend to buy more of the more labor intensive items, most of which are produced locally. The higher income households tend to increase their purchase of the more capital and foreign exchange intensive products as their income rises. Though small in size and number, provincial industries themselves have been the primary source, compared with industrial buyers from the GBR, who constitute an intermediate demand for provincial industry products. Government purchase and direct export of provincial products have been limited.

A survey run by the Rural Industries and Employment Project shows that about 50 percent of all provincial industries—primarily small operations with fewer than 20 employees and/or less than 3 million baht of invested capital—are currently selling 80-100 percent of their output within their own provinces. However, total sales by this group represent only a small portion of the overall markets. Moreover, when this group's product list is compared to the Ministry of Industry records on registered industries (arranged by products and by province) one discovers that many of the products with positive and/or larger than unity expenditure elasticities of demand are currently being produced in the BMR. This implies that if these products can be manufactured in the provinces at the same or lower costs, they would have little difficulty finding buyers.

While the average household income has increased in all areas in all regions over the last two decades, the differences in relative income have also increased ([Table 3](#)). When provincial households were disaggregated into those in cities, sanitary districts and villages, the last group—which is the largest in number—is shown to have the lowest average income ([Table 3](#)). In addition to differential natural resources endowments, analysis of secondary sources reveals that many policies—agricultural product pricing policies, certain aspects of fiscal policies, and even the formal educational systems—were found to have unfavorable effects on the income level of households in rural villages, whose primary occupation is agriculture. The low income of rural households thus limits their demand for both agricultural inputs and consumption goods. To turn the potential demand implied by the high values of expenditure elasticity of demand and marginal budget shares (as detailed in the main report) into real purchasing power, the income of the majority poor households in the provinces must be increased.

A review of government purchases of supplies and equipment for use in its provincial offices, as well as related regulations, procedures, patterns and magnitude of the purchases, confirms the government's potential role in providing the initial boost in demand for provincial industry products by switching *some* of its purchases to provincial sources. It must be noted, however, that government purchases from provincial industries will not increase the aggregate demand. In fact, the overall efficiency may suffer unless household demand catches up to sustain the initial growth in the provincial industries. Also, the size and structure of the budget suggests that the process, if adopted, will be started on a small scale and increased incrementally. Moreover, effective implementation could be extremely difficult, given the expected resistance by personnel and other known bureaucratic constraints.

Foreign demand—especially for products by small industries in the provinces—is expected to play a lesser role in the beginning of the provincial industrialization process, but it will make a more significant contribution later, increasingly becoming the most important source of demand to sustain provincial industries.

Implications and Recommendations

Given its size, the potential demand that the provincial rural population can provide for provincial industry products is significant, even when the expenditure elasticity of an item is less than unity, but is positive. The extent to which a product has become "inferior" because of modern, mass-produced, cheaper substitutes reflects the development path and is an indicator of what not to invest in. The central issues are product development and information about new products and/or technology. If provincial industry products (with the exception of a few large-scale, multi-million-baht ventures with mostly imported technologies) are inferior to the same items produced in and imported from the BMR, then, measures to assist provincial manufacturers in technological improvement—ranging from providing accurate and timely information to product testing—should be the method to increase or at least maintain the demand for these industries. Otherwise, the increased income in rural households may simply lead to even more imports from the BMR.

Supply incentives are generally more appropriate when dealing with import substitutions or exports, whose demand is already confirmed and where the cost factors decide the ability to compete in the existing markets. However, in the initial stage of provincial industrialization, when the ability to influence effective demand is critical, domestic demand needs to be created and increased. Raising rural household real

income takes longer time, but it is the only way to effectively increase and sustain demand for provincial industry products, especially since, "...in most agrarian low and middle income countries, increases in farmers' incomes are the most likely cause of expanding markets for small-scale industries" (Elkan 1989).

Provincial industrialization and raising rural household income should not be exclusive of overall economic efficiency. Given the drastic economic differences between the BMR and the provinces, a reduction in income disparity becomes socially desirable for long-term stability. The real issue at hand is not whether the government should engage in improving income distribution at all, but rather one of choosing an optimal "efficiency-equity" trade-off.

Given the tendency for rural households to purchase more of labor intensive products as their income increases and of local buyers being the most important source for products of small- to medium-size provincial industries, it is possible to achieve provincial industrialization without requiring a large capital investment per enterprise. These industries also tend to be labor intensive. Therefore, a promotion of small-scale industries in provincial areas will, "...maximize employment and by so doing maximize the dissemination of increased income, and the geographical dissemination of income-earning opportunities" (Elkan 1989), thereby reducing the need for labor to migrate into the BMR.

Taking into account both the currently attractive environment for foreign investment in Thailand and the need to increase employment in the provincial areas, the following policy measures are recommended:

The first track involves the promotion of small-scale industries in the provinces, mainly through measures that will increase rural household income and (probably less effective) through the existing, new supply incentive measures. An initial increase in rural household income usually results in an increase in the demand for durable goods—such as simple furniture and agricultural tools made by small, local manufacturers—in addition to an increase in the purchase of non-durable consumption goods. However, this demand will eventually reach market saturation due to the durable nature of the products. The ability to maintain either a service-providing role by producing service-related products to customers, or to modify their products and/or expand their markets beyond the old ones becomes crucial, and assistance will be needed. Maintenance service also becomes costly in proportion to geographical distance, and it could be an area in which local industries have the advantage. It is also natural that with higher income, there will be a shift in demand toward better quality, or more modern products. Timely and accurate information on new products, technology and markets is critical for the long-term survival of small provincial industries.

The second track focuses on continuing promotional policies to attract large-scale Thai and international investments in order to fully exploit the existing comparative advantages that Thailand currently possesses.

A two-track provincial industrialization policy is possible, because the success of each track requires different conditions and thus different strategies and measures. Since no single general measure for provincial industrialization will ever work without bias in one way or the other, conscious decisions must be made and appropriate measures designed and implemented for both large- and small-scale industries. More importantly, it must be kept in mind that the objective for provincial industrialization is not—and should never be—industrial growth *per se* but to generate additional employment opportunities and higher income in the provinces. This is a necessary condition for sustained demand, leading to industrialization and economic development in the long run.

Reference

Elkan, Walter. "Policy for Small Scale Industry: A Critique." *Journal of International Development*, 1,2 (April) 1989: 231-260.