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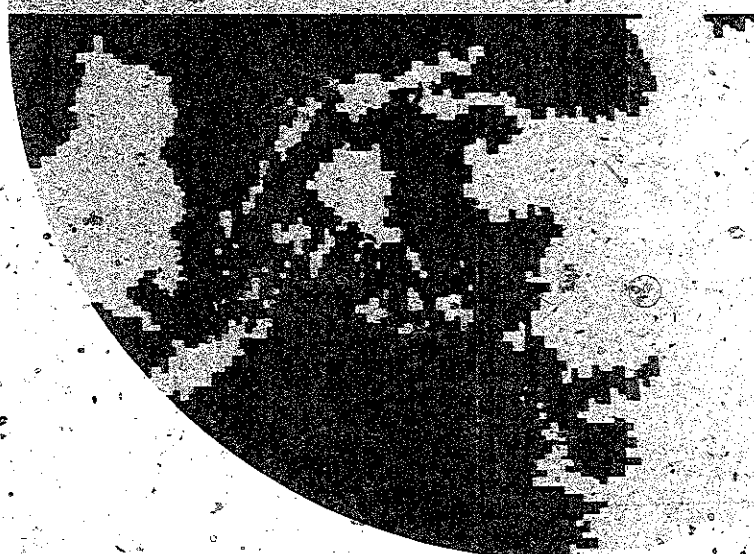
ECONOMIC POLICY AND ECONOMIC GROWTH

Arnold C. Harberger



International Center for Economic Growth

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Economic Policy and Economic Growth

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International Center
for Economic Growth

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PREFACE

In late 1984, the Institute published *World Economic Growth: Case Studies of Developed and Developing Countries*, edited by Arnold C. Harberger, of the University of Chicago and University of California at Los Angeles. The response to the study, which examined five developed and seven developing countries, was so positive that the Institute has established a new International Center for Economic Growth to develop a research and publication program on economic policy, focusing particularly on less-developed countries.

This monograph is the first of the new Center's publications. It reprints, with minor editing changes, Harberger's introduction and conclusion, together with the table of contents from the larger study.

The heart of Harberger's conclusion is his thirteen policy "lessons," which represent the findings of policy professionals on how to encourage growth. Countries that have had good economic performance have tended to follow these lessons; countries that have stagnated or even declined have tended to violate them.

Future publications of the Center will examine issues of privatization, the underground economy, tax policy, trade policy, and other issues related to economic growth. We hope this monograph, which serves as a summary of the larger study, will make its essential conclusions accessible to a large audience of people concerned about these important issues.

Glenn Dumke
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San Francisco, California
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ABOUT THE AUTHOR

ARNOLD C. HARBERGER is Gustavus F. and Ann M. Swift Distinguished Service Professor at the University of Chicago, as well as professor of economics at University of California at Los Angeles. He has been a consultant to central banks, finance ministries, and planning agencies in more than a dozen developing countries, as well as serving in a similar role for the World Bank, the International Monetary Fund, several regional development banks, and the foreign aid agencies (as well as others) of the United States and Canada. He is the author of *Project Evaluation* (1972), *Taxation and Welfare* (1974), and the editor of *Key Problems of Economic Policy in Latin America* (1970).

Economic Policy and Economic Growth

Arnold C. Harberger

The study, *World Economic Growth: Case Studies of Developed and Developing Nations,** and the conference whose proceedings it records seek to explore the connections between economic policy and economic growth. To the layman this may appear to be a simple task, but quite emphatically, it is not.

A good starting point for demonstrating that the task is not easy is to go back to the era of the immediate postwar period, when many people thought it was. This period marked the birth of the modern theory of economic growth. Its hallmark, the so-called Harrod-Domar model of economic growth, was built on the basis of two simplifying assumptions: (1) the national income of a country is proportional to its capital stock, and (2) increases in the capital stock come from the savings of the people, which is assumed to represent a given proportion of the national income. This was a simple world indeed, and the policy implication of the underlying analysis was clear: to increase growth, one should increase the national savings rate.

This approach gave rise to an extended period in which the discussion of economic growth focused almost exclusively on the stock of physical capital, and on the national savings rate as a means of increasing that stock. Within this framework it was easy to identify the force that produced economic growth, and it was also reasonably easy to test whether a particular policy was likely to increase or impede that force. A simple theory, a straightforward causal mechanism, and easy identification of growth-

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producing policies: an economist's paradise, it would seem, until it was realized that this paradise did not even come close to capturing the reality of the world in which we live.

Older analysts of economic growth, even as far back as Adam Smith (1776), did not start with a theoretical model but tried to build up their analyses on the basis of their observations of the real world. Their writings exude the complexity of the growth process as if from the pores.

Starting in the middle 1950s, the spirit of the older analysts was revived, as the approach taken in the Harrod-Domar model was broadened and extended so as to include a much more comprehensive list of the sources of economic growth. These sources would include:[1]

- increases in the active labor force through demographic growth, increased labor force participation, or absorption of the unemployed;
- improvement in the quality of the labor force through education, experience, and on-the-job training;
- improvements in efficiency through better allocation of the labor force, i.e., the shifting of labor force from lower-productivity to higher-productivity jobs;*
- increases in the capital stock through increased private-sector or public-sector savings (adjusted, of course, for the negative growth stemming from the depreciation or retirement of old components of the capital stock);
- improvements in the quality of components of the capital stock through improved design and technical innovation;
- improvements in efficiency through better allocation of the capital stock, i.e., the shifting of capital from lower-productivity to higher-productivity activities;*
- improvements in efficiency through the expansion of activities subject to economies of scale;

*"Productivity" in these cases should be taken to refer to marginal productivity, gross of taxes, and similar distortions.

- improvements in efficiency through the reduction of distorting elements such as (1) taxes that give differential treatment to the use of resources in some activities vis-à-vis others; (2) quotas and licensing schemes that prevent resources from flowing into certain activities, even though those resources would be highly productive there, and (3) monopoly elements and other private restraints that impede the efficient allocation of resources within the economy;
- improvements in efficiency through finding cheaper and better ways of producing existing products;
- improvements in efficiency through the improvement of existing products and the development of new ones.

Readers will quickly appreciate the common sense reflected in the above list. It would be hard to quarrel with or to amend. It appears truly to reflect the reality and complexity of our world. The only trouble is that now, faced with this more realistic interpretation of how the process of economic growth works, it becomes harder to identify how policy measures impinge on that process.[2] Thus even up to the present day, those who have tried to analyze actual growth rates by the modern theory of economic growth have found themselves limited (substantially) to giving empirical estimates of how much of the observed growth was due to the accumulation of capital, how much to the increment of the number of workers, the improvement of the quality of labor, the better allocation of resources, or to technical advances. Economists have not been able, then, to move forward and say what role government policies have played in the entire process.

Sometimes it is possible to study the effects of a single government policy on the rate of economic growth. This is relatively easy to do where the policy operates mainly on a single source of growth. Thus, an educational program works to improve the quality of the labor force; if the degree of improvement can be estimated (as indeed it often can), one can estimate the contribution of that particular policy to economic growth. It has also proved possible to estimate, for example, the contribution to economic growth made by the research programs that developed (and subsequently improved) hybrid corn, and similar varietal improvement programs. The task of linking a particular policy with its "contribution" to economic growth is also relatively easy when one is dealing with, say, a tax incentive designed to expand investment.

But how does one build a link between a country's growth rate and the entire package of laws, decrees, administrative measures, judicial constraints, etc., that constitute that country's economic policy at any given moment? This is a question that, though they are building on the very solid advances we have seen in the past thirty years, economists have not been able to answer.

Our study attempts, using a much more holistic approach, to get around the difficulty—indeed the virtual impossibility—of building a direct link of modern theory between the observed growth rate of a country and its overall economic policy. The underlying idea is to identify episodes of successful growth, stagnation, and even retrogression in economic activity, and then to try to see whether different types or styles of economic policy characteristically prevailed in these different episodes. In particular there is the question of whether what economic science would call "good" economic policy seems to be associated with "good" results, and similarly whether "bad" policy tends to be associated with "bad" results.

The economic histories of many countries covered in this volume provide an excellent opportunity for comparisons among episodes of different types. This is especially true of the less-developed countries (LDCs), because in those instances the possibility of episodic comparison was actually one of the criteria applied in compiling the list of countries to be studied.

Jamaica and Ghana are dramatic examples. In the former country, gross domestic product (GDP) rose about 3.8 percent per year from 1960 to 1966, then rose over 6 percent per year from 1966 to 1972, and finally fell, between 1973 and 1980, by a total of about 18 percent. In Ghana, income was growing at about 5 percent per year around the turn of the decade of the 1960s; then, from 1962 to 1968, the rate fell to 1.7 percent per year. This was followed by a sharp spurt from 1968 to 1971, again at about 6 percent, after which growth slowed to about 3 percent before turning sharply negative after 1974.

Uruguay's GDP grew a total of 9 percent from 1955 to 1973, while population grew about 17 percent. Thus GDP per capita gradually eroded over this period. GDP then grew by 46 percent (or 5.6 percent per year) from 1973 to 1980, while population rose by only 6 percent.

Tanzania's economy grew at an average annual rate of 5.4 percent per year during the period 1965 to 1977, while population grew at 3 percent. Thereafter, output virtually stagnated, while population expanded by 9 percent in the four years between 1977 and 1981.

The dramatic changes in the Mexican economy were not in the GDP growth rate, but in other variables. Between 1953 and 1973, domestic inflation averaged less than 5 percent per year; during the next seven years the average rate was 22 percent; from 1980 to 1982 the average was 42 percent. Another way of seeing Mexico's situation is to note that from 1953 to 1973 the average growth rate of GDP was 7 percent, while from 1973 to 1982 it was less than 6 percent. This apparently innocuous difference takes on new meaning once one realizes that the earlier period predated Mexico's major oil discoveries, while the later witnessed their full exploitation.

Indonesia and Taiwan are the big success stories among the less-developed countries represented in our study. But even in their cases one can find a basis for contrasting good episodes with bad. As is characteristic of success stories, in these two cases the bad episodes came at the beginning, and were relatively brief. Indonesia's economy was declining in per capita terms in the early 1960s. Her 1967 GDP was 14 percent higher than her 1960 GDP, while population was 19 percent higher. Moreover, inflation burgeoned to over 300 percent per year during this episode. In contrast, from 1968 to 1980 GDP grew at an average rate of 8 percent and the average rate of inflation was 23 percent per year.

In Taiwan the comparison is perhaps best described as being between outstanding episodes on the one hand and a merely "good" initial performance on the other. From 1955 to 1960, income per capita rose by a mere 15 percent (over the five-year period). Successive subsequent quinquennia, in contrast, generated growth rates of 37 percent, 43 percent, 31 percent, and 43 percent. The Taiwan story, then, concerns how the country passed from a more or less ordinary situation to being labeled the "Taiwan miracle."

The economically advanced countries represented in our study were chosen mainly for their importance in the world economy. The United States, Japan, West Germany, and England are four of the five largest national economies in the non-Communist world. In addition there are interesting differences among them as to institutional arrangements, styles of economic policy, and above all, growth performance. Sweden was added to the group as a particularly good representative of the democratic socialist approach to economic policy. Table 1 gives certain key items of information concerning both the industrial countries and the LDCs covered in our study.

In addition to the twelve studies of individual countries, our study also contains a paper specifically oriented to the topic of trade liberalization. The reason for this will become apparent to readers as they digest the material in the studies of individual countries, particularly those referring to the LDCs. The degree of openness of an economy is one of the strategic variables on which its policymakers must decide, and much evidence suggests that a relatively high degree of openness is a key factor in permitting a small economy to enjoy rapid growth over an extended period. Thus the process of trade liberalization is often an important component of programs designed to modify a country's economic policy so as to promote economic growth. It is surely of sufficient importance to warrant its inclusion as a special topic in a series of studies on the relationship between economic policy and economic growth.

The overwhelming majority of participants in the conference—not only the authors of the principal papers, but also the formal discussants as well as the great bulk of attendees—have devoted a great part of their professional lives either to studying economic policy, consulting about it, or implementing it directly. In a very real sense, this was a conference of professionals talking to professionals, and its ambience and tone faithfully reflected that fact.

As in most fields, economic policy professionals come over time to share certain perceptions, attitudes, and concerns, even when their individual viewpoints on many specific matters may differ.

Table 1

Basic Indicators of Economic Performance

	GDP growth rate		Population growth rate		Average inflation rate	
	1960–70	1970–81	1960–70	1970–81	1960–70	1970–81
Industrial countries						
West Germany	4.4	2.6	0.9	0.0	3.2	5.0
Japan	10.4	4.5	1.0	1.1	5.1	7.4
Sweden	4.4	1.8	0.7	0.3	4.3	10.0
United Kingdom	2.9	1.8	0.6	0.1	4.1	14.4
United States	4.3	2.9	1.3	1.0	2.9	7.2
Less developed countries						
Ghana	2.1	−0.2	2.3	3.0	7.6	36.4
Indonesia	3.9	7.8	2.1	2.3	4.9	20.5
Jamaica	4.4	−1.2	1.4	1.5	4.0	16.8
Mexico	7.6	6.5	3.3	3.1	3.5	19.1
Tanzania	6.0	5.1	2.7	3.4	1.8	11.9
Taiwan	9.8	8.2	3.1	1.9	3.4	10.7
Uruguay	1.2	3.1	1.0	0.4	51.1	60.2

Sources: World Bank, *World Development Report 1983*, Tables 1, 2, 19; for Taiwan, *Statistical Yearbook of the Republic of China*, various issues.

The professionals in this field are certainly not naive—they do not need textbook lessons to convince them of the fearful complexity of the growth process. They *know* there is no magic formula—no combination of one or two or even ten or twelve policy buttons that, once pushed in the right order, will guarantee economic growth.

Economic policy professionals are also well accustomed to frustration. Proposals aimed at improving policy must run a gauntlet of hazards and obstacles on their way to implementation. Most proposals do not survive, and of those that do, many emerge so mutilated or distorted that they no longer serve their intended purposes.

The frustrations of the policy process lead many professionals to become cynical after a time—to burn out, as it were. Some simply abandon their economic policy interests and turn to other things, usually in private life. Others just lose enthusiasm and "adapt to the system."

The conference group was not, however, made up of cynics and dropouts. They were members of a different clan—of dedicated people who somehow manage to bear frustration without losing hope or heart.

The foregoing paragraphs suggest the broad outlines of the professional's approach to the relationship between economic policy and growth. First is the broad recognition that policy can influence growth, either for good or ill, in many ways. The task is thus to try to exploit as many as possible of these avenues for the good. Second, it is clear that governments operate under political and social pressures from many different sources, and it would thus be foolhardy to expect those governments to march solely to the economist's drumbeat in formulating policy. Third, one must recognize that to the extent governments follow the beat of other drummers, they will probably sacrifice some amount of economic progress. And finally, successful economic policy consists in maintaining as high a batting average as possible in the countless policy decisions affecting the economy. When it must yield to other forces and pressures, successful policy will find ways to minimize the sacrifice or compromise of sound economic objectives, and will avoid critical errors of macroeconomic policy.

Some Lessons of Economic Policy

Following are some widely shared conclusions of policy professionals about the principal "lessons" associated with successful growth policy:

1. *Avoid false technicism in economic policymaking.* Too often, and in too many countries, the task of economic planning has been conceived as that of making projections (predictions) of future economic progress. Sometimes these predictions have been elaborated in incredible detail, to the point of projecting the output of individual industries five or ten years into the future. Such exercises simply have not paid off. They have been a waste of good talent and money. They have distracted able people from the more important task of attacking real economic policy problems; and, to make things worse, they have generally been wide of the mark—often corrupted by commingling with political promises and propaganda.

2. *Keep budgets under adequate control.* Budgets need not be balanced, but there are severe limits to the budget deficits that can be incurred with relative impunity. Somewhere along the line, budgetary authorities must learn to say no to spending requests, and standing behind them, governments must learn to resist pressures to spend more. The time for governments and budgetary authorities to take their stand is clearly *before* budgetary discipline has broken down. Some bending and yielding there will (and probably must) always be, but once authorities have caved in too many times, it is as if a dam had broken, and they will be overwhelmed by a flood of requests from newly-hopeful solicitants.

3. *Keep inflationary pressures under reasonable control.* To encourage economic development in a small country, the optimal policy may be to live with the ongoing rate of inflation in the world economy. However, if, for whatever reason, a higher rate must be accepted, it should be kept both moderate and steady.

Most of the major inflations in the postwar period have had their roots in excessive fiscal deficits (see the previous point), which the governments could only finance by resort to the printing press. This was true in Argentina, Chile, and Indonesia in the 1960s, and in the recent eruptions of inflationary forces in Africa. But it is also possible to unleash very dramatic inflationary forces by printing money in order to grant credit to the private sector—as occurred in Uruguay for more than two decades, and in Brazil for about a decade beginning in the mid-1960s.[4]

Inflation undermines growth in two ways. First, it disturbs the most basic process whereby relative prices guide resources from lower-valued to higher-valued uses. In fact, the very essence of growth occurs as resource investments are made in situations featuring high relative output prices (benefits) and low input prices (costs). The key to the process is clear signals about relative prices. Inflation, on the other hand—especially when it is unsteady and thus unanticipated—disturbs those signals by obscuring the difference between *relative* and *absolute* price rises.

A second problem with inflation results from rewarding people for estimating the correct inflation rate—and thus making money from people who guess either too low or too high. Guessing the inflation rate does nothing to make the economy grow, and inflation thus diverts productive resources to non-productive purposes.

Finally, inflation tends, especially when it is unanticipated and unindexed, to generate capricious transfers of wealth among economic sectors and groups. This breaks the link between earnings and effort, and has been known to cause violent political upheavals sparked by the embittered losers.

4. *Take advantage of international trade.* It may be that most policy professionals, deep down, are free traders at heart. But this is not the way they speak in policy forums: on such a politically incandescent topic as protectionism, the professional's credibility with different groups depends on discretion. Thus, rather than openly celebrating free trade, modern policy professionals tend to emphasize the strategic choice between a relatively open versus a relatively closed economy.

The relatively open economy implies high imports and high exports relative to GDP. The relatively closed one implies the reverse: low imports (because of import restrictions) and low exports. Restrictions on imports act also as indirect restrictions on exports by causing changes in exchange rates, thus raising the prices of exported goods. The underlying reason for this process is that imports must ultimately be paid for by exports; and if you limit one, you thus necessarily limit the other. Protecting imports thus *dis*protects exports, distorting the most efficient allocation of resources as protection of relatively less efficient import-competing industries diverts resources (capital and labor) from more efficient export industries. In our study, Taiwan presents the most vivid picture of advantages from liberalizing trade restrictions. With liberalization in the early 1950s, a veritable explosion of trade occurred over the next two and a half decades, increasing the dollar volume of Taiwan's exports 200 times between 1954 and 1980.

The policy professional's task at this stage is to moderate these distortions, to avoid reducing the volume of trade very seriously below its potential.

5. *Some types and patterns of trade restrictions are far worse than others.* Economists' understanding of restrictive processes took a giant step forward in the 1960s with the development of the concept of "effective protection." It was found, among other things, that the same tariff on a final product can imply incredibly different amounts of effective protection, depending on how important are imported inputs into the productive process and on how they are taxed.[5] The only sure way to guarantee against catastrophic variations in rates of effective protection—even with moderate-looking rates of nominal protection on final products—is to make the rate of nominal protection uniform across all final products. This obviously means including raw materials and capital goods in the list of commodities subject to the uniform rate of protection. Even goods that are not produced in the country, and perhaps never can be, should still be subject to the uniform rate so as to keep "honest" the degree of effective protection granted to products in which they are inputs.[6] For only when all *nominal* rates of protection are equal are all *effective* rates equal to this same nominal rate. Only a given uniform rate of tariff can automatically avoid capricious and distorting variations in the effective rates of protection actually achieved. Modification of tariff schedules in the direction of greater equality is thus one of the most important reforms advocated by professionals.

6. *If import restrictions become excessive, and reducing them directly is politically impossible, mount an indirect attack on the problem by increasing incentives to export*—helping to compensate for the anti-export bias that comes with restrictions on imports. The most natural instrument for encouraging exports is to rebate

at the border indirect taxes incurred during production. Such rebating is explicitly approved by the General Agreement on Tariffs and Trade (GATT) and has been implemented in whole or in part by many countries.

Other devices for encouraging exports include rebate of direct taxes and even (more drastic still) direct subsidies. (Although not approved by GATT, the latter have been used by some countries and are justified up to a point on purely economic grounds.) Obviously, when this neutralizing device has been fully implemented, further use of it ceases to be a corrective and becomes a new source of distortion.

7. *Make tax systems simple, easy to administer, and (as much as possible) neutral and non-distorting* with respect to resource allocation. The best tax for accomplishing all three of these purposes is the value-added tax. First introduced in France in the early 1950s, this tax has come to be the most important source of revenue in close to half the non-Communist world. Its neutrality, perhaps its most distinctive attribute, results from the fact that as goods pass through successive stages of production, they are taxed only on the value added at each successive stage. Thus, by the time they take shape as final products, each element or component of the final product has been taxed only once. This tax is a great improvement over the sales tax system it replaced in many countries—avoiding taxation of full value at each stage of the productive chain. This obviously ended up taxing the value added of the early stages several times, and also generated strong artificial incentives toward vertical integration of productive processes.

8. *Avoid excessive income tax rates.* There is little economic justification for rates exceeding 50 percent on any kind of income. Such rates distort behavior and create large disincentives to economic activity, while yielding little revenue. In general policy professionals favor careful and prudent design of tax systems, paying special attention to (a) allowing business firms a proper recovery of capital (for tax purposes) over the economic life of an asset, and (b) preventing inflation from grossly distorting the calculation of income for tax purposes, and of the consequent tax liability.

9. *Avoid excessive use of tax incentives to achieve particular objectives.* Such incentives have been especially common in a number of Third World countries. The Brazilian law favoring invest-

ment in the northeast and in Amazonia is a good example. Under this law, a firm in another region that owes the government 1,000 in corporation income tax can take 500 of this and invest it in an approved project in the northeast, and end up paying only 500 in tax. In truth, the firm would be investing money that would otherwise belong to the government; but the firm would have claim to the income produced. Note that the firm would be better off making the investment even if it ended up extracting only 200 or 300 in return—i.e., even if it made very bad, money-losing investments.

Another case was an investment tax credit at the incredible rate of 30 percent, which was in effect in Bolivia in the mid-1970s. Under this law, a firm could invest 1,000 yet have only 700 of "its" money involved. The remaining 300 would otherwise have gone to the government as taxes. Such a firm would probably be quite content if the investment produced a relatively quick return of 900 (viewed in light of "its" capital-at-risk of 700); yet the investment would be a disaster from an economic point of view (900 of return on a 1,000 investment). All investment tax credit schemes share this basic flaw. It was more obvious in the Bolivian case because of the very high 30 percent rate at which the tax credit was granted.

10. *Use price and wage controls sparingly, if at all.* They are rarely (if ever) justified on strictly economic grounds, so at the very least they represent a situation of non-economic objectives impinging on strictly economic goals, tending to frustrate achievement of the latter. Price and wage controls tend in particular to vitiate the crucial signaling role that prices are supposed to play—moving resources from lower-valued to higher-valued uses. High prices should reflect scarcity and attract resources to the activity in question; low prices should reflect abundance and help keep unwanted additional resources away. Most price controls reflect efforts to keep prices low in the face of scarcity, or—what often amounts to much the same thing—to perpetuate prices which used to prevail, in the face of drastically changed circumstances. The typical consequences of price controls in such situations are (a) production, responding to the signal of a low controlled price, fails to increase and may even decline in the face of scarcity; and (b) black markets emerge, frustrating for at least some buyers the efforts of government to keep prices low. Little good has ever come

from government ventures into the swamp of price and wage controls.

11. *Quotas, licenses, and similar quantitative restrictions* on output, imports, exports and other economic variables are often found in tandem with efforts at price control of various types. Once again, only rarely can a cogent economic justification be found for such practices; for this reason policy professionals view them with great suspicion. In general, such restrictions almost automatically indicate that resort is being had to some criterion other than price for rationing the limited supply among contending demanders. This gives easy scope for favoritism, which in practice can (and often does) readily degenerate into corruption. These evils are then added to the fact that such quantitative controls almost invariably reduce economic efficiency.

12. *Policy professionals tend to take a rather technical view of the problems associated with public-sector enterprises.* The professionals have typically seen too much of the world to take a dogmatically ideological position in connection with public enterprises. Some public enterprises, they know, have succeeded, while others have compiled records that no one will ever envy. The differences between the successes and the failures, it seems, can best be summarized by saying that public enterprises have succeeded on the whole when their governments allowed them to behave like enterprises. If the government is intent on using public-sector enterprises as vehicles to pursue other non-economic goals, then almost inevitably their success as economic entities is put in peril. The ways are countless in which governments have encroached on the economic functioning of their enterprises. They have artificially kept down the prices of the goods and services that public enterprises sell. This is dramatically true for electricity, gas, and telephone companies, as well as other public utilities, often with the consequence that the companies, deprived of funds by low rates, were unable to maintain the quality of service. They have required the enterprises to pay above-market prices for inputs—most particularly for manual (blue-collar) workers, but also often for materials, via rules that preclude the enterprises from seeking least-cost sources on the international market. They have also set maximum salaries (usually related to those of high government officials) that were far below those pre-

vailing in the private marketplace for major business executives. If under those circumstances public enterprises succeed in attracting managers comparable to those of similar private enterprises, it is only because some particularly dedicated people are willing to make major personal financial sacrifices. In addition, many public-sector enterprises are routinely precluded from taking the tough decisions that often make the difference between viability and failure—to shut down a product line, to close a plant, to lay off workers when demand falls.

Policy professionals know that all of the above possibilities represent threats to the economic viability and success of public-sector enterprises. Thus they realize that the public-sector enterprises are at an inherent disadvantage in the search for economic efficiency vis-á-vis private enterprises. Nevertheless, a number of public enterprises—in a goodly number of different countries—have somehow managed to surmount these obstacles and turn in good, at times even outstanding, economic performances. These successes have been achieved only through some sort of (at least tacit) understanding between the enterprise and the government, to the effect that the enterprise will not be forced or pressed to behave in an anti-economic fashion. Policy professionals hold up these cases as models for the rest.

13. *Finally, make the borderlines of public-sector and private-sector activity clear and well-defined. When the two compete in a given area, the same rules should govern their operations.* Arbitrary or capricious confiscations, without due compensation, tend to produce a typical and understandable reaction. In sectors that consider themselves threatened (even if confiscation has not yet occurred), private owners immediately tend to disinvest. Saving rates fall and capital tends to flow overseas, usually in a clandestine manner (via black markets in currency, underinvoicing of exports, overinvoicing of imports, and analogous maneuvers). Multiple examples exist of this counterproductive reaction. Rarely has a country ended up being the real gainer as the result of arbitrary and insufficiently compensated confiscation.

It would fly in the face of reality, however, to assert that a clear line can be drawn between public-sector and private-sector activities. The United States is one of the countries where the line is clearest—with electricity companies, transit systems, and other public utilities occupying much of the borderline. Most developing countries, however, have public-sector enterprises scattered widely, almost throughout the industrial complex. In these cases, the professionals' rule is clear: let the public and the private sector compete freely, under the same tax laws, the same regulations, the same rules. And, in the worst cases, if a public-sector enterprise cannot compete (a) let it go under, (b) bail it out by just enough to keep it alive, but (c) never let it outcompete legitimate private enterprises, simply by undercutting prices and making losses that are then financed out of the public treasury.

The above vignettes should impart at least some insights into the way of thinking of most policy professionals. It should be clear from these examples that policy professionals believe they can recognize instances where economic policy is "good" as well as where it is irremediably bad. It should be clear, too, that some cases are difficult to classify—complex mixtures of good and bad elements, with the professional remaining confident of his capacity to tell one from the other. Finally, it should be clear that good policy, in these terms, does not carry with it any particularly heavy ideological or political overtones. Certainly good policy would appear to be feasible in the hands of European Social Democrats or Christian Democrats or Socialists, also in the hands of British Conservatives or Labourites, or of American Democrats or Republicans, or indeed of the great bulk of political groupings that are likely to rise to governmental power (in the non-Communist parts of the world) in the foreseeable future.

The Professionals Read the Record

In the following section, as editor of *World Economic Growth,* I will attempt to distill some lessons from the contributions of the individual authors represented in the study. The exposition shifts to the first person here, so as to reflect the subjective nature of some of the judgments that had to be made in extracting from each contribution just a page or two of observations and summary.

The industrial countries. Perhaps understandably, there was more emphasis on macroeconomic stabilization policy in the essays dealing with the industrial countries than was the case with respect to the less-developed countries. The stabilization emphasis was strongest in the cases of the United Kingdom and the United States; the essay on Japan occupied an intermediate position; while those dealing with Germany and Sweden became rather seriously involved in policies affecting the structure of the economy.

The United Kingdom. Wilfred Beckerman emphasizes the fact that until recently there was not much difference between the policies actually implemented by the Labour and Conservative Parties in postwar Britain. It was the Conservatives who first instituted economic planning (via the National Economic Development Council) as a central government function. Also, when they replaced the Labour Party in the government, the Conservatives failed to undo any of the major changes (nationalization of industries and extensions of the welfare state) that Labour had implanted. Nor, one can add, did Conservative governments do much to impede or reverse the growth of government in the U.K. From 27 percent under the Conservatives in the late 1950s and early 1960s, the ratio of government expenditures to GDP rose to 31 percent under Labour in the late 1960s. In the early 1970s, it continued rising to 35 percent under the Conservatives; then to 38 percent under Labour in the late 1970s, and finally to 41 percent under Mrs. Thatcher between 1980 and 1982.[7]

In attempting to account for Britain's slow growth of GNP (at an average of 2.25 percent per year between 1953 and 1982), Professor Beckerman explores four hypotheses: (i) other European countries grew faster because they had more "catching up" to do (from wartime devastation); (ii) Britain was already a "mature" economy in the early postwar period and had little further to gain from transferring workers out of agriculture or exploiting industrial economies of scale; (iii) bad labor relations and class antagonisms operated as a severe brake on economic growth, especially as real wages kept rising in the face of economic stagnation and growing unemployment; and (iv) the British economy was hamstrung for some three decades, largely because it started the early 1950s suffering from a serious currency overvaluation — a malady which successive governments persistently refused to correct.

Professor Beckerman finds the last two hypotheses far more credible than the first two—a conclusion with which, on the basis of the evidence he presents, I am inclined to agree. I cannot help but feel, however, that the mounting weight of government, which grew virtually unchecked over a span of more than thirty years, probably also played a significant independent role.

The United States. Robert Gordon begins his essay with a diagnosis and ends with a series of prescriptions. The diagnosis notes (i) that the growth rate of nominal GNP has been much more volatile than that of money; (ii) that the rate of inflation has moved relatively slowly over time, signifying that the instability of nominal GNP is largely reflected in a volatile growth rate of real GNP; (iii) that there is such a thing as a natural rate of unemployment, below which the inflation rate tends to accelerate and above which inflation tends to subside; and (iv) supply shocks (such as the oil price rises of the 1970s) tend to be reflected in sharp changes in the inflation rate (the prices of non-shocked—e.g., non-oil products being sluggish to adapt). Efforts to blunt these changes are likely to shift the burden of the shock onto real output.

Based on these observations, Gordon recommends that the monetary authority should take the growth rate of nominal GNP to be its target in the short run, with the possibility of special *ad hoc* adjustments of this target to accommodate sharp supply shocks when they occur. He also observes that the velocity of circulation of money has been relatively stable between cycles (though not within them); hence the orthodox monetarist proposal of a relatively stable rate of growth of the money supply meets with his approval as a guidepost for the longer run.

Gordon notes, though with somewhat less emphasis than I would accord it, the phenomenal volatility of the "effective exchange rate" in recent years. He cites a rise of 26 percent in this rate in the first three quarters of 1981 and another of 11 percent up to the end of 1982. He notes that the decline in net exports during 1981–82 accounts for three quarters of the contemporaneous decline in real GNP. He might have added that during 1978–80, when the U.S. dollar was depreciating in unprecedented fashion, the average price (unit value) of imports rose by nearly 50 percent, while that of exports (also to a substantial degree governed by the exchange rate) rose by some 30 percent. The forces governing the exchange rate thus likely played an important role in bringing about rises of 25 percent in consumer prices and of 19 percent in the GNP deflator in this earlier period.

Gordon's principal policy recommendations are: (i) monetary policy should be aggressively expansionary when the economy is far below its normal growth path, but should put on the brakes as that path is approached; (ii) temporary supply shocks should clearly be accommodated by monetary policy, but relatively long-lasting shocks pose a dilemma in which one must choose between unwanted inflation on the one hand and unwanted shortfalls of output on the other; (iii) fiscal deficits, such as the recent and prospective ones in the U.S., are not greatly worrisome when the economy is far below its normal growth path; they became more of a problem as one nears that path; (iv) for the future the United States should pay more attention to "lessening institutional constraints" so as to "improve macroeconomic efficiency and place less of a burden on traditional policy tools." The institutional constraints to which he refers concern long-term wage contracts (which impose rigidities that impede short-run adjustment); interest rate ceilings (which raise the welfare cost of inflation); the lack of provisions in the tax law for adjusting interest payments and receipts, as well as capital gains, for inflation; the institutional barriers to countercyclical fiscal policy (both on the tax and the expenditure sides); and the absence of policies oriented toward reducing the natural rate of unemployment.

Japan. Yutaka Kosai begins with an analysis of Japan's most recent growth experience. He finds that the slowdown of Japan's growth rate from over 11 percent in 1965–70 to less than 5 percent in 1970–80 and to around 3 percent in 1980–82 can be explained by a few key factors: (i) gross fixed capital formation, which rose from 15 percent to over 20 percent of GNP during 1965–70, returned to 15 percent over the decade of the 1970s; (ii) a very sharp deterioration of the terms of trade occurred during the 1970s, linked in significant measure to the rise in energy prices; and (iii) technological progress slowed due (a) to the closing of the technological gap between the Japanese economy and those of what used to be more advanced economies and (b) to the growth in the relative share of services, which characteristically enjoy only modest technical advance.

Correctly diagnosing these forces as being substantially beyond the control of economic policy, Professor Kosai then inquires into the degree of success with which the Japanese economy met the challenges of the 1970s. He brings in a largely favorable verdict, the principal failure being an episode of stagflation in the mid-1970s. The inflation rate was in double digits for three years starting in 1973, and reached almost 25 percent in 1974. Meanwhile real GNP uncharacteristically (for Japan) fell between 1973 and 1974, and stood in 1975 only a percentage point above its 1973 level. Professor Kosai attributes this episode to an unwillingness of the Japanese authorities at the time to appreciate their currency; they responded to a higher influx of resources by nearly doubling the money supply between 1970 and 1973 and almost trebling it between 1970 and 1976. This was not typical of the behavior of the Bank of Japan during most of the postwar period. On the whole the authorities were quick to put on the brakes when balance-of-payments difficulties threatened. Moreover, one must also recognize that whatever inflation Japan has experienced during the postwar period has been compatible with a dramatic appreciation of her currency, from a fixed rate of 360 yen per dollar, which prevailed through the 1950s and up to 1970, to a rate that fluctuated between 200 and 250 yen per dollar during 1978–82.

One of the anomalies of the Japanese case is the degree to which the government was able to maintain a stable and successful economy in the face of persistently large budget deficits. Since 1978 the deficits have regularly exceeded 5 percent of GNP; more surprising still is the fact that financial institutions (including specialized credit institutions), increased their holdings of the obligations of government and of official entities by more than 5 percent of GNP in each year from 1975 to 1982.[8] There can be little doubt that the disruptive potential of these deficits, and particularly of the mode of financing them, was greatly assuaged by the high rate (oscillating around 20 percent since 1970) at which Japanese households saved out of their disposable income.

Germany. Frank Wolter documents in dramatic fashion the steady slide of the West Germany economy from the days of the "German miracle" in the 1950s to a state of virtual stagnation at the turn of the 1980s. In terms of a framework very similar to that set out in the introduction to this summary, he traces the decline of the growth rate emanating from non-residential private business. Some of his results are summarized in table 2. They show a steady deterioration of the rate of growth of private sector business output, an erosion that clearly derives from a steady fall in total factor productivity. When this in turn is broken down into its components, it turns out that most of the principal components contributed to the decline—the change in labor quality, the reallocation of labor, the reallocation of capital, and changes in volume (both via economies of scale and via capacity utilization) all were weaker forces for growth during 1970–80 than they were in 1960–65. Only the forces of education and of advances in knowledge contributed more to growth in the recent past than they did in the early 1960s.

The decline of the German economy was, in Professor Wolter's words, "largely conditioned by a gradual erosion of market forces." In the early years policy was characterized by emphasis on the market mechanism, private control over resources, and reliance in competition and an open economy. The public sector, however, played an important role in monitoring the system, providing infrastructure, and helping overcome bottlenecks. Germany had inherited a strong aversion to inflation, which was kept within bounds by forceful and determined Bundesbank policy.

Growth slowed somewhat in the 1960s; as labor (particularly skilled labor) became progressively scarcer, reliance was placed on *Gastarbeiter* (guestworkers) from the Mediterranean countries. Real wages nonetheless rose, propelled in part by the growing scarcity of skilled labor.

The 1970s were marked by a shift of policy toward a welfare state philosophy. The immigration of foreign labor was largely halted, protection was accorded to labor intensive industries, mandatory employee benefits were expanded, and the firing of employees was made much more difficult. In addition, new transfer programs were enacted by the government, aiding

Table 2

Sources of Growth in the Federal Republic of Germany

(average rate of change in percent per annum)

	Non-Residential Private Business				
	1960–65	1965–70	1970–73	1973–79	1979–81
Real Gross Domestic Product per hour worked	6.0	5.8	5.3	4.5	1.8
Capital-Labor Substitution	1.1	1.4	1.6	1.7	1.4
Total Factor Productivity	4.9	4.4	3.7	2.8	0.4
Change in Labor Quality	1.1	0.4	0.3	0.3	0.4
Education	0.3	0	0.7	0.4	n.a.
Sex	0	0	0	0	0.1
Age	0.8	0.1	–0.4	–0.1	n.a.
Reallocation of Labor	0.7	0.7	0.4	0.4	n.a.
Reallocation of Capital	2.6	0.8	1.0	–0.1	n.a.
Volume Changes	0.4	0.6	0.1	0.1	–0.3
Economies of Scale	0.5	0.4	0.4	0.2	0.1
Capacity & Utilization	0.1	0.2	–0.3	–0.1	–0.4
Advances in Knowledge	0.1	1.9	1.9	2.1	n.a.

Source: Frank Wolter, *World Economic Growth*, Chapter 5.

> . . . the disabled, the unemployed and workers at large. Subsidies and benefits for education, retraining, child care, housing and savings were substantially increased, pensions were raised, . . . and subsidies for weak firms, weak industries . . . , and weak regions were piled up. In addition the public sector increased its supply of services and engaged in large-scale promotion of civil servants. As a result there was a massive expansion of public expenditures . . . and a shift from public investment to public consumption (Wolter, p. 109*).

Professor Wolter concludes with a succinct summary of the German case:

> [There is a clear positive relationship between economic growth and capital formation and between the rate of capital formation and profit margins]. . . . Growth was rapid when government was small, and . . . slow when government became large. . . . Government . . . was strong when it was small, but became weak after it grew larger.
>
> . . . Rapid economic development [occurred when] government largely confined itself to working the supply side, . . . by setting and monitoring the rules of the game and by supporting incentives to save and invest [and by deregulating] the economy—including the removal of barriers to . . . trade and factor movements. . . . Weak economic growth set in after a prolonged period of demand management. . . , sectoral and regional subsidies, [and the rise to prominence of] the relatively regulated tertiary sector.
>
> Economic growth was high when wage policies were moderate and when the income distribution shifted in favor of capital; at the same time, real wages increased rapidly and full employment was achieved. . . . Growth became low [under] aggressive wage policies which pushed up the wage share in GNP; soon thereafter [the rate of] real wages increased slowly and mass unemployment emerged.
>
> [Finally], economic growth was rapid when public transfers were moderate, but sharply declined [in the wake of] prolonged emphasis on redistribution.

Sweden. Ulf Jakobsson's account of Sweden's recent economic history parallels in many ways that of Germany. Sweden's growth rate of real GDP was over 4.5 percent per annum in the 1960s, dropped to less than 2 percent per year in the 1970s, and turned negative in the 1980s. Meanwhile her inflation rate rose from 4.4 percent per year in the 1960s to over 10 percent per year in the 1970s. Examination of the annual data reveals that it was around

*Chapter and page references are to *World Economic Growth.*

the middle of the 1970s that stagnation really set in. At about the same time the inflation rate hit double digits.

It is notable that Sweden's government deficit, which averaged less than 1 percent of GDP in the 1960s, and less than 2 percent of GDP in the first half of the 1970s, burgeoned to 5 percent by 1978, over 7 percent by 1979, over 8 percent by 1980, and over 9 percent by 1981. These deficits, moreover, were largely financed by the financial sector, whose credit to the government increased, between 1977 and 1978, by 5 percent of GDP—more than its entire accumulated growth between 1970 and 1975. Worse yet, between 1980 and 1981, financial sector credit to the government expanded by nearly 8 percent of 1980's GDP.[9]

Underlying the growing deficit was a dramatic rise in public-sector expenditures. These grew as a fraction of GDP from around 50 percent in 1975 to around 70 percent in 1983,[10] while taxes and fees remained about constant. Jakobsson speaks of

> the problems that were created by the rapid growth of public consumption and public expenditure in Sweden in the 1970s. There is reason to stress that the growth of public expenditure is part and parcel of a fundamental structural change in the Swedish economy, whereby the public sector has come to play an increasing part in every sector of the economy.

Dr. Jakobsson shows us, in his table 4, how the number of people in public sector production plus those receiving income from public sector programs grew from 44 percent of total employment in 1965 to 59 percent in 1970, 69 percent in 1975, and finally to 84 percent in 1980. He shows, too, how subsidies to food, to industry, to housing, and to other parts of the business sector grew from 3.7 percent of GDP in 1970 to 9.6 percent in 1980. In addition, regulations—particularly the designation of priority sectors to receive credits on particularly favorable terms—have discriminated against non-priority sectors (including industry), and placed them at a severe disadvantage.

The difficulties faced by Sweden in consequence of these multiple recent expansions of public-sector employment, expenditure, and activity are compounded by the fact that they came on top of a public sector that was, by international standards, already very large. Taxes were thus already extremely high before the great spurt of expenditure in the late 1970s. Jakobsson's table 5 reports that the full effective marginal rate of taxation was probably around 40 percent for the average blue-collar worker in 1955, but reached close to 70 percent by 1970—and apparently *could not* be increased significantly despite the great fiscal pressures of the late 1970s. Similarly, the full effective marginal rate of taxation for the average white-collar worker would have been close to 45 percent in 1955, close to 70 percent in 1970, and close to 80 percent in 1980–82. Rates in that range are already too high by many criteria. To push them farther is likely to be counterproductive in terms of its effect on output, and may even lead to a fall in total tax receipts. Small wonder, then, that Sweden found it impossible to increase tax revenues to match the dramatic growth in expenditures in the late 1970s.

The less-developed countries. As distinct from the major industrial countries of the Western world, the LDCs, in part because of their number, in part because of the great variety of social and cultural backgrounds they represent, reveal great differences among their modes of social organization, the political philosophies of their respective governments, and, not least, the degrees to which and the effectiveness with which these governments have been able to exercise their authority. As the net result of the great variation among the countries in all these dimensions, we observe a whole spectrum of experiences, both good and bad. The notes that follow briefly summarize some of the main observations and insights perceived by the authors of the seven papers dealing with specific LDCs.

Jamaica. Gladstone Bonnick takes pains, in his paper, to disabuse us of simplistic and impressionistic interpretations of Jamaica's recent history. He objects to the frequent linkage of liberal, private-sector-oriented policies with good results and of centralizing, public-sector-oriented policies with bad results. From 1966 to 1972 the economy grew at over 6 percent per year, while from 1973 to 1980 it suffered an uninterrupted decline, which over the period totaled 18 percent. Meanwhile, inflation soared from an average of 7.5 percent per annum in 1966–73 to an average of 21.2 percent per year from 1973 through 1980. At the same time Jamaica's budget deficit rose from 2.5 percent of GDP in 1966 to 19 percent of GDP in 1976, and was still at 13.5 percent of GDP in 1981.

Professor Bonnick contends that the differences between the two main parties in Jamaica are mainly in rhetoric; he disputes, to a degree, the association of the Jamaica Labor Party (1962–72, and since November 1980) with free-market policies and that of the People's National Party (1972–80) with socializing and centralizing tendencies.

The thrust of Bonnick's argument is basically that the Jamaica Labor Party really did not have a liberal orientation. During 1962–72 it regularly implemented controls on prices and on foreign exchange, and intensified them after 1967. It was instrumental in imposing quantitative import restrictions to protect local manufacturing. It also implemented in the 1960s the "Jamaicanization" of banks and insurance companies. Moreover, since returning to power in 1980, the JLP has nationalized the principal oil refinery of the country.

A counterpart of this argument is that many of the policy mistakes of the 1970s were the natural outgrowth or extension of policies initiated by the JLP in the 1960s. When the oil crisis of 1973 hit, when Jamaica's tourist flow slackened and withered, and when aluminum and banana exports started to decline, foreign exchange revenues were so sharply cut that they could barely cover the most urgent demands for basic foodstuffs and for material imports for industry. Bonnick's implication is that, were the JLP in power in the 1970s, it probably would have acted much as did the PNP.

But there can be no doubt that many of the PNP's actions flew in the face of sound technical economics. The government deficit, from 1972 to 1980, rose from around 4 percent to over 15 percent of GNP; the foreign debt multiplied by about 10 while total debt moved from less than 30 to nearly 80 percent of GNP; banking system holdings of public-sector obligations multiplied by 15. The failure of taxes to rise as a percentage of GDP, apart from a new bauxite levy (with very questionable incentive effects), is a dubious distinction in the light of the rise in government expenditures from around a quarter to over 40 percent of GNP. The size of the public administration doubled in relation to GDP between 1972 and 1979. Import controls, exchange controls, and price controls were greatly intensified. Banks and other industries were nationalized and lands acquired at a time when the budget was under unprecedented strain.

All these measures run counter to the mindset of the policy professional, as sketched above. To the extent that the two main parties coincide on such matters, the prospects of reversing the adverse trends that have characterized Jamaica's recent past remain dim indeed.

Ghana. Michael Roemer traces the tragic history of Ghana's economic policy and performance since 1950. It is a sad story because the best comes at the beginning, the worst at the end. In the early 1950s, Ghana was still under British rule; her economy was quite open; and she had one of the highest standards of living in Africa. By 1980 her living standard had fallen by almost a quarter, and her inflation rate had grown from virtually zero to the point where from 1976 to 1981, it oscillated between 50 and 120 percent.

The causes of this debacle are not obscure. Indeed, readers of this chapter can easily anticipate them, for in the period of economic decline, Ghana transgressed nearly every lesson of economic policy set forth above. With respect to false technicism, Professor Roemer reports:

> The story of Ghana's debacle is partly the story of discredited theories of development, especially the "big push" and import substitution approaches. . . . In most important ways Ghana was a model of such development strategies, which include central planning of economic activity, and especially a strong commitment to industrial development protected by high trade barriers. Ghana, in many respects had turned out to be a model of how *not* to develop . . . a valuable case study from which to understand why some countries . . . have maintained strong economic growth rates over long periods, and why many others have not (Roemer, p. 202).

Fiscal discipline prevailed in Ghana in the 1950s, but by the late 1960s fiscal deficits were ranging from 6 to 9 percent of GDP. After a brief dip in the early 1970s the deficits spurted again, this time to the range of 10–15 percent of GDP.

Clearly, inflation had gotten out of hand by the last half of the 1970s. In Ghana's case, the fiscal deficit was the overwhelmingly preponderant cause. In the 1950s Ghana's public sector actually was a net lender to the banking and monetary system; but in the early 1960s, government was already a substantial net borrower, taking about a third of bank credit. In the late 1960s and early

1970s this figure fluctuated between a third and one half. Then, as the great inflation broke out in the late 1970s, government (together with public enterprises) began to monopolize bank credit, with the private sector's share falling from about 20 percent in 1973–75 to less than 10 percent in 1980–82. All during this period each year's increase in the banking system's lending to the public sector was itself sufficient to make a major inflation of prices inevitable.

Professor Roemer has himself summarized how most of the other lessons of economic policy were violated:

> Thus, as export revenues stagnated, the government reduced the incentive either to diversify exports or to increase them . . .
>
> The protective duties . . . were highly differentiated and import licensing—especially as corruption made the impact of quotas more unpredictable . . . [helped] to produce a [complex and] chaotic system. Effective rates of protection ranged from . . . negative effective protection for several export industries to over 200 percent for [many import-substituting] sectors. [Some industries even] used material inputs that, at world prices, were worth more than their outputs.
>
> Policies toward factor prices exacerbated the adverse impact of Nkrumah's system of trade incentives. A combination of minimum wage legislation, controlled interest rates, an overvalued exchange rate, duty-free import of capital equipment, and tax-reducing investor incentives all conspired to make labor artificially expensive . . . , and thus to encourage capital-intensive choice of technology and industry. [In addition,] real interest rates ranged from −2 to −23 percent per year.
>
> [These] policies pushed Ghana to virtual international bankruptcy with an overstimulated economy that could no longer be contained by import and price controls, an enlarged public sector that could not be managed effectively by . . . Ghanaian manpower, an economic structure unsuitable to Ghana's endowments, and a price structure that promised no solution to Ghana's . . . stagnation (Roemer, p. 214).

Tanzania. The case of Tanzania is similar to that of Ghana in many respects, but the degree of the malady is somewhat lesser. Whereas Ghana's negative growth rate of per capita income increase began in the 1960s, Tanzania's dates from the 1970s. Ghana's slowdown started around 1960, Tanzania's after 1967. Ghana first moved into double-digit inflation in 1964, and Tanzania in 1967; and up through 1982 Tanzania had experienced only four years of inflation exceeding 20 percent, compared with

Ghana's nine. Moreover, Ghana had two years of inflation of over 100 percent and six over 50 percent, while Tanzania's top recorded inflation rate was 30.3 percent.[11]

Tanzania's superior performance in comparison with Ghana was greatly influenced by the massive amounts of foreign aid it received (U.S. $2.7 billion from 1971 to 1981), by the fact that most of its arable land was not under cultivation when the country achieved independence, and by the good fortune of having started with a widely diversified agricultural export base.

But within its own context, Tanzania's policy behavior was much like Ghana's. Although there was no significant trend in the terms of trade, export volumes fell by more than 50 percent over the 1970s. This was in considerable measure due to the deterioration of Tanzania's real exchange rate, which appreciated by nearly 50 percent between 1970 and 1981.

The appreciation of the real exchange rate, in turn, was due in part to the effects of an import-substituting industrial strategy, which increasingly squeezed out imports of manufactures and consumer goods in general, but which also drastically curbed imports of agricultural tractors and their replacement parts. At the same time internal inflationary finance pushed up local prices and costs far more than was occurring in the major world trading centers, and the nominal exchange rate was not adjusted to compensate for this difference. Indeed, over the decade of the 1970s, while the U.S. GDP deflator was doubling, that of Tanzania nearly trebled; yet the shilling was devalued, vis-à-vis the dollar, by only about 15 percent.

The internal inflation gave rise to an accentuation of price controls. Uma Lele reports that the number of commodities under price controls increased from 400 in 1974 to 3,000 in 1976. Black markets soon developed, in which prices reached up to six times the official peg.

Much of the thrust of Tanzania's policy was, like Ghana's, toward industrialization. And, as in Ghana, much of this development used public-sector enterprises as its vehicle. Similarly, a number of industrial projects emerged with negative value added, i.e., using more foreign exchange for buying imported inputs than they saved by producing the final product at home. Moreover, as in Ghana, artificial pricing (among other things) led to an artificially high level of capital intensiveness in industrial investments.

The emphasis on industry also diverted much-needed funds from the agricultural sector, which quite apparently harbored most of the products in which Tanzania had a significant comparative advantage. Moreover, government regulations of prices further confounded the agricultural scene. For nearly all controlled products, the official prices in real terms fell over the decade of the 1970s, and certainly from the mid-1970s to the end of the decade (Tanzania's worst crisis period). Part of the reason why the government pushed down real prices paid to producers was because the official marketing agencies were losing money. On the other side, the government was reluctant to raise consumer prices—presumably for political reasons. The end result was (i) large and growing subsidies to the public-sector entities that marketed food crops and (ii) still further borrowing by these bodies from the banking system to cover their losses above and beyond the subsidies they received. All of these problems associated with marketing came about after the government first supported agricultural marketing cooperatives in order to oust the country's Asian minority from this sector (which Asians then dominated), and later abolished these same cooperatives in favor of public-sector enterprises.

In short, the net result of a great many of Tanzania's policy initiatives has been the proliferation of inefficiency throughout the economy. Industry and agriculture have both been made more inefficient through decrees, regulations, and controls. The country has lost much of the benefit that could be gained from foreign trade. Its investments were often ill-chosen and ill-suited to their purpose, proliferating inefficiency still more. And finally, in many sectors a growing and highly inefficient public sector has supplanted what once was a thriving and economically effective private sector.

Mexico. Mexico presents an interesting contrast between two major periods of its recent history. During 1955–73 she had virtually no petroleum exports, yet managed a compound annual real growth rate of close to 7 percent and an average inflation rate (GDP deflator) of only 5 percent per year. With the coming of the petroleum boom (1973 to 1982) the real growth rate fell to less than 6 percent while the rate of inflation averaged 26 percent, and reached a maximum of 58 percent in 1982. Moreover, the country suffered two grave balance-of-payments crises, in which the price of the dollar leaped upward by 80 percent and 270 percent, respectively. The public-sector budget deficit, which in the earlier period was largely kept below 2 percent of GDP, burgeoned to an average of 8 percent in 1973–82, and reached a maximum (in 1982) of 19 percent of GDP.

Obviously, there was an incredible loss of fiscal restraint. It appears that when the authorities were really without significant resources, they could with relative impunity deny funds to countless political claimants, but when Mexicans began to view their country as an oil-rich nation, the authorities simply caved in to demand after demand for public-sector funds. I believe that there is a great element of truth in this interpretation, but it must be tempered by a recognition that in the 1955–72 period economic policy was dominated by two giant figures—Antonio Ortiz Mena in the Ministry of Finance and Rodrigo Gomez in the Central Bank—whose force of will and character also played an important role in imposing monetary and fiscal discipline.

Professor Gil Díaz recognizes the great contrast between the pre-1973 and post-1972 period, particularly with respect to fiscal and monetary restraint. But he also take pains to point out that many of the policy mistakes that exacerbated Mexico's problems in the late 1970s and early 1980s were the fruit of seeds already planted in the earlier period. Many of these mistakes derived from a tendency to underprice utility services and other products of public-sector enterprises. Indeed, in a fascinating calculation presented in his table A-6, he estimates that, with "economic" pricing of the outputs of the public sector, its deficits from 1965 to 1980 would have been converted into surpluses except for two years, 1975 and 1976.

Some of the subsidies to public enterprise prices were an outgrowth of price control mechanisms; as controlled private-sector prices became (usually through inflation) more and more uneconomic, "the government first [supported] faltering firms with credit . . . and, eventually, [took] them over as they went under" (Gil Díaz, p. 342).

Trade policy is another area in which later mistakes were presaged by policies pursued during the 1955–72 period. The average import tariff was raised from 8.8 percent in 1954 to around 20 percent over the 1960s, but import licenses and similar controls were probably a more important source of trade restriction. In 1956 only 9 percent of import categories were subject to such controls; this figure reached 60 percent by 1966, 65 by 1970, and 80 percent by 1973.

In addition to these policy failings, Gil Díaz takes pains to point out a little-understood but profoundly important consequence of the world inflation for Mexico and many other LDCs—as world interest rates rose to reflect anticipated inflation, the payment of interest in effect came to represent a partial amortization of real debt (i.e., simply due to world inflation the real outstanding debt from any given loan goes down from period to period, and lenders are compensated for this loss by a higher, inflation-related interest rate). Close to 80 percent of Mexico's cumulative "external deficit" (i.e., its public-sector borrowing from abroad) disappears when an adjustment (for U.S. inflation) is made to take this factor into account. (See Gil Díaz, appendix table A-2). Similarly, Mexico's perennial (since 1956) balance-of-payments deficits are reduced by about 20 percent when the component of interest payments reflecting the U.S. inflation rate is counted as amortization.

Mexico's troubles since the mid-1970s are thus viewed by Gil Díaz as being (i) partly the result of ill-advised pricing, trade, and other policies, many of which had antecedents in the two preceding (and relatively calm) decades, (ii) partly the consequence of the way in which the international inflation interacted with the nation's international debt to exacerbate fiscal deficits and monetary expansion, and (iii) perhaps predominantly, a weakening of the will or capacity (or political courage) to bring under control a deficit that was growing increasingly out of hand.

Indonesia. Indonesia shares with Taiwan the distinction of being the countries which came out of the period under review in an ambience of virtually unalloyed success in economic policy. Her failures occurred earlier—specifically in the period of 1960–65; they were followed by a remarkably long and sustained recovery, which has carried up to the present. Indonesia also deserves special credit for being, from among the relatively populous oilexporting nations, the one that apparently learned most about how to take advantage of oil booms.

On achieving independence, Indonesia inherited from the Dutch a tradition of conservative macroeconomic policies combined with substantial regulation and other intervention at the microeconomic level. During the decade of the 1950s, economic policy did not diverge greatly from its traditional path, though towards the end of the decade signs of a brewing inflation were felt, partly fueled by military expenditures. During the 1950s the country underwent postwar rebuilding, put down several secessionist rebellions, and engaged in armed confrontations against both the Dutch and the Malaysians. It is surprising, under these circumstances, that per capita real income grew by as much as 1.2 percent per annum over the decade.

Indonesia's crisis period was clearly 1960–65, when per capita income growth turned negative, and inflation soared, reaching about 600 percent in 1965 and 1966. Official foreign exchange reserves dwindled until they became negative; government receipts were eroded from over 13 percent to around 4 percent of GDP. Chaos reigned in the economy. The policy mistakes were the familiar ones: massive government deficits financed by monetary expansion, growing overvaluation of the currency, and a consequent stagnation of imports, which in Indonesia's case carried with it a drastic fall in tax collections (as at that time taxes fell mainly on traded goods); the fall of revenues, in turn, only exacerbated the deficit and the consequent monetary expansion.

Parallel to the scenario just described was a welter of controls and restrictions. Many of them were not new, but were rendered much more burdensome by the growing shortages of traded goods and by the exploding inflation. Also, owing to its fiscal strains, the government was unable to accomplish even rudimentary maintenance of the nation's infrastructure; after the close of this chaotic episode, it took nearly a decade to restore public utilities, and transport and irrigation services.

Indonesia's new government under General Suharto has followed a quite consistent set of economic policies from 1966 to the present. Its key precepts have been macroeconomic: avoiding inflationary excesses in the budget, and steering clear of any kind of exchange control. In early actions, the Suharto government doubled real tax collections, and sharply raised the prices charged by public enterprises. It also implemented several financial reforms, and replaced a set of sharply negative real interest rates with a pattern of decidedly positive ones. The revenues, together with foreign aid averaging about 3 percent of GDP, set the stage for one of the most remarkable stabilization experiences ever recorded. From around 600 percent in 1965 and 1966 the rate of inflation dropped to 111 percent in 1967, to 84 percent in 1968, and to 10 and 9 percent, respectively, in 1970 and 1971 (see Gillis, table 3). Meanwhile, GDP grew by 2.3 percent in 1966 and 1967, by 11.1 percent in 1968, 9.2 percent in 1969, and 6.5 and 4.9 percent, respectively, in 1970 and 1971. Over the whole stabilization episode, the average compound rate of growth of GDP was an impressive 4.5 percent per annum (1.9 percent in per capita terms).

Indonesia's record on handling an oil boom reveals a very distinct learning process. During the spurt in oil prices of 1974 and after, Indonesia's exports of petroleum and its products rose from U.S. $1.5 billion in 1973 to $4.9 billion in 1975 and $5.6 billion in 1976. Meanwhile the foreign assets of the monetary system, which started at U.S. $710 million in 1973, peaked at $1.6 billion in 1974 and turned negative in 1975 and 1976. This was largely a reflection of the squandering of foreign exchange resources by PERTAMINA (the state-owned oil company) in the debacle referred to by Professor Gillis (chapter 9, p. 247). However, Indonesia was much more prudent in handling the second oil boom, which started in 1979. In this case oil exports rose from U.S. $7.4 billion in 1978 to $8.9 billion in 1979 and $12.9 billion in 1980. Over the same lapse of time, the foreign assets of the monetary system grew from U.S. $1.7 billion in 1978 to $4.7 billion in 1979 and $9.6 billion in 1980. The wealth taken from the ground was largely being "parked" in the capital markets of the world until good uses could be found for it. No other populous oil country has managed an oil boom this well.

Professor Gillis notes other achievements of Indonesian economic policy—successful maintenance (through timely devaluations) of non-oil exports in the face of both petroleum booms, steady reduction of customs duties, elimination of excessive rates of income tax, etc. Yet he notes ample flaws as well: a long-standing policy (just recently corrected) of massive subsidies to the local users of petroleum products, a maze of unjustified fiscal incentives and "unadministerable taxes," "the persistence of strong protectionist policies [particularly through quantitative restrictions] and the ponderous and restrictive system of licensing and regulation." (Gillis, p. 258). It often takes two or more years to process an investment license, and reductions in customs duties by the Department of Finance have been countered by "import quotas, bans, and other quantitative restrictions [imposed by the Departments] of Industry, . . . of Agriculture, . . . and of Trade." Rates of effective protection still range from negative to as high as 4000 percent (for tires). Protection of textile and footwear industries imposes nearly $500 million a year of costs on Indonesian consumers.

Indonesia's successful development is thus an example of how a preponderance of good policies in critical areas can be sufficient (perhaps with a little luck on the side) to generate an enviable rate of economic growth, in spite of the presence on the country's policy record of obvious and important blemishes and failings.

Taiwan. Taiwan is clearly the exemplar among the countries treated in our study. Not only were its achievements more dramatic even than Indonesia's, its errors and failings of policy also seem to have been minimal, once its growth process got on track. Initially (1950–54) Taiwan followed what were then modish policies of high barriers of trade, low interest rates. In addition, from 1950 through 1953, inflation ran at the rate of over 5 percent per quarter more than two thirds of the time, and over 10 percent per quarter more than a third of the time. Exports measured in U.S. dollars were only $96 million in 1954 compared with $93 million in 1950, and meanwhile the U.S. dollar had suffered a 15 percent inflation. Imports exceeded exports by more than 50 percent from 1951 through 1954, and were more than double 1954's exports. Domestic saving languished at around 5 percent of national income. How this panorama changed over subsequent years is shown in table 3. By 1980, real national income had experienced an eightfold increase, and per capita income had more than quadrupled. Exports had multiplied by 200, and imports by more than 100, measured in U.S. dollars. Professor Tsiang's table 1 indicates that, in terms of quantities, exports multiplied by 50 and imports by 20.

Table 3
Basic Economic Data of Taiwan

	1955	1960	1970	1980
National Income (1967 NT$)				
Total (Billion NT$)	112.8	151.7	387.2	879.1
Per Capita (NT$)	11,895	13,601	26,582	49,832
Domestic Savings as Percent of National Income	4.9	7.6	23.8	32.9
Exports (Million US$)	127	164	1,439	19,575
Imports (Million US$)	185	287	1,363	19,428

Source: S. C. Tsiang, *World Economic Growth*, Chapter 11.

Tsiang emphasizes the extent to which the Taiwan miracle involved implementing the basic policy guidelines that one can derive from economic science (and, in general, from common sense as well). He deals in turn (i) with the necessity for the nation to exploit the opportunities afforded by international trade and international investment, and (ii) with the importance of maintaining realistic (and positive) real interest rates, both as an incentive to save and as a means of ensuring that available investible funds are allocated to the most productive investments.

Under the first heading he details how the Taiwanese government jettisoned a whole set of protectionist trade policies—high protective tariffs, import licenses and quotas, multiple exchange rates. This liberalization of the economy so boosted the real exchange rate facing exporters that many new exports were stimulated. Exports doubled from 1954 to 1961, doubled again from 1961 to 1964, and again from 1964 to 1968–69. From 1968–69 to 1971 they doubled again. By 1980 exports were nearly twenty times those of 1969, 100 times that of 1961, and 200 times those of 1954.

This export expansion involved hard work as well as policy liberalization. As new commodities entered the list of exports, many of them enjoyed tremendous booms. But, for many new exports, and particularly for those that grew the most, import quotas, "voluntary restraints," and other barriers tended to rise to put a cap on the boom. Taiwan's response was to remain undaunted, to accept the limits that emerged, and to obtain a policy environment in which yet other new exports could develop and prosper.

Taiwan's second major policy thrust concerned the capital market. One major key here was maintaining positive real interest rates. In the first experiment in this direction, Taiwan's ongoing inflation was quickly brought down to less than .5 percent per month in the second quarter of 1950, only to spurt again when the policy of high interest rates was relaxed in the third quarter. But the Taiwanese authorities learned the lesson well; average real interest rates on one-year time deposits were significantly positive in each of the subsequent twenty-two years, and the lapse from policy discipline in this regard (in 1973) was mercifully brief.

Uruguay. It is perhaps fitting that this review should end with Uruguay following Taiwan. No case treated in this volume is more pervasively successful than that of Taiwan, and none is more classically tragic than that of Uruguay. Uruguay not only possessed all the ingredients for dramatic economic success; she already had attained it more than 100 years ago; and, to a degree at least, had maintained it during much of the first half of this century. She then failed ignominiously in the late 1950s and the 1960s, but recovered sharply starting in 1974, only to stumble once again in the early 1980s.

The ingredients of the Uruguayan drama are by now familiar. The biggest secret of her success up to the 1950s was fiscal discipline and monetary restraint. Indeed, for the first thirty-five years (1828–62) of her existence as a nation—years, by the way, characterized by great prosperity—Uruguay had no money of her own at all. The level of per capita income estimated for 1866 (1600 U.S. dollars of 1981 purchasing power) was so high that it is hard to imagine that much growth could have occurred in subsequent decades. At the very least retrogression did not set in, and the Uruguayan standard of living must have compared well with those of Western Europe and North America.

Many things happened in the years after 1866. In 1875 a low uniform tariff was replaced by a highly protective, differentiated system, with a consequent loss of dynamism on the export front. In 1896 a State Bank was formed, which later was to become an important engine of inflation; it was soon joined by other public-sector companies in a variety of industries. Still later the country gravitated in the direction of the modern welfare state, installing an expensive social security system during the first quarter of the twentieth century and enacting a 48-hour work week as early as 1915.

Professor Rámon Díaz sees several underlying weaknesses of Uruguayan policy, some of them significantly antedating the country's economic retrogression of 1955–68. These weaknesses included a highly protectionist commercial policy; an exchange rate that was overvalued most of the time, in part because of import restrictions, in part because internal inflation tended to produce a growing overvaluation any time the effort was made to maintain a given exchange rate or to blunt the size of a required devaluation; and a fiscal policy which, though historically quite conservative, ran significantly to deficits in the 1960s and terribly so in the early 1980s. Besides these problems, the tax system was far too complex for a country of Uruguay's size, and it produced serious inefficiencies. The country also pursued a monetary policy that, especially in the period after 1955, produced inflation (through private credit expansion) even when policymakers were containing fiscal deficits; and its controls over prices and interest rates, which would have produced harmful effects even without inflation, produced grossly distorted resource allocation when combined with one of the world's most rapid inflations. As if these problems were not enough, the country also had a social security system that greatly inhibited private incentives to save without making any significant contributions of its own to national capital formation.

Professor Díaz emphasizes that most of these specific failings of policy either helped to produce Uruguay's great inflation or were themselves grossly exacerbated by it. In this light it is ironic that the nation's finest economic performance of recent times (1974–81) was characterized by a significant improvement on nearly all of the listed policy fronts, but not in the control of inflation, which averaged some 60 percent per year throughout this period and remained this high even in 1979 and 1980. Though inflation dropped in 1981 and 1982, the money supply (including quasi money) grew by 50 percent and 77 percent in these two years. The stage was set for another crisis, which indeed can be said to have occurred in 1982, when GDP, investment, exports, imports, and industrial production all fell drastically. The stage may now be set for another period of recovery—Alejandro Vegh Villegas, who guided the nascent boom of 1974–75, returned as Finance Minister in late 1983 to try to duplicate his earlier feat.

Some Observations and Reflections

To me at least, the experiences recorded in our study confirm and reinforce the wisdom of the policy professionals. Without a doubt, the more successful economies have come closer to implementing the tenets of policy design that these professionals would set than have those economies that have foundered or stagnated.

The less-developed countries. In Ghana, by far the worst-performing country represented here, we have what can only be called a wholesale violation of these tenets; in Tanzania the violation is probably less extreme, and it has been moderated by the inflow of huge amounts of foreign aid. Jamaica experienced a debacle much like that of Ghana, also grossly violating policy norms in the process; the recent stemming of the decline in her real GDP also seems to be due more to massive doses of foreign aid than to any major turnaround in policy.

On the plus side, Taiwan is quite clearly the country that came closest to putting into effect a very wide range of policies of the types that professionals recommend. Indeed, Professors T. C. Liu and S. C. Tsiang were important participants in the formulation of economic policy there for most of the period from 1955 onward, and had a direct influence on the process. Among the less-developed countries surveyed, Indonesia probably gets, after Taiwan, the best overall marks for the great bulk of the period studied. Here we see a pattern that is repeated in a number of LDC's (specifically in Mexico during the 1955–73 period), of quite successful macroeconomic policy combined with a rather mediocre performance on the microeconomic front.

The distinction between micro and macroeconomic policies can easily be blurred, particularly when one considers the general "opening up" of an economy to international trade to be a distinctly macroeconomic action. At the extremes it is clear that the implementation of a particular investment project or the reduction of a small group of tariffs belongs on the micro side; while a generalized expansion or contraction of credit, or an across-the-board reduction in trade restrictions belongs on the macro side. The problems lie with the murky area in between, and here the greatest difficulty concerns policy with respect to international trade.

I have come to consider a trade policy to be liberalizing in a macroeconomic sense when it stimulates the expansion of non-traditional exports.[12] Taiwan from 1955 onward has passed this test brilliantly, and Mexico from 1955 to 1973 (with the dollar value of non-oil exports trebling while U.S. prices increased by only two-thirds) did more than moderately well. By way of contrast, from 1973 to 1981 Mexico's non-oil exports increased only about 10 percent in dollar terms while U.S. prices nearly doubled.

Mexico thus gets quite good marks for macroeconomic policy in the earlier period (when, one should recall, the budget was kept under control, inflation held in check, and the exchange rate successfully maintained), despite many policy flaws at the microeconomic level. But in the later period Mexico fails all the macroeconomic tests (budget, inflation, openness to trade) and certainly does no better than before on microeconomic policy matters. Indonesia, also with a less than ideal set of microeconomic policies, carried out an exemplary stabilization program in the late 1960s, and subsequently maintained budgetary discipline while non-oil exports rose from U.S. $700 million in 1970 to U.S. $9 billion in 1980.

Jamaica is another country where policy was substantially flawed, from a technical point of view, even when it was at its best. But there is no doubt that this policy was technically much sounder before 1972 than it has been subsequently. Jamaica's policy fails on macroeconomic grounds (budget, inflation, and trade and exchange restrictions) in the later period, at the same time as some of its microeconomic blemishes were being transformed into festering sores. Jamaica's record is one of acceptable growth in the earlier and disastrous retrogression in the later period. Incidentally, Jamaica's nontraditional exports (total exports minus those of aluminum, bauxite, and sugar) grew during the "better" policy phase (1962–72) from 132 million to 166 million U.S. dollars of 1980 purchasing power, only to stagnate and then decline during the subsequent period of failing technical policies. The decline in the real value of nontraditional exports continued after 1980, thus tending to support Professor Bonnick's contention that major structural reforms have not been undertaken by Jamaica's new government.

In Tanzania, many policies have been pursued that run counter to the professionals' best judgment, but massive inflows of foreign aid have helped to counterbalance their effect. Tanzania's experience looks very good in comparison to Ghana's, and quite bad compared with Indonesia's. Her failings of macroeconomic policy tended to grow through time, the budget deficit on the whole staying under 5 percent of GDP up to 1973, and ranging from 5 to 10 percent of the GDP thereafter. The inflation rate also rose through time. Prices (GDP deflator) took about ten years to double after 1965, they doubled in six years from 1974 to 1980, and consumer prices trebled in the six years leading up to 1982. On the trade side, Tanzania's exports of products other than coffee, cotton, and sisal multiplied by 2.5 (in dollars of 1980 purchasing power) in the decade following 1955, then increased by only a quarter in the subsequent decade, and finally fell by about 10 percent between 1975 and 1980. This confirms Uma Lele's perception that Tanzanian policy was operating to place ever tighter restrictions on trade as time went on.

Uruguay contrasts with Indonesia and Mexico in that the major differences between its policies in its "good" and "bad" periods were more on the microeconomic than on the macroeconomic side. A general liberalization from controls (most dramatic in the case of exchange controls) and a major tax reform were the dominant characteristics of the reform period that started in 1974. Budgetary restraint prevailed most of the time prior to 1974, and very distinctly from 1974 through 1980, but it was gross budgetary laxity starting in 1981 that helped cause the crisis of 1982–83. Yet even while the budget was being kept under control the inflation problem persisted; at no point in Uruguay's post-1974 boom could one say that this particular macroeconomic challenge had been surmounted.

Uruguay took steps to liberalize its trade policy in the mid- and late-1970s, but she certainly did not go as far in this direction as the professionals' policy tenets would have dictated. Nonetheless, at least when one gauges the success of Uruguay's trade liberalization efforts by the performance of her nontraditional exports, the record is quite good. When policies were at their worst (1955–65), Uruguay's exports (other than wool, meat, and hides) dropped from 165 million U.S. dollars (of 1980 purchasing power) to $58 million. As policies improved somewhat starting in 1966, this figure grew to $131 million in 1973. Then under the major policy reforms that started in 1974, nontraditional exports grew to reach, in 1981, the total of 450 million 1980 dollars. Notably, as the coherency of Uruguay's policy fabric began to break down (in the 1982–83 crisis period), nontraditional exports once again stagnated.

Thus, as far as the LDCs are concerned, it is probably fair to say that at least a crude sort of "justice" prevails in the economic policy realm. Countries that have run their economies following the policy tenets of the professionals have on the whole reaped good fruit from the effort; likewise, those that have flown in the face of these tenets have had to pay the price.

It seems, too, that this crude justice also entails punishments that, to a fair degree, fit the crime. Microeconomic policy comprises the thousands, maybe even tens and hundreds of thousands of ways in which the public sector impinges on the economic life of a country. No single point of contact is likely to be so important that a major flaw or even outright failure would be fatal; each transgression carries a small price, but the penality adds up if the transgressions are many. It is the overall "batting average" that counts—in microeconomic policy. If there is a single mortal failure in microeconomic policy, it is that of approaching such policy with an attitude that ignores, fails to respect, or even disdains the findings of economic science and the judgments of policy professionals. Many countries have adopted such attitudes, and it is for them that the cost of their failings of microeconomic policy has been highest.

Macroeconomic policy is quite another matter. Here a single major error can carry large costs, and the interaction of two or three big mistakes can carry a country to the brink of disaster. Inflation is a bad mistake to begin with; when combined with an exchange rate that fails to adjust to reflect an ongoing inflationary process it becomes much, much worse; add to this a pervasive attempt to keep down prices by fiat and the mixture becomes downright explosive.[13]

In general, the record also shows that stability of economic policy, of the type that engenders confidence on the part of the public, is a tremendous asset. This is particularly true where macroeconomic policy is concerned, because of the high significance of the public's perceptions and expectations in this area. The Mexican and Indonesian cases are especially good examples, for in each of them the "good" period of economic policy was characterized by a stable leadership that tried to stay close to the macroeconomic "rules of the game." Even though both these countries pursued microeconomic policies with many flaws, the stability of their macropolicies along with the continuity of their economic leadership seem together to have pointed a good path to progress. Uruguay experienced its greatest growth during 1974–81; here again there was a great stability of economic leadership. Ghana's success in the early years of independence likewise reflects a continuity of policy from the past, followed by failure when the continuity was broken. And, needless to add, Taiwan represents a sterling example of what a stable and well-oriented policy environment can do.

It is perhaps worth noting that among industrial countries also, erratic policies seem inimical to growth. Within countries long expansions have tended to be characterized by stable policies, and among countries those with the best histories seem also to have had greater policy stability. The world champions in this respect are without doubt Switzerland and Japan.

The industrial countries. I believe that the most profound lesson that emerges from the reviews in our study of the experience of the more advanced countries is simply that, viewed from the standpoint of economic criteria, governments can grow too big. The country with the most favorable recent growth experience—Japan—is the one with the smallest public sector; those with the least favorable growth—Sweden and the United Kingdom—have the largest public sectors relative to the size of their economies. More direct evidence is provided by the studies of Sweden and Germany; in both case the authors attribute the progressive decline in the rate of economic growth to the increasing size of government and the growing pervasiveness with which it impinges on the private sector.

I do not want the above statement to be taken as a value judgment. It is arguable—and to a degree both authors can be interpreted as conceding—that the additional functions that the German and Swedish public sectors have taken on reflect the wishes of their respective populations—welfare state programs usually have a sizable clientele, often a majority. The message that I derive from the studies in question is not that large and pervasive government should necessarily be avoided, but rather that large and pervasive government carries with it a significant economic cost, in terms both of the efficiency with which the economy functions and of the rate at which it is likely to grow.

The Human Side of Economic Development

This is an area in which, by the very nature of the case, there will be less than total consensus, even among policy professionals. Yet there are many points on which, I believe, substantial agreement can be attained.

First, most of us would agree with the late Harry G. Johnson in considering it more appropriate, when it comes to the human side, to think of poor people, not poor countries. Far too often financial or other aid that was motivated by humanitarian values has ended up being creamed off by governmental elites or other power groups whose living standards were not much different from those of legislators and bureaucrats in the industrialized (developed) countries. Humanitarian aid, when given, should find its way to those groups and classes in society by whose position or plight it was motivated.

Second, most of us realize that the life of the upper and middle classes in a great many developing countries is certainly not much worse, and sometimes a good deal better than our own. The social problem of such societies lies not in the standard of living of these classes, but in the presence, side by side with them, of a huge group (usually a substantial majority) of disadvantaged people, living in poverty.

Third, one cannot legislate poverty out of existence in such a country. The state of underdevelopment for an economy stems from the low productivity of the great mass of the people. The only tried and true way out of that state is to fundamentally improve their productivity. For this, the most obvious route is investment in human capital. The second clear route is the accumulation of physical capital, which raises what economists call the marginal productivity of labor. On the whole, it has been found that where adequate investment in human capital has been made, where the society has a labor force that is capable of using modern technology, and where the government provides an environment conducive to the accumulation of capital at home and possibly for its import from abroad, the capital stock grows so as to permit the real wages of labor to increase substantially. The "miracles" of Taiwan, Korea, Singapore, and Hong Kong all attest to this. So, too, do the "miracles" of Japan, Italy, Spain, Greece, Brazil, and Mexico.

Fourth, the funding of efforts to improve human capital need not all come from the State. I believe most professionals feel that too much of such public funds have typically been allocated, in many LDCs, to the children of the middle and upper classes, too little to the children of the very poor.

Fifth, when thinking about human progress, one must think in realistic, plausible, sensible terms, not utopian ones. Thinking in utopian terms is one of the important sources of the ill-advised economic policies with which much of this volume has been concerned. One must realize that for the great bulk of human history, each succeeding generation lived almost exactly like its forebears. It is only during the last few centuries that this pattern has been broken, and it still prevails for many people in many parts of the world.

But, sixth and finally, the world's recent economic history contains much to be proud of. It is probably true that for the poor people of the world the quarter century between 1950 and 1975 was the best quarter century in history. We should not forget this basic fact. While we inquire as to what mistakes were made, and as to where we went wrong, we should also ask ourselves what we did right.

Consider, then, the record of the recent past. The World Bank reports that the low income countries averaged 2.9 percent per year in per capita income growth in the period 1960–81; the middle-income countries 3.7 percent, and the industrialized countries 3.4 percent per year. This is a truly astounding performance. The historic rate of growth of per capita income in the United States, say from 1900 to 1950, was not much more than 1.5 percent per year. And this was a period during which the U.S. was genuinely pulling ahead of most of the world. Now, since 1960, we have the poorest of countries doing as well as the U.S. did while it was on its way to reaching its apogee as the dominant economy in the world (a spot from which it has been clearly receding since 1950).

Moreover, the improvement in *welfare* as distinct from income has been even more dramatic. The crude death rate of the low-income countries today is approximately equal to that of the middle-income countries in 1960; the crude death rate of the middle-income countries today, in turn, is approximately equal to that of the industrialized countries in 1960 (and, indeed, even now, for the latter figure hasn't changed much). The story with respect to life expectancy is also impressive. In the low-income countries it went from 41 years in 1960 to 58 years in 1981, in the middle-income countries it went from 50 years to 60 years, in the industrialized countries it went from 70 years to 75 years. So we can probably say that life expectancy in the low-income countries is today higher than it was, on the average, in the middle-income countries during the decade of the 1950s.

Many factors influenced these dramatic achievements, but surely those related to public health measures and innovations were of great significance. As far as general economic growth performance was concerned I would again emphasize the human capital aspect. In the low-income countries other than India and China the proportion of the relevant age group attending primary school went from 50 to 83 percent for males, and from 24 to 55 percent for females; secondary school attendance in these same countries went from 6 to 19 percent of the age cohort; those in higher education doubled, from 1 to 2 percent of their cohort. Interestingly, the low-income countries as a whole (including India and China) have now reached, in these respects also, levels that exceed those of the middle-income countries in 1960.

It is my hope that by learning from our successes and our failures, and by increasing diligence in improving the understanding of economic forces and processes that we get from economic science, we can help ensure that this transformation of the economic lot of the poor of the world will continue for a long time to come.

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1. This set of developments is the fruit of work done by Solow, Kendrick, Schultz, Abramovitz, Dennison, and more recently Griliches, Jorgenson, and many others.

2. A particular policy, say, for instance, subsidizing investment in the chemical industry, may simultaneously add to the overall stock of capital (thus tending to promote growth) and distort the allocation of the capital stock among industries (thus tending to deter growth).

3. The figures cited in the foregoing resumes of LDC experience, (with the exception of Taiwan), were taken from the International Monetary Fund, *International Financial Statistics Yearbook* (Washington, D.C.: 1983).

4. During the last few years, inflation in Uruguay seems to have been of fiscal origin, but before that—for more than two decades—it was due principally to excessive credit extended to the private sector. In both Uruguay and Brazil, the excessive credit expansion was mainly centered in a state bank (the Banco de la Republica in Uruguay and the Banco do Brasil in Brazil), which was not under the effective regulatory control of the central bank and which acted with an almost imperious autonomy.

5. If a final product costing 100 in world markets is granted a tariff of 20 percent, and if the local substitute uses 60 of imported inputs, which enter duty free, the production of the local substitute saves only 40 (= 100 – 60) of foreign exchange. But since the internal price can now rise to 120 (= 100 + 20%), the local firm will make money so long as its costs do not exceed 60 (= 120 – 60). Its costs can be as high as 60 in order to save 40 of foreign exchange; its "effective protection" is therefore 50 percent [= 60/40) – 1]. Let the product in question be a woolen sweater, and the imported input be woolen yarn. Suppose, too, that some firms in the country make cashmere sweaters, which sell for 200 in the marketplace and use 160 of imported cashmere yarn, which also enters free of duty. Now the degree of effective protection is much higher. A 20 percent tariff on a world price of 200 means that the internal price can rise as high as 240. The imported input (cashmere yarn) costs 160. Hence domestic costs of up to 80 can be incurred (behind the 20% tariff barrier) with the operation still yielding a profit. Since only 40 (= 200 – 160) of foreign exchange is saved, and since up to 80 of domestic costs can be incurred in order to do so, the effective protection in this case is 100% [= (80/40 – 1].

6. If the yarn used to make woolen sweaters (in the example of the preceding footnote) were subject to a 20 percent duty, the cost of imported inputs would have been 72 (= 60 plus 20%). The margin for profitable use of domestic resources would have been 48 (= 120 – 721), which, taken together with a foreign exchange saving of 40 (= 100 – 60) implies effective protection of 20 percent [= (48/40) – 1]. If the cashmere yarn had been subject to 20 percent duty, its cost per cashmere sweater produced would have been 192 (= 160 plus 20%). The final product, with a 20 percent duty, could sell for up to 240 (=200 plus 20%). Domestic costs of up to 48 (= 240 – 192) can therefore be incurred in order to save 40 of foreign exchange. Effective protection is thus once again 20 percent [=48/40) – 1].

The general formula for the rate t_{ej} of effective protection of activity j is

$$t_{ej} = \frac{t_{nj} - \sum_i \alpha_{ij} t_{ni}}{1 - \sum_i \alpha_{ij}} .$$

where t_{ni} is the nominal rate of protection accorded to imported input i and α_{ij} is equal to the fraction of j's total costs (measured at world prices) that are accounted for by imported input i. It is easy to see that when $t_{nj} = t_{ni} = t^*$, i.e., when a uniform tariff of t^* prevails,

$$t_{ej} = \frac{t^* - \sum_i \alpha_{ij} t^*}{1 - \sum_i \alpha_{ij}} = \frac{t^* (1 - \sum_i \alpha_{ij})}{(1 - \sum_i \alpha_{ij})} = t^*.$$

That is, all effective rates of protection are equal to t^* when that is the nominal rate applying to all imports.

7. International Monetary Fund, *International Financial Statistics Yearbook, 1983.*
8. Ibid., pp. 309–311.
9. Ibid., pp. 478–481.
10. See Ulf Jakobsson, this volume, Chapter 4, Diagram 8.
11. Data from International Monetary Fund, op cit.
12. Readers should note that the expansion of nontraditional exports is a rough indicator whose movements should be interpreted with caution and common sense. Nontraditional exports of a country might boom because of a great mineral discovery or because of a dramatic rise in their international prices; this would not be a reflection of a liberalizing policy. Likewise, movements of their international prices might cause them to fall, or they may be squeezed out by the effects on the real exchange rate of a price boom in the traditional exports or a huge inflow of capital. But on the whole it should be noted that, while usually, for LDCs at least, traditional exports tend to be small in number, each accounting for large export receipts, nontraditional exports (actual and potential) tend to be much more numerous, and the balance of payments is much less vulnerable to movements in the world price of any one of them. Moreover, where trade is initially highly restricted, a government has a simple way of itself giving a strong positive stimulus to all exports—namely by liberalizing import restrictions. Historically, strong liberalizing policies have in fact tended to generate palpable stimuuli to nontraditional exports taken as a group.
13. Professor Anne Krueger has an excellent description of the way in which the costs of policy errors magnify when these errors interact in a section entitled "The Prototypical Illiberal Economy." See Anne O. Krueger, *World Economic Growth,* Chapter 14.

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Edited by **Arnold C. Harberger**

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