PN-AAP-690
isn: 34142

ardas

FREE MARKETS AND ECONOMIC DEVELOPMENT IN POSTWAR DEVELOPING COUNTRIES

by

Alvin Rabushka

December 1983

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

UNITED STATES INTERNATIONAL DEVELOPMENT C[redacted]ATION AGENCY
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

March 9, 1984

MEMORANDUM FOR THE EXECUTIVE STAFF, A.I.D./W and OVERSEAS

FROM: PPC/PDPR, Edwin Hullander

SUBJECT: Free Markets and Economic Development

In April 1983, the Bureau for Program and Policy Coordination asked Dr. Alvin Rabushka (Hoover Institution, Stanford University) to carry out an analysis of successful, market-oriented examples of economic development. Attached is a copy of Dr. Rabushka's final report.

As Rabushka points out, economic theory establishes the essential conditions under which free, or competitive, markets operate and demonstrates that free markets maximize economic efficiency. But economic activity does not operate in a vacuum; it depends on government to provide an institutional framework in which the market economy can function. Rabushka considers the mix of fiscal, monetary, regulatory, and international policies that are appropriate to the free market economy. He also examines, in detail, the post war policies, and the results of those policies, that have been pursued in Hong Kong, Singapore, Taiwan, Korea, the Ivory Coast, Chile, and Sri Lanka. Recognizing that most countries do not stress free market policies, Rabushka then explores how more modest policy reforms can improve efficiency.

Use for abstract?

I commend the report to your attention.

Attachment: as stated.

FREE MARKETS AND ECONOMIC DEVELOPMENT IN POSTWAR DEVELOPING COUNTRIES

by

Alvin Rabushka

December 1983

153

This report is the result of Contract No. OTR-0092-C-00-3127-00, undertaken for the Bureau for Program and Policy Coordination. The author would like to thank Professor Ronald McKinnon of Stanford University and Jerome Wolgin of the U.S. Agency for International Development for their helpful comments. All views expressed are those of the author and do not necessarily reflect those of A.I.D., the Hoover Institution or the U.S. Government.

Table of Contents

Free Markets and Economic Development in Postwar Developing Countries

Sustained economic growth is the key to improving the living standards of several billion people who inhabit the poorer countries in Africa, Asia, and Latin America. In the post-World War II period, a handful of countries have successfully grown their way out of poverty to provide their people with sharply higher living standards. Most have not! These few remarkable cases have an important common feature: most have emphasized free market economic policies as the keystone of their overall developmental strategy.

The object of this study is to identify and analyze the successful, market-oriented examples of economic development. This identification process consists of two steps. The first step is to pinpoint those countries whose overall economic policy relies on competitive markets in the private sector as the main vehicle for growth. (I use the phrase "economic policy" as shorthand for the several dimensions of fiscal, regulatory, investment, trade, monetary, and exchange rate policies.) Since these countries are few in number, a second step is to identify examples of incentive-enhancing reforms that have been introduced in countries which otherwise exhibit a high degree of government control or direction. The purpose of the second step is to demonstrate that it is possible to aid the process of development through a variety of modest policy changes which promote economic efficiency in less open economies.

Thus, policymakers need not be faced with an either/or prospect--either install free market policies wholesale to stimulate growth or do nothing at all.

The organization of this study is as follows. Economic theory establishes the essential conditions for the existence of free, or competitive, markets, and demonstrates that free markets maximize economic efficiency. But economic activity does not exist in a vacuum; it depends on government to provide an institutional framework in which the market economy can function. Section II considers what mix of fiscal, monetary, regulatory, and international policies are appropriate to the free market economy. Sections III through VII examine, in detail, the postwar policies that have been pursued and their results in Hong Kong, Singapore, Taiwan, Korea, the Ivory Coast, Chile, and Sri Lanka in order to determine which components of economic policy are most central to rapid growth.

Most countries do not stress free market policies. Still, many have experimented with one or more incentive-enhancing liberal measures. Any reform that increases reliance on market forces is likely to foster greater efficiency in that sector of the economy. The remaining portions of this paper turn from the overall economy-wide "macro" analysis to an assessment of "micro" changes in policy, exploring how modest reforms improve efficiency. I examine a variety of partial liberal reforms that have been tried to assemble a shopping basket of possible measures that leaders in developing countries could select, given their own peculiar circumstances.

It is important to have a clear picture of the free market model of development. Although no country fully reflects the textbook model of the perfectly efficient, competitive market economy, such a model provides a set of standards against which real world economies can be studied. What are the main features of a free market economy?

I. Free Markets

The term "free markets" is shorthand for the economist's concept of "perfectly competitive markets." While economists differ on the merits of free market policies as a basis of economic organization and activity, virtually all agree on the meaning of the term and its consequences for economic efficiency.

The science of economics is concerned with the allocation of scarce resources in a society. Scarcity implies that choices must be made among alternative uses of any one resource. Choice, in turn, entails costs--the money one uses to import railway equipment cannot be used to purchase jet aircraft. The resources available to people determine how much and what mix of goods and services they can feasibly produce. Of course, it makes sense to produce as much as possible at the least-possible cost, which means that there are more goods and services to go around for everyone. This is just a common-sense notion of economic efficiency: to the extent that economies produce inefficiently, there is simply less to go around.

A market is a place or device enabling people to negotiate exchanges. In the marketplace, individuals compare their personal valuations with each other as they buy or sell goods and services. Buyers and sellers conclude their exchanges after settling on a price, which is typically expressed in the units of some currency. In the modern electronic age, markets can range in scope from the Sunday morning village bazaar to interconnected 24-hour gold markets in New York, London, Zurich, and Hong Kong, in which all buyers and all sellers throughout the entire world can negotiate exchanges at a single price.

Let's define the market mechanism more precisely. The market is a method of organization in which owners of property and labor services make individual decisions to consume, produce, and distribute on the basis of unregulated prices. To say that a free market is synonymous with competitive markets implies that no one imposes price regulations on economic exchange, and that buyers and sellers are free to enter and exit. Free entry and unregulated prices satisfy the requisites for competition. To repeat this important statement, to have free markets means that there must be no legal or arbitrary barriers to access, nor any legal restraints on the pricing decisions of buyers and sellers. The notion of perfect competition, or perfectly competitive markets, is satisfied under the following conditions. First, no one buyer or seller is dominant enough in the market to set prices. Rather, each buyer and seller is small in size and is a "price-taker," rather than a "price maker." In economic parlance, there are no monopolists or monopsonists, who can by themselves set the buying or selling price of any item. Second, goods have standardized qualities, which means that buyers know what they are getting for their money. Third, there must be free movement of resources. New producers must be allowed the right to compete with existing suppliers and existing producers must be allowed to go out of business if they wish. Otherwise, resources are "locked in" and cannot be released for use in more highly-valued activities. Fourth, buyers and sellers are assumed to have complete knowledge of market conditions, especially prices. When these four conditions are satisfied, the abstract definition of perfectly competitive markets is fulfilled. The model of perfect competition is, of course, only an abstraction about the real world, but one that economists have found helpful in explaining observed regularities in economic behavior.

In a free market economy, the government does not interfere with the prices established by market forces, the supply and demand conditions resulting from millions of individual decisions to buy and sell, nor does it protect existing firms from the pressure of competitors. Government imposes no legal restrictions limiting market entry of buyers or sellers. Nor can there be private collusion among buyers or sellers which would restrict output and raise prices.

Welfare economics is that part of economic analysis that seeks to identify the conditions under which societies use their resources in the most efficient way. Economic efficiency means getting the largest possible benefit from any given level of effort; or, attaining any specific level of benefits with the least possible cost--in short, getting the biggest bang for the buck!

The central theorem of welfare economics is that perfect competition yields an optimal allocation of resources. Perfectly competitive markets, or free markets, are allocatively efficient. Perfect competition in every market yields a set of prices for inputs and outputs which places maximum valuation on every economic good. In such a market, the value of any item to each consumer--how much he is prepared to pay--is exactly equal to the marginal cost to any producer--how much he must spend to produce it. (In economics, the marginal utililty of commodity <u>x</u> equals the marginal social cost of <u>x</u>.) It is the price mechanism which equates consumer value to producer cost. The free movement of price in competitive markets insures that production costs are minimized, and that profit-maximizing producers will produce the goods that consumers most desire. Resources will not be wasted either producing at higher cost than is necessary or in supplying goods consumers do not want. In this sense, the free market economy is the most efficient system of economic organization.

What is the proper role of government in the free market economy? Its role is limited to defining property rights, enforcing contracts, protecting people from fraud, and similar activities that establish the rules of the game. It does not, to repeat, interfere with prices or competition.

The rationale for government can arise, in purely economic terms, when the conditions of perfect competition are not satisfied. Examples include the presence of monopolies (the absence of competition), externalities which inflict costs that are not compensated (e.g., pollution), and the need to provide such public goods as national defense, because private suppliers have no practical way to charge for the benefit of their services. Governments also negotiate international agreements. Most governments provide a monetary framework. Some people dislike the way a market economy allocates incomes and want the government to redistribute income in accord with different values, an extr me example of which would be absolute equality of incomes.

Apart from an economic role for government, many attribute to government a number of social and political purposes. Examples include advancing education, imposing religious values, preventing abortion, and so on. These activities cost money, and often force people to behave in ways they would otherwise not behave. Only government, with its legal monopoly on coercion, has the power to tax and regulate to attain these goals.

In practical terms, governments do many things. As the activities of government move the economy away from a competitive market system, efficiency declines, which usually means slower growth and a lower standard of living.

Economics textbooks have less to say about social and political objectives than about the conditions and consequences of competition. But even if we limit (intellectually, at least) government to its minimum economic functions, we have created an institution that will tax, spend, regulate, print money, negotiate treaties, and carry out other economic acts. Can we define the legitimate scope of government action that would be consonant with a free market economy?

II. The Role of Government in the Free Market Economy

Whenever government takes resources from the economy and uses them in ways that do not match consumer valuations with producer costs, efficiency is impaired. Thus only where the market economy cannot supply consumer desires, such as national defense, the provision of all private goods and services should reside in the marketplace.

The abstract model of perfect competition is found only in economics textbooks. Where competition exists in the real world, it is always found in some political, institutional setting, where government leaders make decisions on economic policy. Economists justify a role for government to provide public goods, enforce contracts, correct market failures (uncompensated externalities), redistributive income (though this is highly contentious), but often they pay less attention to the precise way governments function. Decisions to tax, spend, regulate, manage the money supply, and negotiate international agreements may result in outcomes that seriously distort or regulate prices and limit free entry, which harms efficiency. The purpose of this section is to identify which public policies least interfere with free markets. The general term for these policies is non-intervention, or non-interference, in the market. Let us look at the specifics of taxation, spending, regulation, monetary policy, and international agreements.

<u>Taxation.</u> Tax policy should aim at three goals. First, to remove as few resources from the economy as possible to pay for the legitimate activities of government. The reason is that resources in private hands are used more efficiently in producing goods and services than the same

resources placed in public hands. In general, governments do not stress profit-maximizing activity nor do government enterprises have to meet the competitive test of the market to stay in business. Taxes should thus be as low as possible.

A second goal of policy is that taxes should not distort prices produced by the interaction of supply and demand in the market. Tax policy should strive for neutrality between production and consumption, and among products and industries. Government should not use its power to tax to alter prices to favor any one industry, or producer. To give but one example, import duties protect domestic producers from competition, penalize consumers, and raise the costs of inputs for exporters.

Third, the costs of administration and collection of taxes must be minimized. Borrowing from Adam Smith, time of payment, manner of payment, and amount of payment ought to be certain and not arbitrary. Every tax ought to be levied in the manner in which it is most convenient for the taxpayer to pay it. Overhead should be minimized.

Finally, high rates of taxation must be avoided lest they destroy incentives to work, save, and invest. Historically, high customs duties fostered smuggling. Today, high tax rates in some countries foster growing tax evasion.

<u>Spending.</u> Spending should be confined to the provision of those essential public goods and services that only government can provide--defense, public safety, and public works are the most readily agreed-upon examples.

Apart from the overall size of public spending, the government should not grant subsidies to producers, which distort production costs, or consumers, which may shift resources from investment to consumption. The public sector should provide a framework within which private employers will find it profitable to create new jobs, rather than take on the task of employment for its own sake.

In the real world, most governments provide commercial services (e.g., airlines, trains, buses, housing) to their subjects. In providing these services, governments or their agencies should set prices to reflect scarcity and full opportunity costs, or contract out the provision of services to private firms on the basis of competitive bids.

Many scholars hold a popular view that governments have a responsibility to those of its citizens who, through no fault of their own, are unable to meet their "basic human needs." This safety-net function is widespread in most Western industrial democracies, but its growing cost is increasingly cited as one reason why economic growth has slowed since the early 1970s, as resources are shifted from investment to consumption. Although equity (distribution of income) concerns are admirable, only sustained economic growth, not the politically driven redistribution of income, can lift a nation's people out of poverty.

Finally, overall government spending should be linked to the availabililty of tax-generated receipts. The government should avoid domestic or foreign borrowing to finance higher levels of spending than domestic resources can sustain, lest debt servicing costs become an economic burden. Balanced budgets should be the norm of fiscal policy, with borrowing confined to circumstances of national emergency or economic recession, when receipts may temporarily decline and disrupt the financing of on-going essential public programs. But every effort should be made to restore fiscal balance as soon as possible.

Regulation. The key to free markets is unregulated pricing and free entry and exit. Regulations imposed for the general welfare should not distort the pricing mechanism, which equates supply and demand, nor restrict entry and exit.

Some regulation is inevitable in every economy, to protect worker safety, standards of air and water quality, and so on. In the implementation of these policies, public authorities need to balance benefits against costs--all too often the benefits of regulation are cited with little regard for costs, which can raise prices or eliminate jobs.

Monetary Policy. Stable prices are the target of monetary policy. In a world of purely paper money, lacking any form of gold, metallic or commodity backing, inflation is all too common. The controversy over fixed versus floating exchange rate regimes applies as much to poor as to rich countries. Whatever monetary mechanism is selected, a correctly valued exchange rate is a central ingredient in the efficient use of national resources. An overvalued exchange rate encourages imports and discourages exports, distorting costs for domestic producers and exporters.

International Agreements. Governments negotiate agreements with each other on such matters as defense, aid, trade, tariffs, quotas, monetary links, and air landing rights, to name a few. The key principle of these agreements is to defend the national interest. In the process, however, it is important not to interfere with the free movement of prices. Tariffs and export duties, for example, have seriously retarded growth in many poor countries. Foreign aid has often been used to subsidize politically favored sectors of the economy, as the Korean case study that follows demonstrates, thus postponing internal reforms which promote efficiency.[1] Quotas have been a chief source of corruption as the artificial scarcity they generate yields a very high economic dividend to their holders.

This set of categories includes most, but not all, of the economic activities practiced by governments and their agencies. In each category, there is enormous opportunity for government intervention that would radically thwart the efficiency features of free markets, which depend on unregulated pricing and free entry. Indeed, one can only find a handful of postwar examples in which governments of poor countries adhered to, rather than violated, these maxims of policy.

Among postwar developing countries, the closest textbook approximation to the model of perfect competition is Hong Kong. Admittedly, many of its political, social, and economic circumstances may be unique, still it affords a clear statement that maximum reliance on free markets as a tool of economic policy successfully brought sustained high rates of growth and high living standards to the majority of its people--in short, a model for development.

III. Hong Kong: The Textbook Illustration of Free Markets

Perhaps the single best example of the market economy model of development is found in the incredibly successful record of Hong Kong.[1] Hong Kong has had to overcome many obstacles, and has received virtually no foreign aid in the process. Its land area is virtually resourceless and consists largely of unproductive granitic rock formations. It suffers a population density that ranks it among the world's most overpopulated areas per square mile; and it is dependent on imports for its food, raw materials, and all capital equipment. Located thousands of miles away from its most important markets, Hong Kong has been unable to control population movements across its borders; and, to this day, it continues to be ruled by a colonial government that critics regard as obsolete, antiquated and inconsistent with the principles of independence and self-rule.

Yet, despite these formidable obstacles, the rate of growth of the Hong Kong economy has been so rapid for so long that it has come to have an almost certain inevitability, despite a population that must periodically absorb large waves of penniless refugees arriving by land or by sea.

The British Crown Colony of Hong Kong lies inside the tropics on the southeast coast of China, adjoining the province of Kwangtung.[2] It consists of a small part of the Chinese mainland and a scattering of offshore islands, the most important of which is Hong Kong Island. Including reclamations through 1980, the total land area of the colony is 409.3 square miles, of which Hong Kong Island together with a number of small adjacent islands comprise 29.2 square miles. Kowloon and

Stonecutter's Island comprise another 4.3 square miles. The New Territories, which consist of part of the mainland and more than 230 offshore islands, have a total area of 375.8 square miles.

Of the 409.3 square miles in the colony, only 9.4 percent is used for farming; 74.9 percent is marginal unproductive land. Within the remaining 15.7 percent (about 38.6 square miles) of built-up urban areas, most of Hong Kong's people live and work.

The small colony of Hong Kong is almost entirely lacking in natural resources. Its mineral wealth is negligible, consisting of a modest amount of iron ore, building stone, kaolin clay, graphite, lead, and wolfram. Most of the activity in the mining and quarrying industry concentrates on the production of building stone and sand. Only one-seventh of the land is arable; the colony cannot, therefore, feed itself, and throughout most of its history has encountered difficulty in maintaining an adequate water supply. Virtually all the materials of industry, and the vast majority of food stuffs, must be imported.

The shortage of land, and on occasion of water, is accompanied by an absence of local coal, oil or other source of power.

Between five and six million people live within Hong Kong's limited space. Of these, over 98 percent can be described as Chinese on the basis of language and place of origin. More than half were born and have lived their whole lives in Hong Kong; the remainder are refugees and immigrants from other countries, mainly China.

Historically, Hong Kong became a British possession in 1841 for the simple purpose of trade with China. Two Opium Wars forced China to cede Hong Kong Island and Kowloon to the British in perpetuity. Mainland rulers have long declared these "unequal" treaties invalid. A third conflict in 1898 awarded the New Territories to Britain on a 99-year lease, which is scheduled to expire on July 1, 1997. (More on this later.) At the outset, Hong Kong was a barren island with no large or established community entitled to political representation. It was established as a military, diplomatic and trading station, not as a settlement in the normal sense. The colony immediately began to play an influential role in the China trade and attracted a substantial multiracial community of foreign traders. It survived as an entrepôt free port until after World War II, when the transition to industrial economy took place.

Throughout its history Hong Kong has absorbed political refugees. Several hundred thousand entered Hong Kong in the 1930s during the Sino-Japanese War. Still another influx took place during the Chinese civil war of 1948 and 1949, when nearly half a million people entered the colony. Another flood of persons crossed the border in 1962 and nearly a quarter of a million persons from China and Southeast Asia entered in the late 1970s. Thus Hong Kong authorities have historically had very little control over the arrival of new immigrants, which has made it very difficult to implement such social programs as housing, schools, health and other services in an orderly manner.

Since the end of World War II, Hong Kong has enjoyed a steady pattern of utterly remarkable economic growth. In 1948, per capita income in Hong Kong stood at US$180. Hong Kong's postwar transformation has been so dramatic that by 1981 per capita income reached approximately US$5,000, a more than sevenfold increase in real terms. In the early stages of its industrialization, real gross domestic product (GDP) grew about seven percent per year from 1948 to 1960. From

1961 through 1981, real GDP has risen nine percent per year. These rates of growth have doubled per capita income during each of the past two decades. Exports have risen steadily throughout the postwar period, increasing by 9.4 percent a year in real terms during the decade of the 1970s.

During the 1970s, productivity (measured by output per work-hour) increased eight per cent per year at the same time hours worked per worker fell two percent per year. Since the oil-induced world recession of 1974, the unemployment rate has generally remained beneath three percent and the economy has worked at full employment despite an inflow of several hundred thousand refugees and immigrants in the late 1970s.

Capital formation (savings as a share of GDP) has exceeded 20 percent throughout the 1960s and 1970s. Hong Kong's economic transformation has occurred without foreign aid or special concessions to overseas investors.

What factors have fueled Hong Kong's outstanding economic success? The answers can be found in the territory's liberal economic policies and its prudent, conservative fiscal policies.

In Hong Kong, economic affairs are conducted in a free-enterprise environment. Government policy has long dictated a virtually hands-off approach toward the private sector, leaving people to pursue their self-interest as they see fit. In short, it is an economic policy of noninterventionism and minimum regulation.

It is a general principle of Hong Kong's economic and tax policy not to discriminate between residents and non-residents. On this principle, overseas investors may fully own local factories.

Hong Kong is a duty-free port and allows the entry and exit of most raw materials, consumer goods and commodities, with only a registration charge. The absence of tariffs and exchange controls means that Hong Kong manufacturers can supply both domestic and foreign markets on the basis of least-cost production.

The government of Hong Kong does not impede the setting up of private business enterprise. Free entry is permitted and encouraged into almost every line of production. Legal formalities to set up a business are few and inexpensive. Except for land grants from the mid-1970s to land intensive industries that inject new technology into the economy, no protection or government assistance is traditionally given to manufacturing industries, utilities, service industries, or private citizens. No attempt is made to distort factor prices in favor of any particular type of development. Market forces are allowed to shape the economy, and industries that lobby for protection from the competitive forces of the marketplace are fiercely resisted. As a result, Hong Kong enjoys the most modern factory facilities in the world.

Hong Kong does not impose a statutory minimum wage. Earnings of industrial workers fluctuate with overall economic activity. Loyalties to firms are less important than salary and fringe benefits and thus workers respond quickly and rationally to alternative employment opportunities. Trade unions play little part in setting wages or working conditions. Labor is highly mobile between industries and trades, with little restrictions owing to rigid craft demarcation or entry protected by trade unions. Thus Hong Kong enjoys a free market in labor.

In spending only what it can afford, the Hong Kong government is, by worldwide standards, unique. Few governments so intently hold expenditure within means. Its standard rate of tax on earnings and profits is 16.5 percent for corporations and 15 percent for individuals. It maintains official government reserves which dwarf its miniscule debts or fiscal obligations. The official view in Hong Kong is that a low tax system encourages investment and work, thereby generating rapid growth, which yields sufficient revenue to finance essential public services. Hong Kong has developed extensive housing (about half the population receive substantial government housing subsidies), education (compulsory and government-financed through middle school), health (the infant mortality rate fell from 99.6 per 1,000 live births in 1950 to 11.8 in 1980, and smallpox, cholera, and tuberculosis have been virtually wiped out), and other social and community services through low rates of taxation, with virtually no need to resort to borrowing, which would burden the economy with debt service payments. Although Hong Kong has minimal defense requirements, the cost of its security forces, borne largely by local taxpayers, approximately equals the same share of national income as found in several small Western democracies. In 32 of the 35 years through 1982, the budget has ended the year in surplus, and interest earnings on the accumulated surplus have become a major revenue item. For the 1982-83 budget year, these accumulated reserves equalled about half of all government spending, which contrasts with so many countries for which the public debt represents a very large share of national income and an even larger share of public spending. The virtue of a net surplus position is that these resources allow the government to sustain public services during periods of economic downturn that might reduce receipts below budgeted levels, without having to increase tax rates or borrow to make up the shortfall. This is not a strategy of demand management. An open economy is not amenable to demand management since any applied fiscal stimulus would quickly drain out in higher imports.

The government has tried to operate its economic services on a commercial basis where possible. Once it has determined that it must supply a service to achieve social or economic objectives, either because the provision of services cannot be found in the private market or because these are common facilities that only the public sector can provide (e.g., water supplies), it tries to conduct these public enterprises with minimum cost to the general taxpayer, relying on user fees and charges that reflect commercial opportunity costs. For many years, the railways, run by a government department, turned a handy profit that funded other social objectives. Public economic services in Hong Kong have rarely become heavily subsidized.

Monetary policy has been the most variable element in Hong Kong's postwar economic environment.[3] When Hong Kong went off the silver standard in 1935, it adopted a sterling exchange rate regime, which remained intact until 1972. In July 1972, the Hong Kong dollar was pegged to the US dollar at HK$5.65 to US$1 and stayed tied to the US dollar until November 1974. Hong Kong, for practical purposes, followed gold standard rules during this fixed exchange rate period, where the domestic money supply was determined by the overall balance of payments situation. Between 1974 and October 1983 the Hong Kong dollar floated freely as a pure fiat currency. It no longer required full foreign backing for the note issue. Money could literally be printed at will, though the government maintained external reserves which it could use to support the currency. In October 1983, the government refixed the exchange rate at HK$7.80 to US$1, and reimposed full external backing for all newly issued currency. Uncertainty over Hong Kong's future in light of China's stated intention to recapture sovereignty in 1997 (see below) prompted a run on the Hong Kong dollar, which reached a low of HK$9.55 to US$1. Repegging the exchange rate quelled the monetary panic. During the 1960s, inflation averaged 2.4 percent annually; it rose sharply to an annual average of 12.9 percent during 1970-1981.

Under the floating rate regime, there were no effective monetary control devices available to the Hong Kong government to control the domestic money supply, other than prevailing on local banks to raise domestic interest rates. The liquid assets requirement introduced in 1964 was easily circumvented by accepting a deposit from a foreign bank and redepositing the funds in the same bank: the Hong Kong branch's deposit counted as a liquid asset while the deposit from abroad was not subject to the liquidity requirement. Proponents of greater monetary stability in Hong Kong forcefully advocated either that the Exchange Fund specify a monetary target or an exchange rate target.

Central banks often create money in the process of buying government debt. Since Hong Kong has no public debt to speak of, all inflationary pressure arises from private demand for money, which is often fueled during speculative binges in the property and stock markets.

Curiously, Hong Kong's period of strongest economic growth, the industrial world's highest average annual rate between 1975-1980, occurred during a period of monetary instability. This observation suggests that monetary stability is neither necessary nor sufficient for growth, so long as the economy is free to adjust its internal cost/price structure to trade profitably in world markets and enjoys business confidence! Through its floating rate regime, Hong Kong's competitive internal prices hád àdjusted to world pricos through appreciation or devaluation of its currency, rather than through an increase or reduction in the quantity of money, which, now in the presence of a restored fixed exchange rate regime, would spur or contract economic activity.

Reflecting the economy's internal freedom, Hong Kong is a completely free markot in money. No barriers restrict exchange between the Hong Kong dollar and other currencies. Indeed, the ever increasing funds that have been attracted to Hong Kong banks helped finance industrial development and have made Hong Kong a major financial center.

Government spending and employment are closely monitored to guarantee that the rate of growth of the public sector is not out of line with that of the private sector. This is to insure that the public sector, which has a natural tendency to grow over time, does not crowd out the private sector to the detriment of Hong Kong's external competitiveness. However, as the Hong Kong economy has prospered, its government has been unable to resist the pressure to increase public spending. It stood at 7 percent of GDP in 1950, ranged from 13 to 20 percent during the 1970s, and reached about 24 percent in the early 1980s. Much of this increased spending has been financed from sales of government land leases, not from borrowing or increases in direct or indireot taxes. Whether the current 24 percent ratio is a temporary response to the 1981-82 worldwide recession, or reflects a permanently larger public sector, remains to be seen.

How has the common worker fared under this economic system?[4] The evidence on postwar income distribution suggests that the 70 percent of the population in the third through the ninth deciles have gained the greatest share of the increase in total national income. Low-paid unskilled workers have benefitted most from the rapid increase in employment opportunities. The well-being of the poorest 20 percent has shown dramatic improvement: by 1976, their average household income reached US$1,300, which surpassed the poverty index of all Asian countries. Low income households pay little in income taxes. A family of four does not enter the income tax threshhold until it earns beyond US$11,000. Indeed, only 218,000 salaried taxpayers of a total population exceeding 5 million bore any income tax liability in the 1982 tax year. Moreover, 13,000 taxpayers, about 6 percent of the total number in the salaried tax net, contributed over half the total yields from the salaries tax, despite the low standard 15 percent rate.

From the end of World War II through July 1982, Hong Kong has enjoyed remarkable political and economic stability, which has fostered prosperity without much internal pressure for the welfare state or outside intervention. What has made this stability possible?

One answer is found in Hong Kong's unique political geography. Hong Kong's prosperity has served mainland China's developmental interests, largely through its earnings of foreign exchange doing business in and with Hong Kong. Entrepreneurs from Britain and other countries benefit from commerce in Hong Kong. Finally, the local residents, many refugees from China, have found personal freedom and an opportunity for economic improvement--life in Hong Kong has been materially good. Thus a tripod of consent--Britain, China, and the local people--has fostered this haven of economic freedom.

Second, the fact of economic resourcelessness necessitates a heavy dependence on external trade. This open economic structure restricts the range of productive economic intervention: the government can do little to alter the cost/price structure of exports or imports to the benefit of Hong Kong. This fact alone encourages a hands-off attitude by government toward the private sector, though other developing countries in similar circumstances have been less inclined to follow Hong Kong's policy.

In August 1982, Hong Kong's economy reacted sharply to an announcement in Beijing that China intended to reclaim sovereignty over Hong Kong by 1997, when the New Territories' lease is due to expire. Although the Chinese authorities promised that Hong Kong's free-wheeling economy would not be integrated into China's socialistic, state-directed system, the shattering of political confidence in Hong Kong's economic future sent the stock, property, and foreign exchange markets sharply downward. Asset values fell by up to one-third within a few months. Although Hong Kong remains attractive for short-term business activity, long-run investment has been put in serious jeopardy, thus severely damaging the long-run growth prospects of the economy. Investors lack confidence that Chinese authorities will preserve the free market eonomic system of Hong Kong after 1997, and have begun to transfer resources elsewhere.

To summarize, Hong Kong closely fits the textbook model of perfect competition in its maintenance of unregulated pricing and free entry. Its overall economic policies complement market competition. The low tax structure does not distort prices nor extract excessive resources from private hands. Subsidies are not granted to producers of internationally traded goods or services. Regulations are held to a minimum to avoid increasing costs. World commerce is conducted on a free trade basis to allow least-cost production. Unstable monetary policy has not severely retarded economic growth, though the loss in political confidence in the wake of China's stated intention to reclaim sovereignty in 1997 has forced the government to repeg the exchange rate to minimize price uncertainty. In short, the period from 1945 through 1982 vividly demonstrates the benefits to a population from adherence to a market model of development.

IV. Vignettes of Growth: Singapore, Taiwan, and South Korea

Hong Kong has enjoyed a truly remarkable record of rapid economic growth in the postwar era. But it does not stand alone among developing nations; its geographical cousins of Singapore, Taiwan, and South Korea have also racked up enviable economic track records. These four examples demonstrate that market economies, unencumbered by massive public sectors or heavy-handed government regulation of business, can rapidly uplift standards of living. Of course, political, economic, and social circumstances vary from case to case, but one can nonetheless discern a common strategy of economic growth.

What did Singapore, Taiwan, and South Korea have in common as they entered the postwar years? Each endured major wartime disruption, each lacked abundant natural and financial resources, and each was a poor country with a low standard of living. All three initially embarked on a program of import-substitution industrial development behind a protective wall of tariffs and quotas. All sought foreign aid. Growth under this initial strategy was at best moderate.

External circumstances prompted the leaders of all three countries to switch strategies from a policy of import-substitution for a limited domestic market to the development of labor-intensive, manufactured goods for export to world markets. International price competition replaced domestic subsidies and tariffs; private firms seized the initiative in deciding what to produce and where to sell. Government relaxed its grip on the economy and increasingly allowed the marketplace to determine the pattern and scope of economic development.

What ingredients go into a successful strategy of export-led economic growth?

1. The exchange rate system is reformed to make sure that a country's currency is correctly valued. An overvalued currency cheapens imports, makes exports more expensive, thus hampering the growth of exports, and invariably leads to a balance of payments crisis with its attendant problems.
2. Tax incentives are used to encourage foreign and domestic investment, including the establishment of special industrial estates or free trade zones that expedite the production of goods for export.
3. Governments often raise interest rates to encourage national savings and capital formation and discourage borrowing for consumption or less efficient uses.
4. Emphasis is placed on the private sector for the creation of jobs and the distribution of income and wealth.
5. Governments consciously try to hold down the size and growth of public spending, lest an expanding public sector crowd out private investment and spending. Government spending is directed at investment in infrastructure that facilitates industrialization, rather than on consumer subsidies. Public services are financed from revenue obtained from rapid economic growth, not from higher tax rates. Finally, utilities and government enterprises price their services rationally to reflect full opportunity costs.
6. Measures are taken to prevent an excessive rise in labor costs.

These three Pacific Basin economies have coupled high growth with no adverse effects on the distribution of income. It has not been necessary to choose between growth and distribution. Because Singapore seems in many respects a twin of Hong Kong, we shall begin our economic travelogue there.

A. Singapore

Singapore, "the Lion City," is an island, city-state economy, located virtually on the equator.[1] Three-fourths of its 2.4 million people are Chinese, the balance consisting chiefly of Malays and Indians. Its land area of 600 square kilometers is largely devoid of natural resources and its people must import the bulk of their food and raw materials to survive. Singapore's major assets are a strategic location on the trade routes connecting Europe and Japan, an excellent harbor that does not require periodic desilting, a diligent workforce, and an honest, efficient government inherited from British colonial days.[2] From a state of relative poverty in 1946, with a per capita income in the range of several hundred dollars, Singapore is now regarded as a member of the first world, with a per capita income of about US$5,000. Sustained growth over several decades has enriched its two-plus million citizens.

Founded in 1819 by Sir Stamford Raffles, an entrepreneurial employee of the East India Company, Singapore soon became a well-known port and marketplace in Southeast Asia as well as the center of British economic interests in the region.[3] Raffles grafted a policy of economic liberalism onto a strategic location. By making Singapore a free port, he broke the Dutch monopoly over trade in the region. Trade became the major economic activity and British influence grew over the entire Malay

Peninsula.

For the next century-and-a-half, the island's rulers steadfastly adhered to its founder's vision of making Singapore a great emporium resting on the Victorian doctrine of free trade. Successive colonial governors zealously nurtured the port, maintained a lean and efficient administration, and allowed merchants and bankers full scope for the exercise of their talents -- a nineteenth century laissez-faire approach to government. Taxes were held to a minimum and no harbor dues were levied as these could harm shipping and commerce. Indeed, the voluntary contributions of private citizens, not government taxes, financed the construction of the island's first lighthouse. It was government policy to avoid monopolies and encourage free competition to assure efficient business practices and low costs.

Politically, Singapore moved from a trading post under the control of the East India Company to become a British Crown Colony in 1867. It was integrated into a broader political unit known as the Straits Settlements, which encompassed the British possessions of Penang and Malacca. It developed close economic ties with the nine states of peninsular Malaya that were under British influence. It adopted a financial system which pegged the Singapore dollar to the pound sterling, in which the local banknote issues enjoyed 100 percent backing in sterling. Its steady growth as a trading center and as home to British regional interests was interrupted when Japan conquered and occupied the strategic port during World War II. The British returned in 1946, but Singapore had a new status as a separate crown colony, since Penang and Malacca were joined into a broader Federation of Malaya.

Political independence was inevitable and elections were first held in 1947. Singapore gradually moved to internal self-government in 1959 as Lee Kuan Yew, who became Singapore's first prime minister, and his People's Action Party (PAP) took control. The PAP attained full independence through a merger with Malaysia in 1963. However, this merger was shortlived. Singapore was expelled from Malaysia in 1965, when it became an independent, sovereign nation.

Apart from having to rehabilitate a war-ravaged economy, the immediate postwar years placed three major obstacles in Singapore's path to prosperity.[4] First, a communist insurgency in neighboring Malaya during 1948-1960 spilled over into urban Singapore in the form of labor union agitation. Labor unrest would complicate any plan to encourage industrialization. Political stability was a sine qua non of development. Second, as rising protectionism brought stagnation to entrepôt trade during the 1950s, rising unemployment threatened to become a serious domestic problem.

Third, shortly after independence in 1965, Britain announced plans to withdraw its armed forces stationed in Singapore at an accelerated pace. Since British military spending accounted for almost 20 percent of the gross national product and 6 percent of employment, accelerated withdrawal threatened to create both a severe recession and a defense vacuum.

Lee Kuan Yew and the PAP proposed a political union with Malaysia, which would provide a good-sized domestic market for an industrial strategy of import substitution. Expulsion from the union with Malaysia, on political grounds by the government in Kuala Lumpur in 1965, destroyed the import-substitution strategy, since after 1965

Singapore-based goods faced a tariff wall throughout the rest of Malaysia. Producing for a much smaller domestic market in Singapore alone could not generate enough new jobs. Factories which had been established with the hope of a larger market faced excess capacity. By the mid-1950s, the British had largely defeated the local communist insurgency in Malaya, thus restoring overall stability to the region. The PAP set about its task of creating jobs through a policy of industrialization, shifting from exclusive reliance on the entrepôt trade that historically had been the foundation of the economy.

Independent Singapore had inherited the free port and free-trade policies of its colonial past. Up to the end of the 1950s, when entrepôt trade was the mainstay of the economy, the only major import and excise taxes were on petroleum, liquor and tobacco, levied for revenue purposes. During the import substitution phase of industrialization from 1959 through 1967, tariffs and quotas were imposed to protect nascent industries.

To assist local entrepreneurs and to stimulate the development of import-substituting activities, the government adopted legislation in 1959 granting approved "pioneer industries" up to five years exemption from the 40 percent company profits tax, and generous depreciation allowances.[5] It temporarily abandoned the principles of free trade in favor of modest import tariffs and quotas. The government actively directed and participated in the economy. It created an Economic Development Board in 1961 to grant loans to approved companies and to take equity positions. The Board was also responsible for planning, construction, and operation of industrial estates.

External adversity provided a golden opportunity for Lee Kuan Yew and the PAP. The withdrawal of British military forces freed-up a large piece of land that the government converted into a major industrial estate, providing choice facilities to foreign investors. Deprivation of a common economic market with Malaysia forced a change in policy away from import substitution to manufacture for world markets. A candid internal assessment of the poor performance of highly protected "pioneer" industries, along with recognition that import protectionism was damaging the entrepôt trade and inhibiting the development of new exports, reinforced the reality of a shrinking domestic market. The government also got control of the labor movement with restrictive legislation on labor activists and union activity.

Although sudden expulsion from Malaysia in 1965 prompted Singapore's shift from import-substitution to export-led development, other countries have steadfastly held to an import-substitution strategy despite poor economic performance.[6] An external shock is not a sufficient condition for a radical change in developmental strategy. It also takes astute and determined political leadership.

Tax Incentives for Exports. After 1965, as a new, independent city-state with a sharply contracted domestic market, Singapore shifted quickly to the strategy of export-oriented industrialization. The government turned to already experienced foreign companies to invest and manufacture for export.[7] Adding to the "pioneer status" legislation, companies were given incentives to export. In 1965, they were permitted to deduct double the expenses of developing world markets from their taxable income. A 1967 act granted tax concessions on profits earned from exports. The consolidated Economic Incentives Act of 1967 remitted

90 percent of the profits tax if export performance was above a base level for eligible industries. Existing industries seeking to expand could obtain accelerated depreciation allowances and extension of "pioneer status," conferring 100 percent tax exemption for an additional period of 10 years. The government treated foreigners and foreign capital equally with the local citizenry. 100 percent foreign ownership of Singapore firms was allowed. Immigration of necessary business personnel was freely allowed. Remittance of profits was freely allowed. No controls were imposed on capital movements. In the 1980s, new incentives were granted to encourage research and development work in high technology industries, and the maximum personal income tax rate was lowered from 55 to 40 percent (similar to the company tax rate) to insure that Singaporeans did not view high tax rates as a serious disincentive to continued hard work.

To summarize, the Singapore government installed a raft of economic incentives to woo foreign investors. Tax holidays, "pioneer status," accelerated depreciation allowances, export incentives, unrestricted repatriation of capital and profits, relief from double taxation, readily available factory sites accompanied by many amenities, and subsidies for manpower training programs. Many of the tax incentives were appropriate devices to compensate exporters for the excess costs they previously endured due to the brief experiment with protectionism. One can construe the offsetting effects of these export incentives as moving the overall tax and fiscal system in the direction of greater neutrality. The response to these measures was overwhelming (see below).

Labor Regulation. A second target of economic policy was a peaceful labor movement. To secure this aim, in 1966, the PAP enacted legislation that prohibited strikes unless approved by a majority in secret ballot, required registration of all unions, and forbad non-citizens and criminals from working in union activities.[8] Further legislation in 1968 placed the promotion, transfer, recruitment, retrenchment, and assignments of tasks of workers within the sole prerogative of management--these subjects were held to be outside the scope of labor-management negotiations. The Act also encouraged collective agreements of three to five years duration. The results were nothing short of spectacular. In 1961, 116 strikes cost Singapore 410,000 lost man-days of work. The communist grip on labor unions was broken in 1964. After 1968, only seven strikes erupted in the next 3 years. Days lost to industrial unrest fell to 1,011 in 1977 and completely disappeared in 1978. Although these measures severely curtailed the freedom of organized labor, rapidly rising wages and greater choice of jobs during the 1970s muted any desire by most workers to support labor union agitators.

In effect the government has set up a system of wage non-bargaining. With acquiescent unions, wage levels are set annually by a decree on the recommendation of a tripartite National Wages Council (NWC) composed of employers, unions and government representatives. Wage awards to workers have routinely exceeded inflation, but have not priced Singapore goods out of world markets. To be sure, NWC wage awards have not tried to repeal the laws of supply and demand. The NWC has not been so much concerned with holding labor costs below market rates as it has been with preventing an organized labor movement from extracting excessive wage agreements from management. Too high labor costs would slow the processes of industrialization and job creation. Peace, stability, and not pricing Singapore goods out of world markets have been the goals of labor policy.

Public Finance. To begin with, it has been the policy of Singapore's government to concentrate on trade, rather than foreign aid. Nor has Singapore any foreign debt to speak of.[9] Of the government's total public debt, only one-tenth is external, which equals about four percent of GNP, low by international standards, and well below the government's external assets. Singapore has consciously financed its own public development expenditure--infrastructure, utilities, ports, housing--from tax receipts.

The consolidated public sector consists of the government, which spends 60 cents of each public dollar, seven statutory boards, which spend the other 40 cents, and the Monetary Authority of Singapore, which acts as the government's central bank and holds the country's financial reserves. The government's budget expenditures are divided into two categories: current spending and development spending. Approximately 60 cents of each government spending dollar goes for such current services as defense, justice, social and community services, economic services, and debt servicing payments, with 40 cents allocated to development projects. A portion of annual current spending consists of transfers to a Development Fund, which, in turn, loans some of its funds to the seven Statutory Boards. The most important of these are the Housing Development Board and the Jurong Town Corporation. The boards develop housing, which they rent or sell to the public, industrial sites, telecommunications, port facilities, and so on. The boards conduct their affairs in accord with sound commercial criteria, relying on user charges, rather than appropriations from general tax receipts.

Where does the revenue come from to finance Singapore's public spending? In 1981, for example, total government revenue, not counting the receipts of the statutory boards, or the earnings from Singapore's official external reserves, came to S$9.6 billion. Of this sum, direct taxes (largely income and property taxes) supplied 32 percent, indirect taxes about 15 percent, the sale of goods and services by government about 8 percent, and investment income and miscellaneous receipts provided 12 percent. The balance consisted of loan repayments to the development fund, drawing down of development fund stocks (which exceed S$8 billion) and contributions from a special payroll tax set up to finance retirement benefits.

By 1980, Singapore had accumulated an apparent domestic public debt exceeding S$13 billion, equal to about 62 percent of GNP. Annual debt service payments appear to consume 23 percent of recurrent government spending. However, the debt is largely a fictional construct of the government's bookkeeping structure. Indeed, Singapore's external assets exceed its public debt, which, on a consolidated basis, means the public sector is a net creditor.

Treasury securities are largely purchased through the mechanism of the Central Provident Fund (CPF). Established in 1955, the CPF is a compulsory savings scheme--a tax--to which most employed residents of Singapore and all employers are subject. An initial rate of 5 percent of payroll imposed both on employer and employee between 1955 and 1968 has risen, by 1980, to a combined payroll tax of 37 percent. This sum is withheld into the national pension fund. The fund, in turn, invests its receipts in Treasury securities, which are issued by and the proceeds subsequently held by the Monetary Authority of Singapore. The proceeds of these treasury debt sales are then funneled into development expenditures and loans to statutory boards; most is invested overseas. Conceptually, CPF funds can be treated as public sector assets, which are held by the Monetary Authority of Singapore. In effect, the CPF acts as an arm of the MAS, withdrawing liquidity (via the payroll tax) from the domestic economy. The proceeds of government securities, "borrowed" from the CPF, are initially deposited with the MAS, which converts these funds in the foreign exchange markets into gold, dollars, yen, deutschmarks, and other external assets, which appear as assets on the MAS balance sheet. The surplus position of the MAS, its assets exceeding liabilities, include CFP contributions, past budget surpluses, and interest earnings on its currency cover, which also consists of foreign assets. The total MAS surplus exceeds the total public debt of the government. The CPF is, in effect, a mechanism for national savings that the government can direct into infrastructure, public housing, and external assets.

Individual contributions to the fund are credited with annual interest, typically exceeding the inflation rate. Payments in the 1970s averaged about 6 percent. (MAS earnings on its invested reserves have usually exceeded this rate.) Individuals may use funds contributed to the CPF before retirement for the purpose of purchasing a flat in the new housing estates developed by the Housing Development Board. After age 55, funds may be withdrawn for retirement, but, due to stable prices, it has been customary for retired persons to subsequently deposit these withdrawals into the government-run Post Office Savings Bank (which also buys some Treasury debt offerings). The CPF and the Post Office Savings Bank are the chief devices by which domestic savings are mobilized and channelled to government to finance development expenditures.

In the distant future, as the Singapore population ages, contributions to the CPF may lag behind withdrawals. At that point, residents will begin to dissave unless tax rates increase or interest payments on CPF holdings of government securities are reduced. Singapore could then face a budgetary problem.

Economic growth has made the revenue picture so healthy that the government has been able in the 1980s to reduce marginal rates for individual income taxes and speed up depreciation for companies. High growth has meant greater tax receipts, increased public consumption and investment, and rising after-tax income. Contributing to sustained growth is the conscious determination of government to control the growth rate of public spending to insure that the private sector is not crowded out. Since independence, public spending has remained in a narrow range, usually below 25 percent, despite a sharp increase in defense spending following the withdrawal of British forces.

<u>The Monetary System</u>. Technically speaking, Singapore maintains a floating-rate exchange regime, in which the value of the Singapore dollar is largely linked to the value of the currencies of its two main trading partners, the United States and Japan. Responsibility for the domestic Singapore dollar banknote issue resides in the Board of Commissioners of Currency, which maintains full external backing for its

note issue in the form of gold, dollars, sterling, and other foreign assets. Until the Singapore dollar was floated in 1973, the Currency Board's activities were automatic: it simply bought and sold unlimited quantities of domestic currency at the fixed exchange rate. Since 1973, Singapore has pursued an independent monetary policy. Approximately half of the Singapore money supply consists of banknotes and half of demand deposits with local banks. The Monetary Authority of Singapore (MAS), established in January 1971, serves as the central bank, save responsibililty for the note issue, and is responsible for the regulation of banking.

Over time, Singapore's money supply is largely determined by the state of the balance of payments.[10] Exports of goods and services, earnings from other items for shipping, insurance and services, and capital inflows (including government borrowing abroad) generate foreign-exchange accumulations by the banks. These can be converted into Singapore dollars at the Currency Board, thereby augmenting the currency in circulation and increasing demand deposits through multiple credit expansion. Conversely, imports of goods and services, payments abroad for invisibles, and capital outflows (including government investing abroad) require the banks to make foreign exchange payments abroad, which tends to reduce currency in circulation and contracts demand deposits. However, as Singapore's balance of payments has been persistently in surplus, the net effect on the money supply has been expansionary, which reflects the growth of Singapore's export-oriented economy, and its role as a financial haven for wealthy residents in less stable neighboring countries.

The government can vary the size and rate of change of the money supply by remitting the proceeds of its large foreign assets or by borrowing abroad. In so doing, it produces a net inflow of foreign exchange, and correspondingly the volume of local currency in circulation, to the extent that these funds are deposited with the commercial banks. It can also pressure local banks to repatriate capital invested abroad. Conversely, to dampen an inflationary upsurge, it can contract the supply of money by investing official funds abroad (removing them from the local banks), or require that a fraction of the net inflow of private funds be deposited by the banks at the MAS. The MAS can also reduce or increase the cash-reserve requirement of the commercial banks and finance companies, thereby raising or lowering their capacity to lend and create demand deposits.

Overrapid monetary expansion in the United States and Great Britain in the late 1960s and early 1970s prompted Singapore to switch from an exchange-rate system pegged to the U.S. dollar to a floating-rate system in June 1973 to avoid importing inflation. Since that time, balance of payments surpluses caused the Singapore dollar to appreciate from a value of US$1.00 = S$3.00 to a current value of S$2.12 to one U.S. dollar. The Monetary Authority of Singapore has used its assets in pursuit of stable prices with the result that Singapore, perhaps of any market economy in the world, best held inflation in check throughout the 1970s. So long as Singapore maintains full external backing of its currency (in which, incidentally, its gold reserves are only officially valued at US$42 per ounce), it is likely to maintain a stable price level for the foreseeable future. It is current policy to allow the domestic money supply to grow in keeping with the growth of surpluses in the balance of payments. One can think of Singapore's money supply as similar to a gold-standard, balance of payments monetary system, with the exception that its huge control over foreign assets allows the government to manage the exchange rate to maintain a stable domestic price level, while remaining mindful that an appreciating local dollar does not damage the competitiveness of Singapore exports. It has done so in a consistently successful manner.

Economic Performance. The bottom line test of any poor country is the annual rate of economic growth.[11] In Singapore, real growth averaged about 9.3 percent between 1960 and 1980. Throughout this period of high growth, prices remained remarkably stable: the Consumer Price Index rose a scant 1.2 percent per year during the 1960s and, by worldwide standards, a modest 5.6 percent per year during the 1970s. As a result, real wages and purchasing power grew rapidly. A 1960 per capita income of S$1,329 became, in 1980, S$9,293 (and the Singapore dollar appreciated by 27 percent against the U.S. dollar over this period).

Economic growth can be ascribed to rapid increases in capital formation. Gross domestic fixed capital formation grew from 10 percent of GNP in 1960 to an astonishing level of 40 percent by 1980, a fourfold increase in the share of national income devoted to investment. Small wonder that the index of industrial production rose 12 percent each year during the 1970s. Although the rise in capital spending has been accompanied by a corrresponding shift downward in consumption spending as a share of GNP, the absolute level of real consumption rose three-to-four-fold between 1960 and 1980. The reason is that high growth rates provide the means both for greater investment and consumption. In turn, rising investment reinforces strong growth. Too, public sector spending has focussed on infrastructure, port and site development, and utilities, thus providing an attractive framework within which industrial development could take place.

Foreign investment played the major role in the export-led strategy for industrialization and growth. Foreign investment, led largely by American investors, rose at the absolutely phenomenal annual rate of 50 percent from 1967 to 1972. It grew from S$157 million in 1965 to S$3,380 million in 1975. The number of foreign-controlled manufacturing companies rose from 83 in 1959 to 383 in 1973, with an increase in their paid-up capital from S$56 million to S$1,225 million, triple that of domestic controlled firms. In the decade encompassing 1966-1975, value added in manufacturing rose from S$145 million to S$3,411 million, or by eight times. Domestically produced goods rose from 6 percent of total exports in 1960 to exceed half by 1972. Unlike Hong Kong, the development of manufacturing industry for export in Singapore has occurred predominantly in the subsidiaries of foreign companies.

The export-growth strategy of industrialization met its jobs targets. A potentially disastrous unemployment situation in the 1950s gave way to full employment in the 1970s. This result is all the more remarkable in that population grew from 1.6 million in 1960 to just under 2.4 million in 1980, an increase of about 50 percent. However, the number employed more than doubled, from 448,600 to exceed 1,068,900. Jobs were created so fast that Singapore encountered a labor shortage as it entered the 1980s.

The statistics on trade are staggering. Total imports and exports came to about S$7.5 billion in 1960; by 1980, the corresponding total surpassed S$92 billion. During the 1970s alone, trade rose at an annual rate of 20 percent from about S$12 billion to S$92 billion. Total trade is about four to five times the national income.

The tourist industry has grown by leaps and bounds from an annual number of 90,000 visitors in 1960 to surpass 2 million in 1980--almost as large as the Singapore population itself.

<u>The Future</u>. Success has confronted the government of Singapore with new, but certainly pleasant, problems. Continued political stability make Singapore's free enterprise economic system so attractive to investors that an earlier unemployment problem has given way to a labor shortage. Also, an increasing share of the work force has entered the personal income tax net. Singapore's leaders have thus modified their policies in taxation and the determination of wages.

First, taxes. Although tax incentives have been a prime vehicle for stimulating overseas investment and manufacturing for export, the PAP has adhered to a fairly steeply graduated rate structure for the island's personal income taxes, ranging up to 55 percent on income exceeding S$600,000. Fearing that high taxes could become a disincentive to hard work, the government announced in 1979 its policy to reduce gradually the levels of personal income tax rates in the following three years to a top marginal rate of 40 percent--the same as the company tax rate.

To facilitate business, depreciation rates of plants and machinery were accelerated. Elaborate tax incentives were also given to promote research and development activities in pursuit of making Singapore a high technology, highly skilled labor force economy. To stimulate the growth of the financial sector, stamp duties on certain financial instruments were abolished, and a 10 percent concessionary tax rate was granted to offshore gold transactions.

Turning to wages, recall that the Singapore government exercises an effective control over basic wage rates. Throughout the 1970s, the National Wages Council set annual wage increases at about 6 percent. In 1979, as part of a conscious policy to make the use of labor more efficient (given a labor shortage and stringent immigration controls), the government raised the average wage of a semi-skilled worker by 18 percent. However, the ministry of labor stipulated that wage increases must be related to productivity: employees whose work performance or attitude is unsatisfactory should NOT be paid the NWC wage adjustment. The government no longer wants to attract immigrants from Indonesia and Malaysia, who seek low-skilled, low-wage employment. Thus firms are being told that investment should seek highly skilled, expensive labor, as Singapore's leaders consciously try to upgrade to a higher technology economic base.

In addition to the employer contribution to the state pension scheme, there is now a compulsory training levy on employers taking 2 percent of payroll. This Skills Development Fund is used to subsidize the training of workers and subsidize interest payments on the purchase of new machinery and equipment required to increase labor productivity.

B. Taiwan

Taiwan, known diplomatically as the Republic of China, is provincial home to 18 million people of Chinese background.[12] It has a checkered history. Its most popular name, Formosa, comes from its period of encounter with Portuguese traders, who named it "Beautiful

Island." Although long settled by a small number of Chinese immigrants from the mainland, it was not incorporated into the united Chinese empire until late in the Ming Dynasty, in the sixteenth century. It fell under foreign domination with Japanese occupation in 1895, but was returned to China in 1945 at the conclusion of World War II. The civil war between Nationalist and Communist forces for control of China between 1946 and 1949 brought increased attention to Taiwan. Facing certain defeat, the Nationalist government and armies fled to Taiwan in 1948, where they set up a "temporary" provisional government. They also imposed authoritarian political rule over the native Taiwanese population. For the first decade or so of its island incarnation, the Nationalist government concentrated its planning for a triumphant return to the mainland.

By 1980, mainlanders had diminished to a bare 15 percent of the population of Taiwan. Talk of recovering the mainland had been idle rhetoric for the last two decades. In place of past military and political dreams, the leaders of Taiwan have focussed their energies into turning the island of Taiwan into a rich, prosperous economy. Adopting a strategy of capitalist development with some state assistance, the economy of Taiwan had grown so rapidly that a prosperous people of Taiwan stand in marked contrast to an economically less well off one billion Chinese across the straits of Formosa. With a per capita income of almost $2,500 in 1981, Taiwan is among the world's top 20 exporters, and its people enjoy a standard of living manyfold that of their compatriots in neighboring People's Republic of China.

As mainland China has established diplomatic ties with more nations, Taiwan has become politically isolated. Still, despite diplomatic adversity, its externally-oriented economy grew at about 10 percent a year throughout the 1970s. As other nations have warmed up to mainland China's communist government, Taiwan had demonstrated that reliance on market forces brings greater economic rewards compared to the listlessness and inefficiency of state-directed and state controlled economic life in mainland China. Taiwan's economic ties with other nations have thrived despite the shock of America's withdrawal of diplomatic recognition in 1979.

Political power in Taiwan is shared between the Kuomintang Party, the armed forces, and the president, Chiang Ching-kuo, son of Generalissimo Chiang Kai-shek, Nationalist China's leader for nearly four decades. Although locally-born Taiwanese have taken over more and more middle-level and top positions, the remnants of the original mainlanders who fled China in 1948 are still clearly in charge. Taiwan maintains a formal written constitution, with a division of powers among the executive, legislative and judicial branches of government, and elections are held for members of the legislature and local government offices. But this constitutional facade should not mask the reality in which the Kuomintang maintains a firm grip on political life. There is no serious or effective opposition to the Kuomintang.

The government has become something of a gerontocracy. Both the parliament and the separate national assembly, whose job it is to choose the president, were elected in 1948 before the Nationalists left the mainland. Of the 760 members of parliament originally elected, fewer than 300 remain and all but a handful are over 70. The national assembly's ranks, almost 2,700 when elected in 1947, have thinned to about 1,000. Reflecting a growing political liberalization, one quarter of the members of parliament (who now number some 400) have been elected from the Taiwan provincial population; the remaining 300, shrinking each day, still "represent" all the other provinces and regions of the mainland. The key lesson to be drawn from this brief exposition of Taiwan's government is that persistent political stability has allowed officials to take a long-run view of the economy and adopt economic, fiscal, and other policies conducive to rapid economic growth.

Resources. The province of Taiwan is made up of one large semi-tropical island and a few adjacent small islands, which have virtually no development potential, comprising a total land area of about 36,000 square kilometers.[13] One-fourth of the land area is arable; the rest mainly mountainous. Its climate consists of a long, wet summer, with a short, mild winter. Like Hong Kong, it suffers the threat of violent typhoons and torrential rains in late summer. However, its overall favorable climate permits multiple-cropping and year-round farming.

Taiwan is poorly endowed with mineral resources. Its main reserves are inferior quality coal, exceptionally high quality marble, natural gas, and few other minerals. Taiwan must therefore largely import the bulk of its raw materials for industry.

During their occupation between 1895 and 1940, the Japanese developed the power industry, built a network of railways and highways, and improved the economic infrastructure for their own economic goals. However, much of this was destroyed by allied bombing and the lack of maintenance during World War II. The repatriation of Japanese personnel at the end of the war reduced the number of skilled and managerial personnel on the island, severely retarding industrial rehabilitation efforts. Taiwan's economy faced an uphill climb.

Land Reform. The first major economic policy was a comprehensive land-reform program designed to augment agricultural output and secure the Nationalists' political base in the countryside.[14] The Nationalists had failed utterly on the mainland in coping with landlords in their limited efforts at land reform, thus abetting the Communist advances in rural areas. They would not fail twice.

Beginning in 1948, the government began to sell some public land to tenant farmers. The next step was the compulsory sale of land by landlords. Privately-owned land in excess of specified amounts per landower had to be sold to the government, which would, in turn, resell that land to tenants. The purchase price was set at 2.5 times the annual yield of the main crops. Landlords were paid 70 percent of the purchase price in land bonds denominated in kind, and 30 percent in industrial stock of four public enterprises previously owned by the Japanese. Between May and December of 1953, tenant households acquired 244,000 hectares of farmland, 16.4 percent of the total area cultivated in Taiwan during 1951-55.

The distribution of landholdings changed dramatically between 1952 and 1960. Families owning their own plots of land rose sharply, and the proportion of land cultivated by tenants fell from 44 percent in 1948 to 17 percent in 1959. The ratio of owner-cultivators to total farm families increased from 36 percent in 1949 to 60 perent in 1957. By 1957, part-owner families and owner cultivators owned more than 83 percent of total farm land.

Private ownership of land fostered more efficient farming practices, since families now owned the full proceeds of their production. Agricultural output rose sharply. Land was worked more intensively.

Responding to market forces, farmers grew less of low-valued rice and increased their production of more profitable crops, such as vegetables, fruits, livestock, and poultry.

In Taiwan, market forces largely set agricultural prices, letting farmers reap the benefits of their rising output. The government did not set up an "agricultural development board" to procure agricultural products at below market prices, a policy that other poor countries have employed to tax their rural sectors, which invariably depresses output and rural living standards.

Industrialization. The Korean War strengthened military ties between the United States and the government in Taiwan. Billions of dollars in foreign economic and military aid poured into the island. During the 1950s, U.S. aid financed approximately 40 percent of Taiwan's import bill. This huge volume of foreign aid allowed the financial authorities to grossly overvalue Taiwan's currency, which subsidized domestic consumers who could purchase imports at less than half of world prices. Each New Taiwan Dollar (NT$) bought more U.S. dollars, and thus commanded greater international purchasing power, as a result of overvaluation. Behind this shield of foreign aid, Taiwan embarked on an inwardly looking import-substitution policy of industrialization. The intent was to develop industries that produce for the local market, protected behind a shield of tariffs and quotas. The overvalued exchange rate meant that domestic manufactured goods were not price-competitive in overseas markets, since production costs denominated in NT$ translated into higher US$ trading prices.

All seemingly good things must come to an end. In retrospect, the 1960s and 1970s demonstrated that massive foreign assistance may have hampered, not helped, Taiwan's economic growth. When the United States government in the late 1950s anounced plans to phase out its massive economic assistance, the government of Taiwan placed greater emphasis on export promotion. To increase exports would require massive infusions of private foreign capital and technology. To earn foreign exchange, trade, not aid, would have to become the watchword of developmental policy.[15]

From 1958, the government moved convincingly in a new direction.[16] It promulgated a Program for Improvement of Foreign Exchange and Trade Control. An initial exchange rate of NT$5 to US$1, which had led to a complex multiple exchange-rate system and repeated devaluations, was replaced by an official uniform exchange rate, reflecting market supply and demand, which stabilized at NT$40 to US$1 by August 1958. This simplification eliminated advance deposit requirements and other strict import and foreign exchange controls; administrative costs were also sharply reduced. As a result, the real effective exchange rate for exports remained stable during the 1960s and 1970s, which led to accelerated export expansion. The reason is that a correct exchange rate links internal prices (based on efficient, least-cost production) to world markets on a competitive basis. To compensate for distortions imposed on exporters, which had characterized the prior import substitution regime, the government undertook a number of concrete steps. It gradually liberalized and finally abolished the commodity import quota system. Tariffs were reduced. Import controls were liberalized. It granted three-year income tax exemptions to certain categories of industries to stimulate investment. It revised the Income Tax Law and the Company Law. It began to relax controls over the establishment of factories. It considered setting up a stock market to foster local equity participation in the economy. It instructed the Bank of Taiwan to raise interest rates to encourage private saving. These steps were a modest precursor to massive new changes in law, which took effect in 1960 with the promulgation of the Statute for the Encouragement of Investment.

Key elements in the 1960 financial reform package granted those export-oriented productive enterprises, which met the statute's criteria, a five-year income tax holiday, set the maximum rate of profits tax (including surtax) at 18 percent, compared with the ordinary 32.5 percent rate, allowed all reinvested undistributed profits to remain free of tax, gave a tax deduction for exports equal to 2 percent of annual export proceeds, exempted or reduced productive enterprises from stamp taxes, and permitted 7 percent of profits before taxation to be set aside as a reserve against losses due to exchange rate revisions. Annual tax refunds due to these new incentives, as a percentage of total income, stamp, customs, and commodity taxes, ranged from a low of 19 percent in 1963 to a high of 52.4 percent in 1972, with the annual average in the 30-percent range. Taiwan's remarkable economic growth, in part, is directly linked to these sharp reductions in tax rates.

Adding more of a good thing, the government revised and expanded the scope of the investment statute in 1965, authorizing the creation of duty-free export processing zones. Developmental strategy had now become wholly export oriented. Three zones grew so fast that by 1970 they provided 7 percent of all jobs in manufacturing and turned out a tenth of all exports. In some years, the entire balance of merchandise trade surplus could be traced wholly to the trade balance within the zones. A necessary accompaniment to an export strategy was the steady reduction in the rate of protection provided by tariffs throughout the 1960s and

1970s.

A summary of Taiwan's export incentives includes reimbursement of customs duties and harbor dues imposed on imported contents of export products, refund of the commodity tax on products for export, extension of foreign exchange loans for the import of raw materials for export processing, extension of low-interest export loans, exemption of income tax and business tax on export transactions, cash bonuses for exports, establishment of bonded warehouses, and export processing zones. A $100 million trade deficit that had largely been financed by U.S. aid was thereafter more than offset from increased export earnings.

Other Reforms. Tax concessions for exports, to neutralize the prior bias of the import-substitution period, is only one part of Taiwan's growth strategy. Other dimensions include incentives to mobilize domestic savings, control inflation, and produce domestic goods on an efficient basis. Overall, the government has adopted sound fiscal and monetary policies. It was first necessary to establish and maintain exchange rates that would not overvalue the Taiwan dollar, since an overvalued currency would discourage exports and encourage imports. Between 1954 and 1960, the government therefore carried out four successive devaluations which adjusted an exchange rate of NT$15.55 to US$1 to a more realistic rate of NT$40 to US$1. It remained in place until 1973, when the Taiwan currency was revalued upward to a rate of NT$38 to one U.S. dollar, a compromise between the revalued Japanese Yen and the devalued U.S. dollar, the currencies of Taiwan's two major trading partners.

The effect of a correctly valued Taiwan dollar means that commodities and equipment imported into Taiwan were sold to end users at realistic, rather than subsidized, prices, thus minimizing waste and inefficiency. Most important, a devalued Taiwan dollar enhanced the competitiveness of Taiwan goods on world markets. Exports correspondingly rose at fantastic rates.

Since 1960, Taiwan has maintained a gold standard rule, balance of payments, fixed exchange-rate monetary system, coupled with such discretionary monetary policy measures as changes in reserve requirements, and raising deposit rates of interest. The currency enjoys one hundred percent external backing in such forms as gold, foreign currencies, and other financial instruments. Taiwan's exchange rate remained virtually constant during the 1960s as the government ran substantial budget surpluses; public borrowing from the banking system declined from 45 percent of domestic credit in 1962 to 9 percent in 1970. During the 1960s, inflation averaged 3.4 percent. From time to time during the 1970s, huge balance of payments surpluses brought domestic monetary expansion and inflation as external balances were converted into local currency. On one occasion, Taiwan authorities lifted restrictions on luxury imports to produce a trade deficit, and a concomitant monetary deceleration. An upward revaluation from NT$40 to NT$38 in 1972 was followed by another shift to NT$36 in 1978. In 1979 a foreign exchange market was established which allowed a daily float. Domestic inflation in the late 1970s brought a devaluation to NT$38.

The government has set all institutional interest rates in Taiwan throughout the period 1960-1981. Taiwan's financial system is dominated by government-owned banks, which often behave like a department of the Ministry of Finance. Only since the late 1970s have the commercial banks been allowed to vary their interest rates within a range set by the government. Thus the government could exercise a direct lever on the supply and demand of domestic credit by its interest rate policy. To encourage savings, and to insure that credit would only be used by more efficient borrowers, the government raised the interest rate on savings deposits in the Bank of Taiwan and other banks. This pulled more savings into the banking system, and while it meant higher charges on bank loans, it also insured that only efficient firms would have a call on the nation's scarce savings. Bank rates on secured loans rose as high as 23.4 percent in 1954 and, as the supply of savings increased, fell gradually in steps to 11.3 percent in 1972. Private and government consumption fell as an increasing share of national output was channeled into capital formation. Gross saving as a percentage of GNP increased from less than 10 percent during the 1950s to surpass 20 percent during the 1960s. To encourage saving, earnings from savings accounts were granted income tax exemption.

Fiscal policy has placed no strain on the island's central bankers. Overall policy is, taking one year with another, to maintain a balanced budget. The experience of the Nationalist government during its mainland rule of the late 1940s with rampant inflation, one of the five worst in world history, which also contributed to their downfall, insured that inflationary issue of banknotes would be forsaken as a method of financing government spending on Taiwan. Despite major tax cuts in 1960, deficits in the four fiscal years through 1964 were quickly transformed into a string of steady, uninterrupted budget surpluses, which reached a high of 25 percent of annual spending in 1974.[17] Low taxes have stimulated high rates of economic growth which, in turn, have raised more than sufficient revenue to sustain sharply rising levels of government spending on both defense and social programs, sharply reducing the government's borrowing needs.

In 1974, the Minister of Finance, K.T. Li, noted that "placing too much emphasis on increasing tax revenue is detrimental to economic development, and without economic development there can be little increase in national income. Only when national income is on the rise can the people afford to pay more taxes."[18] A conservative budgetary policy, predicated on low taxes, has eliminated inflationary pressures and promoted a regime of stable prices. With the money supply largely determined by the balance of payments, and a market determined exchange rate, Taiwan has enjoyed rapid growth and relatively stable prices.

Results. Export expansion fueled economic growth and created millions of new jobs. Even as higher productivity reduced the need for labor, sharply rising exports during the three periods 1961-66, 1966-71, and 1971-76 generated net increases in employment of 377,000, 1,015,000, and 925,000. Rapid expansion of exports created jobs fast enough to allow the economy to reach full employment by 1971, and maintain that status throughout the 1970s. Export growth made it possible to maintain full employment despite steadily rising productivity and continuous migration from agricultural areas into the cities.

At the end of World War II, per capita income in Taiwan was a low, low US$70. It rose so rapidly that it reached US$2,280 in 1980.[19] Until the 1960s, population also grew at the high rate of 3.5 percent, but has since levelled off at about 2 percent. Real gross national product has grown at the astounding annual average rate of 9.2 percent over the past three decades: 8.2 percent in the 1950s, 9.4 percent in the 1960s, and 9.9 percent in the 1970s. Real GNP has doubled every seven years since 1963. By 1980, real GNP was eleven times that of 1952. The whole country was literally transformed from poor to middle-income in just one generation.

The structure of the economy changed to reflect the prominent role of manufacturing for export. Employment in agriculture decreased from 51.4 percent of total employment in 1952 to less than 30 percent in 1979, while employment in the industrial sector increased from 20.4 percent to 41.8 percent during the same period.

The labor force was successfully absorbed during the 1960s. The unemployment rate fell from a worrisome 6.5 percent in 1952 to 1.2 percent in 1979. The annual growth rate of manufacturing real wages reflected this process of labor absorption, rising by 2.7 percent in the 1950s, 6.2 percent in the 1960s and 10.7 percent in the 1970s. Increased use of unskilled labor during the 1966-71 period seems to have caused the wage rate for unskilled labor to rise more rapidly than that for skilled labor. The poorest paid members of the work force derived the greatest benefits from the export-led industrialization of Taiwan.

The various savings reforms worked their wonders too. The average ratio of net domestic savings to national income from 1951 through 1959 was only 5 percent and from 1960 to 1962, 8 percent. The savings ratio jumped to 13 percent and more after 1963. Since 1967, the savings ratio has exceeded 20 percent of national income; in the 1970s it was around 30 percent.

Almost half of all investment before 1962 was financed by U.S. aid. Almost no private foreign capital flowed into Taiwan before 1961, but this changed dramatically after 1964. Private foreign investments from 1962-69 came to US$378 million. Foreign investment was about US$150 million every year in the 1970s, increased to US$330 million in 1979, and US$466 million in 1980. Private foreign investment contributed significantly to Taiwan's prosperous transformation. In 1976, exports by private foreign and overseas Chinese firms amounted to US$2.2 billion, or 29 percent of Taiwan's total exports, reaching 82 percent of exported electronics and electrical products.

In the mid-1970s, the government of Taiwan embarked on a series of major development projects that entailed substantial government involvement in the economy. Ten basic construction projects were announced that encompassed a national freeway, railway electrification, a new railway line along the east coast, a new modern international airport, a nuclear power plant, and two harbor projects--these all fall within infrastructure development. However, the projects also included a giant shipyard, a steel mill, and a petrochemical complex, in a state-directed effort to develop heavy industry to accompany Taiwan's dependence on light industry. These latter three have not been profitable ventures and there are no current plans to embark on a new series of major projects once these are completed. While these projects are massive, they do not presage a substantially greater role for government in the future evolution of the economy.

Scholars worry a great deal about the effects of rapid economic growth on the distribution of national income. Rapid growth is all fine and well, they say, if it does not produce marked gaps between rich and poor that foster unrest and political instability. The experience of Taiwan confounds these critics, because Taiwan is now regarded, after three decades of very rapid growth, including strong performance in the reformed rural sector, as a low inequality country. The poorest quintiles of the population enjoyed increases in real household income more rapidly than the richest, thus narrowing the gap between rich and poor.[20] Illiteracy has given way to near universal literacy. Life expectancy is on a par with Western societies. Ownership of cars, homes, telephones, and refrigerators, to name a few durables, is more reflective of Western standards of living than of Asian. Taiwan is prosperous en mass. All this in just three decades, on a relatively resourceless island, that must commit a large portion of its annual budget to defense spending.

C. Korea

South Korea (hereafter Korea) differs from Singapore and Taiwan in several respects. It is a peninsula, not an island. It is populated by Koreans, not Chinese. Its climate is temperate, not tropical or semi-tropical.

To even the most casual observer, Korea resembles Singapore and Taiwan in many other respects. It suffered the ravages of war in the early 1950s, which literally decimated the country. It survived on foreign aid in the first few years of its postwar rehabilitation. It had to cope with precipitous withdrawal of U.S. economic assistance in the early 1960s. It is a relatively resourceless country, which must import the bulk of its raw materials for industry. It has leaped from the status of impoverished to middle-income nation in the short span of two decades. It has enjoyed a good measure of political stability. Export expansion was its primary engine of economic growth. Private sector enterprises have led the way in investment and job creation, though the government has played a leading part in setting interest rates and allocating credit.

Resources. Korea is a small and densely populated country of 37 million people.[21] Its total land area of 99,000 square kilometers, just over triple that of Taiwan, is largely mountainous. Only 23 percent of its land is cultivated. 67 percent is forested mountain slopes, and the cities, industrial facilities and roads are concentrated into a small 10 percent. The rugged topography and harsh winters limit the productive potential of agriculture. Mineral resources are also limited, largely confined to poor quality coal. Korea's population density of 363 persons per square kilometer of land is among the world's highest. However, population pressures have abated substantially in the postwar era, falling from 3 percent annual growth in 1961 to 1.7 percent by the mid-1970s.

Political and Economic Background Before 1960. Japanese success in the Russo-Japanese War (1904-05) led to its military occupation of Korea in 1905 and outright annexation in 1910.[22] During thirty-five years of rule, the Japanese brought capital, new agricultural practices, and developed the foundations of an industrial base, bringing Korea into the modern economic world.

Korea was liberated from Japanese occupation at the end of World War II, but was immediately partitioned along the 38th parallel between South Korea and North Korea. The South had a majority of the population, its most productive agricultural land, and the bulk of light industry; most of the heavy industry and more than 90 percent of the electricity-generating capacity were in the north. What industrial facilities the south inherited were largely destroyed during the Korean War of 1950-1953. Thus South Korea's economic development had to overcome three obstacles in the first decade of its modern independence: withdrawal of skilled Japanese managerial personnel, partition, and wartime devastation.

Massive United States and United Nations assistance was required to rehabilitate its war-ravaged economy. Virtually the entire of the country had suffered extensive destruction. Three-fifths of the cultivated land had been laid to waste, property damage exceeded $3 billion, most industrial facilities had been demolished, the death toll was estimated at over 3 million (both sides included), and approximately one-quarter of the population roamed the countryside as refugees. Ten million people were homeless and five million survived purely on relief. Reconstruction began immediately with foreign grants. Although inflation quickly subsided, the economy registered only modest gains. During its period of dependence on aid, which totalled $2.3 billion, investment was inadequate, exports grew slowly, and output increased at much too low a rate to bring about full employment and rising real wages. Growth averaged 5.5 percent from 1954 to 1958, but fell to an annual average of 3.6 percent between 1959 and 1962.

Behind a shield of foreign aid, Korea erected barriers of tariffs and quotas in pursuit of an import-substitution industrial policy. By now, we should not be surprised that Korea initially chose an import-substitution strategy, achieved only modest gains from it, and abandoned it in the early 1960s in favor of an export-expansion policy.

The regime of Syngman Rhee held sway all through the 1950s, but its increasing autocratic rule culminated in a student revolt of 1960 which toppled the government. Rhee resigned in April 26, 1960, and elections were held the following July. Factional struggles and political turmoil after the election paved the way for a military takeover in 1961. Its leader, General Park Chung Hee, firmly ruled without interruption until his assassination in October 1979, thus providing 18 years of political stability within which Korea dashed for development on a pace that rivalled Hong Kong, Singapore, and Taiwan. When the political and economic dust had settled in 1962, Korea was a very poor country with a per capita income of US$87, total economic output just $2.3 billion and a high population growth rate of 2.9 percent. The prognosis for growth was not good.

Korea, too, underwent a land reform program, but it was largely completed more than a decade before rapid economic growth began and contributed little to it.[23] Japanese occupation had imposed an oppressive land tenure system on Korea, which passage of a Land Reform Act in June 1949 began to remedy. The proportion of the rural population owning land rose from 16.5 to 71.2 percent between 1947 and 1974, reflecting greater equitability.

However, private ownership of land did not bring dramatic gains in output and rural incomes because the government sustained a policy of grain pricing and procurement that did not reflect market forces. Rhee's government and Park's first decade subsidized urban consumers at the expense of rural producers. Not until the 1971 election revealed that Park was losing support in rural areas did the government substantially increase producer prices. It had been able to suppress prices because PL 480 grain imports alleviated grain deficits, simultaneously generating local currency with which to help win the government. When the United

States changed PL 480 commodities into dollar repayable loans by 1971, grain imports became a drain on foreign exchange. During the 1970s, the government improved rural incentives, sharply increasing grain prices to stimulate increased yields and improve rural incomes.

In retrospect, the PL 480 foreign aid program was a critical deterrent to reform of national grain pricing policies, allowing the Korean government to hold down grain procurement prices. U.S. withdrawal of soft PL 480 commodity loans forced the Korean government to increase grain prices to encourage greater output, in the process raising rural incomes. Land reform, begun in 1949, did not bring full benefit to rural dwellers until pricing policies were reformed in the 1970s.

The reduction of foreign aid in the 1960s was a blessing in disguise. It prompted the new Korean leadership to adopt growth-oriented, outward-looking policies. The key to growth would be an emphasis on rapid expansion of exports. This decision brought changes in the areas of taxation, new incentives for exporters, and modifications in interest rate policy and, especially, the exchange rate. Dividends were immediate and massive: Korean exports averaged over 30 percent in annual growth from the early 1960s through the late 1970s, predominantly in the form of labor-intensive manufactured goods, in which Korea enjoyed comparative advantage in low-cost labor. In 1960, industry supplied 20 percent of national income; in 1980, the share had more than doubled to 42 percent. Agriculture's share fell from 38 to 16 percent over the same period. Thus the economy was literally transformed in two decades.

Economic, Fiscal, and Monetary Reforms. As U.S. aid was scheduled to be cut off, the government reformed the exchange rate of its currency.[24] Since imports in the 1950s had been largely financed from aid, not trade, it had not been necessary to adopt a realistic exchange rate. An overvalued Korean currency, the won, subsidized domestic consumers of imports, but retarded the growth of exports. In 1960, for example, more than half of Korea's foreign exchange receipts were earned on government transactions, of which military procurement was the single largest item. Korean officials found they could get more dollars per soldier in uniform, whose costs were stated in Korean Won, if they kept the official won exchange rate overvalued against the dollar. This method of absorbing foreign aid was devastating for the development of commercial exports. (By 1975, after exchange rate reform, government transactions produced less than 3 percent of foreign exchange earnings, while that of manufactured exports had grown to 74 percent.) The 1962 rate of 130 won to the U.S. dollar was sharply devalued to 256 per dollar in 1964. A unitary floating exchange rate was put in place in March 1965 and the value of the won steadily fell to 484 to one dollar by 1974, where it remained during the balance of the 1970s. In effect, the successive currency devaluations produced a uniform exchange rate at a level near the free-trade exchange rate, which is the exchange rate that would exist in the absence of both protective measures against imports and export incentives.

The net real exchange rate for exports was kept steady between 1961 and 1972. Export incentives were granted to offset the higher production costs that domestic inflation brought. Korea pegged the won to the US dollar from 1974 at W434 to US$1. The won was devalued in January 1980 by 16.6 percent and subsequently pegged to a currency basket and depreciated further. It is now on a managed float, falling to W745 to

US$1 by late 1982. Despite the highest inflation rate among the gang of four, export incentives were freely used to sustain a high export growth rate.

The government holds a controlling interest in all the national banks, and owns all the special banks and development institutions, which are thus subject to comprehensive government controls. Although the government has begun denationalizing state-owned banks in 1982, it dictates interest rates, lending policies, customer service, and other aspects of banking. Until 1979, when the Korean Bankers' Association began to fix deposit and loan rates within ranges established by the Monetary Board, the government set all institutional interest rates. The government doubled nominal deposit rates as part of the 1965 financial reform, which sustained a relatively high real rate of interest through 1971. Since 1973, however, real deposit rates have been negative.

The government has used its control over the banking system to allocate credit and has made extensive use of selective credit policies. About 60 percent of bank lending is for government-designated purposes, such as export support. Loans for exports have consistently carried rates below the deposit rate. Subsidized loans for priority sectors are usually eligible automatically for special rediscount rates at the Bank of Korea. Government guarantees have also been provided for foreign borrowing of almost any firm showing a capacity to export. The effect of selective credit allocation at below market rates has been to hold down deposit rates of interest. In turn, lower interest rates reduce the quantity of deposits (the banking system's deposit liabilities) and the total volume of funds available to lend (the banking system's loan assets). The resulting shortage of domestic saving has compelled Korean businessmen to borrow abroad, which has generated a large foreign debt.

During the post-1965 export boom phase of Korean development, monetary policy has consisted largely of imposing reserve requirements on bank deposits, which has varied from 12 to 35 percent, often changing sharply overnight. The virtually automatic rediscount mechanism which supports priority loans for export finance tends to produce excessive monetary expansion, despite the reserve requirement provision. Institutional interest rates remain consistently below their free market levels as credit is rationed to exporters at below market prices. From time to time, credit ceilings have been used as instruments of monetary policy to get control of inflation. The overall effect of selective credit allocation, which has entailed negative rates of interest for savers, has been to reduce national saving and credit availability, perhaps slowing the overall rate of economic growth.

Compared with Singapore and Taiwan, foreign investment has played a relatively smaller role in Korea's industrialization, amounting to about $1.5 billion. Government guarantees of overseas borrowing by Korean businessmen encouraged foreign borrowing.

Apart from maintaining an effective free trade exchange rate through using export incentives to offset domestic inflation, the government implemented a series of trade liberalization and tariff reform measures to achieve greater internal economic efficiency. In pursuit of export expansion, exporters were granted preferential credit. Other steps included indirect tax exemptions on inputs into export promotion and export sales, a 50 percent reduction on income taxes from export earnings (abolished in 1973), tariff exemption on imported raw materials and equipment for export production, and a "wastage allowance" on imported raw materials for production of exports. Following the example of the successful Kaohsiung Export Processing Zone in Taiwan, the Korean authorities passed legislation creating several tax-exempt and duty-free zones of their own in the late 1960s, which generated tens of thousands of jobs in a few short years. These measures should be viewed as moving the overall tax and fiscal system in the direction of greater neutrality to compensate for the bias imposed during the import-substitution phase of postwar Korean development.

Broadly speaking, the government allowed the forces of supply and demand to prevail in labor markets. It imposed no statutory minimum wages or other labor cost-increasing measures. As a result, the economy achieved full employment by the late 1960s, after which real wages rose sharply.

The Korean public sector comprises the central government, local governments, and various public sector enterprises.[25] Most budget transactions occur at the level of the central government. Its budget, in turn, consists of a general account, an economic development special account, and a variety of other small special accounts. Funds are transferred back and forth across these accounts for a variety of current and capital expenditures. What is important is to note, first, that total government spending has typically been less than 20 percent of GNP, though from time to time it has reached as high as 23 percent. In aggregate terms, the Korean public sector has not crowded out its private sector. Nor have taxes discouraged work, savings, or investment. Direct taxes only take 5 percent of GNP, with the remaining 16 percent of GNP collected from a value-added tax, excise taxes, customs duties, and several miscellaneous charges. The income tax takes inflation into account through regular increments in exemptions. Also, the government has reduced the top marginal rates in the late 1970s from 70 percent to 55 percent on incomes exceeding $99,000; it plans still further tax rate cuts in the 1980s. The level of company taxes has been consistently monitored, and the rate was reduced from a prior level of 33 to 38 percent to 20 percent in 1982. High rates of economic growth have enabled the government to implement periodic tax rate reductions at the same time still enjoying overall increases in tax receipts. Korea's public finances are well managed.

Overall, the government allocates about 30 percent of the general budget to its investment and loan accounts, which largely represent investment expenditure. Thus public sector funds have not been frittered away on consumer subsidies.

In 1962, foreign transfers, largely U.S. aid, represented 8.8 percent of GNP. It declined to 1.2 percent by 1975, reflecting both U.S. aid reductions and increasing Korean self-reliance. In its place, the country turned to external borrowing to take up the slack. An external debt of a few billion dollars in 1971 rose tenfold past $20 billion by 1981, when Korea had become the world's third largest borrower on international capital markets behind Brazil and Mexico.[26] The percentage of export earnings needed for interest and repayment still remains low at about 12-13 percent. In borrowing so heavily abroad, Korea's pall-mall rush to industrialize parted company with its three Asian cousins, who eschewed external debt financing as a vehicle for growth. The Koreans have paid a stiff price for overheating their economy: GNP fell 6.2 percent in 1980 and real wages fell for the first time in many years. For the moment, Korea's modern miracle has shipwrecked on the shoals of excessive foreign debt. By contrast, because Hong Kong, Taiwan, and Singapore followed more neutral monetary and financial policies, their economic growth was largely self-financed. Korea may face slower growth rates in the near future compared with its geographical cousins.

From the vantage point of a Monday-morning quarterback, it is easy to criticize the Koreans for trying to move too fast into the modern technological age. However, compared with dozens of other third world countries still struggling to surpass a poverty level of existence, the achievements of Korea's last two decades are nothing short of heroic. Starting from a lower base, the country's rate of growth in exports has outpaced that of Taiwan, Singapore, and Hong Kong. But the Chinese threesome, unburdened with debt, may find the path to future growth less strewn with thorns.

Results. From a per capita income of $87 in 1962, two decades of rapid growth have propelled per capita income to about $1,600 by 1982.[27] Though still lagging behind Taiwan, Singapore, and Hong Kong, the gains in Korea are nonetheless impressive. A GNP growth rate of 2.2 percent in 1962 reached 6.9 percent in 1964, 8.1 percent by 1968, and has averaged 9 percent through 1979. A trivial $41 million of exports in 1961 grew to $8 billion by 1976, rising more than 30 percent every year between 1960 and 1979. (As an aside, per capita income in North Korea, which inherited the bulk of pre-liberation heavy industry, is about one-fifth to one-fourth that of the South.) Predictably, rapid export growth, chiefly manufactured goods, created millions of new jobs: the open unemployment rate declined from 8.2 percent in 1963 to a low 3.9 percent in 1976. Throughout this period, the average increase in real wages exceeded 7 percent. Rising wages, in turn, fostered significant gains in nutrition, literacy, longevity, infant mortality, and the consumption of automobiles, refrigerators, and other consumer goods. Throughout this period of export-expansion, labor productivity grew 7 percent a year.

V. Ivory Coast

Africa boasts no spectacular growth stories to compare with the Pacific Area Basin. Statistics published in the World Bank's annual World Development Report reveal that annual increases in per capita income of three percent are extremely rare. In some cases, per capita incomes have barely grown at all. For most, the rate has ranged between one and two percent. An annual average increase of 3 percent puts one in the African ledger of success stories.

At the top of this ledger sits the Ivory Coast, with a per capita income in 1980 that exceeded oil-rich Nigeria. More than any other African nation, the Ivory Coast has been a model of political and economic stability since self-rule, which began in 1960. It would be difficult to tell from an examination of postwar economic, fiscal, and monetary policies when the French stepped down and the Ivorians stepped in. President Felix Houphouet-Boigny, the only president Ivorians have known, has himself defined the country as "partial to a policy of liberalism, and openness to foreign investors."[1] Let's begin with a demographic, historical, and economic profile of Africa's best example of the free market model of development.

Historical, Political, and Economic Perspective. The Ivory Coast was formed by French colonizers in 1893 as a geographical entity out of more than fifty ethnic groups. Coffee and cocoa, first in French and then later also in African planter hands, were the country's main products. Timber comprised the third main export. The postwar transition from French to Ivorian rule took place peacefully, with the country's sole president maintaining close economic, political, and cultural ties to France.

The pre-1960 economy was largely a primary plantation export economy. Raw materials were shipped abroad, chiefly to France, for processing. In turn, the Ivory Coast was a market for French manufactured goods. The French also built a sound infrastructure of harbors, railways, roads, and canals that reinforced the economy's outward orientation.

President Houphouet-Boigny has formed and led the country's only political party, the Democratic Party of the Ivory Coast, for its entire existence. There is no effective political opposition to him or one party rule. As a result, the Ivory Coast has enjoyed unbroken political stability, which has enabled the government to take a long-run view of economic policy.

The president's policy of "liberalism and openness" shows up in the country's population and approach to immigration.[2] Of the 6.7 million residents in 1980, 50,000 were French, about 100,000 were of Lebanese and Syrian extraction, and nearly two million arrived from neighboring African countries: nonIvorians comprise 30 percent of the total population. Since independence, the French population has increased, filling high level positions in both the public and private sectors. The French have played a major role in the development of universal French-language education as the government's chosen means of unifying the country's fifty different tribal groups. Growth of the agricultural sector, the most important part of the economy, has depended heavily on immigrant African labor.

Unlike many newly-independent developing countries, the Ivory Coast has maintained close ties with its former colonial master, France. The French connection shows up in monetary policy, trade, and education, buttressing the general outward orientation of economic policy. The Ivory Coast briefly experimented with import-substitution industrial policy in the 1960s, but has emphasized its traditional external orientation in the 1970s and 1980s. Although competitive markets do not prevail in every aspect of the country's economy, economic policy more closely mirrors the textbook conditions of economic efficiency than anywhere else in Africa.

Monetary Policy. The Ivory Coast does not have a separate national currency or monetary policy.[3] It does not set its own interest rates. It participates in an externally managed monetary system which guarantees foreign investors the right to convert local money into French francs at a fixed rate, and insures the free repatriation of profits and capital.

The Ivory Coast, with the majority of old French African colonies, is a member of the West African Monetary Union. A 1962 treaty with France established a common central bank, the BCEAO (Banque Centrale des Etats de l'Afrique de l'Ouest), which issues a single currency and guarantees its free convertibility into French francs at a rate of CFAF50 to one. All member country foreign (non-franc) reserves are centralized in an operations account with the French treasury. The treaty also provides for free circulation of capital within the union. Member countries deposit their foreign currency proceeds in this French operating account and are entitled to draw on it for their own foreign currency requirements. The system gives member countries considerable flexibility in drawing reserves--a country may exceed its separate balance under certain conditions--but credit lines are limited by gross foreign reserve positions. BCEAO must grant prior approval to all lending in the union in excess of CFAF100 million.

Interest rates on deposits, moving up or down reflecting market forces, are set by the Monetary Union, not the governments of member countries. No distinction is made between foreign and domestic firms for purposes of lending; the bulk of local credit has typically gone to foreign-owned enterprises in the post-independence period. Given the open structure of the Ivory Coast's economy, the rate of inflation depends on inflation in the rest of the world and changing market prices for its main exports. Although the CFA franc depends on the stability of the French franc for its own stability, the 1962 treaty provides for a proportional revaluation of member countries foreign balances in the French Treasury in the event of a devaluation of the franc. Financial reserves of the Ivory Coast are thus insulated from irresponsible French monetary policy.

To summarize, the monetary system in the Ivory Coast insures free movement of capital within member countries and between member countries and France, international convertibility at guaranteed exchange rates, interest rates set near market levels, and a limited, prudent access to credit for local lending. The Ivory Coast cannot print its own money nor discourage exports by maintaining an overvalued currency. Local and foreign investors thus enjoy confidence in the country's money, in the same way that Singapore's Currency Board insures holders of that nation's money.

Public Finance.[4] Let's begin with taxation. During the 1970s, taxes averaged about 25 percent of GDP. Although the ratio of taxation to GDP in the Ivory Coast is high compared with most developing countries, the structure of tax rates does not erode individual incentives. Income taxes supply 20 percent of current revenue, with commodity taxes--excise, import and export taxes--comprising the balance. Wealth taxes are virtually non-existant.

Profits tax is set at 35 percent, with a five-year exemption for any new factory. A salaries tax is levied at a 5.5 percent rate for local staff and 10.5 percent for expatriates. There is also a graduated personal income tax, but the effective rate is low since family members can subdivide income equally among themselves (splitting) for tax reporting purposes.

The Value Added Tax is set at 19 percent. It is complemented by customs duties on imports that range from zero--capital goods imported for the establishment of new industries and raw materials not available locally are exempt from customs duties--to as high as 90 percent of the CIF (customs, insurance, freight) value. (See next section on economic policy.) Export taxes on coffee, cocoa, and cotton have contributed about one-fifth of current revenue.

In general, taxation has not been used to redistribute income in the Ivory Coast. Only the income tax is structured to be progressive, and its splitting provisions minimize any redistributional effects. Thus while the aggregate level of taxation is high by third world standards, the rates of taxation are generally low on all economic transactions, save imports. Thus a relatively neutral tax system does not impede economic efficiency apart from the distorting effects of tariffs on a modest amount of industrial activity.

Public spending consists of both current and capital outlays. In general, public spending has grown more rapidly than either current revenue or domestic savings, forcing the Treasury to resort increasingly to borrowing to finance the difference (since the government can't print its own money). Current spending as a share of GDP rose from 14.6 to 16.6 percent during 1965-1975; as a proportion of current revenue it rose from 73 to 83 percent, reflecting burgeoning education and housing programs.

Public investment spending has risen even more rapidly than current spending. Apart from massive spending on infrastructure, the government operates twenty-six state enterprises, contributes to the support of twelve public institutions, and holds a majority participation in nineteen mixed companies. Public enterprises have increased their proportion of total public investment from 30 to 60 percent in the decade spanning 1965-1975, sometimes with questionable efficiency. It is generally conceded that financial control over public enterprises could be strengthened.

Resources for public investment come from budgetary transfers (from any excess of current revenue over current expenditure), transfers from an agricultural Stabilization Fund, modest local borrowing, and a growing dependence on foreign borrowing. (The Stabilization Fund, in the Ministry of Agriculture, stabilizes prices paid to producers of export crops, chiefly cocoa, coffee, cotton and vegetable oils, and profits from the difference between export costs and export prices. Excess profits are transferred to the Treasury for general use.)

On independence in 1960, public investment amounted to about 7 percent of GDP. By 1975, its share had more than doubled to 15 percent. Unfortunately, the expansion was financed mainly from external sources. Taking 1975, for example, the budgetary surplus, the Stabilization Fund, and other public enterprises contributed about 9 percent of GDP to national savings, but public debt service payments abroad drained 4 percent. The 10 percent difference was made up from foreign borrowing. Between 1969 and 1975, the Ivory Coast's external public debt increased from \$388 million to \$1,536 million. As concessionary loans diminished and hardening of terms of foreign loans increased, the debt service ratio (percentage of exports) doubled from 5.9 to 10.9 percent. Debt service payments grew from CFAF5.5 billion in 1965 to CFAF33 billion ten years later. In the same decade, the share of public borrowing in the financing of total public investment rose from 30 to 50 percent; the proportion from the nation's own resources correspondingly declined. A ratio of public to private investment of 42 to 58 in 1960 was virtually reversed to 60 to 40 by 1975. Long-run growth cannot be sustained if the public sector gobbles up all investment funds. An overly ambitious public investment program, coupled with proliferating public enterprises, have put the future growth of the economy at risk. Rising debt service payments transfer capital abroad, lower national savings, and makes the country even more dependent on external resources to finance necessary infrastructure. Moreover, to the extent that public investment results in inefficient projects, economic growth will slow, domestic savings will further diminish, and the burden of debt service will proportionally rise.

Reflecting increasing reliance on foreign borrowing, the Ivory Coast shifted from a positive net foreign reserve position in the West African Monetary Union to a negative position for the first time in 1975.

It is clear that both the growth rate of current spending and public investment cannot be sustained at the high rates of the past

10-15 years, lest the entire economy and its people be imprisoned by debt service charges. The 1976-1980 five year plan, recognizing these dangers, emphasized a greater role for private foreign investment.

Economic Policy. From its inception, the Ivory Coast has largely maintained an outward orientation. Economic policy can be described as "controlled liberalism."[5] The government has been favorably disposed toward foreign capital (foreigners own 67 percent of the equity of local manufacturing companies), entrepreneurs (witness the 100,000 Lebanese-Syrians and 50,000 resident French), and open borders (two million neighboring African laborers work in the Ivory Coast). It has lapsed from liberal grace by regulating agricultural prices, setting minimum wages, and distorting the structure of internal industry through a limited policy of tariff-protected import substitution.

Before independence, the Ivory Coast was a plantation economy, with a wholly outward, largely French, orientation. On independence, the government set out to diversify the economy through an industrial policy stressing import substitution. It imposed a tariff structure that ranged as high as 100 percent on some items, and adopted an investment code that granted a five year exemption on business profits. As a result, the contribution of import taxes to current revenue rose from 24 to 36 percent between 1965 and 1975. Priority firms were granted duty-free import privileges in an attempt to boost local manufacturing, which stood at a modest 4 percent of GDP. Some firms prospered. However, high effective protection often meant inefficient output from others, which developed excess capacity. Exemptions on capital imports biassed some firms in favor of capital-intensive techniques and industries, despite high urban unemployment. It turned out that the chief beneficiaries of the protective tariff shield were large foreign, rather than smaller domestic, firms.

In the 1970s, the Ivory Coast reemphasized its historic export orientation for both agricultural and, now, manufactured products. The 1975-1980 five-year plan notes that the domestic market cannot serve as the main factor in industrial development and that "industrialization based on substitutes for imports means high cost prices, [and] low yields. That is why the development of the industrial plant will have to be essentially based, in years to come, on the creation and the development of long distance export activities."[6] This new direction in policy entails "an active search for private nationals and foreign investors," which requires a gradual reduction in tariff protection for local industries. In particular, Ivorian planners want to avoid extending the initial import-substitution policy from light industry to intermediate or heavy goods, a policy many Latin American nations have unprofitably pursued.

Despite the protection of tariffs, manufacturing had only grown from 4 to 12 percent of GDP by 1974, much consisting of processing agricultural raw materials or processing imported semifinished products. Thus a figure of 12 percent overstates the contribution of industry to economic output. Moreover, the growth rate of value added in import-substituting manufacturing industries declined in the early 1970s, compared with the 1960s. In all, manufacturing only provided 45,000 jobs by 1975 of a total population exceeding 6 million.

The return to a general policy of export orientation recognized two features of the economy. First, the bulk of employment and output are in the agricultural sector, which enjoys considerable comparative advantage and which has always depended on external trade. 75 percent of the population earn their living and a similar percentage of export proceeds come from agriculture. Second, rapid job creation in the industrial sector cannot be achieved by manufacturing for a limited, home market, thus the switch to manufacturing for export.

Compared with other African countries, the government has generally maintained a regime of high producer prices. Many African leaders have turned their food surplus nations into grain importers through the double-edged sword of an overvalued exchange rate and low producer prices paid by official state agencies. By reducing local currency earnings of agricultural producers, these policies destroy incentives and shrink output. In the Ivory Coast, producer prices per kilogram for cocoa have ranged from as low as CFAF55 in 1965 to as high as 175 during 1974-76, reflecting changing conditions in world markets. Similar variations apply to coffee and other plantation products. The government also sets minimum agricultural wages, which have been held to a relatively low level, but high enough to attract several million Africans from less well-off nearby countries. The average producer price has been high enough to generate expansion in output of both industrial and food crops. Industrial crop output expanded 5 percent a year between 1965 and 1975, and despite a large population increase, the Ivory Coast has reduced its dependence on food imports. The private agricultural sector, owned largely by Ivorians, has responded to agricultural price incentives.

Minimum wages are also imposed on the private sector, but have not damaged the competitiveness of the export-oriented raw material processing industries.

To the extent that the government has sought to redistribute income and eliminate differences among regions, it has done so through the expenditure side of the budg t, not through taxation. It has drawn up regional investment programs and has put into place an Ivorianization employment policy. However, the Ivorianization of the private and public sectors has been implemented with a view to economic efficiency and the maintainenance of high standards. Localization of labor and equity ownership has not been pursued to the detriment of economic growth and the maintenance of a profitable economic environment.

Results. The Ivory Coast has enjoyed a truly astonishing growth record by African standards. Its GDP grew at an annual rate of 8 percent during the 1960s, falling slightly to 6.7 percent during the 1970s. It has managed to sustain these high rates with virtually no industrial sector to speak of, relying largely on commercial agricultural exports. Between 1950 and 1975, exports of cocoa, coffee, and timber increased in volume respectively four, five, and thirty times. The Ivory Coast thus belies the thesis that industrialization is essential to strong economic growth.

Recall the openness of the country's borders to population movements. Immigration, coupled with a high birth rate, has brought rapid growth in the population. It grew by an annual rate of 3.7 percent in the 1960s and an even higher 5 percent in the 1970s. Subtracting population increases from GDP growth rate cuts the annual increase in per capita income to a less dramatic 2.5 percent between 1960 and 1980. Still, by 1980, residents of the Ivory Coast enjoyed the highest per capita income in Sub-Saharan Africa, including oil-rich Nigeria. In 1950, with a per capita income of around $70, the Ivory

Coast was an extremely poor nation. By independence in 1960, income had risen to $145, in 1974 to $450, and by 1980, to $1,150. The trend growth rate has been steadily upward.

To the extent that economic growth slowed moderately in the 1970s, this can partially be attributed to the sharp expansion in public spending and the nation's heavy debt burden. By 1980, external public debt reached $4,265 million, equal to about 42 percent of GDP. Its international reserves had fallen to no more than two weeks of import coverage. The Ivory Coast is following more closely in Korean footsteps than in those of Hong Kong, Taiwan, and Singapore, in which public investment has been financed from internal sources.

Has rapid economic growth in the Ivory Coast increased or decreased the inequality of income distribution? The World Bank mission to the Ivory Coast in 1975 concluded that among 13 African nations, the Ivory Coast qualified as a low inequality country.[7] This distribution of income is all the more remarkable in light of a large French population with incomes ten-to-twentyfold that of the African population. One reason for the more evenly distributed income is that per capita farm income is not much lower than per capita salary payments, due to a regime of high producer prices. The Ivory Coast has not excessively taxed its farmers to support urban dwellers or industrial development. Price incentives in agriculture have been a major factor in the country's strong economic performance.

<u>Summary.</u> The Ivory Coast has been and remains a primary commercial crop exporting nation. Coffee, cocoa, timber, and other cash crops contribute most of the nation's export earnings and jobs. This has necessitated an economic policy of outward orientation. To all intents

and purposes, the country has conducted a free-trade regime, save for a modest amount of import-substitution light industry. A stable monetary system, free convertibility at a guaranteed exchange rate, open borders, and a minimum of internal regulation have allowed market forces to dictate the scope and structure of development. The modest distorting element of tariffs on internal prices is now gradually being reduced. The worrisome elements in the economic policy mosaic are the trend growth rates in current public spending, public enterprise activity, and especially the accumulation of external public debt.

What makes the Ivory Coast such an excellent example of the market model of development is its convincing proof that industrialization need not be the sole route to successful growth.

VI. Chile

Since 1973, the economic policy of Chile's military regime has come to be known in financial, academic, and media circles as the "Chicago experiment." Many informed lay persons see Chicago as the spiritual and intellectual home of free-market economics. Economists identify Chicago with attempts to use notions of price theory and competition in the marketplace to explain a wide variety of real world economic behavior. A number of the key economic policy makers in Chile, known as the "Chicago boys," hold advanced economics degrees from the University of Chicago. In just a few short years, they have transformed a closed, highly regulated economic system into an open, free market economy. In the span of six years, they reduced triple digit inflation to one and two digit levels, virtually abolished import duties, privatized a heavily nationalized economy, balanced a budget in deep deficit, and converted a balance of payments deficit into a surplus. Despite these incredible changes, critics of the military government hold the Chicago boys responsible for the severe recession that hit Chile in 1981, which reduced real GNP by 14 percent in 1982. Even those who favor the regime's free market policies dislike its stern political authoritarianism. Nevertheless, critics of the military regime acknowledge the post-1973 policies as moving the country "Towards a Free Market Economy."[1]

<u>Background to Liberal Reform.</u> Chile consists of a 2,600 mile long strip of territory, 250 miles across at its widest point, located in South America between the rugged Andes and the Pacific Ocean. The northern deserts contain large deposits of nitrates and copper. In the center is a long, rich agricultural valley, where the population--a

spanish-speaking, Roman Catholic mixture of Europeans, mestizos and Indians--is concentrated.

The country initially developed as an area of large pastoral landholdings, subject to Spanish rule by the viceroyalty of Peru. A military uprising in 1818 won independence from Spain. Chileans fashioned their first constitution in 1830, which laid the basis for later emergence of parliamentary government. Longstanding border disputes with Bolivia and Peru were climaxed by the War of the Pacific (1879-1884), which gave Chile rich nitrate deposits and other minerals. Exploitation of these mineral resources brought wealth and developed railways, but Chile became heavily dependent on world markets for its prosperity.

The Great Depression hit Chile extremely hard.[2] In 1930, imports fell 13 percent in value, real mining product fell 27 percent, and per capita real GDP fell 14 percent. Chile, maintaining its gold standard monetary policy, suffered a 29 percent decline in gold reserves, resulting in credit restrictions, a fall in wholesale prices, and a rise in the Central Bank interest rate. The economy further declined through 1932, when per capita GDP fell to 49 percent of its 1929 level. The League of Nations asserted that the Great Depression hit Chile the most severe of all nations. By 1939, per capita GDP had only recovered to 76 percent of the 1930 level and the dollar value of its exports only to 53 percent.

As a consequence of this bitter decade, the prevailing economic philosophy switched from a liberal, open economy to a closed, heavily regulated system. The government decided to develop internal industry to reduce dependence on foreign imports. For the next quarter century, Chile's leaders imposed a regime of multiple exchange rates, a myriad of indirect taxes and surcharges on imports, direct taxes on the major export producers, explicit and implicit subsidies, tax rebates, and regulations concerning direct investment and capital movements. The government substantially expanded its regulation of and intervention in the economy. It established a quasi-public development corporation in 1939, which controlled or influenced a high proportion of financial and real investment.

A rapidly deteriorating internal situation led to the first of three postwar shifts in economic policy in 1956.[3] It consisted of simplification and partial unification of the exchange rate system, several major currency devaluations, a loosening of import restrictions, and the elimination of automatic wage adjustments to the increase in the cost of living index in the previous year. A deteriorating economy brought a new regime into office in 1958 which set out to attract foreign capital. Commercial banks were freely allowed to buy and sell foreign exchange. The currency was again devalued to bring interal Chilean costs in line with world prices. Licensing was removed for permitted imports and the list was made virtually all-inclusive. Liberal depreciation allowances for tax purposes were introduced for large-scale mining, and tax exemptions were granted for foreign investment in particular industries.

A balance of payments crisis in 1961 forced the government to terminate the free market in foreign exchange and imports were severely curtailed. A burgeoning government deficit and exhaustion of foreign exchange reserves led to further restrictions on trade and fueled inflation. The third switch in postwar economic policy moved the country in the direction of more government control in 1965. Key provisions included Chileanization of large-scale mining, and a major expansion in domestic social programs for the purpose of redistributing income and political power toward the lower economic classes.

The presidential election of September 1970 brought Salvador Allende to power. Representing a coalition of Communist and Socialist parties, he announced a long-run aim of transforming the economy. He proposed to reduce external dependence and the role of the private sector in Chile. The state would take over the basic natural resources, banks, foreign commerce and other strategic sectors. Short-run components of policy included state-guaranteed production contracts, containing inflation by strict price controls, a minimum readjustment of wages and salaries of 100 percent of past price increases to workers, housing and other social subsidies, agrarian reform, government generated employment, ultimately turning Chile into a socialist country. All large-scale copper mining was nationalized.

The economy responded poorly to these measures throughout 1972 and 1973. Per capita GDP fell, inflation reached 500 percent, real exports declined, international reserves dissipated, the currency depreciated, exchange controls were imposed, and martial law was invoked on several occasions. Strikes frequently immobilized the economy. Political instability brought a military coup on September 11, 1973. The new regime suspended civil rights and the constitution and set out to reverse economic policy. Against this backdrop, the free market experiment began.

<u>Fiscal Policy.</u> As Allende's policies took effect, a year end increase in wholesale prices of 21 percent in 1971 took an exponential

leap to 143 percent in 1972 and to an incredible 1,147 percent annual rate as 1973 closed. Small wonder the country was in turmoil during 1973.

The proximate cause of this inflationary outburst was the collapse of government finances.[4] When we add the formal budget deficit to the subsidies granted public enterprises, the overall public sector deficit rose from 3 percent of GDP in 1970 to an astonishing 24 percent in 1973. To finance this monumental deficit, government borrowing rose from 56 to 88 percent of total domestic credit--the private sector was completely crowded out of the credit markets. The bulk of new credit required to finance the rising deficits came from the printing presses of the central bank. In 1973, the creation of new high-powered money was equivalent to 21 percent of GDP.

Bringing inflation under control thus required gaining control over public finances. The new economic team set out both to increase tax collections and improve the efficiency of public enterprises. They consolidated service and turnover taxes into a comprehensive value-added tax imposed at a uniform rate of 20 percent. They also sharply reduced central bank subsidies to state commercial enterprises. Current revenue, which consists of taxes plus the operating surplus of public enterprises, virtually doubled in one year from 16.5 to 31.4 percent of GNP. A huge deficit in 1973 was transformed into an overall surplus of 3.7 percent by 1976, and the budget remained in surplus for the balance of the decade. By 1978, credit subsidies to the private sector had also been effectively eliminated. Public spending fell by 6 percent of GDP between 1974 and 1978.

The need for the central bank to print money to finance these deficits diminished as the government's credit appetite dropped from 88 percent of total domestic credit in 1973 to 10 percent in 1980. The issue of high powered money fell sharply to a low 2 percent of GDP by decade's end. All money supply growth indicators were a small fraction of their 1973 levels.

Price increases steadily moderated. The end of year increases in wholesale prices fell from the thousand percent level in 1974 to 570, 411, 152, 65, 39, 58, and 28 percent by 1980. In 1981, the rate fell to single digit levels. To all intents and purposes inflation was curtailed. The very painful task of balancing the budget, by raising taxes, reducing subsidies to public enterprises, and cutting overall spending, was successfully completed despite a major world recession in 1974 that severely affected Chile's export markets.

Liberalization of Trade. The "Chicago boys" set out to attain both external and internal free trade.[5] Prior to the military coup, domestic producers enjoyed an average nominal tariff of 94 percent, with rates on some items, for example cars, that reached 500 percent. In addition, the Allende government had imposed a variety of nontariff restrictions on imports that included quotas, outright prohibitions, restrictions on obtaining the necessary foreign exchange, multiple exchange-rate practices, restrictive licensing, and so on. Many of these measures were a response to an overvalued exchange rate and the unavailability of foreign exchange.

Trade liberalization required both the elimination of trade barriers and the correction of an overvalued exchange rate. The new government quickly unified exchange rates and instituted a policy of minidevaluation, gradually adjusting the exchange rate (more Chilean escudos, later pesos, per dollar) to correct an overvalued currency, which produces an anti-export and pro-import bias. The combined general rate rose from Escudos 280 to the dollar in 1973 to 860 in 1974, to 12,500 (12.5 pesos) by June 1976. From June 1976, the periodic minidevaluations gave way to a daily change. By year's end, the currency fell 39 percent to 17.42 pesos to the dollar. This sequence of devaluations had the purpose of trying to neutralize the impact of domestic inflation on prices in Chile compared with world prices.

By 1976, the government eliminated all restrictions on overseas payments for current transactions; all nontariff barriers had been eliminated. As well, it had announced as early as 1974 a plan to progressively diminish protection for producers of import substitutes. An average nominal tariff rate of 94 percent would fall, in biannual steps, to an average and top rate of 10 percent by mid-1979. Ron McKinnon has called this experience "the most remarkable unilateral move toward free trade since the Manchester liberals repealed the corn laws and other protectionist measures in mid-nineteenth century Britain."[6]

Non-copper exports soared from 20 to 60 percent of total industrial and agricultural exports as their prices became increasingly competitive in world markets. Industrial exports alone rose from 8 to 20 percent. The industrial sector responded positively to a reduction in tariff protection. All indices of industrial production were higher by the end of the decade. Meanwhile, at home, import substitutes were steadily replaced by a growing variety of goods produced all over the world. To repeat, by 1980, Chile had moved from an autarchic to a free-trade country.

Domestic inflation remained well ahead of world levels throughout the post-1973 period, which necessitated continued adjustments in the exchange rate to prevent currency overvaluation, and maintain the real exchange rate. Chile continued its policy of exchange rate adjustments during 1977, but in early 1978 adopted a tabular exchange rate system designed to break inflationary expectations. The system consisted of a preannounced path of devaluation over an extended period, in which the Central Bank stood ready to buy and sell dollars as in a fixed exchange rate system. On June 30, 1979, accompanied by a slight devaluation from 36.89 to 39 pesos to the dollar, the authorities imposed a fixed exchange rate system.

What was the logic of transforming a policy of, first, periodic discrete devaluations, and second, preannounced daily devaluations, into a fixed exchange-rate regime? As devaluations steadily bring domestic prices closer to world levels, that is, as the higher rate of internal inflation slows reducing the large gap between domestic and international inflation, a fixed exchange-rate regime will finally bring domestic price inflation in line with international rates. (A risk of fixing the exchange rate is importing inflation if the international economy becomes unstable.) A crucial assumption in this package is that fiscal and wage policies remain under control, lest internal costs rise out of line with world price increases. By mid-1979, the budget was in surplus and wage increases had been restrained. Under a fixed exchange-rate regime, Chile's monetary policy became a classic gold standard, balance of payments system. The foreign exchanges completely dominate the country's monetary and financial policies. Domestic credit at the Central Bank is targeted toward a desired path for foreign exchange rates, and the fixed exchange rate determines the domestic price level. Under this regime, internal and external prices are in equilibrium.

In mid-1979, then, Chile maintained a pure _fiat_ currency, unbacked by any explicit currency cover (as in the traditional currency board systems). So long as Chile can command control over sufficient foreign reserves to maintain the assigned fixed-exchange rate, the country's money supply depends on the overall balance of payments, expanding in the presence of surpluses and contracting under deficits. Thus the balance of trade and capital flows determine the overall activity of the economy. Should wage increases or government deficits get out of hand, causing an overvalued currency, Chilean goods would quickly lose their competitiveness in world markets and a flood of cheap imports would necessitate new trade barriers.

Accompanying the movement to external free trade and free movement of capital was a policy of internal _laissez-faire_ and a desire to reduce the role of the state in the economy.[7] It did so by trying to shave the overall level of public spending and selling off public enterprises to private hands. As already noted, public spending fell by about 6 percent of GDP between 1974 and 1978. Inheriting 507 public enterprises in 1973, the government reduced its ownership to 70 in four years and set a target of just 15 by 1980. (The Allende regime had dramatically increased the number of public enterprises from 46 to 507 in its three year administration.) It also reversed the process of agrarian reform by returning a significant share of expropriated land to old owners. As the state withdrew from banking, the share of financial resources deposited in private financial institutions rose from 7.5 to 64.7 percent between 1974 and 1979. The state also terminated its developmental assistance to small producers in the agricultural, mining, and industrial sectors.

Reflecting diminished state control over the economy, public sector employment fell 20 percent between 1974 and 1978. Between 1964 and 1974, public employment had risen from 210,000 to exceed 360,000, but declined to 293,000 by 1978.

Organized labor was excluded from the process of internal liberalization. Collective bargaining was disallowed and strikes were forbidden. These measures were relaxed in 1979, but at no time in the process of liberal reform was a free market in labor ever permitted.

Results. Taking into account the severe recession of 1975, induced largely by a recession in Chile's export markets, the statistical indicators of economic performance reveal a generally upbeat picture. Real GDP rose 4.2 percent in 1974, fell sharply by 16.6 percent in the 1975 recession year, and then increased in annual amounts of 5, 8.6, 6, and 7.2 percent. Consumer price increases declined from three-to-four digit levels to moderate two digit numbers. A colossal fiscal deficit yielded to actual Treasury operating surpluses. Non-traditional exports tripled as a share of overall exports. In real terms, net capital inflows increased six fold between 1974 and 1980, moving the balance of payments into surplus and increasing foreign reserves. A disquieting feature was the unemployment rate, which remained stuck in the 12 to 14 percent range between 1976 and 1980, suggesting that many did not share in the otherwise stunning economic transformation.

Since 1981, Chile's free market experiment has fallen on hard times. It is imperative both to acknowledge economic hard times and search for its causes. In particular, to assess how the regime's economic policies may have been a culprit.

Recent Economic Performance. Four factors pushed Chile's economy into a sharp tailspin: wage policy, a sharp fall in the price of Chile's main export, a fixed-exchange rate currency, and massive external borrowing.

A 13 percent unemployment rate in early 1975 surged to 20 percent within one year due to a reduction in public sector employment and spending, and a world recession that drove copper prices sharply lower.[8] World recovery restored the unemployment rate to 13 percent by March 1977, but it remained at that level despite strong growth through the end of the decade. One reason for the stagnation in unemployment was the adoption of an inflationary, domestic wage-indexing procedure when the government switched from its passive, periodic devaluations to its preannounced downward crawling peg in February 1978. Nominal wage increases were granted on the basis of past domestic price increases, rather than on the basis of forward movements in the planned exchange rate. As a result, wages rose much faster than the prices of tradeable goods, especially after the exchange rate was fixed. To buy peace with labor, the government permitted free collective bargaining beginning June 1979, and employers were forbidden to reduce real wages (in terms of the domestic CPI). The real wages index rose 12.7 percent in 1977, and by 14, 10.8, 8.7, and 8.9 percent over the next four years. During the same five years, real GDP rose at the much slower rate of 9.9, 8.2, 8.3, 7.5, and 5.3 percent. The result of this policy must be that over time domestic costs would rise above internal market clearing and world levels, thus retarding the creation of new jobs, and prevent the economy from adjusting smoothly to changing circumstances. The 1979 Act meant that supply and demand for labor did not determine real wage rates.

A second factor in Chile's economic downturn was the world recession, which severely reduced the prices and volumes of its principal exports. Copper, which comprises nearly half of Chilean exports, suffered a drop in its price from 99 to 79 cents a pound between 1980 and 1981. Along with other export goods, total overseas sales fell US$745 million, or about 3 percent of GDP. Copper prices failed to recover throughout 1982, plummeting to 60 cents a pound in November 1983 despite a strong U.S. economy recovery, thus depriving Chile of several billion dollars in export earnings.

A third factor was the clinging to a fixed-exchange rate. As a rise in international interest rates pushed the US dollar sharply higher against other currencies, the Chilean peso, due to its fixed nominal exchange rate, correspondingly appreciated, thus overpricing exports and cheapening imports. The resulting balance of payments problem forced a devaluation in mid-1982 and the switch to a floating rate in August of the same year.

A final factor was the explosive rise in external debt. Between 1977 and 1981, real GDP grew at an annual average rate of 7.8 percent. Strong growth meant an extraordinary increase in the demand for both capital and consumer goods. Foreign lenders were eager to finance much of this demand. As a result, private sector foreign debt rose from $3.4 billion in 1979 to $6 billion in 1980, to $10.0 billion by the end of 1981. Including the public sector, total foreign debt during these three years rose from $8.5 billion to $15.6 billion. Interest payments alone on this debt reached $1.4 billion in 1981. The current account deficit of the balance of payments hit $4.8 billion during 1981, about

15 percent of GDP. The country was spending well beyond what it earned, in the process sliding increasingly into debt. Pushed up by rising interest rates, debt service payments alone threaten future growth.

The inflexibility of wages forced unemployment up sharply from 11 percent in late 1981 to 19 percent by mid-1982. Real GDP fell sharply by 14 percent during 1982. To bring Chilean prices in line with world prices, the currency was devalued by 18 percent in June 1982, the estimated degree of overvaluation. This devaluation set off a wave of speculation against the Chilean peso which drained dollar reserves. Central Bank intervention to maintain the real exchange rate led to further losses in international reserves. By late 1982, Chile faced external foreign debts exceeding $17 billion, while holding international reserves of only $2.5 billion. The country successfully negotiated an agreement with the International Monetary Fund for $825 million in 1982, which entails an austerity program (for the public sector) and currency devaluations, which reached nearly 100 percent during the second half of 1982, to encourage the production of tradeable goods for world markets.

There was no way Chilean planners could insulate their economy from the shock of world recession. However, wage rigidity and a currency fixed to a rising US dollar exacerbated the mismatch between Chilean and world prices. The logic of a fixed-exchange rate system remains in force only if domestic wages are set by market forces, not political agreements, and if public finances and international transactions remain in balance. In the case of Chile, wage rates rose excessively fast, public finances lapsed into deficit from 1979, and trade flows moved against the country. A floating rate would have permitted a smoother transition to, but not prevent, a lower level of economic activity, and would have fostered a quicker recovery.

VII. Democracy and Development in Sri Lanka

Unlike Hong Kong, Singapore, Taiwan, Korea, the Ivory Coast, and Chile, Sri Lanka is a democracy with universal suffrage. Many attribute the economic successes of these Pacific Rim economies and of other select Latin American and African societies to the imposition of liberal economic policies by colonial government, political strongmen, one-party states, military regimes, or authoritarian governments. Such a correlation raises the question if liberal economic policies, which generate high growth, are compatible with western-style democracy. The extent to which free market economic policies remain in force and foster strong growth in Sri Lanka would demonstrate that free elections and free markets are compatible, that a liberal economy need not preclude democracy and the franchise.[1]

By worldwide standards, Sri Lanka is a very poor country, with a per capita income below US$200 a year. Since 1798, the island had been ruled by the British, until in 1948 it was granted independence. Under British rule, the island had developed a sound administrative and physical infrastructure, external financial reserves, and a high literacy rate in English. But between 1948 and the 1970s, the country slowly disintegrated economically and was only kept afloat by massive infusions of money from the international-aid-to-Sri Lanka club, to which the United States was a major contributor.

Sri Lanka's history dates back 2,500 years to its original settlement by the Sinhala people from the South Asian subcontinent. The Sinhala were followed in turn by the Tamils from South India, Arab traders, Portuguese spice merchants, Dutch traders, and lastly the British. Ceylon (as the island was named under British rule) developed as a plantation economy, exporting tea, rubber, and coconut. Its modern day political evolution developed from the westernization of its indigenous elites in the early decades of the twentieth century. Political progress was rapid. Universal suffrage was granted in 1931 and peaceful independence in 1948. Since then, however, island politics have not been so tranquil. Nationalist sentiments have dominated politics during much of the past thirty-three years.[2] Political disputes between Sinhala and Tamil have often flared into violence, most recently in July 1983, resulting in the establishment of martial law. Up-country Buddhists have continued to feud with lowland, coastal English-speaking leaders, and one prime minister has been assassinated.

On the economic front, socialism and state-control have steadily replaced private ownership and the market economy. The export-oriented plantation sector has been heavily taxed to finance free education, free medicine, free water, sanitation, subsidized food, and cheap transport. When the plantations were finally nationalized in the mid-1970s, the public sector controlled more than 90 percent of the economy. Although these policies may have increased literacy and lowered infant mortality, they were accomplished only through government pre-emption of resources and the destruction of incentives to the total detriment of economic growth. As economic stagnation set in, further government efforts to redistribute income resulted only in a redistribution of poverty. The government of socialist-leaning Mrs. Sirima Bandaranaike (1970-1977) ruled through a perpetual state of emergency, which was declared in the course of a violent youth rebellion in 1971 and remained in force until 1977. Her economic policies beset the economy with import controls, foreign exchange controls, price controls, and a plethora of state industrial and trading monopolies. She nationalized land, banks, and businesses. The results were food and other shortages, black markets, and widespread evasion of controls and taxes. Her strategy of import substitution fostered inefficient, overprotected industry. Low food prices and food rations for all, regardless of income, eroded producer incentives, even for those subsisting on their own land. A massive public sector smothered the remains of private sector initiative, and a great deal of the country's talent decided to migrate overseas. The country's external reserves were run down and massive budget deficits, financed by new money creation, brought a ruinous inflation. By 1975 economic life had virtually ground to a halt.

In past elections, communal rivalry between Sinhala and Tamil had invariably dominated all other issues. In the 1977 election, which had been postponed since 1975, economic issues were paramount. In fact, this election marked the first time in democratic Sri Lanka that any new general election had not been held on schedule. Promising a new direction in economic policy, the United National Party, under the leadership of J.R. Jayewardene, swept to a landslide victory. The new government immediately set out to reverse thirty years of socialist economic policies.

Jayewardene's landslide rests on the perception that socialism and state controls have utterly failed in Sri Lanka, and were largely responsible for rising unemployment, shortages of essential goods, widespread nepotism and corruption, and an inefficient and unresponsive public sector. Sri Lanka's new president is a close friend of Singapore's dynamic Prime Minister, Lee Kuan Yew. Despite the differences between the urbanized Chinese city-state of Singapore and rural Sri Lanka, there is growing admiration in Sri Lanka for what is called the "Singapore model" of development: competition, free trade, tax concessions, and foreign investment. Public servants in Sri Lanka are sent to Singapore to learn about its administrative skills and techniques.

Before 1977, economic policy in Sri Lanka had stressed import substitution. Sri Lanka's new economic policy is now predicated on the belief that a small home market defeats an import substitution strategy and that Sri Lanka has always fared best as an export-led economy. Therefore, economic growth must come from encouraging both traditional plantation exports and new manufactured goods. To this end, a spate of new economic and fiscal policies has been adopted.

New Economic Policies. The government has eliminated the old, fixed exchange rate system that overvalued the Sri Lanka rupee. Although this policy held down the costs of food imports, it discouraged exports and led to a system of price controls and rationing that created shortages, queues, and an incomprehensible maze of producer taxes and consumer subsidies to compensate for the effects of price distortions. Now the rupee is allowed to float. This new realistic exchange rate system has restored producer and export incentives, eliminating the need for price controls and rationing. The price mechanism, not the bureaucracy, now allocates goods, and corruption has been significantly reduced.

A policy of licensing imports to control the inflow of foreign goods has been replaced with a commitment to the open economy and the application of very selective tariff protection. Liberalized imports have forced inefficient, protected industries and public monopoly enterprises to compete with private enterprises. The government has closed some public firms and reduced the subsidies of others. In 1979, general subsidies to state industries were slashed by nearly 80 percent, from Rupees 1,486 million to Rupees 300 million. Public industries have been instructed by the new government to become commercially viable, which has forced them to raise prices to meet higher production costs or go out of business. The new liberal import policy increased activity in the business and manufacturing sectors so much that despite a significant reduction in the business turnover tax rate in 1978, revenues from this source nonetheless rose 62 percent in 1979.

To move quickly from an import-substitution to an export-led strategy for economic growth, the government has granted a large number of tax concessions and reductions. In 1978, it created the Greater Colombo Economic Commission (GCEC), which exercises jurisdiction over 160 square miles of land extending north from the capital, Colombo, to the airport. Within this territory, the GCEC has established several free trade zones that offer investors a variety of incentives, with no limit on foreign equity participation. These include (a) up to ten years of full tax holiday on salaries, profits, dividends, with a potential extension of fifteen more years; (b) no income tax on the salaries of foreign personnel; (c) free remittance of dividends, no exchange controls, and tax free status for non-resident shareholder dividends; (d) free transfer of shares; (e) no import duty on raw materials, machinery, and so on. The GCEC goes out of its way to eliminate "red tape" to all investors.

By December 1982, the GCEC had approved 174 projects, representing investors from 21 different countries. Providing employment for 25,000 people, the fully developed zone will employ 50,000 people. To see the importance of this figure, total industrial employment in the entire country in 1979 stood at about 150,000. In the first five years of operation of the GCEC, total foreign investment in the free trade zone came to Rupees 4,800 million (US$250-300 million). As a result of this economic program, industrial exports rose substantially.

Phase One of the first free trade zone has been fully let. To speed up development in the second phase, the GCEC has turned over to private developers the opportunity to supply housing and administrative facilities, thus reducing government expenditure and further bringing market forces to bear on the process of industrial development.

In addition to GCEC investments, a Foreign Investment Advisory Committee (FIAC) also authorizes joint ventures between foreign businessmen and local equity participants. Five-to-ten-year tax holidays on profits, dividends, and non-resident management fees are granted in a variety of approved investment or business areas including hotels, urban development projects, companies that construct power and irrigation projects, pioneer industries, gem exports, and so on. Total approved investments by 1982 came to Rupees 10,400 million (over US$500 million) and envisaged new jobs from these approvals are estimated at 67,000.

To complement the investment opportunities, Sri Lanka has established offshore banking in the form of Foreign Currency Banking Units, which offer offshore banking facilities to all non-residents and GCEC enterprises. Permissible currencies include French and Swiss francs, Japanese yen, Dutch guilders, English pounds sterling, German deutschmarks, and US dollars. Profits from the operation of offshore banking are tax free. Total assets and liabilities rose from Rupees 596 million in late 1979, when the FCBUs were authorized, to Rupees 13,000 million by December 1982 (US$650 million).

Tax holidays to encourage investment have been accompanied by a variety of other fiscal relief measures. Included are such measures as exemption for interest earnings up to Rupees 2,000 on deposit with the National Savings Bank (a measure to spur savings), and exemption of up to one-third of assessable income if such income was spent on purchase of shares in new approved businesses, a contribution to a retirement fund, the purchase or construction of a house, or was classified as a research and development expenditure.

In 1980, both individual and corporate tax rates were cut. The maximum tax rate of 70 percent on individuals' income was lowered to 55 percent. Corporate rates were cut to 40 percent for companies with publicly quoted shares. Capital gains on publicly quoted companies are exempt from tax.

In the November 1981 budget, import and export duties were further reduced. However, an income tax surcharge ranging between 5 and 15 percent was levied on business firms and individuals to increase revenue. As well, a decision was taken to eliminate the tax holiday on new investments on March 31, 1983, which led to a raft of new share offerings to beat the deadline. Facilitating the capital markets was the establishment of a stock exchange, set up on September 29, 1982.

The 1983 budget proposed a general sales tax increase from 2 to 4 percent, and an across the board increase in the various turnover tax rates, along with a modest restoration of a 5 percent import duty on hitherto free items. The government of Sri Lanka has thus tried to raise additional revenue from its own sources, even as it increased its reliance on foreign sources.

Universal subsidization of all Sri Lankans in foodstuffs has been replaced with a selective subsidy in the form of "food stamps" to those with monthly incomes below Rupees 300/month (US$18/month). Food prices now realistically reflect local or overseas production costs.

State industrial and trading monopolies have been gradually reduced or eliminated. In 1977, some 90 percent of the economy was controlled by the public sector; this percentage fell to two-thirds by 1981 and the government hopes to continue in this direction.

The government has begun to shift public spending from consumption subsidies to investment in economic infrastructure, largely in the fields of irrigation, hydroelectric power (needed to support growing industrial demands on power), transportation, and communications. Consumption subsidies are scheduled to fall as a share of the budget.

<u>The Results.</u> Economic statistics that are thus far available are encouraging. Unemployment fell from a peak level of 24 percent in 1973 to about 15 percent in 1980 and, if recent rates of economic growth can be sustained, is expected to fall to the single digit level in the 1980s. Since 1977, real rates of economic growth have doubled. During the regime of Mrs. Bandaranaike, economic growth averaged 3.1 percent per year, a gain of about 1.5 percent per capita. Since 1977, the economy has grown at real annual rates of 8.2, 6.3, 5.8, and 5.8 percent respectively through 1981, and increases in per capita incomes are nearly threefold that in the prior regime. These higher growth rates since 1977 have been achieved despite the worst cyclone in decades, a worldwide economic slowdown, oil price hikes, and a severe drought.

Economic reforms often move in fits and starts. The United National Party government, taking office in mid-1977, inherited an economy in severe disrepair, suffering high inflation due to a 30 percent growth in the money supply fostered by the Bandaranaike government's policy of consumer subsidies. The Jayewardene government set out to fix both of these problems. First, it got the growth rate of the money supply down to 11 percent in 1978, thus slowing inflation. But it also embarked on an ambitious program of public spending on dams, power projects, housing, and other public works to make up for years of public neglect of the nation's infrastructure. Public spending outpaced the nation's internal and foreign aid resources, generating massive budget deficits. The Central Bank was forced to buy Rupees 6,800 million of new treasury bills in 1980 (virtually tripling central bank holdings of government debt in one year), and both the money supply and inflation accelerated to an annual growth rate of 30 percent. Central Bank purchases of treasury debt came to Rupees 3,800 million in 1981 and Rupees 3,300 million in 1982. Budget deficits averaging nearly Rupees 15,000 million for the three years 1980-1982 have also necessitated a substantial increase in foreign loans and grants. By the end of 1982, external debt stood at Rupees 35,600 million (US$1.75 billion) while the domestic debt had reached Rupees 36,600 million. Debt service payments for the 1983 budget are estimated at 29 percent of total current expenditure. By the end of 1982, total external reserves were sufficient to finance only approximately three months worth of imports.

Since the Jayewardene government has taken office, the Sri Lanka Rupee has depreciated approximately 30 percent against the US dollar. The government has been unable to get its fiscal house in balance. It has relied on inflation financing of a substantial portion of its annual budget deficits by Central Bank purchases of government debt. As a result, consumer prices doubled from 1977 and 1982. However, the floating exchange rate has prevented the currency from becoming overvalued and has not damaged the export performance of the economy. Without continued massive foreign financial assistance, the economy would surely have grown at a lower rate.

Another obstacle to economic recovery is the slow process of denationalization. Since the former government had nearly destroyed the private sector, the process of returning to a market economy is a slow, painful one. Two-thirds of the industrial and trading sectors remain in public hands, but this is a considerable reduction from the more than 90 percent that prevailed in 1977.

In 1983, the Jayewardene government overwhelmingly won a national referendum to continue the present government for another six years, bypassing, in the process, the normal election schedule. Investors are thus promised another six years of relative continuity in economic policy. If the economy can sustain its strong growth throughout this second term of office, it will have scored notable gains in a little more than one decade.

Although government policy has maintained the real exchange rate, internal inflation threatens to be a serious problem if the budget deficits are not slowly curtailed. Sri Lankans will need to temper their rush to development with fiscal prudence, lest their path to progress be strewn with thorns of debt and economic instability.

VIII. Free Markets and Economic Growth: An Empirical Summary

The principal goal of economic policy is to insure that scarce resources are allocated as efficiently as possible. It is generally recognized that the community's scarce resources can be efficiently allocated only by the price mehanism. For the pricing mechanism to work requires that neither the government nor a collusive private sector regulate prices or restrict entry and exit for buyers or sellers. Free competition insures the lowest possible prices for consumers and least-cost production.

Of course, in every society the government plays a major economic role in providing such services as national defense, public safety, and public works. It also provides the institutional framework within which economic exchanges take place. However, too often government undertakes responsibilities it cannot afford and interferes in the economy by subsidizing or taxing different economic interests. The extent to which a government pursues sound policies has an important effect on overall economic efficiency.

This discussion paper documents seven cases of postwar economic growth built largely on a free-market foundation. The seven reflect differences in historical development, geography, climate, population, resource endowments, culture and tradition, and postwar political structures. Although no two have undergone the same exact experience, one can distill a core of policies that foster growth and also identify other dimensions of policy that play a supportive role.

Most developing countries depend heavily on trade. The seven are no exception. They export primary products, raw materials, and manufactured goods, importing, in turn, a wide variety of foodstuffs and finished products. The mechanism which links the internal costs and prices of a country's goods and services with overseas buyers and sellers is the exchange rate. A rate that is too high (an overvalued currency) harms the competitiveness of exports in world markets. Imports become artificially cheap. These circumstances invariably lead to a balance of payments problem, and motivate the government to impose a variety of tariff and nontariff restrictions on imports. Protection, imposed either to preserve scarce foreign exchange or to deliberately assist the growth of import substitutes, typically results in inefficient production, since producers are spared the test of market competition. Thus the price of domestic inputs into locally produced goods rises above least-cost levels. A correctly valued exchange rate is absolutely central in equating domestic and world prices. A correct exchange rate is one that would prevail under conditions of free trade: no restrictions of any sort on imports and exports. Under free trade, buyers and sellers conduct their exchanges in domestic or world markets on a least-cost basis, and each country can exploit its comparative advantage in any good or service.

What stands in the way of maintaining a correctly valued currency or, as is all too often the case, preventing an overvalued currency? Large public sector deficits frequently force inflationary central bank purchases of public debt by issuing currency. The inflation tax becomes a primary vehicle by which a public sector deficit is financed. In the process, domestic prices rise above world levels. Unless the currency is correspondingly devalued, the exchange rate becomes overvalued. In addition, as public debt grows, debt servicing payments rise, further straining the public finances. Those countries that have avoided public debt, domestic or foreign, have enjoyed the most rapid growth. Sound public finance goes hand-in-hand with free trade.

Another serious obstacle to a correctly valued currency is government regulations, such as minimum wage standards, that push local costs above world levels, thus pricing local goods out of world markets.

External free trade is the best way to insure internal free trade. It is desirable that domestic producers have access to all the factors of production, labor, raw materials, goods and services, and capital, on a least-cost basis. Policies that raise wages above market levels (as set by supply and demand), or distort the cost of borrowing through selective credit allocation, or unnecessarily increase the costs of any input above market levels means a loss in efficiency. External free trade makes domestic regulations extremely costly and the effects readily visible, since any unwarranted increase in domestic costs damages external competitiveness.

In short, free trade, free entry, free movement of capital, no wage and price controls, coupled with a balanced budget, set in an environment of political stability comprise the essential ingredients in the recipe for growth. Other dimensions of economic policy can also accelerate or retard growth, but appear to be less important. The seven case studies suggest, for example, that the particular structure of a monetary system is not as important as maintaining a correct exchange rate, which offsets domestic inflation against world prices. The seven countries include examples of fully backed "currency board" currencies that appreciate, currencies that remained pegged to major international currencies such as the US dollar and French franc, or those that float, typically downward. Trouble arises when the currency is allowed to become overvalued, as in the Chilean situation in 1981.

Savings and investment policies also hinder or help long-run growth prospects. The most prudent strategy is to finance investment from domestic savings or foreign investment, rather than from borrowing. A burgeoning public debt drains resources away from investment into debt service and often implies higher future taxes to repay this debt, which discourages new investment. It also cramps fiscal flexibility. Hong Kong, Singapore, and Taiwan have relied on domestic savings and private foreign investment. Korea, the Ivory Coast, Chile, and Sri Lanka have borrowed heavily on both domestic and overseas financial markets. These latter countries face a more unsettled economic future because of their heavy indebtedness. A rapid rise in world interest rates, such as occurred in the early 1980s, imposed an unexpected rapid increase in debt service payments that countries like Chile could ill afford.

Although specific tax incentives can promote investment, incentives <u>per se</u> are less important than the maintenance of a neutral, low-tax environment, which does not destroy incentives to work, save, or invest. Hong Kong maintains a flat tax; others mix graduated income taxes with a variety of indirect taxes. But the overall burden of taxation rarely exceeds 20-25 percent. This aggregate percentage may be high by third world levels, but the rates on any given tax are not punitive. In three cases, Hong Kong, Singapore and Taiwan, tax receipts are sufficient to fund public spending. The other four face the prospects of higher taxes or lower public spending to get their fiscal houses in order.

It is sometimes alleged that economic growth depends on industrial development, of which the urban, city-states of Hong Kong and Singapore are cited as two prime examples. Taiwan and Korea are also noted for rapid growth based on manufactured exports. However, these two medium-sized nations retain large agricultural sectors. The Ivory Coast and Sri Lanka, by contrast, depend disproportionately on their primary, crop-producing rural sectors for the bulk of their national income and employment. A policy of high producer prices in the Ivory Coast is largely responsible for the health of that country's economy, whereas food subsidies were a main culprit in Sri Lanka's ill fortunes until the late 1970s. Chile looks to its exports of natural resources. Thus the claim that growth requires rapid industrialization is suspect on the evidence. Free trade is just as beneficial to agricultural and mineral producers as to manufacturers.

To summarize, a policy package of free trade, a correct (free-trade) exchange rate, a domestic business environment free from restrictions on prices and entry, an absence of cost-raising labor regulations, buttressed by balanced budgets and low levels of taxation is the magic formula for economic prosperity. Few countries adopt this mix or sustain high growth rates. If it is not possible to put an entire free-market policy package into place, it may still be feasible in a particular political context to adopt one or more modest incentive-enhancing measures to increase efficiency. In the remaining portions of this paper, a catalogue of proven modest reforms is assembled from which leaders of developing nations can select in pursuit of improved economic efficiency.

IX. A Piecemeal Approach to Market Incentives

Wholesale application of free-market policies in developing countries has been rare. A handful of island tax havens, added to the seven detailed case studies, yields no more than a dozen or so third world economic systems in which Adam Smith would find himself at home. The economies of the more than one hundred remaining nations reflect a large measure of government direction and control that cuts across the entire spectrum of economic policies. One typically finds in these countries a broad range of subsidies, both to industry and consumers, wage and price controls (often to the detriment of local agriculture), tariff and nontariff restrictions on imports, export imposts, capital controls, large budget deficits, a raft of state-owned enterprises (the bulk of which are poorly managed), and often shockingly steep income tax rates that hit the small middle class very hard. All too often, massive government involvement in local economies has retarded growth, exacerbated conflict in ethnically divided societies, and fostered widespread corruption.

Proponents of a Hong Kong economic system are told that such policies are politically infeasible in most poor countries, whose people and leaders will not tolerate unlimited foreign investment and ownership or let the marketplace allocate incomes and wealth. Considerations of local control, distribution of income (often referred to as equity), self-reliance (which explains why so many countries pursued import substitution strategies of development) dominate the policy agenda in most developing nations in Africa, Asia, and Latin America. Once a full panoply of government programs and controls is put in place, it is very difficult to overcome the political obstacles that resist its withdrawal, the myriad of individuals and organized groups that benefits from special privileges, protection, regulations, or preferential access to credit, licenses, subsidies, an official exchange rate, and so forth.

In the same breath, leaders of poor countries increasingly cast an admirable glance at the performance of the supergrowth economies. Indeed, in Taiwan, the government has established a center to which delegations from many poor countries have come to learn how to establish and operate a duty-free export processing zone. Throughout Asia, eyes turn with respect to Singapore. Thirty years of experimentation with heavy government involvement in economic development has brought new sympathy for economic experiments that restore and improve incentives through the efficiency properties in the pricing mechanism. The example that has a strong impact on the largest population bloc in the world is the introduction in 1979 of the rural production responsibility system in China that makes greater use of decentralized decision-making in investment and production in rural enterprises and farms, stronger incentives that link material rewards with the work of households and individuals, and greater use of the market mechanism in allocating resources.[1] In particular, farmers can sell crops beyond a state quota in markets governed purely by supply and demand. As an incentive, the Chinese government has reduced the size of the fixed quota. During 1978-1982, gross agricultural output rose at 5.6 percent a year, roughly double the average rate in the preceding twenty years. Higher prices have increased farmers' real incomes by 10 percent per year. Not surprisingly, the quality and quantity of produce available in urban areas has markedly improved.

These incentive-enhancing, market-oriented reforms have not brought private ownership of land or agricultural equipment, nor the abolition of minimum state quotas, in which quantities and prices are imposed on a variety of crops subject to compulsory delivery. Nor have they radically altered the landscape of overall economic policy which continues to find the Chinese government exercising the dominant role in production and allocation decisions throughout the breadth of the economy. Yet the introduction of liberal reforms in the rural sector, on a miniature free-market scale, has yielded large gains in efficiency and personal well-being of millions of people. Market reforms in rural China demonstrate that it is both politically feasible and economically beneficial to inject market forces into an otherwise heavily controlled economy.

Nor is China's rural experiment an isolated instance. Several dozen countries have injected market-based policies in a variety of areas encompassing private provision of public services, contracting out of public services, rational pricing of public enterprises (which typically means raising prices to reflect full opportunity costs), tariff reduction and simplification, divestiture of state-owned enterprises, allowing private sector firms to compete with state enterprises, closure of inefficient public enterprises, a whole raft of selective tax incentives to promote investment and exports, and so on. A comprehensive list of possible reforms can be assembled around the categories of taxation, expenditure, provision of public services, budgetary policy, trade, regulation, and monetary policy. Taken together, this set of reforms constitutes a total developmental package, resembling the general strategies of the Hong Kongs, Ivory Coasts, and other free-market economies. Viewed separately, each item represents a new reliance on market forces that is likely to foster greater efficiency in that sector of the economy to which it is applicable. A detailed classification, category by category, would include the following reforms.

Taxation: Establish a duty free port--no import duties or export taxes
Maintain low direct rates of taxation
Rely on consumption taxes to promote savings
Grant tax holidays
Permit accelerated depreciation
Provide for loss carryover
Grant reinvestment allowances
Move toward greater tax neutrality

Expenditure: Eliminate general and specific subsidies to business
Reduce the overall size of the public sector
Eliminate food and other consumer subsidies

Budget: Balance the budget
Avoid deficits and borrowing

Public Enterprises: Put on commercial basis
Rely on user fees where possible
Contract out to private enterprise
Make public enterprises independent and profit maximizers
Lease out public enterprises to private management
Divest publicly owned enterprises
Allow private competition with publicly owned enterprises
Abolish state marketing boards

Internal Regulation: Install clear, simple, inexpensive general business requirements
Maintain lenient labor regulations
Eliminate government monopoly privileges for trade unions
Eliminate protection for industry
Eliminate rent controls
Abolish minimum wage legislation
Avoid excessive severance pay requirements
Decentralize decision making
Eliminate system of permits, licenses, and monopolies over private enterprises
Don't hold down agricultural prices
Eliminate marketing board levies

External Regulation: Allow free movement of capital
Maintain a duty free port
Promote free trade

Remove quantitative restrictions on imports and exports
Attract private foreign investment
Minimize dependence on foreign aid
Establish export processing zones
Provide free repatriation of capital, interest, and dividends
Provide guarantees against expropriation

Monetary Policy: Maintain correctly valued exchange rate
Eliminate foreign exchange controls
Eliminate credit rationing
Increase real rates of interest to promote saving
Reduce and control inflation
Establish offshore banking privileges
Maintain currency convertibility

Examples of partial free-market policies abound in such countries as Argentina, India, Thailand, Turkey, Brazil, Kenya, Pakistan, Jamaica, Bangladesh, the Cameroons, Malawi, and Somalia, to name a few. These countries represent as much social, ethnic, geographic, economic, and political diversity as is found throughout the less prosperous regions of Asia, Africa and Latin America. With countries as large as China and India, as politically diverse as Somalia and Turkey, the above checklist of measures gives political leaders considerable choice in selecting reforms that are feasible and desirable within their own countries and the confidence that such changes promote much sought-after gains in efficiency.

X. Case Studies of Market Reforms in Poor Countries

It is a fair statement that postwar economic policy in the developing world has emphasized state participation in or direction of the economy. Governments have interfered in foreign and domestic trade, set exchange rates at artificially high levels, subsidized or taxed on a discriminatory basis, and directly supplied a raft of goods and services. In addition to government spending and investment, public sector enterprises in these countries alone typically account for 7 to 15 percent of Gross Domestic Product.[1] In Allende's Chile and Mrs. Bandaranaike's Sri Lanka, for example, virtually the entire economy had come under the direct or indirect control of the central government. State-owned industry and nationalized agriculture produced as much as 90 percent of national output. In neither country was there any private sector to speak of.

Chile and Sri Lanka are two extremely rare cases in which the government switched policy horses from state control to placing maximum reliance on the free market. Chile's Chicago boys virtually denationalized the entire economy; Sri Lanka's reformers have made a good start in the same direction. As previously discussed, both countries also undertook major tariff and exchange-rate reform, and used tax incentives to attract foreign investment. Searching the postwar record yields almost no other country in which economic policy underwent such a dramatic transformation. Most developing nations have clung tenaciously to widespread government control over their economies.

The reasons for large-scale government economic involvement are diverse, ranging from the need to integrate ethnically distinct regions, to ideological convictions in the superiority of socialism, or the belief that capitalism unfairly allocates income, or a desire to be rid of foreigners. But the successes of Asia's supergrowth economies have not gone unnoticed. In recent years, many poor countries have begun to experiment with modest reforms intended to inject greater efficiency into their economies. These reforms have encompassed changes in the scope and activities of state-owned public enterprises, tax policy, subsidies, economic regulations, and trade and exchange-rate policies. However, public sector enterprises have received the most attention. One reason is that the accounts of public enterprises have shown enormous deficits because they have been used deliberately to subsidize consumers and provide employment. Other reasons include the lack of competition, and access to public funds, which means that public enterprises are not forced to shut down if they lose money. Few public firms follow commercial procedures, thus prices rarely reflect full opportunity costs. Waste, inefficiency, and corruption are rampant. Concurrent with rising interest rates and third-world indebtedness, government officials have been forced to take an economically more hard-headed look at public enterprises.

In this final section, I first examine a variety of successful reforms that largely involve public enterprises, including the introduction of private competition, pricing on a commercial basis, privatization and divestiture, contracting out, and outright shutting down of inefficient firms. Next I discuss examples that reflect changes in internal regulation to foster increased domestic competition. Other topics include fiscal policy, trade and tariff liberalization, and monetary policy. Domestic reform is predicated on increasing the role of prices and competition; international changes are intended to link domestic and international price levels in accord with market conditions of supply and demand.

A. Reform of Public Enterprises

Introduction of Private Competition. World Development Report 1983, the most recent annual yearbook of the World Bank, has documented several successful examples of the beneficial effects of allowing private firms to compete with government-run monopolies.[2] In many cities, bus services are dominated by publicly owned or highly regulated companies operating full-size buses. Most require government subsidies to cover their deficits. In several cities, Buenos Aires (Argentina), Calcutta (India), and Chiengmai (Thailand), private companies running smaller buses have been allowed to provide service: All offer better service and are profitable.

Fifty private companies have been licensed to operate in Buenos Aires. Although the government sets their routes, they compete with each other in price and quality of service. Virtually every route is served 18 hours a day with well-maintained buses. In the late 1950s, a large public company failed to provide service on these routes, losing $44 million in 1959 alone, finally dissolving in 1962.

The experience of municipal Calcutta is starker still. Private buses were permitted to compete with the Calcutta State Transportation Corporation in 1966. They charged identical fares. The private firms earned a profit, while CSTC lost money. On similar routes, CSTC requires a monthly subsidy of $1 million. The private firms flourish through quicker repairs, better fare collection (public bus conductors lack this incentive), and higher labor productivity. Private buses now supply two-thirds of all bus trips.

In Chiengmai, the government has allowed the introduction of minibuses, whose operators set their own routes and fares, usually double that of public transportation. The service is so popular that private minibuses account for 90 percent of all trips at a modest profit, while the main bus company loses money.

Minibuses also operate in Nairobi, Istanbul, and Hong Kong, in each case serving less accessible neighborhoods, often providing the only means of transportation for residents in squatter areas or narrow streets. Earnings of private bus operators typically exceed those in public firms.

<u>Private Provision of Public Services.</u> It is not necessary for government to manage the provision of such public services as fire protection, water supply, sewerage service, and parks and roads maintenance, to name a few, just because the services are supported by public revenues. It is becoming increasingly attractive to contract out the provision of public services to cost-conscious private firms. In the Ivory Coast, for example, water and sewerage service is managed by a private company, of which 52 percent of the shareholders are Ivorians.[3] Although the Ministry of Public Works plans and builds new water projects, the private water company, SODECI, is paid a fee related to the volume of water sold, which covers costs of staff, equipment, energy, and a small profit margin. The fee also covers debt service. Unlike most other West African water companies, which operate at a loss and require subsidies, water charges in the Ivory Coast reflect full opportunity costs. Consumption is metered, waste and losses are low, and receipts are sufficient to finance required expansion of the system.

Water provision in the Ivory Coast reflects the general rule that consumers, not taxpayers, pay for the service they receive, with a concession to poor, small users. SODECI is guaranteed independence from central government intervention, retaining the right to hire and fire its own staff.

Limited evidence also suggests that private firms can maintain national roads at lower cost than government departments.[4] Since 1979, private contractors have taken over the maintenance of about half the national road network in Argentina. In Brazil, the federal highway authority reduced its road maintenance by 75 percent, in favor of private firms, between 1970 and 1980. Private maintenance in the Slovenian region of Yugoslavia has drastically reduced costs and staffing requirements.

One reason for more cost-effective provision is the tender process, which generates keen competition among private firms for the work. One comparative analysis in Brazil demonstrated that private contractors were 37 percent cheaper than a reasonably efficient government department.

Commercial Orientation. Public enterprises invariably run huge deficits. The reason is that they usually price their services on the basis of political considerations, rather than economic costs. Subsidies are a way of life for public enterprises, which means fewer resources are available to the private sector for investment or use in other government programs. Moreover, any service which is subsidized inevitably creates excess demand, which leads to wasteful use of scarce resources that are priced artificially low.

One simple solution is for governments to instruct their public enterprises to set prices which directly reflect costs. The most vivid illustrations of well-run public firms are those which, given a free hand in pricing, have tried to equate costs with prices. The Turkish fertilizer industry is a case in point.[5] A detailed analysis of the industry revealed that eight of seventeen fertilizer plants had serious shortcomings arising out of the scarcity of foreign exchange, which inhibited imports of raw materials and needed credit to finance working capital. Wage controls also discouraged competent personnel from entering the industry. Older plants could not be modernized to use less energy. In 1980, the government raised fertilizer producer prices to world levels, in the process restoring the viability of most companies, which have since expanded output and invested in improvements. Wage controls were lifted, and staff quality has improved. The results? Capacity utilization rose from 41 percent in 1979 to 67 percent in 1981.

In Malawi, a one-party state under the direction of President Banda, the public sector's share of investment stands at about 75 percent of the total.[6] There is very little of what we would call a private sector in the country. Most business enterprises are owned by various combinations of multinational firms, public holding companies, development banks, or a trust owned and directed by the President. Despite an overwhelming public presence in the day-to-day economy, public firms are generally instructed to set prices at levels which reflect full opportunity costs. Wage rates reflect supply and demand, not politically attractive, official pronouncements, and are lower than in surrounding African countries. Not all sectors of the economy enjoy free movement of prices, but the overall thrust is to let market signals dictate trade, investment, and production decisions. Tariffs are kept low and import quotas do not exist.

In response, Malawi has enjoyed sustained high per capita growth of 2.9 percent per year between independence in 1964 and 1979, despite a condition of relative resourcelessness, a landlocked location, the absence of an indigeneous entrepreneurial class, and an initially bankrupt fiscal house. A March 1983 Agency for International Development evaluation concluded that broad application of market incentives permitted the successful operation of public enterprises, which contributed to the strong growth of the economy.

A final illustration is contained in the experience of the Kenya Tea Development Authority, a state-owned enterprise in business since the early 1960s to process and export black tea.[7] KDTA and the growers it serves rely overwhelmingly on world market prices, riding a roller coaster of good or bad times in accord with market conditions. The agency has not tried to protect itself by building up large reserves through excessive levies on producers; it has, therefore, sustained high incentives to growers, operated efficiently, avoided government subsidies, and, over the long run, helped build a viable agricultural export industry.

Divestiture and Privatization. Several countries have begun to experiment with divestiture of public enterprises, or privatization of state economic activities. These terms reflect the selling off of all or part of the operations of public enterprises to private firms and individuals. Prior illustrations include Chile and Sri Lanka. Other illustrations can be found in Pakistan, Bangladesh, Somalia, and Jamaica.

The Government of Bangladesh has recently reformed its fertilizer distribution arrangements which shifted functions from public agencies to private traders.[8] Heavy population pressure on the land means that higher agricultural output has to come from greater use of fertilizer, since new land is not available to put into production. By the mid-1970s, the government had concluded that the nation's distribution system could not supply these higher quantities.

Procurement and marketing of all agricultural inputs, including fertilizer, was in the hands of the Bangladesh Agricultural Development Corporation (BADC), which employed 7,000 staff, operated 67 intermediate and 423 local level warehouses, and ultimately sold fertilizer to 20,000 active private dealers at a fixed price that afforded private dealers little room for profit. Dealers were confined in their operations to a carefully defined local area. As a result, some areas faced shortages of fertilizer, and others lacked adequate transport and storage facilities.

The United States Agency for International Development financed a project that supported construction of additional storage capacity but also phased in greater private sector involvement in fertilizer distribution. Under the scheme, BADC is withdrawing from fertilizer sales; instead, it sells primarily to wholesalers. All private dealers and cooperatives are permitted to buy from all BADC warehouses. Private movement of fertilizer is largely unrestricted. Farmers were permitted to buy from any trader. Licensing of traders was eased, and official prices were lowered thus affording dealers slightly higher profit margins.

Preliminary evidence shows an increase in sales, because each trader has an incentive to sell as much as he can under the free marketing distribution arrangements, a fall in retail prices due to competition between traders, effective movement of fertilizer from surplus to deficit areas (to take advantage of higher prices), and the development of a whole new class of private wholesalers, who respond to market forces, not the dictates of an official agricultural agency. It took, altogether, approximately five years to bring the wholesale function of fertilizer distribution into the private sector, but this success has produced plans to transfer seed and pump operations from BADC to the private sector.

Privatization and divestiture have been prominent features of recent policy initiatives in the African nation of Somalia.[9] In order to promote agricultural development, in 1977, the government loosened its restrictions on private land purchases in a region known as the Upper Shebelli, which take the form of 50 year leases. Between 1978 and 1982, over 4,800 leases were granted to cooperatives, private companies, and individuals that totalled just under 150,000 hectares. To facilitate irrigation and mechanization, the government gave away 38 pumps that had been lying idle, and sold off some 330 wheeled tractors that had been received as a gift from Iraq. A third change was a reduction in the role of the Agricultural Development Corporation (ADC), a marketing monopoly, which had held a monopoly of foodgrain purchase. Since May 1981, farmers need no longer sell their grain to ADC and can store as much of their annual output as they wish. A marketing monopoly has given way to virtual free trade in grain. Although ADC guarantees producer prices, free market prices are typically higher, which means that few farmers now sell to ADC.

In parallel, a state trading company, ENC, has lost its import monopoly on many basic goods. In its place, the government now grants letters of credit to private importers.

Fishing has also been privatized. Government created "cooperatives" and state fishing units working under the Coastal Development Agency failed to maintain a fleet of motorized boats, due to the lack of individual incentives among fishermen. The government price policy paid fishermen far below the market price. Other problems of public ownership and management surfaced, too. Free provision of inputs discouraged routine maintenance, nor were penalties imposed for improper handling of equipment. In 1981, the government undertook to sell off the motorized boats to private individuals: formerly 85 percent of the boats in government service were out of use; today, 85 percent in private hands are in service.

On a final note, the government has closed and handed to private agents four public enterprises and autonomous agencies: the Livestock Development Agency, the Agency for Building Materials, the Agency for Textiles and Household Appliances, and Somalfish, and is considering the abolition of other agencies.

In a report prepared for the U.S. Agency for International Development, Elliot Berg Associates concluded that the process of divestiture and privatization in Somalia had brought a strong surge in private agricultural activity, largely due to the government's new emphasis on private farming.

On a smaller scale, efforts at divestiture are being made in Jamaica. The newly elected government, under the leadership of Prime Minister Edward Seaga, has closed two of eight government-owned sugar mills and leased five others to domestic and foreign sugar producers.

Some 20,000 acres of land held by the Government Agricultural Development Corporation are being assessed for possible divestiture. In the tourism sector, four hotels have been leased to private firms. Others have been converted to office space.

Elsewhere, the Peruvian government that took office in July 1980 announced its intention to sell its shares in some 70 state-owned enterprises. In Pakistan, two small engineering firms were returned to the private sector, along with a rice mill and two sugar mills. The Government of Zaire abolished a number of agricultural public enterprises in 1978, and the Sudanese government has returned the public bus system in Khartoum to private ownership.[10]

<u>Closing Public Enterprises.</u> Some governments have taken the extreme measure of simply shutting down unprofitable public enterprises. In Malawai, for example, Spearhead Limited, a mini-congolerate that encompassed petrol stations, tobacco estates, tea and coffee estates, garment factories, and other pursuits, had flourished by the dubious procedure of bank overdraft under Treasury guaranty.[11] Due to poor management, increasing politicization of management, a lack of equity capital, and poor investment decisions based on prestige instead of profit, the firm fell into financial difficulty. President Banda, sole trustee and owner of the firm, placed the firm in receivership and instructed Price Waterhouse to sell off potentially profitable operations and close down the rest.

B. Domestic Regulatory Reform

The prior treatment of privatization in Somalia encompassed a number of internal reforms that, strictly speaking, were really exercises in deregulation. As mentioned, these included the practical abolition of the government's agricultural marketing monopoly and major state trading company, which effectively restored free market prices in agricultural production, and opened the import business to internal competition among numerous traders.

A vivid demonstration of the beneficial effects of unregulated pricing on economic activity is found in Cameroon.[12] Although the government tries to exercise overall control of the economy, it generally maintains a hands-off approach toward important sectors of the economy. The government sets producer prices in the case of major agricultural export crops often below world price levels. The differential between export prices and farmers' payments goes partly to infrastructure development and general budgetary purposes. However, despite the maintenance of a nominal price control system of certain essential commodities, and virtually all locally manufactured products and all local industrial products and services, it is largely unenforced and thus inoperative. "Private sector development has thus been relatively unhampered by Government intervention in the area of prices."[13] AID's evaluation suggested that setting producer prices in agriculture closer to world levels, which has come about due to a fall in world prices, would have a beneficial effect on output and rural incomes.

Labor regulation is a crucial part of any developmental policy. It has played an extremely important role in the development of Singapore, the Ivory Coast, and other rapidly growing countries. The cardinal aim of labor regulation is to insure that wage increases do not rise out of line with increases in productivity, thus pushing domestic costs above world levels. The Government of Malawi has been able to keep wage rates in line with the opportunity costs of labor. African manufacturing wages in neighboring Zimbabwe, Zambia, Kenya, and Tanzania are all substantially higher than in Malawi. As a result, Malawi's costs of production are very low for many industries, making Malawi's goods competitive on world markets.[14] Another beneficial impact of this policy has been to cause wage employment to rise more rapidly than growth of GDP.

C. External Regulatory Reform

Examples of external regulatory reform include reform and removal of tariff and nontariff barriers to trade, and currency reforms, most often devaluations, to bring domestic costs in line with world prices. Perhaps the best example of the beneficial effects of trade liberalization and currency adjustment is the case of Brazil, when liberal reform propelled increases in annual economic growth to 10 percent levels and produced what came to be known as the "Brazilian miracle."

Much has been written about the postwar growth of the Brazilian economy, with its switching back and forth between import substitution and export promotion.[15] Although the boom period of tremendous growth, 1968-1974, followed a series of liberalizing measures, at no time did the Brazilian economy reflect an overall free-market approach as, for example, in Chile. Indeed, by 1974, the prevailing economic system could best be described as state capitalism: estimates of the total government share of GDP range as high as 50 percent, with the public sector accounting for some three-fifths of total investment. Government firms dominated public utilities enterprises; electric power generation, the banking sectors, steel, and chemicals.[16] However, within this state-directed capitalistic economy, the government adopted in the mid-1960s several trade and tax policies that sharply improved the efficiency of the pricing mechanism in linking the Brazilian economy to world markets, and thus setting off a boom.

From the end of the Second World War until the mid-1960s, Brazil followed a policy oriented towards import substitution. Its policy mosaic consisted of the use of multiple exchange rates, high tariffs on imports, the exclusion of imports whenever a similar domestic product existed; in short, a highly protectionistic program. Protection for manufactured goods ranged up to 100 percent and more; for primary goods other than coffee, the rate was about 50 percent. At first, domestic production grew rapidly. After 1960, however, growth slowed down, when further attempts at import substitution in capital goods and intermediate products encountered increasing difficulties. Meanwhile, high domestic protection discriminated against exports, both by lowering the exchange rate and by raising the cost of inputs used in export production. Protective measures, all together, reduced exporters' earnings to about one-fourth less in terms of Brazilian cruzeiros for dollars earned than what they would have received in a free-trade regime.

The performance of the Brazilian economy between 1948 and 1967 reflects the diminishing benefits of industrialization via import substitution.[17] From 1948 through 1960, GDP growth averaged 6.8 percent, translating into an annual increase in per capita income of just under 4 percent. 1961 was a boom year: GDP rose 10.3 percent and per capita income 7.2 percent. The next six years, 1961-1967, were less robust. GDP ranged from a low of 1.5 to a high of 5.3 percent during the period, with increases or decreases in per capita GDP ranging between -1.3 and 2.3 percent. Industrial growth, imports, and exports all stagnated, but inflation exploded from the low double-digit level (12-20 percent between 1948-1960) to the high double digit level of 87 percent in 1964. The balance of payments and the government's budget both incurred substantial deficits, the latter amounting to 4 percent of GDP by the early 1960s. Monetization of these deficits is the primary culprit of accelerating inflation. The economic slowdown contributed to growing social unrest, which fostered the military coup of 1964.

Having secured its political position, the new regime installed a reform of the incentive system in the late 1960s.[18] The new policies included the elimination of tax discrimination against exports of manufactured goods, and the introduction of various export subsidies. Second, rates of import protection were reduced and the exchange rates were unified. Third, mini-devaluations were introduced, similar to the Chilean crawling peg, in place of intermittent and unpredictable changes in the exchange rate, to bring an overvalued cruzeiro down to its correct trading level. Fourth, public entity deficits (such as in the railroad system) were reduced and revenue-increasing tax reforms helped lessen the inflationary impact of the government budget. Fifth, the introduction of indexing for financial assets made it easier for the government to finance its remaining deficits in a noninflationary way.

Taking these up in somewhat more detail, exemption from federal indirect taxes enhanced the profitability of exports. Exports were then exempted from state indirect taxes, taxes on financial operations, and the special tax on fuel and oil. These measures were largely aimed at eliminating prior tax discrimination against exports, thus moving the system towards greater tax neutrality, but from 1968 on, additional export subsidies were granted in the form of federal and state tax credits, exempting export profits from income taxes, and preferential credits for exports. Since Brazil never fully operated under a free trade regime, export subsidies served the purpose of compensating for the discrimination against exports that resulted from an overvalued currency and the higher cost of domestic inputs associated with import protection. To repeat, subsidizing exports involved superimposing a system of export incentives on a system of import protection, which tried to neutralize the adverse effects of an overvalued currency and the higher costs of domestic inputs into the manufacture of export goods.

Tariff reduction took place in fits and starts. In early 1967, tariffs on manufactured goods were cut by about half, raised again in 1968, but again put on a downward track through 1973. By 1973, the average tariff on manufactured goods stood at about 57 percent of its 1966 level. Whereas the tariff wall in Chile had been virtually dismantled, in Brazil, import substitution industries continued to benefit from a substantial protective shield.

A series of mini-devaluations begun in 1968 depreciated the cruzeiro. In prior years, the exchange rate had been changed at infrequent intervals, wich gave rise to large variations in real exchange rates and created uncertainty for exporters, who could not accurately forecast the cruzeiro equivalent of their dollar earnings. Devaluations on a monthly basis restored a large measure of certainty in the foreign exchange markets, thus eliminating this obstacle to export growth.

Finally, some remaining measures included reducing public sector deficits through a payroll tax, increasing prices for public enterprises, indexing of financial asssets, and a more favorable treatment accorded to the inflow of foreign capital.

The period 1968-1974 has come to be known as the Economic Boom, as the performance of the economy was truly exceptional.[19] Aggregate indicators reveal that GDP grew at annual rates of 11.2, 10.0, 8.8, 13.3, 11.7, 14.0, and 9.8 percent respectively. On a per capita basis, GDP growth averaged 8.2 percent, exceeding, for a short while, the Asia superstars. Exports and imports rose from a combined figure of just under $4 billion in 1968 to surpass $20 billion by 1974. Industrial output increased by about 13 percent a year, and the inflation rate fell sharply from 55 percent in 1965 to the teens in the early 1970s. The volume of total exports grew at an average annual rate of 10.2 percent, but since exports of primary products remained stagnant, this figure translates into an annual average growth of 18 percent for non-traditional primary and manufactured goods. Only Korea's export growth exceeded Brazil's during this period.

Responding to a more attractive set of incentives, foreign capital flowed in. The ratio of foreign savings to gross domestic investment rose from 0.4 percent in 1966 to 7.7 percent in 1973, fueling a rise in the share of gross domestic investment in GNP from 22.3 to 27.5 percent in the same period. Increased profitability in a more open economy attracted rising levels of foreign investment. Small wonder from this statistical display that Brazil earned the nickname of an "economic miracle."

Since 1975, the economy has staged a mild retreat, with an accelerating downturn in the 1980s. Between 1975 and 1980, per capita GDP grew at the much slower annual rate of just under 4 percent. Inflation accelerated sharply to the hundred percent level. Increases in industrial output declined. And, the country incurred a tremendous increase in both public and private foreign debt, rising from a relatively modest $12.6 billion in 1973, to $32 billion in 1977, surpassing $90 billion in 1983.[20] (The stock of foreign direct investment grew much more modestly.) As a result, the debt-service ratio on public and private debt (amortization plus interest payments expressed as a proportion of export earnings) rose from an already heavy 35.3 percent in 1973 to a burdensome 50.7 percent in 1977, and to an economy-wrecking 350 percent in 1983. The country is literally bankrupt, scrambling from week to week to keep afloat on its foreign debt obligations. All economic growth goes into debt service, with none left for internal investment.

Since Brazil is dependent upon imported oil for about 80 percent of its petroleum usage, the 1974 oil shock dealt its economy a severe blow. However, the Asian growth economies were dealt even proportionately greater shocks, and yet sustained their highest growth during the 1975-1980 period. Thus, the oil price increase cannot be cited as a primary reason for economic retrenchment. We must look elsewhere for the causes. A key place to look, in addition to the massive running up of foreign debt, is in the decision to reverse policy courses back towards import restrictions. Beginning in 1974, there were widespread tariff increases, with some individual items being increased by 100 percent. These were coupled with an increase in nontariff barriers, including an import deposit system, the withholding of import licenses for a variety of finished consumer goods, and the installation of a variety of incentives to encourage import substitution in intermediate and capital goods, with heavy doses of subsidized official credit. An open economy was gradually closed. Brazilian policymakers responded to the 1974 recession by running up debt and restricting imports. A more approrpriate policy mix would have entailed exchange-rate depreciation and less recourse to foreign borrowing.

Prudent fiscal policy has been replaced with massive budgetary deficits, which have brought concomitantly large increases in the money supply and hyperinflation. The public sector deficit as a share of GDP has reached double digit levels. Inflation has become the chief vehicle for additional taxation to close this deficit, which has led to controls over interest rates in the banking system. Financial markets are considerably repressed and interest rates became heavily negative. The exchange rate policy, which tried to offset higher domestic inflation through regular devaluations, gave way to growing overvaluation of the cruzeiro, with further adverse effects on export performance.

In short, a retreat from liberal reforms imposed in the mid-1960s, which brought the great boom of 1968-1974, has resulted in a corresponding contraction of the economy. In retrospect, it seems astonishing that international bankers should have lent so many billions of dollars to the Brazilian public and private sectors without careful guarantees that such investments would be used profitably. The relatively high growth of the economy in the post-1975 years is due to heavy reliance on foreign borrowing, a policy that could not be sustained indefinitely. Korea, Chile, the Ivory Coast, Sri Lanka, and Brazil have all put the future growth prospects of their economies at risk on the retrospectively unwise recourse to excessive foreign borrowing.

To conclude, at no time did Brazil ever embark on a wholesale free market experiment. Rather, its leaders undertook a series of moderate liberalizing reforms in the mid-1960s, largely with respect to trade and currency adjustments, which brought both an export and overall growth boom. Retreat from these policies in the mid-1970s, a return to the historic policies stressing protectionist import substitution, slowed the performance of the economy.

D. Fiscal Reforms

An emphasis on supply-side economics, especially tax cuts, in the early 1980s has created the mistaken impression that budget deficits are relatively unimportant so long as tax rates are set at low levels. Nothing could be further from the truth. The reduction of public sector deficits, through a combination of revenue-enhancing reforms, reductions in public enterprise subsidies, and an overall shrinkage of public spending, significantly aids the fight against controlling domestic inflation and preventing an overvalued currency. An excellent illustration of conservative, prudent fiscal policy is found in Cameroon.

Since independence, Cameroon has practiced a conservative fiscal policy. In the footsteps of Hong Kong, it has more often recorded surpluses than deficits. A conservative fiscal policy has gone hand-in-hand with membership in the pegged CFA franc West African Monetary System. The Bank of Central African States (BEAC) sets credit policies for member countries within the context of the monetary position of the multi-country area as a whole, supervises banking and credit operations within each member country, and also provides short- and medium-term rediscounting facilities to member country banks. Within BEAC, Cameroon has always been the most financially conservative country, keeping its deposits with the Bank of France in excess of required amounts.[21] Since interest rates are regulated by the Central Bank, Cameroon enjoys little monetary policy autonomy.

The effect of these arrangements is that real interest rates on all types of loans have generally been positive, encouraging savings and investment. Interest rate ceilings have not been much lower than market clearing rates. Cameroon has experienced high investment rates, in some years exceeding 20 percent of GDP, and has corresponding enjoyed an average annual increase in per capita income of 2.9 percent since independence in 1960 and 1981.

The example of prudent fiscal and monetary policies in Cameroon reflects a steady hand in these areas, rather than any new departure in public policy since independence. Two decades of stable public finances and consistent monetary policy are valuable lessons that all developing countries could profitably emulate.

Summary

This final section has touched upon multiple mini-reforms that have been profitably implemented in a cross-section of less developed countries. They have ranged from improving the efficiency of public enterprises to liberalizing trade to the maintenance of sound fiscal and monetary policies. It has been possible to put comprehensive free-market policies into place into only a handful of countries. The examples in this concluding section demonstrate that a piecemeal approach to liberal reform, adopting just one or more efficiency enhancing measures, can pay handsome dividends. Of course, the more comprehensive the reforms, the more likely that the pricing mechanism can better do its job. But a small step towards market efficiency is a step in the right direction. It may indeed be politically infeasible in most poor countries to impose a Hong Kong-style comprehensive free market economic regime. It should, however, be possible in virtually every country to locate some area of the economy in which it is feasible to improve efficiency. It is the local people who are the beneficiaries of such measures.

Annex Table - Basic Economic Indicators

	Population (millions) Mid-1981	Area (thousands of square kilometers)	GNP per capita: Dollars 1981	GNP per capita: Average Annual Growth (percent) 1960-81
Hong Kong	5.2	1	5,100	6.9
Singapore	2.4	1	5,240	7.4
Taiwan	18.0	36	2,500	6.6*
S. Korea	38.9	98	1,700	6.9
Ivory Coast	8.5	322	1,200	2.3
Chile	11.3	757	2,560	0.7
Sri Lanka	15.0	66	300	2.5

	Average Annual Rate of Inflation (percent) 1960-70	1970-81	Adult Literacy (percent) 1980	Life Expectancy at Birth (years) 1981
Hong Kong	2.4	18.4	90	75
Singapore	1.1	5.2	83	72
Taiwan	4.1	10.3*	82*	72*
S. Korea	17.5	19.8	93	66
Ivory Coast	2.8	13.0	35	47
Chile	33.0	164.6	..	68
Sri Lanka	1.8	13.1	85	69

(Annex Table cont'd.)

Average Annual Growth Rate (Percent)

	GDP		Industry		Gross Domestic Investment	
	1960-70	1970-81	1960-70	1970-81	1960-70	1970-81
Hong Kong	10.0	9.9	..	..	6.9	14.1
Singapore	8.8	8.5	12.5	9.0	20.5	7.2
Taiwan	9.2	8.0#	16.4	12.9#	16.2	8.2*
S. Korea	8.6	9.1	17.2	14.4	23.6	12.2
Ivory Coast	8.0	6.2	11.5	9.3	12.7	12.1
Chile	4.4	2.1	4.4	0.7	9.9	3.0
Sri Lanka	4.6	4.3	6.6	4.2	6.6	9.4

Average Annual Growth Rate (Percent)

	Public Consumption		Private Consumption	
	1960-70	1970-81	1960-70	1970-81
Hong Kong	8.6	9.9	8.6	9.9
Singapore	12.6	6.3	[illegible].4	6.8
Taiwan	4.5	5.4#	8.3	6.8#
S. Korea	5.5	7.8	7.0	7.1
Ivory Coast	11.8	10.1	8.0	5.8
Chile	5.1	2.2	3.7	0.8
Sri Lanka	..	..	2.1	2.7

(Annex Table cont'd.)

Average Annual Growth Rate (Percent)

	Exports		Imports	
	1960-70	1970-81	1960-70	1970-81
Hong Kong	12.7	9.7	9.2	12.1
Singapore	4.2	12.0	5.9	9.9
Taiwan	23.7	9.3*	17.9	9.1*
S. Korea	33.4	22.0	20.6	10.9
Ivory Coast	8.7	5.1	9.7	5.7
Chile	0.7	9.8	4.8	3.5
Sri Lanka	4.6	-1.5	-0.2	1.4

(Annex Table cont'd.)

	External Public Debt as Percentage of GNP		Debt Service as Percentage of: GNP		Debt Service as Percentage of: Exports of Goods and Services	
	1970	1981	1970	1981	1970	1981
Hong Kong	0.1	1.2	..	0.8	..	..
Singapore	7.9	10.2	0.6	1.8	0.6	0.8
Taiwan	10.6	12.1*	1.4	2.6*	4.5	4.4*
S. Korea	20.8	32.1	3.1	5.8	19.4	13.1
Ivory Coast	18.3	54.4	1.1	13.2	2.5	22.5
Chile	25.8	14.1	3.0	5.3	18.9	27.2
Sri Lanka	16.1	36.6	2.0	2.1	10.3	5.7

Note: *The figures for Taiwan are current to 1978.

Source: For all countries except Taiwan, World Development Report 1983 (New York: Oxford University Press for the World Bank, 1983), Annex Tables 1, 2, 4, 9, 16 (pp. 148-9, 150-1, 154-5, 164-5, 178-9).

Statistics on Taiwan come from Shirley W. Y. Kuo, Gustav Ranis, and John C. H. Fei, The Taiwan Success Story (Boulder, Westview Press, 1981), pp. 7, 12, 23, 27-30, and from World Development Report 1980, the last year Taiwan was included in World Bank reports.

Footnotes

II. The Role of Government in the Free Market Economy

1. The harmful effects of the PL 480 grain shipments to Korea between 1955 and 1971 are set forth in David I. Steinberg, "Development Lessons from the Korean Experience--A Review Article," Journal of Asian Studies, XLII, No. 1 (November 1982), pp. 96-97.

III. Hong Kong

1. This section draws heavily from two of the author's prior books. See Alvin Rabushka, Value for Money: The Hong Kong Budgetary Process (Stanford: Hoover Press, 1976) and Hong Kong: A Study in Economic Freedom (Chicago: University of Chicago Press, 1979).

2. Current figures are found in Hong Kong Annual Reports. My figures are taken from Hong Kong 1982. Report for the Year 1981 (Hong Kong Government Press, 1982).

3. For a thorough treatment of the history, analysis and prescription of Hong Kong's monetary system, see the entire November-December 1982 issue of Asian Monetary Monitor, Vol. 6, No. 6, pp. 1-69, published in Hong Kong.

4. S.C. Chow and G.F. Papanek, "Laissez-Faire, Growth and Equity--Hong Kong," Economic Journal, 91 (362), June 1981, pp. 466-85.

IV. Vignettes of Growth: Singapore, Taiwan, and South Korea

1. I have made substantial use of several sources in preparing this brief description of Singapore's postwar development. For a

comprehensive history of Singapore from its founding until the mid-1970s, see Mary Turnbull, History of Singapore 1819-1975 (Singapore: Oxford University Press, 1975). On more concrete topics of economic development, see Lee Soo Ann, Singapore Goes Transnational (Singapore: Eastern Universities Press, 1977); Goh Keng Swee, The Practice of Economic Growth (Singapore: Federal Publications, 1977); Theodore Geiger, Tales of Two City-States: The Development Progress of Hong Kong and Singapore (Washington, D.C.: National Planning Association, 1973); Chow Kit Boey and Amina Tyabji, External Linkages and Economic Development (Singapore: Chopman, 1980); and Nicholas Harman, "The sovereign municipality," The Economist, December 29, 1979. A detailed analysis of the transition to and results of Singapore's export oriented policy appears in Augustine H.H. Tan and Ow Chin Hock, "Singapore," in Bela Balassa, Development Strategies in Semi-industrial Economies (Baltimore and London: Published for the World Bank by the Johns Hopkins University Press, 1982), pp. 280-309.

2. Goh Keng Swee, The Practice of Economic Growth, p. 2

3. This political and economic history is summarized in Ibid., pp. 2-3.

4. Theodore Geiger, Tales of Two City-States, p. 15.

5. Ibid., p. 159.

6. Ibid., p. 192. See also Lee Soo Ann, Singapore Goes Transnational, p. 60-63.

7. Theodore Geiger, p. 163 and Lee Soo Ann, pp. 22-23.

8. Nicholar Harman, "The sovereign municipality," The Economist, December 29, 1979, pp. 9-11.

9. In writing this section on Singapore's public finances I have

consulted the annual Singapore Yearbook, Singapore's annual budget documents, and the annual report of the Board of Commissioners of Currency. Thoughtful accounts of the Monetary Authority of Singapore, the currency system, the CPF, and their links to the budget are found in The Financial Structure of Singapore (Economics Department, Monetary Authority of Singapore, June 1980); Tan Chee Huat, Financial Institutions in Singapore (Singapore: Singapore University Press, 1978); and John R. Hewson, "Monetary Policy and the Asian Dollar Market," in Papers on Monetary Economics (Singapore: Published for the Monetary Authority of Singapore by Singapore University Press, 1981), pp. 165-94.

10. Theodore Geiger, p. 189.

11. Statistics on the performance of Singapore's economy are found in Chow Kit Boey, pp. 3-5, 14, 26, Theodore Geiger, pp. 168-69, and Lee Soo Ann, pp. 31, 35, 60-63, and Economic Survey of Singapore 1980, Ministry of Trade and Industry, entire volume.

12. This treatment of Taiwan in the postwar era depends heavily on several sources. The first is a collection of speeches delivered between 1959 and 1974 by K.T. Li, a major figure in the economic planning of the Taiwan government, having long held the most important post as Minister of Finance. It is entitled The Experience of Dynamic Economic Growth on Taiwan (Taipei and New York: Mei Ya Publications, Inc., 1976), and contains a valuable appendix of statistical tables. Another is a book-length treatment by Shirley W.Y. Kuo, Gustav Ranis, and John C.H. Fei, The Taiwan Success Story: Rapid Growth with Improved Distribution in the Republic of China, 1952-1979 (Boulder: Westview Press, 1981). A third is T.H. Lee and Kuo-shu Liang, "Taiwan," in Bela

Balassa, Development Strategies, pp. 310-50. Also useful is Hugh Sandeman, "An island on its own," The Economist, July 31, 1982. For a thorough review of monetary and fiscal policies, see Maxwell J. Fry, "Financial Structure, Monetary Policy and Economic Growth in Hong Kong, Singapore, Taiwan, and Korea, 1960-1981," (University of California, Irvine: March 1983, mimeo).

13. "Public Policy and Economic Development," in K.T. Li, The Experience of Dynamic Economic Growth on Taiwan, pp. 35-40.

14. Shirley W.Y. Kuo, et al., The Taiwan Success Story, pp. 48-55.

15. See Terutomo Ozawa, Multinationalism, Japanese Style (Princeton: Princeton University Press, 1980), p. 84. He shows that Taiwanese anticipation of the cessation of U.S. economic aid in 1965 brought the outward export-looking policies, which gave birth to Taiwan's "economic miracle," into being.

16. Details of these policies appear throughout K.T. Li's public essays and speeches and are found in Shirley W.Y. Kuo, pp. 73-84.

17. See Appendix, Table 16, "Net Revenues and Expenditures--All Levels of Government," in K.T. Li, p. 519.

18. "The Role of Fiscal Policy in Economic Development," in K.T. Li, p. 470.

19. The statistics reported in this section come from Shirley W.Y. Kuo, pp. 7, 12, 23, 27-30

20. The distribution of income is treated in Ibid., pp. 34-38.

21. My exposition of Korea's postwar economic development is largely drawn from the following sources: Parvez Hasan, Korea: Problems and Issues in a Rapidly Growing Economy (Baltimore: The Johns Hopkins University Press for the World Bank, 1976); Parvez Hasan and

D.C. Rao, coordinator authors, Korea: Policy Issues for Long-Term Development (Baltimore: The Johns Hopkins University Press for the World Bank, 1979); Kwang Suk Kim and Michael Roemer, Growth and Structural Transformation (Cambridge: Harvard University Press, 1979); Larry E. Westphal and Kwang Suk Kim, "Korea," in Bela Balassa, Development Strategies, pp. 212-279; Hugh Sandeman, "Asia's most ambitious nation," The Economist, August 14, 1982; and Major Statistics of Korean Economy 1979 (Seoul: Economic Planning Board). This section's summary of resources is summarized from D.C. Rao, "The Pattern of Economic Growth, 1961-76," in Parvez Hasan and D.C. Rao, Korea, p. 15.

22. Further information on Korea's historical setting is found in Parvez Hasan, Korea: Problems and Issues, pp. 25-29.

23. For a comprehensive analysis of Korea's land reform and grain pricing policies see Sung Hwan Ban, Pal Yong Moon, and Dwight H. Perkins, Rural Development (Cambridge: Council on East Asian Studies, Harvard University Press, 1980). See also David I. Steinberg's review of this study in "Development lessons from the Korean Experience--A Review Article," Journal of Asian Studies, XLII, No. 1 (November 1982), pp. 96-97.

24. See Kwang Suk Kim and Michael Roemer, Growth and Structural Transformation, p. 45. For a checklist summary of the full set of economic reforms, see p. 161 of the same volume.

25. Marinus van der Mel, "Public Finance," in Parvez Hasan and D.C. Rao, pp. 327-364.

26. Hugh Sandeman, "Asia's most ambitious na ion," The Economist, August 14, 1982, p. 17.

27. Rich details are contained in Major Statistics of Korean Economy 1979.

V. Ivory Coast

1. "Excerpts from the speech of the President of the Republic given at the VI th Congress of the PDCI-RDA (16 October 1975) in Summary of the Five Year Economical, Social and Cultural Plan, 1976-1980, Republic of the Ivory Coast, Ministry of Planning, p. 10.

2. The most comprehensive English-language treatment of economic progress in the Ivory Coast is found in Bastiaan A. den Tuinder, Ivory Coast: The Challenge of Success (Baltimore and London: Published for the World Bank by the Johns Hopkins University Press, 1978). This section draws from pp. 11-19.

3. Ibid., pp. 16, 54-61. See also Jean Masini, et al., Multinationals and Development in Black Africa: A Case Study in the Ivory Coast (New York: Praeger, 1980), p. 18.

4. Bastiaan A. den Tuinder, Ivory Coast, pp. 62-94, 103-116.

5. The phrase is found in Ibid., p. 20. See also pp. 20-54, 95-99. A summary of the country's economic policy is also found in Jean Masini, Multinationals and Development, pp. 5-34.

6. Summary of the Five Year Plan,"Chapter 5: Industry," p. 32.

7. Bastiaan A. den Tuinder, Ivory Coast, pp. 130-39.

VI. Chile

1. Alejandro Foxley, "Towards a Free Market Economy: Chile 1974-1979," Journal of Development Economics 10 (1982), pp. 3-29.

2. Jere R. Behrman, Macroeconomic Policy in a Developing Country:

The Chilean Experience (Amsterdam: North-Holland Publishing Company, 1977), pp. 22-25.

3. Ibid., pp. 34-77.

4. Statistics and analysis of Chile's changing public finances are found in Alejandro Foxley, "Towards a Free Market Economy;" pp. 3-12; Arnold C. Harberger, "The Chilean Economy in the 1970s: Crisis, Stabilization, Liberalization, Reform," Carnegie-Rochester Conference Series on Public Policy 17 (Amsterdam: North-Holland Publishing Company, 1982), pp. 115-22; Ronald I. McKinnon, "The Order of Economic Liberalization: Lessons from Chile and Argentina," Carnegie-Rochester Conference Series on Public Policy 17 (Amsterdam: North-Holland Publishing Company, 1982), pp. 160-69; and Chile 1980 Economic Profile (Published by the New York Office of the Chilean Development Corporation), pp. 30-32. These authors rely on data published by the Central Bank of Chile, the National Planning Office (ODEPLAN), the Ministry of Finance, the Chilean Development Corporation, though McKinnon also draws from the International Monetary Fund, International Financial Statistics Yearbook and Government Finance Statistics Yearbook.

5. Arnold C. Harberger, "The Chilean Economy in the 1970s," pp. 127-32, and Ronald I. McKinnon, "The Order of Economic Liberalization," pp. 172-78.

6. Ronald I. McKinnon, p. 174.

7. Alejandro Foxley, pp. 10-16.

8. Arnold C. Harberger, pp. 133-38, and Ronald I. McKinnon, pp. 164, 175.

VII. Sri Lanka

1. This section is based on direct field research conducted by the author in March 1981 and draws from his article "Adam Smith in Sri Lanka," Policy Review, Fall 1981, pp. 54-62. For statistical data, I have made extensive use of the Monthly Bulletin published by the Central Bank of Ceylon (Colombo: Sri Lanka, March and April, 1983), the Annual Budget Speeches of the Minister of Finance and Planning, and the Central Bank's Annual Review of the Economy.

2. For a brief review of ethnic politics in Sri Lanka, see Alvin Rabushka and Kenneth A. Shepsle, Politics in Plural Societies: A Theory of Democratic Instability (Columbus: Charles E. Merrill, 1972), pp. 129-141.

IX. A Piecemeal Approach to Market Incentives

1. World Development Report 1983 (Washington, D.C.: The World Bank, 1983), p. 54.

X. Case Studies of Market Reforms in Poor Countries

1. Leroy P. Jones and Edward S. Mason, "Role of Economic Factors in Determining the Size and Structure of the Public-enterprise Sector in Less-developed Countries with Mixed Economies," in Leroy P. Jones (ed.), Public Enterprise in Less-Developed Countries (Cambridge: Cambridge University Press, 1982), p. 23.

2. World Development Report 1983 (New York: Published for the World Bank by Oxford University Press, 1983), p. 52.

3. Ibid., p. 53.

4. Ibid., p. 90.

5. Ibid., p. 55.

6. Jerome M. Wolgin, et al., The Private Sector and the Economic Development of Malawi (Washington, D.C.: U.S. Agency for International Development, March 1983), pp. 22-26, and Accelerated Development in Sub-Saharan Africa: An Agenda for Action (Washington, D.C.: The World Bank, 1981), p. 92.

7. World Development Report 1983, p. 78.

8. Accelerated Development in Sub-Saharan Africa, pp. 67-68.

9. Elliot Berg Associates, Encouraging the Private Sector in Somalia, A Report Prepared for the U.S. Agency for International Development (September 1982), p. 47.

10. Elliot Berg, Changing the Public-Private Mix: A Survey of Some Recent Experiences in LDCs, A Report Prepared for the International Monetary Fund Fiscal Affairs Department (February, 1983), pp. 9-10.

11. Jerome M. Wolgin, The Private Sector, The Public Sector, And Donor Assistance in Economic Development: An Interpretive Essay (Washington, D.C.: U.S. Agency for International Development, March 1983), p. 18.

12. Salvatore Schiavo-Campo, et al., The Tortoise Walk: Public Policy and Private Activity in the Economic Development of Cameroon (Washington, D.C.: U.S. Agency for International Development), March 1983).

13. Ibid., p. vii.

14. Jerome M. Wolgin, et al., The Private Sector and the Economic Development of Malawi, p. 25.

15. The literature on Brazil is both voluminous and controversial. I have made substantial use of the following books and articles:

William G. Tyler, Manufactured Export Expansion and Industrialization in Brazil (Tubingen: J.C.B. Mohr (Paul Siebeck) for the Institut fur Weltwirtschaft an der Universitat Kiel, 1976); William G. Tyler, The Brazilian Industrial Economy (Lexington: D.C. Heath and Company, 1981); Bela Balassa, "Incentive Policies in Brazil," World Development, Vol. 7, pp. 1023-1042; and a debate conducted in the pages of the American Economic Review on the extent to which Brazilian growth adversely or beneficially affected the distribution of income which includes Gary S. Fields, "Who Benefits from Economic Development?--A Reexamination of Brazilian Growth in the 1960's," Vol. 67, No. 4 (September, 1977), pp. 570-582; Montek S. Ahluwalia, et al., "Who Benefits from Economic Development?: Comment," Vol. 70, No. 1 (March, 1980), pp. 242-245; Paul Beckerman and Donald Coes,"Who Benefits from Economic Development?" Comment," Vol. 70, No. 1 (March, 1980), pp. 246-249; Albert Fishlow, "Who Benefits from Economic Development?: Comment," Vol. 70, No. 1 (March, 1980), pp. 250-256; and Gary S. Fields, "Who Benefits from Economic Development?" Reply," Vol. 70, No. 1 (March, 1980), pp. 257-262.

16. William G. Tyler, Manufactured Export Expansion and Industrialization in Brazil, pp. 56-58.

17. William G. Tyler, The Brazilian Industrial Economy, p. 3.

18. Ibid., pp. 4-5, William G. Tyler, Manufactured Export Expansion, pp. 190-253, and Bela Belassa, "Incentive Policies in Brazil," pp. 1024-1025.

19. William G. Tyler, The Brazilian Industrial Economy, p. 4, and Bela Belassa, "Incentive Policies in Brazil," pp. 1026-1027.

20. Fortune, August 22, 1983, p. 150.

21. Salvatore Schiavo-Campo, et al., The Tortoise Walk, pp. 29-31.