Governments and Markets in Economic Development Strategies

LESSONS FROM KOREA, TAIWAN, AND JAPAN

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Governments and Markets in Economic Development Strategies

To Father (in memoriam),
Mother,
and Farzana

Preface

The reader may be given a foretaste of what follows by a list of some of the major aims of this book.

The first aim has been to show that the spectacular growth rates achieved by the outward-oriented economies of Taiwan, Korea, and Japan during the postwar years cannot be ascribed to the kind of policies advocated by neoclassical economists. These economies differed little from the import-substituting (IS) economies in the degree of interventions or the instruments employed to implement them.

The second aim has been to show that what distinguished these economies from the IS economies was their much greater concern with the rapid development of comparative advantage in the industries they promoted. As a result, they pursued the dual policy of promoting exports in established industries while also encouraging the rapid development of comparative advantage in more capital- and technology-intensive industries. It is shown that the policies employed in support of these dual objectives could be interpreted as responses to market failures.

The third aim has been to explore the political and economic conditions that permitted the early transition from IS to export-oriented (EO) regimes in Taiwan and Korea. It is shown how the historical evolution of these countries, in which Japanese colonialism and U.S. interventions were important elements, helped to create the conditions for this transition.

The fourth aim has been to show that the EO strategies implemented in Korea and Taiwan make more strenuous demands on the government than the IS policies they replaced. Their success in other countries with different political structures and administrative traditions cannot therefore be taken for granted.

It should be apparent from this short list that this book intends to be both eclectic and controversial. It is eclectic because the causes of economic growth have their origins in culture, history, and economic, social, and political structures; and these connections may be observed to advantage in economies that have either succeeded spectacularly or failed visibly. It is controversial because the interpretation developed here runs into established neoclassical orthodoxy. This has been unavoidable. But whether this book is also useful, whether it generates any light with the heat of controversy, is a matter I will let the readers decide.

Contents

1

The Superiority of Export-Oriented Regimes: Neoclassical Interpretation and Dissent

The central task of development economics, as I understand it, is to determine the mix of government and markets that in a specific stage and context of development holds out the greatest promise of accelerating this process. The first generation of development economists (the structuralists[1]) who addressed this problem in the 1940s and 1950s appear to have been greatly impressed by the pervasiveness of market failures obstructing the progress of poor primary-producing countries toward an industrial take-off. To realize the dynamic benefits believed to flow from the establishment of a manufacturing sector, the thrust of policy recommendations that emerged during this period favored industrialization under a protectionist regime. Beyond this consensus, however, there existed numerous disagreements regarding the range of industries and the order in which they were to be established, the extent of planning and public entrepreneurship that was thought appropriate for promotiong industrial investments, and the choice of instruments with which protection was to be accorded to the new industries. In most countries, however, this debate was largely superseded by policies already set in motion, the preferences of bureaucrats, and the mounting pressures of payments crises; most developing countries chose to adopt or continue an import-substitution (IS) regime, characterized by an overvalued currency, import licensing, high tariffs, and varying levels of investment planning.

Although growth rates in most developing countries accelerated visibly under the IS regime, most of them found the momentum difficult to sustain beyond the first few years. There were other aspects, too, of this regime which did not inspire much confidence: the payments situation was no better than before, there was little expansion in industrial employment, growth in the primary sector was generally slow, and industrial investment in several countries had come to be dominated by foreign capital. By the early 1960s these problems had begun to call forth a critical reexamination of the IS regime both from economists of the right and left. But as the greater economic success of a handful of export-oriented (EO) economies, including Taiwan and Korea,[2] came to light during the late 1960s and 1970s, this promoted a neoclassical revival in the area of development economics. The neoclassicals felt encouraged to reject not only the IS regime almost in its entirety, but also to repudiate the basic theoretical premises behind the IS policies.[3] They maintain that the EO economies implemented policies aimed at optimizing the static efficiency of resource allocation—by bringing domestic prices into greater conformity with world prices. The superior growth record of the EO economies is, then, attributed to the greater dynamic efficiency flowing from the more efficient allocation of resources.

While this neoclassical interpretation of the rise of EO economies was given prominence in part by the general resurgence of the right over the past decade, it has not gone unchallenged. A careful reexamination of the evidence on EO policies has led to the charge that neoclassical economists have not been getting their facts straight.[4] Several of the more prominent EO economies have been more interventionist than neoclassical economists have admitted. A major objective of the present work is to substantiate this thesis with respect to the two most successful EO economies, Taiwan and Korea,[5] and the postwar Japanese economy during the critical 25 years (1950–75) of its ascent into the ranks of the developed economies. This survey reveals a picture of EO policies that is generally at variance with neoclassical characterizations of them. In all three countries governments have played an actively interventionist role both in the promotion of exports and the selective fostering of import substitution.

A comprehensive critique of the neoclassical interpretation of EO policies cannot rest content with demonstrating its interventionist character. It could be argued, as it often is, that the "remaining" interventions in Korea, Taiwan, and Japan represent missed opportunities for further improvements in economic policies—their elimination could have led to still higher rates of growth. The position taken here, however, is that these interventions, along with several other factors, help to explain the superior growth performance of these countries. It will be argued later in this chapter that EO policies generally sought to correct market failures, improve the x-efficiency of industries, and enhance the bargaining strength and competitiveness of domestic firms *vis-à-vis* their foreign counterparts. Given this interpretation, I naturally consider the government's effectiveness in formulating and implementing appropriate policies to be an indispensable ingredient in the success of EO economies. Consequently, the country studies devote considerable attention to the economic, political, and social circumstances that contributed to effective policy formulation and implementation.

The first section contrasts the neoclassical assessment of EO policies with the EO policies implemented in Taiwan and Korea. This is followed by a discussion of the superiority of EO regimes; it includes a summary of neoclassical views and a dissenting view on the economic rationale for interventions observed in the EO regimes of Taiwan and Korea. In a final section I also offer some general remarks on the reasons for effective formulation and implementation of policies in the three economies studied here.

POLICY REGIME IN EXPORT-ORIENTED ECONOMIES

The success of the EO economies has been seized by many neoclassical economists as a vindication of their belief in the superiority of private market forces as the engine of economic growth.[6] Soon after reports of their success came to light, massive research programs were launched in quick succession by the Organization for Economic Cooperation and Development (OECD), National Bureau of Economic Research (NBER), Institute of World Economics, at Kiel, and the World Bank to document and compare the superior economic performance of EO economies against the less impressive performance of economies operating under IS regimes.[7] In general, these studies agree in describing the EO economies as based on private enterprise, managed by market forces and operating under a virtual free-trade regime—at least as far as their export production was concerned. The evidence from the country studies (reported in detail later) is generally at variance with these characterizations.

Consider first the nature of reforms in the foreign trade regimes of these countries, as this is often considered to be the key to the superior export performance of the EO economies. Contrary to claims, the transition to rapid export growth in Taiwan and Korea was not attended by a switch to a virtual free-trade regime, not even with respect to export production.[8] Probably the most significant reform in this area was the institution of unified, near-equilibrium exchange rates to replace the overvalued, multiple exchange rates of the IS period. However, this move was not complemented by any significant decline in import controls or tariffs. In Taiwan, visible progress with import liberalization did not even begin until 1972, some 14 years after the exchange rate reforms of 1958.[9] Korea implemented a partial import liberalization which culminated in the introduction of a negative list in 1967 but little further progress was made over the next decade. The fact is that the EO regime was not created by dismantling the system of import controls and tariffs. Instead, a set of export promotion policies (many of which had been instituted earlier) was grafted onto a basically unaltered system of domestic protection accorded through import controls and tariffs.

An important element of the export promotion policies in Taiwan and Korea consisted of the tariff-free access to imports used in export production—an arrangement that has erroneously been described as creating a virtual free-trade regime for exports.[10] But although tariffs were rebated on such imports, access to them continued to be regulated by licenses and, at least in Taiwan, such licenses were made available only if prices of domestic substitutes exceeded import prices by some fixed percentage (initially set at 25 percent). Other restrictions on such imports stemmed, for instance, from sometimes very stringent domestic content requirements. Such restrictions apart, the tariff-free access to imported inputs did not constitute a free-trade regime for exports because of the multitude of other export promotion policies (not including export-targeting in Korea) that had the effect of substantially raising the receipts from exports above their free-trade prices.

The claims about financial liberalization are also strongly at variance with the evidence. While real interest rates were maintained at levels that were high relative to the practice in most developing countries—and therefore may have served an important function in the mobilization of domestic savings—they never reached levels at which financial markets could be said to be in equilibrium. In both Taiwan and Korea, the interest rates on the curb markets exceeded the official rates through most of the 1960s and 1970s by a factor of two or more. Moreover, an increasing share of loans to private enterprises in Taiwan were financed by the curb market, thus indicating a strengthening of excess demand for credit at official rates. All in all, the interest rates cannot be said to have performed an allocative function—credit rationing continued to be the order of the day.

The extent of state participation in entrepreneurial decisions also belies the image of Taiwan and Korea as economies given over to private market forces. The share of public enterprises in Taiwan's net domestic product grew from 10.9 percent in 1951–53 to 13 percent in 1961–63 and remained at this level for another decade; in Korea, too, this share increased from approximately 7 to 9 percent over the period 1963 to 1972. The public enterprises loom much larger when we look at their shares in total investment activity. In Taiwan their share in gross domestic capital formation averaged 27 percent over 1961 to 1973, and in Korea this share had grown to 30 percent by the early 1970s. But even these figures do not reveal the full extent of government involvement in the creation of market agents because they exclude private enterprises set up under state initiative or with partial state financing, or those which once set up in the public domain were then transferred to private hands.

Direct state involvement with entrepreneurial decisions does not end with public enterprises. The import of technology by firms has been subject to detailed government scrutiny: the case-by-case screening of such imports has generally determined what could get in, from where, and under what conditions. In addition, the state has established restrictions on entry into some industries; it has established plant size minima, sponsored mergers, determined domestic content requirements, specified detailed export targets, and implemented programs of industry rationalization. In addition, the wage policies, subcontracting arrangements, ownership structures, and product quality of firms have occasionally come under the direct supervision of government. Admittedly, such microlevel interventions appear to be more common in Korea (or Japan) than in Taiwan, but this may partly be due to the presence of better documentation on the former two countries.

Before examining the nature of allocative biases[11] set up under the EO regimes in Korea and Taiwan, I would like to direct attention to two problems of measurement. By convention, the incentives structure is evaluated in terms of effective protection rates (EPRs) and effective subsidy rates (ESRs) observed across industries and for sales in domestic and external markets.[12] But since these measures are based only on price incentives, it follows that they cannot reflect the allocative biases toward infant industries or exports created by various direct interventions. Given that direct interventions were employed frequently in support of infant industries in Taiwan and Korea, one may expect the conventional measures to understate the inter-industry biases. A second problem with the use of EPRs and ESRs arises from the omission or undervaluation of several price incentives in the estimates that are available. Among the most important of these omissions are the subsidies implicit in the provision of market information, technical assistance, industrial estates, warehousing facilities, export insurance, and the cartelization of domestic markets. In addition, there is the failure to incorporate the full value of the credit subsidies arising from the use of inappropriate shadow price of capital. Since many of these subsidized inputs are provided for export production and exports, this is believed to lead to a considerable understatement in the allocative bias toward exports. In Korea, this understatement increases due to the presence of ambitious export targets.

Keeping in mind these difficulties, we can now turn to an appraisal of the incentives structure as revealed by the available estimates of EPRs and ESRs. A misleading assessment of the incentives structure is sometimes presented by directing attention to highly aggregate, economy-wide estimates of ESRs for sales on the domestic and external markets. Since this reveals for Korea only a moderate bias toward exports in 1968 and 1978 and, in the case of Taiwan, the absence of any bias in 1969, it is concluded that EO policies succeeded in establishing neutral incentives across markets in these two economies. An examination of the incentives structure at a less aggregate level, however, reveals biases toward export sales in several industries which are far from negligible. Similarly, the ESRs (for total sales) across major industry groups also reveal significant differentials in incentives: the highest ESRs were recorded for consumer durables, intermediate products and producer durables—industries in which these countries were seeking to develop their comparative advantage. At a more disaggregate level, the evidence on promotion of infant industries is even more striking. In 17 out of 60 industries in Taiwan in 1969, the ESRs for total sales exceeded 100 percent; in Korea 24 out of 150 industries in 1968 enjoyed similar levels of promotion.[13] To sum up, then, the incentives structure revealed by the uncorrected ESRs points to the presence of significant trade and industry biases in both Taiwan and Korea. When the effects of various direct interventions and omissions and undervaluations of incentives are also incorporated, these biases become sufficiently large to be recognized as defining characteristics of EO economies.

SUPERIORITY OF EXPORT-ORIENTED REGIMES

The Neoclassical Interpretation

The thesis that EO economies were characterized by an unbiased incentives structure must be regarded as a central proposition in the neoclassical interpretation of the superior growth performance of such economies. Since neoclassical economists also discount the importance of market failures, they regard the institution of neutral incentives as moving the EO economies nearer to an optimum allocation of resources. Within the context of the standard trade model, this is expected to lead to once-for-all increases in income as well as a higher volume of exports. It is, however, recognized that while these static gains may be substantial, they cannot account for the sustained improvements in the growth rates of EO economies. This has led the neoclassicals to look beyond the confines of their paradigm for dynamic factors to explain the observed acceleration of growth. These dynamic factors include a widening of markets, more rapid growth of exports, and redirection of entrepreneurial energies resulting from reduced opportunities for rent-seeking.[14] The ramifications of each of these factors may be taken up in turn.

Under an IS regime, most industries are constrained to operate within the confines of the domestic market. Once imports have been displaced, the growth rate of the domestic economy places an upper limit on the growth of industries with sales limited to the domestic market. By removing the bias against exports, it is maintained that EO policies eliminate limits on the expansion of domestic industries with a potential comparative advantage. The widening of markets is expected to bring two other distinct benefits. First, it will remove any demand-side limits on the exploitation of scale economies. Second, the opening of the economy to international markets will intensify competition and help to increase the x-efficiency of domestic industries.

Several important benefits are expected to flow over time from the more rapid growth of exports. More obviously, there is the easing of the exchange constraint. This not only permits higher capacity utilization through freer import of inputs, but will also increase the quality of inputs, thereby helping to lower the cost and improve the quality of domestic output. Exports are also expected, through the greater frequency of international contacts they promote, to lower the costs and increase the flow of technology. Finally, higher and more rapidly expanding export earnings increase a country's credit standing, resulting in a greater inflow of direct foreign investment and commercial loans.

The greater market-orientation of EO economies is expected to bring in dynamic gains by reducing the opportunities for rent-seeking. Where direct controls abound, a considerable part of the management's time is spent in claiming, or seeking to augment, their entitlement to shares in the controlled resources. The abolition of direct controls, it is argued, permits the redirection of management's time from such rent-seeking activities toward a more strenuous search for markets and technologies, thereby resulting in more rapid growth and technical change.

The preceding neoclassical interpretation of EO economies is thought to be supported by two kinds of empirical results. Certain country and cross-country studies purport to show a connection between the introduction of EO policies and acceleration in export growth.[15] Second, there exists a variety of studies either establishing a correlation between export and output growth, or demonstrating a link between export growth and contributions to productivity gains.[16] The existence of such associations is taken as evidence of a causal connection proceeding from export to output growth. Taken together, these and other related studies are generally accepted by neoclassical economists as establishing the authenticity of their vision of economic growth.

This vision, however, can be shown to run into problems. The evidence on policies in Taiwan and Korea reviewed here cannot be stretched to fit the neoclassical interpretation; these two economies have followed vigorously interventionist policies in support of both export promotion and the rapid maturity of infant industries. Clearly, this kind of evidence raises serious questions concerning the neoclassical link between the dynamic factors they identify and a neutral incentives structure. The problems of interpreting such complex phenomena cannot be easy, but it seems more plausible to argue that the more rapid export growth in the EO economies was made possible by interventionist policies creating a strong bias toward exports. The export bias may be seen as correcting for market failures in both export production and exporting activity; even if the export bias was excessive, the loss from resulting allocative inefficiencies may have been more than offset by the dynamic gains associated with a more rapidly growing volume of exports. But the more significant dynamic effects may have come out of policy biases aimed at the upgrading of comparative adantage through promotion of a select and rapidly maturing group of infant industries. If this was indeed the dominant dynamic factor, then export growth, too, must be viewed, at least in part, as a consequence of output growth. These and other arguments supporting this alternative explanation are developed more fully in the next subsection.

A Dissenting View

I will now try to show that many of the interventions observed in Taiwan and Korea may be viewed as responses to market failures, or as attempts to improve the x-efficiency, bargaining power, and international competitiveness of domestic producers. This is followed by a discussion of some other factors, not directly related to EO policies, whose contribution to the economic growth of Taiwan and Korea does not receive adequate recognition.

Justifying Interventions. Consider first some rationale for instituting an export bias. Neoclassical economists are apt to assume that once the policy-induced bias against exporting is eliminated, export expansion in the economy's areas of comparative advantage will follow as a matter of course. Clearly, this does not recognize that in an economy lacking a varied and long-standing experience in exporting, the initial transaction and set-up costs of entry may well introduce so large a wedge between export and import prices of any good as to make entry into export markets improbable. Several of the transaction costs may, of course, be anticipated to fall. But where such activity is being contemplated for the first time, prospective exporters are likely to underestimate the reductions over time in transaction costs; alternatively, banks unaccustomed to such activities may be unwilling to finance them. Exporting also involves high set-up costs—the setting up of ex-