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Structural Adjustment and Policy Reform in India: Perspectives from International Experience

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Foreword

With publication of the World Bank's *East Asian Miracle*, the "Washington consensus" for growth and development seems to have converged on one dominant message Less-developed economies which were quick to adjust to outward-looking, market-oriented, private sector-led policies have in recent years exhibited more dynamic growth performances

The East-Asian "Tigers"—Korea, Taiwan, Hong Kong, and Singapore—following pathways set by Japan, and followed in "flying geese" pattern by Thailand, Malaysia, Indonesia, and most recently, the Philippines, represent the vanguard of this movement, although countries in Latin America, and the Middle East can be included

For India and other South Asian nations, economic reforms have come to the fore and have shown tangible results, beset as they were by political vicissitudes of varying degrees of intensity The rejection of a pro-reform Indian government, led by Prime Minister Rao and Finance Minister Singh in the early summer of 1996, caused some doubt as to reform sustainability But the current indications are that the reform, in large part, will continue

India, with a skilled and disciplined bureaucracy and an "opening-up" in trade and external relationships is heading toward an unprecedented growth rate of 5 to 6 percent annually But this very bureaucracy, together with entrenched state, federal, and sectoral interests, may be the most formidable obstacles to continued reform and economic growth

Two cautionary notes are prominent First, reforms have often been pitched to the electorate and the bureaucrats as crisis management tactics, imposed by pressures from the IMF, international development banks, or other external agencies As such, they must fight bureaucratic inertia and general public apathy or resentment, which paradoxically may actually increase with the

easing of the crisis Second, despite general agreement on the theoretical justification and desirability of the proposed reforms, there is neither agreement on the mechanisms and sequencing of reforms nor are there simple keys, without which failure is assured, and with which success is guaranteed

Nonetheless, it was the agreement in 1991 under the IMF's Structural Adjustment Facility to head off a near-calamitous fiscal crisis which signaled a decisive shift in India's development approach and strategy It was in this context that the USAID India Mission in 1993 funded a two-year study of Indian reform issues, submitted by the Asia section of the International Center for Economic Growth (ICEG) in collaboration with the Indian Council for Research on International Economic Relations (ICRIER)

The USAID-sponsored research and policy outreach program was to be centered around the broad theme of Structural Adjustment and Policy Reform in India Some Perspectives from International Experience and consist of three major components (1) Distinguished Author Seminars, where authoritative international scholars would speak in-depth on one or more of key themes, and draw upon personal experience or research output for comparative analysis if relevant, (2) joint research projects which would be undertaken by select Indian research institutes under the direction of ICRIER, and (3) an international conference to be scheduled toward conclusion of the program before a select audience of economists and key policymakers from both domestic ministries and international development agencies

This volume is based mainly on presentations in the Distinguished Author seminar series and at the international conference, held in New Delhi, on February 1996 As the spread of titles indicates, there are papers focusing on macroeconomic issues, the emerging international environment, internal financial reform, and poverty alleviation issues

The second major section, in keeping with the program theme, contains presentations by acknowledged outside academic or policymaking specialists on developing or transitional economy reform efforts (China, Indonesia, Japan, Mexico, and Chile) Finally, the collection concludes with two papers on the "Unfinished Tasks Ahead" by Jeffrey Sachs, Director of the Harvard Institute for International Development, and T N Srinivasan, renowned Indian scholar at the Yale Center for Economic Growth

For the volume's editors, the wide diversity and high prestige of the writers assembled presented an interesting challenge Each of the writers was expected, some to a greater extent than others, to comment on interrelated questions such as the following

1 To what extent have stabilization measures affected structural adjustment?

2 To what extent have structural adjustment programs affected economic stabilization?

3 Can India stand up to global competition? How can its potentials be realized? What constraints stand in the way?

4 How can conflicting issues in deregulation of the private sector and privatization of the state sector best be rationalized?

5 What should be the appropriate reform strategy for meeting social needs and upgrading labor skills? Is there an inherent contradiction between economic reform and desired social policy?

6 What should be the new role of government resulting from the reform process? How can it retain credibility as it seeks to move out of "wrong" areas in order to focus on "right" ideas?

7 How have other developing countries liberalized their economies, and understanding that policies and approaches developed elsewhere may not be replicated, are

there yet some useful lessons for the structural adjustment and policy reform process in India?

The editors have opted for the convenience of leaving for the reader his or her interpretation of the questions and the extent and means of the writers' responses Too often in collections of this type, introductory excerpts have not proved relevant, appropriate, or accurate, thus arousing the discomfiture of both writer and reader Our option does have the distinct virtue of launching the reader on what we expect will be a pleasurable literary journey of sampling and deliberating the insights of Presidents of the American Economic Association, renowned international economic scholars, development ministers from Indonesia, Mexico and Chile, and the aforementioned, Harvard-Yale duo

Yet the editors do not resist the temptation of some pragmatic moralizing, from their reading of the papers and at the conclusion of this introductory chapter

Each author has emphasized the need for a continuous process of reform over a period of time and identified the pitfalls of a deceleration in the pace of reform because of socio- and political pressures We would agree that India has been able to come out from decades of low equilibrium growth and is ready for take-off Confidence within and outside the country about the potentialities of India is on the increase Not unexpectedly, the country is passing through temporary inconveniences of the adjustment processes But at the same time, it has been successful compared to many countries in minimizing the social cost by using necessary safety nets There are, however, many unfinished tasks and the country needs to change its mindset and accentuate reforms to fulfill its targets

For India to grow, it is critical that government resources devoted to supporting SOEs (State-owned enterprises), large State and central government bureaucracies, and an inflated defense establishment be reallocated to a wholesale attack on illiteracy

and improving health care in India's vast rural heartland For India to participate and assert its role in the emerging global environment, it must introduce new policies focused on improving the country's human capital Deregulation and production based on comparative advantage will produce short- and medium-term gains for India, but ultimately the reforms will stop short if the Government of India does not pay more attention to India's greatest resource—its people

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Introduction

This volume is based on papers submitted by a group of distinguished economists from India and abroad at a conference organized by ICEG and ICRIER in early 1996 Its focus is on the policy issues of economic reform initiated in India and on the experiences of other countries like China, Korea, Indonesia, Chile, and Mexico, all of which embarked on similar programs in earlier years, and their implications for India This volume, therefore, is all about learning to reform better

Broadly, the papers are classified in three sections (i) Macroeconomic and sectoral policies, (ii) The reform experiences of selected countries, and (iii) India's reform process the unfinished agenda

In Section One, which deals with macroeconomic and sectoral policies, the papers are subdivided into two groups (1) a section on macroeconomic policy issues which includes five papers, authored by Prof Arnold Harberger, Prof Anne O Krueger, Prof Robert Baldwin, Prof Deepak Lal and Dr S P Gupta and (2) a section on sectoral policies which includes contributions from Prof Helen Hughes on foreign investment and Prof Robert McKinnon on financial sector reform

In Section Two, the reform experiences of selected countries are presented in papers from Prof S Ichimura covering Japan, Prof Mohd Sadli on East Asia, Prof Rolf Luders on Chile, Prof J Rogozinski on Mexico and, Professors Justin Yifu Lin, Wing Thye Woo and Jeffrey Sachs on China

Finally, Section Three examines India's reform process The unfinished agenda addresses papers by Prof Jeffrey Sachs and Prof T N Srinivasan

Prof Harberger initiates the discussions with his thirteen pragmatic and non-ideological "lessons of economic policy" Among these are avoid false technicism in economic policy-

making, keep budgets under adequate control, keep inflationary pressures under reasonable control, and take advantage of international trade He also warns that some patterns of trade restrictions are far worse than others In his view, if import restrictions become excessive and reducing them directly is politically unfeasible, an indirect attack should be launched on the problem by increasing incentives to export This recommendation, however, is questioned by many other economists In his paper, Prof Harberger further pleads for simplification of the tax system and avoiding excessive income tax rates as well as indiscriminate recourse to tax incentives to achieve particular objectives He also argues against use of any control on prices, wages, and quotas, licenses and quantitative restrictions According to Prof Harberger, public sector firms should not be burdened with too many extra demand and supply constraints, which are responsible for the inefficiency of public sector vis-a-vis the private sector Any policy regime should make the borderline of public and private sector very clear and well-defined When the two compete in a given area, the same rules should govern their operations

The next paper presented by Prof Anne O Krueger makes the pertinent point that when reform efforts are initiated, they are decided upon usually by small groups of technocrats, often working in crisis or near-crisis conditions and, economic theory provides considerable guidance as to the desirable set of economic policies However, over time, researchers have had an opportunity to study different reform programs and their outcomes Consequently, many now recommend that when reform enters the structural adjustment phase from stabilization, i e , from macro to micro, a change of guard among policymakers will be useful

Prof Robert Baldwin emphasizes the relevance of international economic environment in the reform process of a country According to Prof Baldwin, the current international trading environment continues to present certain advantages, in addition to obstacles, to countries like India, which have recently opened up

in comparison to the East Asian economies which had done so in the 1960s The benefits of international experience and globalization arise mainly from (1) greater economic interdependence among nations, (2) lower levels of protectionism, and (3) an improved institutional mechanism for resolving trade disputes At the same time, there are disadvantages including (1) increased pressure to open up sectors such as services earlier than desired, (2) an increase in protectionism in developed countries, perceptible in the form of anti-dumping and other non-tariff barriers, and (3) an increasing number of preferential regional agreements that discriminate against nonmembers

On the social cost of economic reform, the views of Prof Hughes and Prof Deepak Lal largely converge Both acknowledge growth as the main instrument for reducing poverty with emphasis on the role of labor-intensive growth Prof Deepak Lal classifies poverty as (1) mass structural poverty, (2) conjunctural poverty and destitution, and (3) seasonal temporary unemployment According to Prof Lal, growth is the only means to the alleviation of mass structural poverty For the remaining poverty classifications however, some income transfer from the public sector will be needed, although that there are cases where public transfer of income has crowded out private transfers In his experience, private/nongovernment organizations perform better in managing the income transfer from the rich to the poor because of their grassroots knowledge at the micro level

Lastly, Dr S P Gupta provides illustrations of areas where inter-country experiences have helped India and, in contrast, where India has failed to absorb these experiences and suffered the consequences in her reform process According to Dr Gupta, there are certain major growth determinants which have been largely ignored in India's current reform effort, contrary to the lessons of successful reforming countries These lie in the sphere of agriculture and the rural sector, technology development, labor laws, and employment generation Besides, there are no signs of

any significant improvement in India's total factor productivity since 1991 There are growing signs of increasing implicit subsidies in the public sector The nature of vested interests in India is fast changing to the detriment of the large rural mass, where the majority of the poor is concentrated Due to the nature of India's foreign investment policy, "fly-by-night" firms which move from one country to another to exploit incentives such as tax holidays and other discriminatory short-term benefits have been invited

In the conclusion, Dr Gupta also stresses that the benefits of public sector reform and privatization must be properly understood No haphazard green field concept of privatization will work Experience shows that reforming the public sector by way of stop-gap measures of corporatization or divestiture of less than 49 percent, MOU and other methods have failed in most countries Indian economists, businessmen and policymakers have, in the past, proved to be very slow in learning from others' experiences Now, the mindset needs a change, particularly amongst the business community and policymakers

The international experience of different developing countries in the area of foreign investments and financial sector reform is discussed in the papers presented by Prof Helen Hughes and by Prof Ronald I McKinnon, respectively

According to Prof Hughes, apart from augmenting the capital base of a country, foreign investment is important in the sphere of management and technology She, however, believes that foreign investment, at best, can only have a complimentary role and, therefore, cannot be a substitute for domestic resources and technology, nevertheless, foreign investment remains important To quote, "Foreign investment can only be effective at the margin, but economics teaches us that what happens at the margin, rather than on average is important" She draws on her international experiences to touch on the emerging controversy in India over the issue of a level playing field for local business vis-à-vis foreign players "Given a set of laws, it is essential that for-

eign investors are treated equally with domestic investors, because giving foreign investors privileges that domestic firms do not enjoy will encourage domestic firms to launder money to become foreign investors " She explains that there is a considerable body of evidence to show that "tax holidays" and other incentives do not attract foreign investors, it is the investment climate and efficient infrastructure which count the most According to Prof Hughes, foreign investment should be welcomed only when trade and investment restrictions of the host country have significantly decreased, otherwise, foreign investments are often seen to be associated with exploitation of the protected domestic market This is the price which Philippines and some of Latin American countries paid In the industrial sector, the host country must establish a proper legal and regulatory body to safeguard the environment and protect the small-scale sector But one should avoid excessive regulation empirical evidence points to more "market failure" resulting from government intervention than from market limitations

In Section Two, the book enters into exhaustive discussions on the experiences of different aspects of economic reform of selected countries and deliberates on the possible lessons India can draw Prof Wing Thye Woo, Prof Justin Yifu Lin and Prof Jeffrey Sachs cover different aspects of China's development Prof Woo and Prof Sachs question the common hypothesis that the outstanding performance of Chinese growth can be explained mainly by an optimal sequencing which gives precedence to (1) agricultural reform over industrial reform, (2) higher priority to reforms of state-owned enterprises over privatization and (3) an economic liberalization over (i e , preceding) political liberalization According to Prof Woo and Prof Sachs, there is no universal "optimal" sequencing In the case of China, agricultural reform happened to come first because it was the largest employment-generating sector and contributed to the composition of GDP According to the authors, the generalized prescription of a standard sequencing argument—that current account

liberalization should precede capital current account liberalization or that domestic trade liberalization should precede foreign investment liberalization—have not always stood the test in many reforming countries On the reform of state-owned enterprises, he says, Chinese total factor productivity in state-owned enterprises is only slightly more than half of that in collectively-owned enterprises, in the case of the former, financial efficiency is negative Indeed, most state-owned enterprises are running huge losses, placing a heavy burden on the budget

Regarding the sequencing between economic and political liberalization, it is wrong to claim that political liberalization undermines economic reforms, he observes Woo and Sachs cite many counter-examples relating to the Czech Republic, Estonia, Poland and Solvenia and even, to some extent, the Russia experience As indicated above, since the agricultural sector is the largest employment-generating sector in China, the major growth impetus for China came from decollectivization and liberalization of the agricultural sector by way of a significant movement from low-productivity agricultural labor into the high-productivity TVE activities The other major growth element in China lies in its integration with the global economy Also, the role of high savings in China has been cited as one of the key factors in accelerating Chinese growth Lastly, the existence of family ties between the mainland and overseas Chinese in investment has been identified as one of the main agents for China's accelerated production Prof Woo and Prof Sachs believe that all these potentialities are there in India Besides, India has additional advantages in three areas (i) the existence of a well-defined and well-tried system of political succession, (ii) an established legal system, and (iii) widespread knowledge of the English language Indeed, according to the authors, the Chinese experience completely demolishes the idea that large countries do not grow fast

The second paper on the Chinese reform experience is by Prof Justin Yifu Lin Prof Lin emphasizes that China, throughout

the reform process, enjoyed continuous growth because of successful micro management and a sound resource allocation system While the Soviet Union and Eastern Europe have had to bear a high cost of transition in the form of a steep fall in GNP value, China has been very successful in maintaining its monotonic growth in GDP However, in the financial sector, the Chinese experience included a rapid expansion of money supply and high inflation Prof Jeffrey Sachs and Prof Wing Thye Woo assert that the Chinese success can be explained in terms of overwhelmingly rural-based, agricultural, and a labor-intensive economy Despite being a "socialist" economy, less than 20 percent of the Chinese labor force was in state-owned enterprises at the start of market reforms The Chinese government adopted a two-track approach to reforms in which the countryside and the coastal provinces were substantially liberalized to engage in market activities, while state-owned enterprises were kept under state control This was expensive in fiscal terms The major growth came from the labor force This situation contrasts starkly with that of Eastern Europe and the former Soviet Union, where the state sector dominated the economy at the start of market reforms Further, this paper underscores the problem of growing income inequalities across regions in China with demands for compensatory policies from the center Along with regional imbalances, there is corruption as well as misuse of state assets which is further undermining public support for existing political institutions This poses a challenge to China's reform effort

Prof Ichimura analyzes the Japanese growth experience He identifies the following as key elements for Japan's rapid growth (1) a high rate of capital accumulation, (2) a high rate of savings, (3) an industrious and well-educated labor force, (4) a high rate of growth in agricultural production, (5) quick learning and improving of foreign high technology, (6) excellent management and labor relations, (7) sound fiscal, monetary as well as industrial policies, and (8) the promotional role of banks with respect to private enterprises

The Japanese government has consistently paid attention to the welfare of the people and has gone for an egalitarian society through its distributive policy in the form of (a) land reform, (b) progressive income tax, and (c) transfer payments to families in distress While this led to increasing income inequality and some social disturbances in most Asian economies with high economic growth, Japan and Taiwan have proved to be the exceptions because of their equitable distribution of income However, this factor never impeded the fundamental process of development in these two countries

Prof Sadli concedes in his paper his inability to spell out whether the Indonesian experience contains an important lesson for current Indian reforms At the time of independence both countries were inclined towards the socialist model of development with a planned economy and a strong public sector occupying the "commanding heights" of the economy But Indonesia became much more pragmatic and market-oriented since 1967 Hence the Indonesian reform process is almost thirty years old, while the Indian experience is barely five years long The Indonesian experience teaches that such an exercise is a very long process, sometimes engaging in a bold step, but often proceeding slowly, with a zigzag course, even at times giving the appearance of backsliding What is happening in India for the last four years has been visible in Indonesia over the last thirty years But over time, the step-by-step and partial progress would have a favorable impact on economic growth

Prof Rolf J Luders takes a close look at the privatization process in Chile He focuses on three aspects (i) privatization, (ii) the methods of divestiture, and (iii) the development effects of privatization Privatization itself has four stages (a) agrarian reforms, (b) state financing of education, (c) public housing where government encouraged private participation, and (d) the novel modernization of the social security, especially the pension, system The three major methods of divestiture mentioned are

(a) liquidation, (b) direct sales, and (c) bidding at auction In Chile, privatization led to (1) a reduction in public sector wealth Independent of the wealth effect, the state reduced its wealth when it decided to use the proceeds during the first round of privatization to finance some of the social expenditure and during the second round of divestitures, the revenues were instead reinvested in infrastructure, (2) enhanced relative efficiency of the private sector compared to the state-owned enterprises (SOEs) From various case studies, he concludes that in five out of six cases of large privatized firms, internal efficiency was enhanced as a result of privatization, and (3) increased private sector employment While privatization is often associated with unemployment, in Chile's case, employment initially fell more rapidly in the case of SOEs and later when employment overall was rising, it grew much faster in the private sector than in the public sector

Prof Rogozinski, concentrating mainly on the success of the Mexican experience in the privatization process, elaborates on the "divestiture process" According to Prof Rogozinski, the divestiture process involves the following (1) a proposal by the coordinating agency, (2) findings of the inter-secretarial commission on financing-expenditure, (3) drafting of a divestiture agreement, (4) designation of the agent bank, (5) issue of sales guidelines, (6) development of a sales profile and prospectus, (7) technical-financial assessments, (8) receipt and evaluation of offers, (9) authorization and resolution for sale, (10) formalization of the sale, (11) divestiture, and finally, (12) creation of the white paper (official documents and procedure of the sale) He feels that the Mexican experience has been positive in terms of not only the number of companies privatized, but also in terms of transparency, efficiency and strict adherence to the legality of the processes carried out

The last section of the book deals with some of the major unfinished tasks in India's reform process These have been elabo-

rated on by Prof Jeffrey Sachs and Prof T N Srinivasan After examining all the areas requiring further liberalization—i e , agriculture and rural development, public sector reform and privatization, financial reform, fiscal and trade reform—Prof T N Srinivasan concludes that reforms in India have been hampered by three factors (i) doubts about India's ability to stand up to global competition, (ii) fears of being overwhelmed by foreign multinational corporations (MNCs), and (iii) worry over reforms causing inequity All of these concerns are misplaced According to Prof Srinivasan, there are several areas where further and faster reform are required private enterprise must be further unshackled from state regulation through changes in labor and land laws, freedom in entry of capital including foreign capital and improvements in infrastructure by allowing state governments greater autonomy, and privatization of SOEs has to be undertaken seriously by making it politically more palatable

Prof Sachs, subsequent to listing the key areas of reform as well as India's unfinished tasks, concludes

> The most unfortunate mistake of governments engaged in economic reform is the belief that economic reforms are a painful necessity that are likely to be costly at the polls This is a simplistic view of a more complicated reality As a general principle, the electorate can sense the difference between a dynamic, honest government attempting reforms, and time-servers Since the public so rarely is treated to the first variety of government, they really appreciate it when the occasion arises

To be sure, it is generally politically tricky to clean up an inherited financial crisis (such as India's in 1991), since budgetary austerity is rarely simple to manage At the same time, however, the public is usually grateful for an end to high inflation and financial uncertainty Most other areas of reform—for example, trade liberalization, stimulation of new labor-intensive manufacturing, improved infrastructure and even privatization—can be

highly popular, except among narrow groups of vested interests Many dynamic reformers, even those carrying out tough stabilization programs, have gone on to achieve great electoral vindication Examples include President Menem in Argentina, President Sanchez de Losada in Bolivia, and Prime Minister Vaclav Klaus in the Czech Republic

In concluding, one observes that there has been remarkable consensus among all the distinguished economists in this volume regarding the contents and contribution of an "open market economy" strategy to higher economic growth and consequential benefits to the society Each author emphasizes the need for a continuous process of reform over a period of time and identifies the pitfalls of a deceleration in the pace of reform through socio and political pressures Everyone would agree that India has been able to come out from the decades-long trend of low equilibrium growth and is ready for take-off The confidence within and outside the country about the potentialities of India is on the increase The country is passing through temporary inconveniences of the adjustment processes But at the same time, it has been successful compared to many countries in minimizing the social costs by using necessary safety nets There are, however, many unfinished tasks and the country needs to change her mindset and accentuate reforms to fulfill her targets

New Insights into the Growth Process

Arnold C Harberger

INTRODUCTION

In this lecture I hope to bring together three quite separate strands, each with its own connection to the larger project that is being formally initiated here today The first strand harks back to a conference in Mexico City, a little more than a decade ago The theme of that conference was the linkage between economic policy and economic growth It drew on the experience of the many individual authors, as well as of the specific countries covered in their studies The conference proceedings were entitled *World Economic Growth*, published by the Institute for Contemporary Studies in San Francisco Not only does the theme of the Mexico City conference bear directly on our present project, it is also true that the conference widened the horizons of the Institute for Contemporary Studies, giving rise to a period of gestation out of which the new offspring was the International Center for Economic Growth, the principal external sponsor and collaborator of this event The Mexico City conference can thus claim to be, in some sense, a precursor of the series we are initiating today

The second strand of my lecture concerns my own recent work on the analysis, perhaps even the dissection of the process of economic growth This work is, I think, important because it focuses our attention on the vital role played by what I call "real cost reduction" in generating episodes or processes of significant and successful economic growth This element of real cost reduction must be seen as something additional to familiar causal forces like increases in the labor force and in the relevant stocks of physical and human capital And just as there are policy lessons

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associated with getting appropriate amounts of investment in, say, physical and human capital, so too there are significant policy lessons to be learned by a country trying to find the best way of harnessing the forces of real cost reduction to enhance its welfare and increase its rate of economic growth

The third strand of my lecture comes very much from the heart Most of you probably do not know this, but the Indian economy was, in a very real sense, a cradle where much of my understanding of the process of economic development was nurtured I was here with an MIT project, working in collaboration with the Indian Planning Commission, for the entire 1961–1962 academic year I then returned, under Ford Foundation auspices, for a goodly stretch during each of the summers of 1972 and 1973 These experiences gave me many insights into the Indian economy as well as the life, cultures and traditions of this subcontinent Now, I am coming back after a twenty-year absence, and I want to share with you some of the impressions, judgments and hopes that this re-entry into the Indian scene has brought forth

Just to alert you in advance, I do not seek to weave these three strands into a single seamless piece of cloth It is better if you think of them as three different ways in which I thought I could bring my own past experience to bear in trying to contribute to the start of this fine new project

LESSONS FROM THE MEXICO CITY CONFERENCE

The Mexico City conference of 1983 had a certain aspect of novelty, at least for its sponsors at the Institute for Contemporary Studies (ICS) That Institute had long been identified as appreciating the virtues of free-market economics and as supporting a free-market orientation in economic policy But on the whole, its conferences and publications spoke with an ideological or philosophical tone as they reflected these attributes The virtues of the

free market tended to be derived from first principles rather than from a weighing of evidence drawn from actual experience

The novelty of the Mexico City conference, for the ICS, was that it approached the whole question of market solutions versus their alternatives from a pragmatic rather than a purely philosophical point of view The speakers at the conference were seasoned "practitioners" who had spent the better part of their professional lives struggling with the policy challenges and dilemmas that appear in real life They were asked to relate, each for a country or area of his or her personal expertise, what they would list as their own "lessons of experience "

I tried, in the concluding chapter of *World Economic Growth,* to summarize their messages In a listing that was meant to distill the spirit of the conference, but without being anywhere near an exhaustive reflection of its full content, I focused on thirteen "lessons of economic policy " In a moment I shall try to review those lessons and also move on to discuss them in the light of an additional decade of experience But first let me quote from the paragraph that closes the recitation of the thirteen lessons

> 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 Laborites, 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 (*WEG*, p 436)

This reflects what I mean when I refer to the pragmatic, non-ideological spirit of the conference As I go through the lessons, you may want, with some justice, to call them rather technocratic But I would at the same time add one or more qualifying adverbs—flexibly technocratic is a better description of the spirit than is just plain "technocratic" Here is another citation which illustrates the point

> These, then, are 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 macroeconomics policy (*WEG*, p 428)

The Thirteen Lessons

And now for a summary, as brief as I can make it, of the thirteen lessons

1 Avoid false technicism in economic policymaking One type of technicism is equating "planning" with just making projections of the future growth and structure of the economy Projections are a useful component of economic policymaking, but they are far from being its essence A good rule is that almost any policy reform that is important involves confronting some vested-interest group—the protected farmers of France, the tax-evading elite in almost every developing country, the public sector bureaucracy that lives from regulation Much false technicism has been a way of simply not facing this sort of reality

2 Keep budgets under adequate control This was not a purist's call for balancing budgets at all costs It was fully recognized that deficits that were small enough could be maintained indefinitely, and that even a big deficit could be swallowed every now and then But continued big deficits drive an economy to the wall in one way or another If carried out in a non-inflationary way, they lead to growing costs of debt service on the one hand, and to a devastating crowding out of private sector investment on the other If, to avoid these problems, the country resorts to inflationary finance, it opens the door to another set of perils

3 Keep inflationary pressures under reasonable control Here, too, the tone was not preachy or moralistic, but pragmatic Certainly one should not "ask" a poor developing economy to be more austere then the world's great industrial powers So living with the rate of "world inflation" has to be seen as a plausible option Moreover, experience has shown that some countries have gone through some quite successful growth episode while maintaining rates of inflation in the order of 15,

20, or 25 percent per year No one felt that these rates of inflation were themselves a factor promoting economic growth But neither did anyone feel that they were such a great deterrent that they would by themselves preclude a successful growth experience

But, lest anyone feel that policy practitioners were too permissive vis-a-vis inflation, I added

> 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 (*WEG*, pp 429–30)

4 Take advantage of international trade Here the tone was a pragmatic "take advantage of the opportunities that international trade offers" rather than a dogmatic proclamation of "free trade as the only sensible objective" Without denying the virtues of free trade, the spirit of the Mexico City conference went in the direction of freer trade, a more open economy, and a greater exploitation of a country's comparative advantage One of the main points was emphasizing the mechanism by which greater restriction of imports tends, virtually unfailingly, to produce an economywide destimulus to exports The open economy is one which leads to high exports and high imports relative to GDP The highly protected economy is one that leads to low imports and low exports Protecting imports adversely impacts exports by producing an equilibrium real exchange rate that makes it less attractive to export It also distorts the allocation of resources "as protection of relatively less efficient import-competing industries diverts resources (capital and labor) from more efficient export industries" (*WEG*, p 430)

5 Some types and patterns of trade restrictions are far worse than others Here we emphasize the fact that most actual tariff structures had a wide range of rates, which in turn led to even wider span of rates of what is called *effective protection* In every case we know of, the economic cost of effective protection could be greatly reduced simply by making tariff rates more uniform Indeed, a uniform rate on all imports is the only known way of achieving equality in the rates of effective protection of all actual and potential import substitutes

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 This "lesson" is based on a famous proposition in international trade analysis, that a uniform import tariff of X percent, combined with a

uniform export subsidy, also of X percent, is equivalent to free trade It is also true that any single tariff on a typical import good tends to end up curtailing the volume of exports and hence of total trade, while any single subsidy to a typical export tends to end up expanding the volume of imports and hence of total trade So I do not think we were mistaken in the economics involved in lesson no 6 Still, of all the lessons, it is the one that makes me most uncomfortable a decade later

When I ask myself why I feel uncomfortable, the answer is that the premise of lesson no 6 seems to be too strong In the last decade, country after country, at all levels of development, has succeeded in drastically reducing its tariffs and other import barriers We have Argentina, Bolivia, Colombia, Costa Rica, Honduras, El Salvador, and the Dominican Republic We have Australia and New Zealand We have Turkey and Indonesia With all these examples of successful import liberalization, in all cases significant and in some cases massive, I feel reluctant to offer, as a piece of expert advice, a policy of export subsidization, as an alternative route to trade liberalization Import liberalization is more direct, more clearly targeted to the ultimate goal The experiences of the last decade show that the best advice is for countries simply to swallow the pill

7 Make tax systems simple Make tax systems simple, easy to administer, and (as much as possible) neutral and nondistorting with respect to resource allocation The "model tax" here was the value added tax

8 Avoid excessive income tax rates My summary went on to say that "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 activities, while yielding little revenue" (*WEG*, p 432) Here again, the progress of the subsequent decade carried farther than the

recommendation I doubt if many policy practitioners would today recommend a top rate of 50 percent on either personal or corporate income Too many countries have experienced positive results from reducing their maximum rates to the 30–40 percent range

9 Avoid excessive use of tax incentives to achieve particular objectives Latin America is the region where resort to tax incentives has been most rampant, but they have been employed to some degree almost everywhere Almost invariably, such incentives distort the allocation of resources while at the same time losing government revenue Often vast transfers of revenue to specific favored groups take place, without any significant improvement in economic efficiency Regional incentive schemes have led to huge sacrifices of revenue with little effect on employment in backward regions Tax credit schemes have even created incentives for business firms to profit, even as they make investments whose return to the economy as a whole is negative

10 Use price and wage controls sparingly, if at all They represent another form of interference with the signaling role that the price mechanism plays In a well-functioning price system, high prices tend to attract resources to an activity, and lower prices to repel them When prices are controlled (i e , kept artificially low), they quite automatically repel resources from the activities concerned But the motives behind the price controls are usually to ease people's access to the goods and services in question There is an obvious contradiction here Artificially low prices cause people to demand more, while suppliers supply less The result is typically shortages, black markets, or both These are outcomes just as natural as your heart rate increasing when you run 100 meters Policy practitioners see little excuse for inviting this type of consequences by imposing controls, or keeping them in place

11 Quotas, licenses and similar quantitative restrictions are equally suspect They often are found in tandem with price controls, but whether or not this is the case, they are *prima facie* evidence that some criterion other than price is being used to allocate a limited supply among contending demanders Usually, favoritism and corruption are piled on top of inefficient resource allocation as consequences of quantitative restrictions of these and other types

12 Policy professionals tend to take a rather technical view of the problems associated with public-sector enterprises Here it was recognized that one from time to time encounters public sector enterprises that can hold their own, in terms of economic efficiency, innovative management and disciplined operation, with those in the private sector But it was also recognized that this is far from being the general rule The blame was placed on the superposition of other objectives on top of strictly economic objectives in the cases of most public sector enterprises Examples include keeping electricity or telephone rates artificially low, paying wages to low-skilled workers that are well above market rates, having ceilings on executive pay that are way below the going rates in private industry, being unwilling to shut down lines of production that do not yield a competitive return, or to lay off workers when demand falls It thus is not at all surprising that public sector firms, when burdened by these and other extra demands and constraints, turn out to be less efficient and profitable than private sector firms

Recognizing this fact can lead in two directions (1) reducing or eliminating the constraints and encouraging public-sector enterprises to behave like private sector firms, and (2) turning to privatization as a device for restoring economic efficiency to troubled public sector firms In 1983, I was inclined to put considerable weight on the first direction Today I would pay much more attention to the second The reason is,

once again, that history has swept far more forcefully than most of us imagined back in 1983 Whereas then, a call for privatization might most likely fall on deaf ears (compared with a simple cry for public sector firms to be allowed and encouraged to act more like private sector enterprises), now, the pendulum has swung quite far in the other direction In fact, too many countries have pursued privatization with almost religious zeal, and have carried it out with little preparation and analysis, and without serious regard for the benefits and costs involved

I believe that today the right stance for a group of practitioners, like that of our 1983 conference, would be to urge the primacy of weighing costs and benefits (to the economy and the society as a whole) in all economic policy matters—including the decision as to what, when, where and how to privatize A good guideline to any government contemplating a program of privatization is that it should be done with the same degree of care and responsibility as is exercised, say, by Unilever, BASF or General Electric when one of them decides to sell off a particular division, product line or subsidiary company

This means careful study of each case, and of the potential market for each company being sold It means a knowledge of the weaknesses of the company in its present state and of possible ways to correct such weaknesses In some cases, the correction can be left to the firm or group that buys the company being privatized But sometimes the source of the problem lies within the hands of the government, and the government should take steps to rectify the problem before privatization takes place When firms are saddled with huge debts inherited from the past, it is usually wise for those debts to be "separated" from the firm before it is privatized When parts of firm are non-viable, they too should appropriately be separated from the firm and perhaps permanently

closed down before privatization takes place Likewise, cases of obviously superfluous numbers in the labor force should be dealt with by the government, before putting a company on the auction block Where price controls or price regulations exist, these should be either eliminated beforehand, or restudied and reset in an economically rational way for a significant future period, so as to provide a "known economic environment" for those who place bids for the firm

I cannot exaggerate the importance of good preparation and execution in the field of privatization A wonderful case in point is that of Telefonos de Mexico (TELMEX) At the moment when Mexico first began its privatization program, TELMEX had a potential market value of about US$ 800 million By taking time and energy to prepare for the process, the government of Mexico ended up getting more than 8 times that amount Such are the rewards for "doing your homework" when the time comes for privatization

13 Finally, make the borderline 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

This is another conclusion of the 1983 conference that has been rendered less pointed, and less generally applicable today than it was a decade ago The wave of privatization around the world seems to reflect a widespread appreciation that there are no good reasons for governments to be in the business of producing shoes, textiles, plastics, chemicals, glass, motors, consumer appliances, automobiles and the like Vast numbers of companies in all these areas have been privatized over the intervening decade, none, to my knowledge have moved in the other direction These things appear to testify to an emerging consensus that activities that *can* appropriately be in the private sector *should* be in the private sector This would define a borderline in the area of natural monopolies, which require significant regulation in any

event Activities like local telephone networks and electricity distribution grids are cases in point Here we have a trend toward privatization as well, but regulation is a significant part of the package Some privatization of electricity and telephone companies actually get (and deserve) bad marks, not so much for the privatization as such but because of the poorly designed regulatory framework into which the newly-privatized companies were inserted

One point is worth noting here Advances in our understanding of the economies of the electricity industry have revealed that it is quite possible to have basically free entry and, in a sense, free competition in electricity generation This requires rigid control of the order in which different generation facilities are plugged in The idea is that the facilities with lowest marginal running costs are always used As demand increases, higher cost facilities are plugged in as needed The "trick" is that all facilities operating in any given hour are paid the marginal cost of the highest-cost facility that is operating during that hour That highest-cost facility barely covers its operating outlays, but all the others gain a surplus above generating cost, which contributes to capital cost recovery as well as a return to invested capital There are also premiums (surcharges) at the peak hours Where this system is in place, as in Chile and Argentina, new generating firms can enter freely, subject to the assurance that their capacity will be plugged in before any higher-cost capacity, and to the parallel assurance that their remuneration per kWh will in each and every hour of operation be the highest marginal running cost of any plant then producing With this rule, it is possible (a) to privatize any electrical generating plant or firm and (b) to permit free entry of new private firms into the business of power generation

Some Reflections on the Thirteen Lessons A Decade Later

Many of you will appreciate, from this brief review together with your own reading of current events over the past decade, that many countries have come to the point where they no longer need to learn these lessons Why? Because they have already learned and applied them My own country experience is limited, but I know that Chile, Mexico and Argentina have all implemented programs of economic policy reform which embody essentially all of the thirteen lessons reviewed above New Zealand and Australia should surely be added to that same list The countries of Central America, the Dominican Republic and Colombia, Bolivia, and Uruguay have all embarked on reform programs that, though still incomplete, move in the same direction

In such countries the policy dialogue moves to a different plane how best to privatize state enterprises, how best to regulate in those cases, like electricity distribution and local telephone networks, where regulation is called for One area where there is a crying need for improvement, in industrial and developing countries alike, is social and economic cost-benefit analysis Vast amounts of public funds are still being wasted all over the world on projects that will never repay their costs, let alone yield a positive economic return Often this is simply the result of the inability of the authorities in question to quantify and judge the relevant benefits and costs But often it comes out of simple pressure-group politics where the outcome favors those who can carry out the most effective lobbying or otherwise have the most political clout Sometimes and, sad to say, not infrequently, outright corruption rises to further bedevil what would be a complicated and difficult process anyway

This gives you some of the flavor of the path ahead for those countries that have implemented well the thirteen lessons and are looking for new policy challenges for the future But many other countries are still in the position of having to absorb and put into

practice the messages of 1983 that have been reviewed in this section

INSIGHTS FROM THE STUDY OF ECONOMIC GROWTH

Ever since the 1950s, economists have been familiar with what I call the modern framework for the analysis of economic growth This framework uses the concepts of economics to achieve a breakdown of a given growth of real output into its component parts In the most commonly used variant of this approach, the increment to the employed labor force in a given period is assumed to contribute (per additional person employed) an amount equal to the average real wage, and the increment to the capital stock is assumed to contribute an amount equal to the average measured real rate of return to capital (gross of both taxes and depreciation if it is GDP growth that is being analyzed)

When these two components—one due to the increment of labor and the other due to the increment of capital—are added together, they typically do not account for the total output growth actually observed The remaining component of growth has been given several labels The earliest label was simply "technical advance" Later, economists became more agnostic and called this "unexplained" part of growth simply "the residual" The label that has stuck the longest and remains in widespread use today attributes the otherwise unexplained component to an improvement in "total factor productivity" or TFP

As we economists tried to explain movements in total factor productivity, we tended to break it up into two main components (1) a contribution due to "improvement in the quality of the human agent," or to the accumulation of "human capital" for short, and (2) a contribution due to "real cost reduction" The standard way of measuring TFP does not permit one easily to separate these two components To do so, we have to separately account for the changes in labor force of each level and quality of labor It

is easy to conceive of a process whereby we measure the increment in the number of civil engineers and assign to this increment a per-person contribution that is equal to the average earnings of civil engineers, and then proceed to do the same with secretaries, truck drivers, accountants, nurses, airplane pilots, dentists, etc When we have done this properly, covering the entire labor force of the country whose growth we are measuring, then and only then can we identify the "residual" that emerges with what I call "real cost reduction "[1]

I am presently working with a simpler and more direct method of separating out the contribution of "real cost reduction " The essence of the idea is to work with a "basic labor unit " When a worker earns the basic labor unit, he is counted as contributing one unit of basic labor But a worker who earns five times the basic labor unit is counted as contributing five units, one unit counted as "raw labor" and the other four units as the reward to the worker's human capital I will not attempt to go into further methodological detail here Let me simply say that the data requirements of this method are not very great at all Using it, we have been able rather easily to construct a breakdown of growth into its components for entities as diverse as individual business firms as narrowly classified (e g , 4-digit) industrial sectors, or as broadly classified (e g , 2-digit) sectors, and finally as national economies, large and small

Tables 1 and 2 are based on the traditional measurement of total factor productivity (TFP) Table 1 shows how countries with high growth rates are characterized by high rates of TFP increase,

[1]In this case, the contribution of human capital is included in the contribution of incremental labor If 100 draftsmen turn into architects, this growth contribution would have a negative component of 100 times the wage of a draftsman and a positive component of 100 times the earnings of an architect The net effect of these two elements would be due to investment of human capital involved in converting 100 draftsmen into 100 architects

Table 1 Real GDP Growth and TFP Increase

Number of Countries	Avg Annual GDP Growth (%)	Avg Rate of Total Factor Productivity Increase (%)	
		Median	Mean
6	Less than 2%	0 00	0 14
36	2 to 4%	0 90	0 88
42	4 to 6%	1 74	1 62
5	6 to 7%	1 88	1 99
7	Over 7%	2 81	2 60

Source Elias (nd)

while countries with low growth rates tend to have little or no TFP increase Table 2 breaks the countries down into three income levels, and shows that for each level, the fast-growing countries exhibit higher rates of TFP increase than do the slow-growing countries The "ratio of differences" shown in each panel of Table 2 is to be interpreted as follows In Table 2A, the ten poor countries with the fastest growth rates had a median growth rate of 4 8 percent and an average rate of TFP increase of 1 08 percent per annum The ten poor countries with the slowest growth had a median growth rate of 2 0 percent and an average rate of TFP increase of zero percent per year So the difference in median growth of the two groups was 2 8 percentage points, while the difference in their TFP growth rates was 1 08 percent The ratio of these two (1 08/2 80) is 39 percent, it indicates that 39 percent of the difference in growth rates is accounted for by their different rates of improvement in total factor productivity
Note that, working with median rates of growth, this ratio of differences is 39 percent for the low-income countries, 41 percent for the middle-income countries, and 47 percent for the high-income countries All these growth measurements are for a very long period (1950–1987), and are based on the traditional breakdown of

Table 2 Real GDP Growth and TFP Increase of Low-, Middle- and High-Income Countries

	Avg Annual GDP Growth (%)	Avg Rate of TFP Increase (%)	Ratio of Differences (%)
For Thirty-Two Low-Income Countries			
10 Highest Rates of GDP Growth			
Median	4 8	1 08	
Mean	5 1	1 13	
10 Lowest Rates of GDP Growth			
Median	2 0	0 00	
Mean	1 9	0 22	
Difference in			
Median	2 8	1 80	0 39
Mean	3 2	0 91	0 28
For Thirty-Two Middle-Income Countries			
10 Highest Rates of GDP Growth			
Median	5 9	1 71	
Mean	6 3	1 63	
10 Lowest Rates of GDP Growth			
Median	3 9	0 09	
Mean	3 4	0 85	
Difference in			
Median	2 0	0 81	0 41
Mean	2 9	0 78	0 34
For Thirty-Two High-Income Countries			
10 Highest Rates of GDP Growth			
Median	6 9	2 94	
Mean	6 7	2 87	

Table 2 Real GDP Growth and TFP Increase of Low-, Middle- and High-Income Countries (continued)

	Avg Annual GDP Growth (%)	Avg Rate of TFP Increase (%)	Ratio of Differences (%)
10 Lowest Rates of GDP Growth			
Median	3 2	1 21	
Mean	3 2	1 09	
Difference in			
Median	3 7	1 73	0 47
Mean	3 5	1 78	0 52

Note These refer to the 32 lowest-income, middle-third, and highest-income of the 96 countries covered in Table 4 of Elias (nd)

growth They are the result of a study by Professor Victor J Elias, who is probably Latin America's most renowned student of the process of growth

In Table 3 we make two shifts of gear First, we move to the newer methodology of growth breakdown, so that TFP increase no longer contains an element due human capital accumulation TFP improvement here means nothing more nor less than "real cost reduction" The second shift of gear is to shorter periods, typically of five but occasionally of four years' duration One unit of observation is thus basically a quinquennium for a country (e g , a Plan Period in India) We see here that, on the whole, an even greater fraction of the difference between high and low growth rates stems from differences in TFP increase (here interpreted as exclusively "real cost reduction") The results shown in the table are dramatic Fully 64 percent of the difference in growth rates (between "successful" five-year periods and "unsuccessful" ones) is accounted for by differences in the rate of real

Table 3 Real GDP Growth and TFP Increase for Subgroups of Countries and by Subperiods

	Avg Annual GDP Growth (%)	Avg Rate of TFP Increase (%)	Ratio of Differences (%)
For Colombia, Ecuador, Greece, Mexico, Portugal, Venezuela			
12 Highest Rates of GDP Growth during any Subperiod			
Median	7 02	2 44	
Mean	7 33	2 97	
12 Lowest Rates of GDP Growth during any Subperiod			
Median	2 36	0 56	
Mean	2 12	0 10	
Difference in			
Median	4 66	3 00	0 64
Mean	5 21	3 07	0 59
For Canada, Finland, France, Germany, Netherlands, New Zealand, Sweden, United Kingdom, and United States			
12 Highest Rates of GDP Growth during any Subperiod			
Median	4 77	2 61	
Mean	4 93	2 32	
12 Lowest Rates of GDP Growth during any Subperiod			
Median	2 07	0 55	
Mean	1 72	0 43	
Difference in			
Median	2 70	2 06	0 76
Mean	3 21	1 89	0 59

Table 3 Real GDP Growth and TFP Increase for Subgroups of Countries and by Subperiods (continued)

	Avg Annual GDP Growth (%)	Avg Rate of TFP Increase (%)	Ratio of Differences (%)
For Japan, Korea, and Taiwan			
12 Highest Rates of GDP Growth during any Subperiod			
Median	10 50	3 86	
Mean	10 46	3 95	
12 Lowest Rates of GDP Growth during any Subperiod			
Median	5 08	2 04	
Mean	5/20	1 96	
Difference in			
Median	5 42	1 82	0 34
Mean	5 26	1 99	0 38

costs reduction, this is for six developing countries In panel B, we see that the corresponding figure (for nine developed countries in Europe and North America) is 76 percent Finally, in Panel C we find that the corresponding figure for three Asian "tigers" —namely, Japan, Korea and Taiwan—is 34 percent Lest this seem very low by comparison with the others, it is worth noting that the absolute contribution of real cost reduction is far and away the highest (the median is 3 86 percent per year, and the mean is 3 95 percent per year) for the Asian tigers in their high-growth periods

I want to emphasize that for my purposes, the story emerging is essentially the same, regardless of whether we use the traditional or the newer methodology The message is that TFP increase is a critical factor in successful growth performance The newer methodology shows that this is not just due to human

capital formation (something we know about and have emphasized all along), but that it is also true even when TFP increase is defined and measured in such a way as to exclude the human capital contribution and to focus sharply on what I have called "real cost reduction"

The Nature of TFP Growth – Yeast or Mushrooms?

I have earlier and repeatedly argued that there are so many ways in which real cost reduction takes place that any search for new "global" explanations is likely to be fruitless What we have to do is learn more about the process of identifying concretely the sources of major cost reductions wherever we can

But one can have a vision of real cost reduction that is much like the one I have expressed, and say simply that indeed it has thousands upon thousands of sources, but that, precisely because they are so numerous, one can deal with them using the law of large numbers These sources could be incredibly numerous, yet be working simultaneously all across the activities of an economy in such a way as to produce a quite generalized expansion of total factor productivity

I have taken as a sort of "straw man" target in this case the commonly used aggregate production equation Y = F(K,L)e Here plays the role of a generalized TFP growth Looking at the equation leads one to think of a process where growth is pervasive throughout the economy, rather than highly concentrated I use here the analogy of dough (to make bread or cake) expanding as a consequence of the yeast that was mixed into it Here the growth is regular, even, steady Another good analogy is what happens when air is pumped into a balloon

But this is not what we observe in the growth process TFP growth tends to be highly concentrated, to pop up in the most unlikely places, and then to move on to other arenas As we think

of successive great technical advances—in automobile making, in rubber tires, in refrigerators, in television sets, in pharmaceuticals, in plastics, in petrochemicals generally, in telecommunications and most recently, of course in the computing "industry"—we see advances concentrated in relatively short time spans (like decades) for each industry group, and advances concentrated in specific industry groups in any one particular decade

I am planning a much more thorough documentation of the above assertion Tables 4a, 4b, and 4c simply represents a first pass It is based on data presented in Kendrick and Grossman's *Productivity in the United States Trends and Cycles* (1980) The basic data are measures of total factor productivity by industry group in four benchmark years 1948, 1958, 1967, and 1976 Each of Tables 4a, 4b, and 4c concentrates on the period from one of these benchmark years to the next

We first record the cumulative TFP growth measured for each industry during the period Then, we array the industries in descending order, according to their cumulative TFP growth rates To find out how much total "benefit" was generated by each activity's TFP growth, the growth rate of column (1) is multiplied by the base period GDP This yields the absolute contribution to growth, which is given in column (2) The key datum, in my opinion, is the cumulative sum of these contributions to growth, which is presented in column (3) The main message here is how quickly the cumulative total rises

One problem with working just with cumulative contribution data like those in column (3), however, is that they take no account of the sizes of the industries conceived Column (5) helps us to make the appropriate comparison, by giving us the cumulative amount of base-year GDP originating in the industries on the list It is on the basis of column (5) and column (3) that one can make statements like those at the bottom of each table, i e

Table 4a Concentration of TFP Growth Among U S Industries, 1948–1958[a]

	TFP Growth (1 0 = 100%)	Abs Contribution of TFP Growth [(1)*(4)]	Cumulative Sum of (2)	GDP by Industry1958	Cumulative Sum of (4)
	(1)	(2)	(3)	(4)	(5)
Communication	0 69	2 63	2 63	3 80	3 80
Pub Utilities	0 69	2 97	4 60	4 30	8 10
Farming	0 59	13 65	19 25	23 30	31 40
Misc Manuf	0 43	0 43	19 98	1 70	33 10
Elec Mach	0 36	1 58	21 56	4 40	37 50
Food & Kindred Prod	0 35	3 53	25 08	10 20	47 70
Instruments	0 33	0 36	52 44	1 10	48 80
Mining	0 31	2 92	28 37	9 40	58 20
Construction	0 31	3 54	31 90	11 50	69 70
Tobacco	0 31	0 52	32 42	1 70	71 40
Railroad Transport	0 27	2 40	34 82	8 80	80 20
Chemicals	0 27	1 15	35 97	4 30	84 50
Apparel	0 25	0 92	36 89	3 70	88 20
Lumber & Wood Prod	0 24	0 76	37 65	3 10	91 30
Fin , Ins , & Real Estate	0 24	6 43	44 08	26 90	118 20
Other	0 06	19 21	63 29	121 70	239 90

Note a Top 13% of industries account for 30% of total TFP contribution, top 30% account for 52%, and top 49% account for 70% The percentages are contributions to GDP of industries ranked according to their percent rate of TFP growth over the period

Source Kendrick and Grossman (1980)

- The top 30% of industries account for 51 percent of the total TFP growth contribution in 1948–1958
- The top 22 percent of industries account for 57 percent of the total TFP growth contribution in 1958–1967
- The top 20 percent of industries account for 69 percent of the total TFP contribution in 1967–1976

I like the mushroom analogy, because it sort of dramatizes the likelihood that big gains in TFP can happen anywhere even in the most unlikely places (lumber and textile mill products in 4b, finance, insurance and real estate in 4c, railroad transport in both 4a and 4b) The mushroom analogy also sets one's mind to thinking that, even where an event is hard to predict, nonetheless one can still do a lot to make conditions more (or less) propitious for that event For mushrooms it is temperature, humidity, absence of too much light For economic policy, it is a stable framework of laws and regulations within which economic agents can make sound commitments, for the middle- and long-term as well as the short It is also the various attributes of that framework, in principle the framework should keep distortions to a minimum and should use the price system as the major channel through which incentives are signaled

Once one recognizes that the main attribute that TFP advances really have in common (i e , that they all work to reduce the real costs of production), one sees that "getting the prices right" is important not only for reducing or eliminating the efficiency cost triangles that we deal with in the comparative statics analysis of economic efficiency, but also for giving good signals to economic agents as they go about the business of generating "technical advance" It does not make much sense to set up a framework in which agents take actions which they think of as saving costs, and which in fact save private costs to the decision-makers themselves, but which do not (or need not) save costs to

the economy as a whole simply because the agents worked with a set of wrong prices

Table 4b Concentration of TFP Growth Among U S Industries, 1958-1967[a]

	TFP Growth (1 0 = 100%)	Abs Contri-bution of TFP Growth [(1)*(4)]	Cu-mula-tive Sum of (2)	GDP by Industry 1958	Cumu-lative Sum of (4)
	(1)	(2)	(3)	(4)	(5)
Lumber & Wood Prod	0 72	2 51	2 51	3 50	3 50
Railroad Transport	0 63	5 52	8 03	8 70	12 20
Textile Mill Products	0 61	2 49	10 52	4 10	16 30
Elec Mach	0 55	5 10	15 66	4 10	37 50
Trans Equip	0 46	7 05	22 71	16 20	40 80
Chemicals	0 44	3 97	26 68	9 10	49 90
Pub Utilities	0 42	4 65	31 33	11 00	60 90
Petroleum & Coal	0 41	1 27	32 60	3 10	64 00
Rubber & Products	0 41	1 23	33 83	3 00	79 60
Mining	0 41	5 20	39 03	12 60	67 00
Communi-cation	0 40	3 61	42 64	9 00	88 60
Trade	0 33	24 93	67 57	76 40	165 00
Other	0 03	7 53	75 10	239 80	404 80

Note a Top 10% of industries account for 30% of total TFP contribution, top 22% account for 57%, and top 40% account for 90% The percentages are contributions to GDP of industries ranked according to their percent rate of TFP growth over the period

Source Kendrick and Grossman (1980)

Table 4c Concentration of TFP Growth Among U S Industries, 1967–1976[a]

	TFP Growth (1 0 = 100%)	Abs Contri-bution of TFP Growth [(1)*(4)]	Cu-mula-tive Sum of (2)	GDP by Indus-try1958	Cu-mula-tive Sum of (4)
	(1)	(2)	(3)	(4)	(5)
Fin , Ins , & Real Estate	1 14	132 25	132 25	115 60	115 60
Apparel	0 37	2 84	135 09	7 70	123 30
Communi-cation	0 34	6 23	141 32	18 10	141 40
Chemicals	0 31	4 85	146 17	15 70	157 10
Elec Ma-chinery	0 30	5 99	152 15	19 70	176 80
Food & Kindred Prod	0 30	6 62	158 78	22 70	199 00
Tobacco	0 29	1 00	159 78	3 50	202 50
Misc Manuf	0 26	0 92	160 70	3 50	206 00
Paper & Products	0 26	2 11	162 81	8 20	214 20
Other	0 08	41 52	204 33	495 70	709 90

Note a Top 20% of industries account for 69% of total TFP contribution, and top 30% account for 80% The percentages are contributions to GDP of industries ranked according to their percent rate of TFP growth over the period

Source Kendrick and Grossman (1980)

Economic Policy and Economic Growth

The significance of economic policy for the growth process is something that few people appreciate, and still fewer really understand The problem is that, historically, the policies that were

alleged to promote growth tended to reflect the view that the State was somehow "responsible" for growth, that it could create more growth almost at will (by well-designed interventions in the economy), even that it could stimulate growth by resort to inflationary policies This old vision of the growth process has been disproved time and again Just in the last decade or so, a new consensus is beginning to emerge, one which is very consistent with the lessons drawn earlier in this paper

The centerpiece of the new consensus is that the economy is an exceedingly complicated organism, with its own life, its own perceptions, its own responses to stimuli, its own reactions to events The primordial rule for government is that it must always treat this complex organism with the respect it deserves Attempts to gain economic growth by "pushing the economy around" are virtually certain to fail

The true task of policy is to create an environment, a framework, in which the organic forces of the economy work naturally to produce economic efficiency and growth The first task here is to build a framework that gives economic agents the right signals The second, and perhaps more difficult, task is to instill in economic agents the confidence that the future as well as the present will be guided by a good economic policy framework

THE PROCESS OF GROWTH
A SUMMARY AND SOME MESSAGES

The main purpose of structural reform in developing countries is to put them in a better position to set in motion a process of accelerated economic growth The policy framework is a very important ingredient in a healthy growth process, but it is important to realize that growth emanates from the effort, imagination, and hard work of economic agents themselves What the policy framework helps to do is ensure that these efforts of economic agents are not misdirected and/or fruitless It can also

help to a significant degree by creating a climate that generates more economically warranted investment, both in physical and human capital

There are four key elements in the process of growth (a) increases in the labor force, (b) increases in the amount of human capital with which the labor force is endowed, (c) increases in the stock of physical capital, and (d) new techniques, better methods, and improved organization—in short, anything that leads to a reduction in the real costs of production For most purposes, we think of (b), (c) and (d) as the principal components of the growth process because they are the forces helping to generate increases in real output per worker and, typically, in real income per capita

By improving and modernizing capital market institutions, and most especially by providing expectations that a stable and healthy framework of laws, regulations and procedures will prevail into the long-term future, good policy can lead to greater amounts of investment in physical capital By improving both the quality and quantity of the output of the educational process, policy can endow the country with a greater contribution to future growth from the human capital side

The general framework of economic policy works in at least two ways to influence the process of growth By presenting economic agents with prices that truly reflect economic costs, it helps them (a) select the most productive projects for investment in physical capital, thus enhancing its productivity and hence its contribution to the growth process, and (b) find more ways of reducing real costs via new techniques, new arrangements, etc When prices do not truly reflect costs, they give false signals to economic agents who then may find ways of making money (at false prices) even while contributing negatively to the welfare of society (in the sense of having true costs exceed true benefits) The protectionist policies of the not-too-distant past are a good example of how a deficient policy framework can present agents with "false prices," leading to economic activities which, while

being privately profitable, have costs that are greater than their benefits when viewed from the standpoint of society as a whole

A modern policy framework not only liberalizes foreign trade, but it also works in many other directions to present economic agents with "true" incentives and "true" prices The economy, taken as a whole, can be thought of in some contexts as an exceedingly complex machine The task of good economic policy is to bring this machine to its maximum operating potential—having it finely-tuned, well-oiled, and well-maintained at all times

The above may lead one to think that living in a prosperous and growing economy is like living in paradise—relaxed, carefree, and content Nothing could be farther from the truth The rapidly growing economy is like a fast-flowing river, full of hazards and challenges, and calling for constant alertness and effort It is in stagnant economies with little or no growth where people may perhaps manage to live and act comfortably and in traditional ways, year in and year out, decade after decade

I want to make the point that danger and turmoil are an integral part of a process of rapid economic growth Let me start by pointing out that the major factor that distinguishes rapidly growing countries from slow-growing ones, and that distinguishes, within a given country, rapid-growth periods from slow-growth periods, is factor (d), which I have called "real cost reduction" but which has also been called "total factor productivity," "technical advance" or even, in the technical literature of economics, "the residual factor in the growth process " Let us take as a starting point that this factor will typically be large during a process of rapid growth

It is principally this factor, combined with an increased endowment of capital per worker, that raises the real wages of labor of a given quality Reducing real costs raises output and income, and with them, normally, the demand for labor The increased demand for labor causes real wages to rise (not artificially but as a

consequence of natural market processes), causing workers as a group to share in the benefits of the growth process

When wages rise in this way, they do not only rise in the activities that experienced real cost reductions, but wages rise throughout the labor market In a properly functioning labor market, the wages of secretaries of given qualifications should not be different, depending on the industry in which each is employed The same goes for accountants, clerks, drivers, mechanics, nurses, machine operatives, etc Thus when a country enjoys rapid economic growth, higher real wages and salaries will have to be paid, not just by the rapidly growing industries, or by those enjoying sharp reductions in real costs, but by just about everybody who employs labor, throughout the economy (Note that the rise of wages is a market phenomenon that depends on supply and demand, it is not equal for all types of labor Indeed, some occupations may be rendered obsolescent by the growth process and see their wages fall But such cases are exceptions, not the general rule)

The greater is the rate of growth, the greater typically will be the extent of wage pressure on all of the various activities of the economy A traditional industry that has lived comfortably through decades of economic stagnation, protected perhaps by a substantial tariff wall, will find life very different in a modern, liberalized and growing economy If it produces for the international market (as is implicit in the idea of it having been protected), it must face a set of international prices which is essentially beyond its control To keep going, it must find ways of reducing its own real costs so as to offset its rising real wage and salary bill Will it succeed or not? That is the question

There is no reason to expect that in a major growth process all traditional activities will survive Quite to the contrary, in countries like Japan, Korea, Taiwan and Singapore (not to mention Western Europe and the United States), the product mix changed notably as the growth process proceeded Indeed, there is the fa-

mous case of a Korean firm which in the early 1960s produced only wigs made from human hair, and which in the interval has passed through a whole sequence of stages, including textiles, shoes, etc, finally arriving in recent years as an important producer of electronics products

The more rapid the growth process, the more pressure there will be on industries and firms They simply will not be able to survive by doing nothing, in the context of generally rapid growth for the economy as a whole They either must find ways of reducing real costs for their traditional products, so as to be able to offset the effects of rising real wages and salaries, or they must shift to other activities at which they can still make a profit while paying the new, higher wage and salary scale

In all of this, traditional attitudes have to change That one's great-grandfather and grandfather and father successfully managed a traditional family business is no justification for today's generation to continue in that same line of activity The tradition may provide one good reason to continue—by giving today's generation the experience and know-how to be among the low-cost producers in the world marketplace And by this I mean low-cost producers who at the same time pay the full costs of the resources they use, without being artificially protected or subsidized

Modern business training teaches MBAs and others to be always alert to new possibilities of making a profit It talks about shifting the base of production so as to make more money, and also about diversifying the production base so as to reduce a firm's exposure to particular risks It talks about saving real costs and raising real profits in any and every way, through better inventory procedures, through modernized accounting methods, through improved sales organization and incentives, and through lower shipping costs It is very important that the messages and attitudes of a modern business training be instilled in the executives and managers who have to deal with the challenges of a lib-

eralized and growing economy When the policy framework is good, and the signals given by the price mechanism are truly reflective of real cost, it becomes more true than ever that "the business of business is making money"—i e, not making shoes, or shirts or any particular thing—and being ever alert and willing to abandon activities that have turned unprofitable and move on in a never-ending search for new activities that generate positive economic rewards

INDIA FACES THE 21ST CENTURY

This is a convenient point in time to examine the Indian economy and Indian economic policy The 21st century is approaching The world economy has been and is in an exciting and turbulent era whose watchwords are liberalization and modernization Indian economic policy has recently undergone important changes in this same direction What can one say at this time about India's situation and prospects?

I approach this question as an external observer with some relevant background for studying India's situation, but with essentially zero *recent* experience I am somewhat like the uncle who has been away on an extended trip and returns to see his nieces and nephews for the first time in many years I hope that, judged in this light, my observations will be of some interest and value

My main points are as follows

1 Despite many policy shortcomings, India's economic performance over the period since 1960 has been quite positive GDP at constant prices has more than tripled, and the pace of growth has somewhat quickened in the more recent period During the period as a whole, the rate of growth of per capita income was about 1 5 percent per year, which is the rate that applied in the United States during the first half of the 20th

century Clearly, this performance by India is something worthy of note Even more positive is the fact that the rate of growth of per capita income reached over 3 percent per year in the decade of the 1980s as the first main wave of modernizing and liberalizing measures of economic policy were being put into effect

2 This growth performance is all the more impressive, and perhaps surprising, in light of the number and extent of the economic distortions and the laggardness of the reform process during these decades For most of this period, and probably even at the end of the 1980s, India would probably have to be classified as one of the least market-oriented of the Third World economies (outside the communist bloc) You know much better than I the extent and depth of the distortions and interferences that pervaded the Indian economy during these years I remember vividly one time in early 1962 seeing a full-page advertisement from the Ministry of Commerce and Industry, stating something to the following effect "We in the Ministry are no longer interested in receiving applications either for investment licensing, or for the importation of capital equipment, in the following 200-odd branches of industry At the same time we wish to announce that we would be most pleased to receive such applications in the following 70-odd industrial categories The reason for this is that there have already been issued sufficient licenses to meet plan targets in the first group of industries, while we are lagging far behind plan targets in the second group" This sounds so plausible to the uninitiated But a professional economist would be bound to ask how the plan targets were set in the first place It was certainly not easy to foresee the shape of things to come, five, six or seven years in advance, as Plan targets were being delineated Yet the Ministry's statement fell little short of regarding the Plan targets as infallible guides My reaction on reading the advertisement was that the planners had targeted too little investment in the

first group of industries and too much in the second To me, a more plausible reaction to the events described would have been for the Government to make a mid-course correction, modifying upward the plan targets in the first group of industries and lowering them in the second

This is only one example of a view of a national economy as being essentially a mechanism, a piece of machinery whose mechanics the planners understand quite well—well enough to predict its likely course, to set requirements, to fix definite targets

In my view the economy is much more like a complicated organism—much more complicated than the human body or any other organism known to man We study the economy with such fascination precisely because it is so complicated, so difficult to understand When we make models of the economy, we simply must drastically oversimplify reality, precisely because reality is far too complex for us to copy This need for oversimplification means that we will always make some mistakes, we will never have a perfect score But some simplifications come closer to capturing the essence of economic life than others On the whole, those that build in the economic motivations of people, of business firms, and of other economic institutions come much closer to the truth than those that are based on rigid assumptions about economic linkages

The characteristic of this "good" class of economic models is that they build in the forces that determine economic outcomes in the marketplace They build in the roles of prices, of wages, and of rates of return to capital as helping to guide resources in directions that will respond to the changing tastes and demands of consumers and other users of final products, intermediate products, raw materials, and capital goods

3 India is really just now in the process of implementing most of the thirteen lessons that were reviewed at the beginning of this paper One of the most important trends, and one that was begun relatively early, is that toward de-licensing of such things as industrial investment, and imports of raw materials and components This has been followed by significant moves to lower tariffs and eliminate quantitative restrictions on imports, as well as to facilitate exports Among other things, the rupee has been made convertible on the trade account, with a prospect of successive widening of convertibility to cover first the current account as a whole and ultimately perhaps even the capital account

I do not think it is my place to try to produce a full list of the liberalization moves, nor of the notably successful efforts at economic stabilization that have characterized the past few years You know these things far better than I do What is very clear to me is that India is still in the relatively early stage of the process of liberalizing and modernizing its economy Many important steps are only now being started, many more are yet to come

4 This promises more rapid economic progress and greater dynamism and prosperity in the coming decades Recall what was said earlier about the critical role of real cost reduction in generating economic progress and of the importance of harnessing the natural motivations of economic agents to the pursuit of this task The "old" Indian economy was one in which an entrepreneur who had a good idea for producing a better product or for reducing the real cost of some existing operation faced a whole gamut of restrictions and requirements He would have to apply for licenses and permissions, he would find needed inputs hard to obtain in the market, and he might be denied access to needed foreign exchange All this may have dissuaded him from pursuing his idea, or it may have simply doubled or tripled the time required to put

the idea into effect In either case, the trammels of the old system would have operated to slow down the rate of economic growth

The new system toward which India is reorienting its economic policy is one in which the system itself provides a framework, within which economic agents can move with great freedom in implementing new ideas and in pursuing greater productive efficiency as well as better satisfaction of consumers' needs

Making the whole process more agile, and very importantly, facing economic agents with prices that more adequately reflect the true cost and economic value of goods and services, will speed up the processes of economic adaptation and economic growth I believe we have already seen the beginning of this in the speeding up of India's growth rate during the 1980s

5 But India as a nation and Indians as individuals must realize that rapid growth is not an unalloyed blessing, it comes mixed with pains and stresses of adjustment that are sharper and more severe than those of a traditional economy that changes only slowly I have pointed out earlier how the faster the growth rate of an economy, the greater is the pressure that is put (mainly through rising real wages) on activities that are not at that moment or in that period able to find ways of reducing real costs, or that lag significantly behind the average industry in this respect The result is that these industries find themselves pressured into greater efforts to reduce real costs, but not all will find these efforts successful Product lines will have to be abandoned, and certainly techniques of production will have to be more rapidly changed, in a dynamically growing economy than in a stagnant or relatively stagnant one I believe that many of India's practices and policies are sort of adapted to the modest-growth experience of the 1960s and 1970s They are not likely to be

equally compatible with a high-growth, modern, liberalized economy

Let me here simply call attention on what you refer to as "exit policy" Exit policy aims, in one way or another, to give to workers a guarantee of relatively stable and long-term employment This it does by making it more difficult for employers to fire or lay-off their workers We have vast experience with legislation of this type in other countries The greater are the restraints on reducing a firm's workforce, the more reluctant that firm becomes to add new workers At the extreme, the addition of a new worker is viewed in the same way as the acquisition of an item of fixed capital A firm hires a worker, then, only when it expects to gain a positive net return from that worker over, say, a period of ten years or more Hiring for the short or middle term becomes something to be avoided Very often, the incentives to give workers security in their jobs thus end up actually reducing the level of employment (from what it would otherwise be) and increasing the pool of unemployed

I believe that in order to meet the challenges of a modernizing economy, linked closely to be world market, India will have to lessen the constraints that exit policy places on employers This will indeed have benefits (through producing greater employment as well as greater economic growth), but I see no way in which these benefits can be obtained without yielding up some of the job security provided by India's current package of exit policies

6 Many other adjustments must be made in existing policies and practices Let me here single out the government deficit (Central plus State) as an example Once again I speak from extensive experience in other countries In the late 1970s and very early 1980s, many Latin American countries were going into debt at unsustainably high rates They were helped along in this process by an international banking community

that was all too willing to lend them money (mainly "petro-dollars" deposited in these banks by oil-rich Middle Eastern countries) The borrowing binge was a happy time for the countries concerned, for net international borrowing practically *means* that total expenditures in the country exceed total production, an event which tends to bring prosperity especially to the sectors producing non-tradable goods and services An extreme was reached in Chile where international borrowing amounted to 15 percent of GDP in 1981, and the so-called net resource transfer exceeded 10 percent of GDP

This borrowing (and its concomitant prosperity) came to an abrupt end in all the countries concerned, precipitating the international debt crisis of the early 1980s This forced on them a huge economic adjustment, which in every case involved a dramatic fall in output, employment and real wages In Chile, the net resource transfer fell to about zero in 1982, real GDP fell by some 14 percent, and unemployment rose from 8 percent to over 25 percent of the labor force

India is not now risking such a huge adjustment because a great deal of its borrowing is being done in the domestic market Nevertheless, even this type of borrowing piles new public sector debt upon old each year, and adds to the real cost of debt service The ratio of public sector debt-to-GDP has about tripled since 1980, this is obviously a trend which cannot continue, and also one which has brought with it an increasing burden of debt service It would certainly be a great folly to continue on this course Recent reductions in government deficits are to be applauded, but the size of the deficits that still remain is a source of worry I believe that it would be quite appropriate to target a true turnaround, with the ratio of public sector debt-to-GDP being steadily reduced over the next decade or so

One useful device for bringing this about is privatization One of the lessons we have learned from other countries is that it is dangerous for a government to use the proceeds of privatization to bridge over an existing gap between public revenues and outlays This only postpones the problem of facing up to the underlying fiscal deficit The lesson that has been learned is to keep a clear distinction between stocks and flows The government deficit itself is typically a "flow phenomenon," i e , the flow of normal revenues falling short of the flow of normal outlays The way to deal with this is by either raising the former or reducing the latter, or both "Patching over" the problem by selling government assets only postpones these necessary adjustments

The indicated use of the proceeds of privatization (the sale of part of the stock of public sector assets) is to reduce the stock of public sector liabilities, i e to pay off the public debt This has been carried out very successfully by a number of countries (most notably Mexico) which imposed a rigid rule of not using a single peso of the proceeds of privatization to cover the fiscal deficit, and devoted all of it to debt reduction or similar operations on stocks (balance sheet items) rather than flows (income and outlay items) Following this type of rule has, of course, a permanent indirect effect on the deficit, because as debt is reduced, so too are the recurring costs of debt service

7 India must find the ways both to reduce greatly the size of its vast bureaucracy and to change its attitudes and ways of thinking Not only is the Indian bureaucracy large in relation to the country's labor force, it is also a bureaucracy that is accustomed to implementing the sort of restrictions and distortions that current economic policy is trying to eliminate It seems quite natural that the changing role of the bureaucracy will lead to its being reduced very substantially in size This, of course, will present major political challenges to whatever

government attempts it But also very important is the need to modify the *attitudes* of the bureaucracy, trying to teach them how to be helpful to the process of real cost reduction rather than placing arbitrary impediments in its path This too will be a major challenge, for few things are as difficult as changing the mind-set of a large collectivity which has built all its ethos and traditions on a quite different way of thinking

8 Attitudes toward profits, and toward business activity in general, must also change if full advantage is to be taken of the move to modernization and liberalization On my first visit to India in 1961–1962, I gathered the distinct impression that the Indian society as a whole viewed profits as being somehow immoral It was "immoral" for State enterprises to make high profits, even when they redounded to the benefit of the public till It was even more immoral for private firms to make high profits (this was reflected in the huge marginal tax rates that were then applied)

Now we should recognize that there are circumstances where businesses obtain "earnings" on the basis of outright deception and fraud But the great bulk of profits in market-oriented economies are not of this type Profits are practically the fuel that drives a market-oriented enterprise system Successful innovations begin by making lots of money They may or may not continue to make money as competition arises from imitators of various kinds From the whole process, first of innovation and then of dissemination, consumers end up as the biggest beneficiaries

Take away or seriously blunt the incentive of profits and the drive to innovate, to reduce real costs, is simultaneously impaired The end result is less progress and less economic growth Somehow, the message should be brought to the people of India that profits on the whole are not "taken away" from somebody else, but are *generated* by the entities

in question They are a reward reflecting the productivity of capital and the fruits of entrepreneurship

It does not make sense to try to proliferate the idea that some profits are good while other profits are bad This practically says to entrepreneurs to "go ahead and earn your profit, but then you will have to stand up before some authority or other and justify that you really deserve them" Such an attitude is a kiss of death to entrepreneurial inventiveness and risk-taking in a modern market economy What you want to have is a set of clear rules and guidelines of business behavior, and so long as a business abides by these rules, there should be no question of the legitimacy of its profits

It is probably true that an important factor explaining why certain countries developed before others is that the early developers learned early not to "second guess" the results of the profit system This is the lesson that somehow has to be absorbed into the ethos of India in order to take best advantage of its new, liberal, open-economy orientation

9 India and China are admirably placed to be the grand winners in the world economic struggles of the coming years This advantage arises precisely because they start out so far behind the others, and it will be enhanced to the extent that they are able and willing to make the adjustments and adaptations needed to permit them to compete and prosper in the modern world economy

Let me interrupt the main flow of my narrative here, to draw a bit on the experience of the United States and Western Europe Few people realize it, but perhaps the most important fact distinguishing the past quarter-century from all others in American history is the fact that the average American factory worker has not experienced a rise in real income over this quarter-century Moreover, if I were asked to make a guess as to what will happen

for the next quarter-century, my answer would be that we should probably expect more of the same

The explanation of this experience has not been that the U S economy has stagnated In fact, real GDP almost exactly doubled from 1965 to 1990, while population increased by about 28 percent So per capita real income has increased by almost two percent per year, but factory workers' real wages have stagnated What has happened is that the internationalization of economic relations has brought great benefit to the American consuming public, but that the producers of tradable goods have been beset by competition from a host of new sources—Taiwan, Korea, Hong Kong, Singapore, Malaysia, Spain, Greece, and Turkey Now we face in the next quarter century a host of new challenges—from Indonesia, Thailand, China, India and others My hope for the future of the American economy is that our consumers will continue to benefit and that our real income per capita will continue to rise But if this happens in a fashion similar to that of the past, it is unlikely that real wages (at least those of typical factory workers) will be able to rise significantly

Politically, the picture in the United States will probably mirror that of the debate over the NAFTA (North American Free Trade Area) treaty Here the American consumer stood to benefit, while certain groups of American factory workers were threatened It is to the credit of the American administration that it opted to back the general interests of 250 million consumers versus the more special interests of a minority of at most 5 or 10 percent of the labor force

The same forces of competition from abroad that have led to a stagnation of manufacturing wages in the United States have in Europe, I believe, led to an increase in the rate of unemployment European workers have been less prone to accept accommodating wage adjustments than have American workers Thus when they are threatened by world-market competition, the adjustment comes more on the side of quantity rather than price

I feel that the dynamic process just described has been at work in the world economy for at least a quarter century and that it will continue into the indefinite future Certainly, I hope this is the case, for it holds the best prospects for the future of the world economy and for the welfare of humanity This process has significant consequences (as just indicated) in the United States and Western Europe It also is likely to have consequences for middle-income countries like Mexico, Argentina, Chile, Turkey, and Greece and even for Taiwan, Korea, Hong Kong and Singapore These economies, with hopefully raising real wages, will find themselves constantly pressured by new, low-cost supplies coming from China, India, and other presently poor countries, as these countries find the keys to managing the transformation and modernization of their economies The bulk of the middle-income countries will be able to sustain rising real wages over the coming decades, but not with the same ease as did such early-industrializers as Taiwan, Korea, and Spain

Who stands to gain the most from the future scenario I am envisaging? Quite clearly, it is India and China and any other currently poor nations that are able to accompany them down a path of successful liberalization and modernization The picture of the future for India is thus quite rosy, if only its government, its public and private sectors, and its bureaucrats and its entrepreneurs can jointly take the steps needed to pursue and complete the process of economic transformation This will require considerable political courage and no little amount of sacrifice by particular groups at particular times But it is the best hope for the future of India's economy and society, and one that the we can expect over the decades to redound to the great benefit of all major groups and sectors

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Policy Reform and Economic Growth: Experience of the 1980s

Anne O Krueger

During the 1980s, "policy reform" became the centerpiece of economic policy in a large number of developing countries Just as import substitution was earlier seen as the formula for economic growth, so was policy reform seen in the 1980s Yet, a large number of questions have been raised about policy reform There is misunderstanding as to what reform consists of, what it is intended to accomplish, and how it is related to economic growth People are concerned about the consequences of reform for the poor, and fear that reform may be inimical to growth

Because India is now engaged in her own reform program, it seems worthwhile to examine these questions, and review the experience with policy reform in a number of other developing countries A natural starting point is to ask why reform is necessary or desirable Thereafter, I shall turn attention to the question of what policies are reformed and how This leads naturally to the issue of the problems that arise in the reform process which are, of course, the focal point of the misunderstandings concerning the reform process Finally, it will be useful to examine the outcome of several successful reform programs to provide an indication of what can be accomplished when reforms are successfully carried through

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WHY REFORM?

An understanding of the need for reform can only be achieved in the context of an appreciation of the learning about development which has taken place over the past half century Formulation of economic development policy has had many characteristics of "learning by doing" about it Decisions in the 1980s to reform can, therefore, be best understood in the context of this ongoing learning process, and a good starting point is with the policies that were widely espoused in earlier years

To a considerable extent, economic development has been a focal point of analysis and of development policy only since the end of the Second World War When, at that time, many countries' governments accepted the mandate to take responsibility for achieving rapid increases in living standards, the world appeared divided between the rich countries and the poor ones In addition, policymakers had vivid memories of the Great Depression

The two phenomena, combined with colonial memories, led those concerned with development to be highly suspicious of markets because of the obvious market failure of the 1930s This suspicion was generalized into a widely held view that many economic activities (most notably agriculture) were undertaken by individuals who were largely unresponsive to incentives, and who did not alter their behavior in response to changes in incentives Simultaneously, it was believed that poor countries were poor because they had very low endowments of physical capital per person Industrial activity was viewed as requiring more capital than agriculture (where the bulk of economic activity took place in poor countries), and capital accumulation was seen as essential to rising living standards Being industrialized was also taken as being virtually synonymous with being rich From the perspective of poor countries, there was also suspicion of the international market not only had the Great Depression provided dramatic illustration of the unreliability and volatility of these markets, but it was generally believed that colonial powers had

become rich in part by industrializing while using colonies as sources of raw materials

Several policy prescriptions emerged naturally from these perceptions First, it was felt that government should take a leading role in fostering economic development and that some form of economic planning would be necessary and desirable to achieve this [1] Second, there was a general distrust of markets and so, consistent with the first prescription and the view that many were not responsive to incentives, government regulation of private economic activity was deemed essential Third, consistent with the perceived desirability of industrialization, it was generally felt that industrial development should take place through "import substitution "[2]

Based on these views, initial development policy was very similar in many countries Plans estimated feasible levels of savings, foreign capital (mostly official) inflows, and hence, investment Estimates of foreign exchange availability were also made and were based on extrapolations of export earnings (because it was thought that little could be done to affect exports) and foreign aid, and demand for foreign exchange formulated was similarly estimated Since, even in the estimates (which were almost always optimistic relative to outcomes) there was likely to be a "shortfall" of foreign exchange, it was easy for policymakers to decide that goods that could be domestically produced should not be imported

In many countries, these policies appeared successful in the early years of development as industrial production grew rapidly (usually, however, from a fairly small base) and strides in health, education, and infrastructure permitted fairly rapid economic

[1]At that time, it was widely believed that the then-Soviet Union had developed successfully through central planning

[2]Theoretical justification for this prescription was seen to lie in the infant industry argument

growth Over time, however, growth tended to decelerate The foreign exchange shortage became worse as resources were pulled into import-competing industries, the incremental output per unit of capital in new import substitution industries rose as "easy" opportunities were exhausted first, and productivity in the import-substitution industries that had started earlier failed to increase, in large part because of the absence of competition and incentives for economic efficiency that were inherent to the import prohibitions of the trade regime

With this deceleration came occasional "foreign exchange crises"[3] And with those crises came "stabilization programs" normally in conjunction with financial support from the International Monetary Fund (IMF) These programs typically included nominal devaluations which corrected at least in part the overvaluation that had resulted from the differential in inflation rates between developing countries and the industrialized countries[4] Other policies were also adjusted However, the usual intent of the decisionmakers was to bring about a correction in the balance of payments, once it occurred, increases in foreign exchange expenditures resumed, with consequent apparent "stop-go" cycles in economic growth

At the same time as these cycles were occurring, many developing countries—including India—were notably successful in raising their savings and thus their investment rates These in-

[3]In Latin America and some other developing countries, "crises" often took the form of rapidly accelerating triple, and even quadruple, digit inflation The causes and consequences were much the same as those discussed here, but for purposes of exposition and for applicability to India, the foreign exchange stimulus to crisis is the one discussed here

[4]Changes in the exchange rate had been resisted because of the desire to encourage investment via "keeping imported capital goods cheap" It was not recognized that the total volume of capital goods imports was constrained by the availability of foreign exchange, which was reduced through maintenance of an unrealistic exchange rates

creases, however, were not matched by accelerated rates of economic growth indeed, the most notable feature of developing countries' economic growth rates until the early 1980s was that their savings/investment rates had increased while their growth rates had remained stationary or declined [5] But that fact was at least in part obscured by the cyclical nature of growth

Also in the course of development experience, a great deal was being learned about the importance of investment in human capital—i e, education, training, health, and so on—as well as investment in physical capital The complimentarity of these two forms of investment was learned, as capital-intensive investment projects were underutilized because of an inability to attract qualified scientists and engineers, and as evidence of the high rate of return to human capital mounted Associated with this came the increased recognition that people, even those with little or no education in subsistence agriculture, do respond to incentives, and that when the incentives to individuals presented by the control system differ from the regulations, enough people will respond to incentives to make the economic costs of the regulations severe

While all of this was happening, a few developing countries abandoned policies of import substitution and began to focus their growth-oriented policies on an "outer-oriented" trade strategy To do this, differential incentives in favor of import substitution were removed, exporters were given ready access to imports of needed raw materials, intermediate goods and capital goods, and a realistic exchange rate policy was established which assured an adequate return on exports even if expenditures could not be recouped for periods of six months or more

The "outer-oriented" countries experienced phenomenal growth, well beyond what anyone had deemed possible earlier Korea achieved an average annual rate of growth of real GDP of

[5]See World Bank (1984) for documentation

over 13 percent for the first decade after these policies were in place in 1963 Taiwan's growth rate was, if anything, slightly higher, although Taiwan's change in policies started in the mid-1950s Thus, by the end of the 1970s, it was evident to all observers that outer-oriented growth had succeeded brilliantly, at least in the East Asian "tigers" of Hong Kong, Singapore, Taiwan, and Korea

Some of the advantages of the outer-oriented strategy were evident These included the increased competition to which individual firms were exposed and the (much) greater efficiency that resulted therefrom, the ability to build factories to an economic size, the expansion of low-cost firms for the international market (instead of being restricted to the scope of the domestic market), the ability to adjust smoothly to shocks in the international economy,[6] and, of course, the ability to purchase from abroad those goods and services which were, for whatever reasons, not producible domestically at reasonable cost

By the end of the 1970s, these advantages were fairly well recognized, but it was the debt crisis of the early 1980s that completed the lessons that needed to be learned The successful East Asian economies, which had debt/GDP ratios as high as those of most other developing countries, were able to rapidly adjust and resume growth, while many other developing countries found their growth halted as they were unable to service their debt[7] It was then that it came to be recognized that the

[6]Theoretically, countries following, import-substitution approach should have been less "dependent" on imports and thus better able to cope when first the oil price increased, and then other shocks, took place Ironically, the "foreign exchange shortages" that accompanied import substitution meant that those few imports that were permitted were generally "essentials" such as oil, pharmaceuticals, and producers' goods As such, reduced foreign exchange availability translated quickly into reduced inputs for factories

[7]Yet a third group of countries, including India, were able to avoid

"stop-go" cycles were much more than that In most countries, there had been a tendency for deficits of state-owned enterprises (SOEs) to increase over time and for public sector expenditures to increase more rapidly than revenues, for the inefficiency of high-cost, protected private firms to increase over time, and, in general, for the excesses of government controls over economic activity to mount as smuggling, underinvoicing, underground economies, and other activities sprang up

While at first it was thought that the debt crisis was a reflection of the difficulties of the early 1980s, it rapidly became clear that the failure of many economies to resume growth was more a reflection of their inappropriate overall economic policy stance than of the severe recession of the early 1980s (which had triggered the crisis) Thereafter, as reforming countries began performing systematically better than those retaining their earlier policies, it was generally recognized that "policy reform" would enable more satisfactory growth performances

WHAT IS POLICY REFORM?

When the first policy reform efforts were undertaken, they were decided upon usually by small groups of technocrats, often working in crisis or near-crisis conditions, with little benefit of experience in formulating their programs They knew that existing policies had failed, that there was a crisis on their hands, and that something had to be done Economic theory provides quite a bit of guidance as to the desirable set of economic policies, but it is of little help in charting out a roadmap of how to move from existing policies to the ultimately-desired ones with as much gain as possible and as little discomfort

borrowing to sustain their growth rate at least up to the 1980s As such, they were not as adversely affected by the events of the early 1980s as were the large debtors, but the price they paid was lower growth in the 1960s and 1970s

Over time, however, experience with reform has increased, and researchers have had an opportunity to study different reform programs and their outcomes[8] By now, there have been enough reform efforts—successful, partially successful, and unsuccessful—and analysis of these efforts has provided some insights It is useful to start by sketching those aspects of reform programs about which there is fairly general agreement Thereafter, I turn attention to some troublesome issues on which there remain many questions

A first point concerns what is meant by policy reform Mark Twain, the American humorist, is often quoted as having said that quitting smoking was easy, he had done it many times! Policy reform would be equally easy if naming a set of economic "reform" decrees were by itself sufficient to do the job Indeed, Brazil has had thirteen "economic policy reform" programs (and five new currencies) since 1986! The main objective of the first cruzado plan was to reduce the rate of inflation, which was then running at an annual rate in triple digits The most recent reform program was launched when inflation was running at an annual rate in quadruple digits! To take yet another example, in the early 1960s, the Egyptian authorities were confronted with a shortage of foreign exchange and approached the International Monetary Fund (IMF) for assistance The IMF was unwilling to support the Egyptians unless they changed some of their policies, including the exchange rate However, the Egyptians desperately needed support, but did not want to change the exchange rate Finally, they reluctantly agreed to do so Subsequent analysis, however, showed that the Egyptian authorities had simultaneously removed tariffs and other surcharges on imports and imposed a tax on exports, so that the "effective nominal exchange rate" was virtually unaltered (Hansen 1976)

[8]See, for example, Bates and Krueger (1993)

Thus, simply calling something a "reform" effort does not make it one Sometimes, the authorities are genuine in their desire to undertake reform, but sufficiently politically constrained to be able to make the necessary changes, and end up announcing "reforms" which stand little, if any, chance of success On other occasions, the authorities may be genuinely committed at the start of a reform program, but withdraw their support in the face of opposition or of initial economic performance that is less satisfactory than had been anticipated

A second point which seems universal concerns initial conditions There have been two common characteristics at the outset of most serious reform programs First, there had developed a national consensus that the old policies were no longer working Second, most policymakers and informed citizenry perceived that there is an economic crisis, sometimes in the form of an accelerating inflation rate and sometimes in terms of balance-of-payments difficulties (as, for example, being unable to service debts) Occasionally, the crisis is perceived as consisting of very poor prospects for economic growth [9] In Turkey in 1980, for example, there was a foreign exchange crisis so that in midwinter in a cold country, there was little heat (and none even in the Parliament Building) and little petrol and inflation was rising to an annual rate in excess of 100 percent However, that had happened twice before in Turkey and in 1980 there emerged a consensus that there was no point in simply repeating the measures that had been taken earlier [10] In Mexico, it was not the debt crisis of 1982 which prompted reforms, but the failure of growth to resume by 1985 that brought the realization that a crisis was at hand and something had to change

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[9]This seems to have been the motivation underlying Korea's economic reforms of 1960–1963, after the American authorities announced that future aid levels would diminish

[10]Those measures had been the classic elements of IMF Stabilization Programs

A third generalization about reform is that, if it is to be successful in stimulating more satisfactory economic growth, it must be an ongoing process Initial reforms can, and usually do, bring some benefits (albeit often with a lag), but sustaining economic growth at a satisfactory rate normally entails a series of reforms which bring about increasingly efficient functioning of a variety of markets and delivery of infrastructure services Korea is still in the process of liberalizing financial markets and capital flows, to name just two areas where reforms continue Moreover, there have been reforms in public finance, in the tax structure, in regulations governing equity transactions, and a host of other areas since the early 1960s Even industrialized countries continue to reform the deregulation of U S airlines and of financial markets in the U S , Europe, and Japan are but recent instances

The fourth generalization concerns the policy domains, in which action is normally required fairly early in the reform process Although reform is ongoing, there are some issues that must be addressed early in the reform process if it is to have a chance of long-run success These include changes to make sure that the overall macroeconomics framework (including the nominal exchange rate, monetary and fiscal policy, interest rate policy, and the foreign trade regime) can be conducive to growth currently and prospectively, and the correction of any other underlying major distortions

Almost all reform efforts have begun at a time when public sector expenditures were well in excess of revenues, with consequent inflationary pressures (or, less frequently, offsetting large-scale foreign borrowing) Although few reformers have ever attempted initially to reduce the public sector deficit to zero,[11] there must be a sufficiently large reduction in the prospective

[11]In situations of hyperinflation, such cuts have been undertaken The Bolivian reforms of 1984 entailed such a drastic cut, but the inflation rate at the start of reforms was 40,000 percent per annum!

deficit to persuade people that the reforms are "serious" Normally, the initial reduction must be accomplished almost entirely by reduced public sector expenditures increasing revenues is largely a matter of altering the tax structure and usually requires time for parliament to debate and decide upon new laws Sometimes, deficits of SOEs can be rapidly reduced by increasing the prices of the goods and services they sell [12] Tax reform, which normally means broadening the tax base while reducing the disincentive effects of high tax rates, normally comes later in the reform process Even on the expenditure side, initial reductions tend to be made in places where it is easiest to reduce expenditures quickly genuine reform requires a careful vetting of expenditure programs, to insure that public sector expenditures are efficiently allocated This latter is a task that takes a considerable length of time, but is essential if adequate infrastructure is to be made available to permit more rapid economic growth which is, after all, an objective of reform efforts

The nominal exchange rate invariably requires adjustment in the initial stages of reform This is both because a prior unrealistic exchange rate normally induces speculative capital outflows, and because a realistic exchange rate is essential if there is to be any hope of altering incentives to encourage a more rapid growth of exports and structural change in the economy

Finally, as already mentioned, in some instances, one or more deep-seated distortions must be addressed if there is to be hope

[12]In Turkey in 1958, once-and-for all increases in the goods sold by State economic enterprises eliminated almost all inflationary pressure within a period of several months, and little else had to be done to restore fiscal balance In some instances, one or more SOEs account for a sufficiently large fraction of the overall deficit that something must be done to correct it if reforms are to have any chance of success This was widely believed to be the case in the Dominican Republic in the early 1980s, when one SOE alone was incurring a deficit reported to be in excess of 10 percent of GDP

for reform The case of the Dominican Republic was already mentioned In other cases, policies toward other markets—including highly unrealistic minimum wage legislation, heavy agricultural subsidies, and huge credit subsidies—have been enormously costly, and reform could not even have begun had they not been addressed Issues such as these are, of course, country-specific and I shall not discuss them any further except to note that it is incumbent upon economists associated with a reform program to undertake sufficient analysis of economic policies and their functioning to identify any large bottlenecks whose existence makes prospects for reform bleak

To varying degrees, each of these "essential initial components" of a reform policy package was present in earlier IMF Stabilization Programs The difference, starting in the 1980s, is that these measures are seen as preludes to fundamental shifts in the relationship between government and the private sector in economic growth, where earlier stabilization programs were seen as completing a necessary short-term adjustment

When the intent is to alter the structure of government business relations, even the initial steps must go further Initial changes in final balance, in the nominal exchange and interest rates, and in other key policy variables must be undertaken in a way that convinces most people that the new alignment of incentives and rewards is not a transitory one Thus, constraints and regulations governing private sector activity need to be removed, with appropriate generalized incentives replacing them Measures must be taken to increase the efficiency of public sector expenditures, while simultaneously moving further toward fiscal balance and amending the tax structure to remove distortions and broaden the revenue base Not only is a change in the nominal exchange rate normally essential in the early stages of reform, but a mechanism needs to be found to maintain that exchange rate in real terms In fact, it is essential not only that the exchange rate be realistic, but that exporters are confident that it can remain so

The way this is most frequently done is by introducing a crawling peg so that the authorities frequently make small adjustments in the nominal rate to take into account any differences in the rates of price increase between their country and that of their major trading partners Alternative means for achieving the same objective can include permitting the exchange rate to float and maintaining price level stability

It was already mentioned that import prohibitions have to be removed and high tariffs reduced This need not happen initially, but if the intent is to shift the country's development strategy from reliance on inner-oriented mechanisms to an outer-oriented one, again the initial signals must be very clear and enough must be done to convince those who are deciding on how to allocate resources that the rewards for exporting are permanently increased Indeed, if businessmen are at all skeptical about the prognosis for the reform effort, it is a near certainty that they will not change their behavior simply because of an announcement that reforms are coming Enough must be done to persuade observers that the reforms are serious and will last

Indeed, to increase the relative return to producing exportables, it is desirable to increase the price of foreign exchange (and assure that the new relative return will endure) while simultaneously reducing high tariffs and eliminating import prohibitions [13] This process need not be completed in the initial stages of reform, but sufficient initial steps must be taken so that decisionmakers within the economy are persuaded that the new and altered incentive structure will persist Moreover, there is less pain in removal of import prohibitions and tariff reductions when they are accompanied by an increase in the real exchange

[13]At a minimum, from the beginning of a reform program, exporters need to be able to obtain any desired inputs from abroad without delay or unnecessary paperwork If the reform program meets with initial success, further liberalization of the import regime must take place, but it need not all be in the initial stage

rate than when they are undertaken at a given real rate The argument for removing quantitative restrictions on imports and for lowering tariffs in the early stages of a reform program is therefore compelling [14]

Another area where action is generally desirable is in the financial markets, particularly with regard to interest rates As part of the effort to have government "guidance" of economic activity in earlier development strategies, nominal interest rates were kept low and credit was effectively rationed In many countries, low nominal interest rates made borrowing very profitable, as real interest rates were negative Although reform need not necessarily entail immediate moves to market-clearing interest rates, all successful reform programs have entailed the raising of nominal interest rates to at least equal the rate of inflation This seems to be desirable because it prevents the most wasteful use of scarce resources negative real interest rates make almost any borrowing attractive, and insuring that borrowers must repay at least what they borrowed in real terms appears to cut out some excesses [15]

Once these initial reforms are undertaken, a successful program will entail continuing changes in a number of markets Exactly which markets are affected varies considerably between

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[14]It may be noted that, to the extent that reduction of inflation is a major objective of a reform effort, reduction in tariffs and removal of quantitative restrictions early in the program helps in achieving that objective

[15]Most reform programs have been followed by significant increases in savings rates It is not clear whether these are a function of the higher real return to savings that becomes possible when banks can charge higher rates on their lending, or whether higher savings is a function of a more rapid rate of economic growth Nonetheless, the changes can be spectacular In the Korean case, for example, national savings was less than 2 percent of GDP in the late 1950 and rose to over 30 percent of GDP by the 1980s

countries, depending on the policies in place at the start of the reform process In most countries, continued lowering of tariffs and moves toward a more open trade regime are an important part of the process Tax reform, as already mentioned, has often played a significant role In Turkey, for example, reforms began in 1980 and all quantitative restrictions on imports were removed by 1983, a major tax reform was implemented at the beginning of 1985, as a value added tax was introduced

In many countries, the earlier set of policies resulted in a major bias against agriculture In those cases reduction or removal of that bias has been an important component of reforms To some extent, that removal happens simply by a move to a more realistic real exchange rate (because many agricultural commodities are exportable and the world price, translated through the exchange rate, determines the domestic price) In Chile, for example, once reforms were under way, fresh fruits and vegetables became major crops and exports grew rapidly Earlier, these crops had not been sufficiently profitable Rural incomes grew not only because of direct farm employment opportunities, but also because of off-farm employment in processing, packaging, and shipping of agricultural exports

Both in agriculture and in other sectors, policymakers contemplating reform have been confronted with a variety of subsidies, price controls, and other government-mandated policies affecting incentives to private producers and consumers Often, subsidies have been sufficiently large that they have had to be reduced simply because of their fiscal impact Even when they are not that large, both subsidies and price controls usually have sufficiently large distortionary effects on incentives that their removal is desirable on economic efficiency grounds In many cases, subsidies that were initially intended to support particular groups (such as the very poor) have been extended over time to the point where the main beneficiaries are not those originally intended In many instances, targeted selective subsidies can be

used to replace the more general ones with increases in economic efficiency and more support for the intended beneficiaries

In some countries, regulations and laws (or union power) have resulted in high labor costs relative to labor productivity Sometimes the costs are direct wages Sometimes, however, there are indirect costs, such as social insurance taxes or requirements that employers provide housing or training Sometimes, too, regulations preventing dismissal of workers makes the employment of additional labor a long-term commitment Regulations such as these provide a strong incentive to substitute capital for labor, and often need attention during reform programs In Chile, for example, employment began expanding rapidly only after a regulation giving workers lifetime security after they had been in a job for six months was removed In Papua New Guinea, the real wage was indexed at a level more than three times that of the Philippines (although there was no evidence that Papua New Guinea workers were more productive than their Philippine counterparts and transport costs are higher in Papua New Guinea) Even a realistic exchange rate and stable macroeconomics policy failed to induce investment in any significant manufacturing activities while that regulation was in effect

Attention to public sector enterprises also becomes important as the reform process continues Reduction or elimination of deficits, with their drain on public resources, is one objective, but so too is more efficient operation In some countries, imposition of rules regulating the extent of SOE access to central bank credits has been beneficial In some cases, efforts at privatization have been successful The economic policy team in Mexico has pioneered in successfully privatizing a large number of former SOEs with consequent benefit for their operation and for the public budget

In many countries, it was important to introduce domestic competition For SOEs, this can happen by removing restrictions on private entry For example, in some countries private market-

ing of some goods has been prohibited, and removal of that prohibition has resulted in significantly more efficient distribution Sometimes, for both SOEs and private firms, introducing competition is easily achieved by removing import prohibitions

The shift in emphasis of public expenditures over time has already been mentioned Often, increased resources are desirable for education, especially at the primary and secondary level Then, too, many reform programs have been started after years of neglect of infrastructure maintenance and rehabilitation of roads, ports, and other facilities are often vital And attention to the quality and availability of transport, communications, and power is essential to support more rapid economic growth

It needs to be repeated that not all countries' economic situation at the outset of reform are the same, and the issues which require urgent attention, and which have the highest payoff, differ Nonetheless, most analysts would cite the policies indicated above as being among the most fre-quent requiring reform Table 1 provides an indication of the sectors covered in a number of countries' reform programs As can be seen, most countries have undertaken measures pertaining to a wide variety of sectors In successful cases, the reforms have generally continued over time, ultimately with extensive changes in the nature of government-business relations

PROBLEMS THAT ARISE IN THE REFORM PROCESS

If reforms were straightforward and guaranteed to deliver immediate benefits to all, it would already have been undertaken everywhere In fact, there are a number of problems associated with reforms that inevitably make the process a difficult one Although some reform programs have been more painful and less successful than they might otherwise be because policymakers

Table 1 Components of Reform Programs of Selected Countries

Components	Turkey, 1980	Chile, 1973	Korea, 1960	Mexico, 1986
Exchange Rate Change?	Initial	Initial	Initial	Initial
Provision to Maintain Real Exchange Rate to Exporters	Initial	In mid-1985	Initial	Not yet
Remove QRs on Imports	After 3 years	Initial	After 3 years	After 1 year
Labor Market	Not yet	1977	Free market	Not yet
Financial Deregulation	Extensive	Extensive	Gradual	Ongoing
Positive Real Rates?	Yes, from start	Yes	By 1964	By 1988
Privatization	Little to date	Yes, early	Not much	Yes, extensive
Fiscal Deficit Reduced?	Yes, until 1985	Yes	Yes	Yes
Debt Rescheduling?	1980	Yes	No	Earlier, but debt problem

made key mistakes,[16] some problems are inherent in the process itself

First, and perhaps most important, earlier policies build up groups with a vested interest in the continuation of those policies Consider, for example, the businessman who builds a factory under import substitution, believing that he will receive protection from international competition Removal of import prohibitions and tariffs is, for him, a serious problem When import substitution policies have been in effect for decades, the extent of opposition to reforms and support for perpetuation of the import substitution regime is large

To a considerable degree, entrepreneurs are able to adjust to altered incentives with much less difficulty than they anticipate Some discover that the availability of an imported input reduces their costs by more than what they lose through lower protection Others are able to narrow their product line and focus their activities on goods that they produce cheaply enough to compete in international markets Nonetheless, the whole point of altering incentives is to spur increased economic efficiency, and that requires change and adaptation on the part of producers They are naturally resistant of the process, in part because it is unknown

In Mexico, for example, a businessman whose factory produced refrigerators for the domestic market was one of the leading opponents of Mexico's reforms Mexican refrigerators were widely believed to be unable to compete with foreign ones Once trade liberalization took place, however, the refrigerator producer discovered that he could import compressors Earlier,

[16]A classic example is Chile In late 1970, the government decided to prefix the exchange rate in an effort to control inflation But inflation continued and the real exchange rate consequently became increasingly overvalued in the next three years Finally a change in policies was undertaken It can be argued that Chile's reform process took three years longer to deliver results than it would have without the "prefix

domestically-manufactured compressors, which had a short life expectancy and required frequent replacement had been used Once the imported compressors were used, the businessman was able not only to compete with imports in Mexico, but also to export Indeed, today, that firm accounts for a sizable share of the U S market in apartment-sized refrigerators

In addition to political opposition, however, there is another "attitudinal" problem That is, what is being attempted is a thorough change in the structure of incentives In part because there is bound to be political opposition, but in part by the nature of circumstances in which reform is undertaken, there is bound to be uncertainty as to whether the reforms will be successful[17] This issue has come to be termed the "credibility" issue in the literature In order for reforms to succeed, it is imperative that they be "credible", that is, that market participants believe that they are permanent During the period of uncertainty, those economic activities, such as import substitution, for which incentives are reduced will clearly decline until people are confident that the new incentive structure will persist However, they will be reluctant to invest in activities which are newly profitable

The upshot is very likely to be a period during which economic activity is either declining or growing very slowly[18] Doubts among those unemployed or concerned about their future, combined with the opposition of the vested interests that grew up around the old incentives, increase political opposition to the reforms That opposition, in turn, reduces the credibility of the reforms, which then increase the duration and intensity of the slowdown in economic activity, further undermining credibility

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[17]This uncertainty is all the greater, the greater the number of past failed reform program

[18]In some countries, the increased availability of imports, a good harvest, or rapid change in expectations has meant that there was no such pause Those experiences are the exceptions, rather than the rule, however

The danger here, of course, is that if the slowdown is sufficiently protracted, opposition will mount to the point where the initial reforms are reversed or the process is halted This period when reforms seem to hang in the balance has been encountered in almost all countries undertaking reform All that reformers can do is to move as rapidly and decisively as possible to make the returns to those who do believe in the new incentives as attractive as possible and to make the reforms as credible as possible The issue is most acute in countries with prior histories of failed reform programs, such as Brazil [19]

Another issue which has been frequently raised has been the question of the "timing and sequencing" of reforms Here, the questions are how fast changes should be made and the order in which liberalization measures and other changes should be made The timing issue is closely related to the credibility issue that was just discussed Proponents of "gradual" reform have argued that the dislocations and pains of reforms may be eased by moving slowly While that may be true if credibility is not affected, gradual reforms give time for the opposition to mount, and may give the appearance of hesitancy on the part of the reformers As experience with reforms has accumulated, the argument for going fast appears to be stronger On one hand, there are experiences such as that of the Polish, where a "big bang" seems to have provided more immediate results with no greater discomfort than have some of the slower reforms of other Eastern European countries On the other hand, a number of pronounced programs have had to be abandoned in the face of opposition [20]

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[19]However, even countries that have successfully carried out reforms, such as Chile and Turkey, had earlier episodes—Turkey in 1977 and 1978 and Chile in 1956-1957 and 1958-1959 It is often forgotten that Spain's spectacularly successful reforms of 1958-1959 were preceded by a failed reform attempt in 1957

[20]In 1977, the Argentine authorities announced a five-year program for the reduction of tariffs They managed only to complete the first two

It has already been pointed out that reforms cannot, in any event, all be undertaken at once Tax reform, prioritizing and streamlining public expenditures, restructuring or privatizing of SOEs, and a number of other measures inevitably take time That much said, however, the weight of the evidence is increasingly on the side of haste, speeding up the time (and the number of new activities) at which people believing in the sustainability of reforms find it profitable to allocate resources based on the new incentive structure appears to be the important consideration in minimizing adjustments costs

The sequencing issue is a little different It has already been seen that some initial measures need to be taken quickly, and that some take time Early analyses of reform programs, however, asked a more general question as to whether some markets (for example, the labor market) needed to be well-functioning before others (for example, trade liberalization) should be reformed Some have questioned whether there is any point in opening up to foreign trade if domestic inflation is unabated

There is not a universal consensus on these issues There have been a number of countries which have liberalized in their trade account before inflation was well under control (Korea in 1960, Poland in 1991, Turkey in 1980, and Chile), and as long as measures are taken to reduce the size of prospective fiscal deficits, it would appear that there can be benefits from trade liberalization[21] To be sure, those benefits will be greater the less the excess demand in the domestic economy, but it seems clear nonetheless that benefits accrue

To date, there are no instances documented in which a goods market was liberalized "too soon" On the factor market side,

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years before opposition led to abandonment of the program

[21]Indeed, insofar as it takes time for businessmen to develop contacts in foreign markets and to start exporting, there are strong reasons for providing incentives to get started as soon as possible

there appears to be a growing consensus that it makes little sense to open the capital account before liberalizing current-account transactions, although restrictions governing foreign direct investment and other long-term capital inflows can generally be relaxed in the early stages of reform

In general, political constraints on reformers are normally sufficiently great that they would be well advised to move as rapidly as possible, and to liberalize whatever markets they can While there are occasionally "bottleneck" sectors, there is no evidence that liberalization of other sectors has harmed economies only that benefits have not been forthcoming as they might have in the absence of those "bottlenecks" The argument for proceeding is that, once the bottleneck is removed in the future, there will be larger benefits from the reform

This leads to the last criticism of reform programs that is frequently heard that it is harmful for the poor It is certainly true that reduction or elimination of some welfare transfer programs is inevitable when these have become high-cost large drains on public sector finances High-cost welfare programs, however, are often discovered to have a large component of waste As such, it is often possible to find low-cost substitute programs which deliver as much, if not more, to the poor at lower cost than the earlier ones

Moreover, the greatest victims of slow growth are the poor it is they who stand to gain most with new jobs, better terms of trade for agriculture, and the other changes that reform can bring The beneficiaries of the old import-substitution, inner-oriented policies are those who oppose reform most vehemently They are usually not only not poor, but are among the better-off in society, having profited from the various provisions of the old regime

The challenge, therefore, is to find the means of targeting programs for the poor who are genuinely adversely affected by the removal of earlier subsidies This can be done in a variety of

ways In Chile, a maternal-infant care program (which also provided nutrients for children under the age of 2) and a government-sponsored employment program for those seeking work turned out to be fairly low-cost and effective In Turkey, an agreement was reached under which the unions lost their power to strike and insist on increases in real wages, but employers were enjoined from dismissing workers for five years The result was that employment did not grow during the first years of the upswing, but dislocation appears to have been greatly reduced

Overall, if reformers can get through the period of uncertainty to the point where most believe that the new incentive structure is permanently in place, the major challenge is to maintain the momentum of reform While judgment has to be exercised as to the relative importance of the next set of moves in different aspects of economic policy, it is probably more important to maintain the perception of ongoing liberalization than it is to identify the precise order in which reforms "ought" to be undertaken

EXPERIENCE OF SUCCESSFUL REFORMERS

I have already mentioned that uncertainty is a major enemy of successful reform people do not know how they will come out and are naturally afraid of change Usually, as well, people in countries where economic growth has been sluggish behind high walls of protection for inefficient public and private firms do not believe that their countries' economies are capable of better economic performance Once that performance starts, however, political support for economic reform begins to increase If the reform process persists, the resulting acceleration in growth provides more political support which, in turn, permits the reformers to take further measures to improve economic performance, and a virtuous circle results

To end this lecture, therefore, I want to concentrate for a few moments on the outcomes of some successful reform programs Before doing so, however, I should note one, often forgotten, phenomenon That is that, strictly speaking, analysis of the effects of reform programs should be carried out by contrasting the state of the economy with what it would have been in the absence of reform Such a contrast is seldom made, and when reforms are less than spectacular, or when economic performance is mediocre, there is a tendency to regard that as "failed" reform In fact, even in instances where reforms are less than spectacularly successful, there is good grounds for believing that economic performance is better than it would have been in the absence of the attempt Inflation may not be significantly reduced, but it may have failed to continue to accelerate, foreign exchange difficulties may not have ended, but imbalances and dislocations may be significantly reduced from what they were earlier Perhaps the best illustration of this is the experience of Ghana That country's economy was degenerating rapidly in the early to mid-1980s cocoa production was down to a small fraction of what it had been two decades earlier, the black market exchange rate was 900 times the official rate, real income per capita had been falling an estimated 2-3 percent per year, and government revenues were declining with the result that most public services were unattended Since a reform program started in 1984, Ghana's real average annual rate of economic growth has been around 5 percent There remain many economic problems and the reform was by no means complete On the other hand, it seems clear that unless something had been done, economic retrogression would have continued, thus, contrasted with a rate of decline of 2-3 percent, a positive 5 percent seems fairly impressive Judging Ghana's reforms fairly, therefore, is not possible without an estimate of what the alternative would have been, and the same is probably true of many other countries where reforms have been less far-reaching than those of Turkey and Chile, discussed below, but have nonetheless yielded considerable benefits

When examining successful reforms, the countries that come to everyone's mind are Taiwan and Korea, two of the "tigers" of East Asia that changed economic policies in the mid-1950s and early 1960s, respectively Partly because their stories are already very well-known, and in part because so many observers believe that events of thirty years ago may not have relevance to today's problems, I choose instead to focus on Chile and Turkey, two countries whose reforms have been much more recent

Let me turn to Turkey first Turkey had fairly rapid growth in the 1950s (Table 2), until inflation and a balance-of-payments crisis led to a stabilization program in 1958 The crisis was manifest in a number of ways critically, however, Turkey had no domestic oil and had already exhausted suppliers' credits By August 1958, it became evident that there would be no oil or petrol with which to harvest or transport the crops unless something was done The stabilization program allowed the resumption of imports, and provided for fiscal and monetary restraint, along with a major exchange rate realignment The program was evidently successful real GDP rose 5 percent in the year following stabilization, inflation fell from 25 percent to 5 percent, and the deficit in the current account was reduced to sustainable levels There followed a decade of satisfactory growth (but not as much as in the early 1950s) and then foreign exchange shortages once again began to mount In mid-1970 came a second major stabilization program, which was again followed by resumed growth However, this growth was somewhat slower, and inflation accelerated after 1970 Turkey was hard hit by the oil price increase of 1973, but despite the adverse shift in her terms of trade and rapid inflation, the exchange rate was adjusted only partially and with lags By 1976, foreign exchange difficulties and inflation were pronounced As can be seen in Table 2, the current account deficit was as large as Turkish exports in that year, although real GDP had been growing rapidly Starting in 1976, however, growth began slowing rapidly, and averaged only 2 4 percent

Table 2 Economic Indicators for Turkey, 1976–1991

Indicator	1976	1979	1982	1985	1988	1991
GDP in 1987 Prices (trillions of liras)	37 3	40 0	43 4	50 1	60 5	67 5
Real GDP Growth (%)	8 8	2 4	2 8	4 9	6 5	3 8
Exports (US$ b)	2 0	2 3	5 7	8 0	11 7	13 6
Current Acc't Deficit (US$ b)	2 0	1 4	0 9	1 0	-1 6	-0 2
Fiscal Deficit (% of GDP)	2 1	6 6	5 8	7 3	11 6	13 2
Inflation Rate (Consumer prices)	18 0	59 0	31 0	45 0	75 0	66 0
Real Exch Rate (1985 TL per $)	2 15	4 65	5 78	6 33	8 51	7 72

Source International Monetary Fund (1994)

over the next three years, just slightly above the rate of growth of population There were two stabilization programs negotiated with the IMF, but each was abandoned within a fairly short period of time By 1980, once again, the lack of foreign exchange and exhaustion of all credit lines led to reductions in output levels many factories were closed, buildings remained unheated in a cold Anatolean winter, and cars and trucks were idle for lack of petrol

In 1980, however, when a reform program was announced, there was an underlying consensus among most Turks that the former economic policies had failed and could no longer be relied upon as a development strategy In consequence, from the outset, it was stated that the 1980 program was intended to alter the

fundamental structure of the Turkish economy In particular, governmental controls were to be largely disbanded with greater reliance on markets and private enterprises to produce growth Moreover, the import-substitution strategy which had been followed since the early 1950s was to be abandoned in favor of an outer-oriented trade strategy In addition, the prospective fiscal deficit (well over 10 percent of GDP, with large deficits incurred by state economic enterprises) was to be sharply curtailed The results for the first several years were not unlike those of earlier programs The inflation rate fell, and the current account of the balance of payments improved sharply Real GDP grew somewhat more rapidly than it had in the late 1970s, but not dramatically However, exports more than doubled in the first three years of the program By the mid-1980s, Turkey's economic growth was accelerating rapidly, averaging well over 6 percent for the 1983–1992 period This growth was led by exports which grew at an average annual rate in excess of 20 percent, increasing their share of GDP from a mere 5 percent in the late 1970s to over 20 percent by the late 1980s Moreover, the Turkish authorities maintained the real returns to exporters by permitting a real depreciation of the Turkish lira In addition, in the early years of the program, the fiscal deficits were reduced substantially[22] Inflation fell from its peak rate of over 100 percent in 1980 to a low of 31 percent in 1982 before it began accelerating again

In the Turkish case, microeconomics reforms were also extensive All quantitative restrictions on imports were removed, and tariffs were lowered so that the highest tariff in the early 1990s was 35 percent Barriers to exports were removed and imports of

[22]The numbers given in Table 2 fail to take into account the deficits of state economic enterprises which themselves were in excess of 6 percent of GDP in 1980 They were reduced to less than 2 percent by 1985, and rose thereafter If those deficits are added to the central government figures, the swing in public finance is much more pronounced than is indicated in Table 2 For particulars, see Krueger and Aktan (1992)

goods used by exporters were permitted automatically and duty-free The tax structure was reformed and the financial system greatly liberalized The Turkish lira was rendered convertible on current account

The consequences were dramatic As already mentioned, exports grew sharply, despite the fact that the reforms started in the early 1980s during the most severe worldwide recession since the Second World War But the quality and variety of goods available to domestic consumers also improved dramatically An earlier suspicion of businessmen as incompetent monopolistic producers of low-quality goods was replaced with a view of Turkish businessmen as competent exporters who could meet competition in international markets

Turkey experienced a decade of highly satisfactory growth following the initial reform period, although fiscal discipline was not sufficiently adopted By the early 1990s, fiscal deficits were soaring and inflation was accelerating In the winter of 1994, an international rating service downgraded Turkey's foreign debt, and the government responded with another austerity program, the results of which are not yet known

Despite the unhappy-to-date ending to the reform, the Turkish economy was transformed during the decade of rapid growth Despite the challenges that remain, the Turkish economy is much better situated today to meet future challenges than it was fourteen years ago It still plans to enter into the customs union with the European Union as soon as the macroeconomics crisis is resolved

Whereas Turkey experienced a rapid and dramatic turnaround in economic fortunes, but with microeconomics success and macro failure, Chile's reforms were much slower to bear fruit, but when they did, growth was dramatic and sustained (see Table 3) It will be recalled that in 1973, General Pinochet succeeded Salvador Allende as President The inflation rate at that

Table 3 Chilean Economic Indicators, 1973–1991

Indicator	1973	1976	1979	1982	1985	1988	1991
GDP	288	262	337	329	356	427	509
GDP Growth (%)	0 8	-3 0	8 8	-0 3	2 7	6 2	6 0
Exports (US$ b)	1 2	2 1	3 9	3 7	3 8	7 1	8 9
Current Acc't Deficit (US$ b)	0 3	-0 1	1 2	2 3	1 4	0 2	-0 1
Fiscal Deficit (% of GDP)	8 0	-1 4	-4 8	1 0	2 4	-0 2	-0 5
Inflation Rate (Cons prices)	na	167 0	33 0	9 0	30 0	15 0	22 0
Real Ex Rate (1985 pesos US$)	na	3 4	2 8	2 1	2 0	2 5	2 5

Source International Monetary Fund (1993)

time was in the triple digits, export earnings had fallen drastically, and imports and domestic production were shrinking During the first three years of Pinochet's rule, activities that had been nationalized under Allende were privatized, the fiscal deficit was eliminated (note that there was a surplus of 1 4 percent of GDP by 1976), and the current account deficit was closed Real economic activity fell, however, from the inflationary heights to which it had risen in 1972–1973 From 1976 to 1979, progress was made as the real rate of growth exceeded 8 percent and inflation fell further (from 167 percent in 1976 to 33 percent in 1979) and exports increased by more than 50 percent

However, desirous of really eliminating inflation, the Chilean authorities adopted the "pre-fix" exchange rate Inflation did not

immediately fall, so the real exchange rate appreciated This policy mistake would in any event have been costly, but coming as it did at the same time as the second oil price increase and the worldwide recession, the consequences were even more severe In particular, the price of copper fell sharply, but private international lenders regarded Chile as creditworthy so that borrowing, and hence total debt, increased As can be seen, the dollar value of export earnings in 1982 was below that in 1979 (in part due to the much lower price of copper), and real GDP fell from 1979 to 1982 It was not until 1985, when the nominal exchange rate was significantly adjusted and other policies were altered, that really satisfactory growth resumed As can be seen, exports virtually doubled between 1985 to 1988, real GDP growth was, as already mentioned, in excess of 6 percent per year Because Chile's population growth rate is very low, this translated into an average annual increase in per capita income of more than 5 percent It may be noted that Chile's fiscal deficit was eliminated, and with it, inflationary pressures have been greatly reduced The top tariff rate is now 10 percent, and the economy continues to grow rapidly

The Chilean government has continued with reforms pension schemes have been privatized, efficiency in ports has increased so much that Argentine farmers now try to ship their produce through Chile, whereas Chilean farmers used to ship through Argentina, a law rescinding the right of workers with more than six months tenure to a permanent job started a rapid increase in employment, the policy toward agriculture has been greatly rationalized, public welfare programs have been reformed to target them much more closely to needy groups, and financial markets have been gradually liberalized Thus, in contrast to Turkey, Chile's economic prospects appear to be good there is no obvious impediment to continued growth at rapid rates over the next several years

For Chile and Turkey and all other countries that have embarked on policy reform, current economic policies will require still further reform if accelerated economic growth is to continue (or, in the Turkish case, to resume) In both countries (as in others where policy reform has been launched), there were many who were skeptical of the potential benefits of reforms when they first started And in both, most cities are now believers From both countries, the lessons may be learned that successful reforms can deliver much more satisfactory increases in real output and living standards and, certainly in hindsight, most support the reforms It is perhaps reassuring that, in both countries, the acceptance of reforms was sufficiently robust so that policy mistakes (Chile's pre-fix and Turkey's fiscal imbalance) did not undermine the benefits of reform While much remains to be learned, success with reforms to date and the number of other countries now embarked on the process of policy reform insures that economists will have ample data on which to undertake further research and further our understanding of the reform process

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Development Prospects Under Increasing Globalization

Robert E Baldwin

INTRODUCTION

One of the most robust growth relationships established over the last forty years is the more rapid growth rates of developing countries that pursue outward-looking, market-oriented trade policies compared to those that adopt inward-oriented, import-substitution policies Of course, we know that a liberal trade policy, by itself, does not guarantee rapid development Countries must, for example, also pursue prudent macroeconomic policies that control inflation and prevent periodic balance-of-payments and debt crises More fundamentally, governments must establish a set of political and economic rules and institutions that encourage individuals to respond to appropriate economic incentives for significantly improving the economic welfare of themselves and their families

Including liberal trade policies in this package of measures imposes the efficiency standards of international markets on domestic markets, thereby enabling a country to specialize more fully in producing and exporting those goods and services in which it has a comparative advantage Increasing exports, in turn, enables the nation to increase its imports of the capital goods and modern technology so essential for significantly raising growth rates Furthermore, the huge markets available internationally permit countries to utilize more productively the large pool of underemployed labor that is characteristic of low-income countries as well as to exploit the increasing returns available through specialization

Until the mid-1980s, the political leaders of India by and large rejected the outward-looking, market-oriented development model in favor of an approach characterized by industrialization through import substitution and inward-looking trade policies in which the public sector played a major role Growth with equity and self-reliance were key goals Some serious liberalization efforts occurred in the mid-1980s, but it was not until 1991, in the aftermath of a fiscal crisis, that India initiated a serious effort of economic liberalization Whether this basic policy shift will not be reversed soon is not entirely clear at this time, but most knowledgeable observers seem to believe this to be the case

Assuming that India continues to move toward a development approach that emphasizes the role of liberal trade policies in its development strategy, an important question to ask is whether India will find it more or less difficult to lift its growth rate with this approach under present world trading conditions than did the East Asian countries that utilized it so successfully from the 1960s onward The answer will significantly influence India's ability to sustain its liberalization program

The major change in the international trading system between the time the East Asian nations first pursued their outward-looking development strategies and the present is the remarkable increase in the degree of economic interdependence among nations that has been driven by new information-based technologies The most apparent manifestations of this greater economic integration of nations have been the increases in the relative importance of international trade and in foreign direct investment A significant lowering of policy impediments to the flow of goods and services across national borders is another important feature of the globalization trend

The increased openness resulting from the reductions in both tariffs and various non-tariff trade barriers that resulted from such multilateral trade negotiations as the Tokyo and Uruguay Rounds should make it easier for new countries following an outward-

looking development strategy to penetrate international markets Furthermore, the recent strengthening of the institutional framework for conducting world trade within a rules-oriented system, specifically the formation of the World Trade Organization (WTO), and the significant improvement in the mechanisms for resolving trade disputes should lessen the degree of risk and uncertainty in the international trading environment In addition, the new information technologies have directly increased the degree of capital mobility in the world economy and the ease with which new technologies can be transferred among countries

There are, however, other features of the current international trading environment indicating that, in some respects, development through trade may not be as easy for latecomers, such as India, as it was for those who first adopted this strategy For example, the nature of liberalization achieved no longer covers just cross-border trade, but now extends to many internal markets This "deep" form of liberalization, which is driven by the new information technologies that make borders less and less relevant for the marketing activities of firms, will force countries like India not only to reduce border trade-restricting measures as the price of gaining access to foreign markets, but to undertake liberalization of various domestic markets for services India is already under pressure to open up more fully its insurance and banking markets, for example However, many of the service sectors in which liberalization is being sought by developed country suppliers are even more inefficiently organized than protected goods sectors, with the consequence that very painful economic and political adjustments are involved in such liberalization In contrast, in their early stages of outward-oriented growth, countries like Taiwan and South Korea not only were not pressured to open such markets, but were not even required to reduce barriers to the importation of goods very much

The increased emphasis in recent years on "fair" trade by the advanced industrial countries, which can be viewed as a protective reaction to the serious adjustment problems these countries have

themselves faced as a consequence of increased globalization, is another development that tends to make it more difficult for developing countries to pull their income levels up by relying to a greater extent on international trade and foreign investment The reductions in the tariffs and non-tariff trade barriers of the developed countries have, in part, been offset by increased protectionism in the form of such "fair" trade measures as antidumping duties and countervailing duties to offset the alleged unfavorable effects of certain types of subsidies and the unilateral closure of international markets under Section 301-type actions The uncertainty associated with these governmental actions has an especially adverse impact on market-driven development processes Current efforts by a number of developed countries to extend these measures by introducing international trading rules related to labor rights and environmental measures are viewed with great alarm by newly liberalizing developing countries who fear that such rules will be so protectionist, that outward-oriented growth is no longer feasible

A final example of a development associated with increased globalization that may act to make it more difficult for latecomers to rely significantly on trade and foreign investment to achieve higher growth rates is the increasing number of preferential regional trading agreements The essence of these agreements is discrimination among non-members in terms of access to internal markets In the current trading environment, nations such as India are rightly apprehensive about the economic wisdom of attempting to create a highly competitive international sector because of the fear that the increased exports gained through such efforts may be suddenly diverted to other countries under newly negotiated regional trading arrangements

It is impossible in a short paper such as this to explore adequately the implications of the above and other features of the increasingly interdependent world economy on the growth prospects of India under its new outward-looking development strategy However, the following sections focus in more detail on two of the

most important recent policy developments in the trading system that affect India The following section examines the significant changes in international rules and the institutional mechanism being implemented as a result of the Uruguay Round and the establishment of the World Trade Organization (WTO) and their implications for countries such as India This is followed by a section that analyzes a policy shift on the part of the major industrial trading powers that, in large part, represents a policy response on their part to increasing globalization This is the shift away from multilateralism and toward the greater use of unilateral, bilateral and regional trade policies The chapter concludes with a summary of the implications for India and other developing countries of these two somewhat contradictory policy developments

THE URUGUAY ROUND AGREEMENTS AND THE WTO

The successful conclusion of the Uruguay Round demonstrates the power of the forces of globalization Though initially opposed by many developing countries such as India and plagued by bitter disputes among the developed countries, e g, on agriculture, as well as between the developed and developing countries, the Uruguay Round was successfully concluded in April 1994, some four years after its scheduled completion Upon the urging of business leaders whose views were shaped by the global opportunities created by the new information technologies, political leaders ultimately concluded that they could not fail in this opportunity to provide new international rules and institutional conditions for both exploiting and accommodating to these new technologies

A key feature of the agreement was the carefully balanced set of concessions between the developed and developing countries that covered the three main sets of negotiating issues in the Round (see Office of U S Trade Representative (1993) for the detailed provisions of the various agreement) The three issues were (1) issues not previously covered by the GATT and involving forms of the

"deep" liberalization previously mentioned, specifically, (a) trade in services, (b) trade-related aspects of intellectual property rights, and (c) trade-related aspects of investment measures, (2) issues covering areas that had initially been subject to standard GATT rules but were later excluded from GATT discipline for special reasons, namely, agriculture and textiles/apparel, and (3) those related to traditional GATT issues such as tariff liberalization, subsidies, dumping, government procurement, technical barriers to trade, dispute settlement, and institutional reform In my view, while on balance the concessions and commitments covering these items make it easier for India and other developing countries to increase their growth rates through economic liberalization, this will occur only if the developed countries adhere strictly to the time schedules for implementation of the agreements and do not make extensive use of certain loopholes in the agreements

The "New" Negotiating Issues

Services

An important feature of the framework agreement negotiated for services is that it not only covers cross-border trade in services but services supplied by foreign firms within a country to consumers in that country as well as services supplied by domestic firms to nationals of other countries who are visiting the country The General Agreement on Trade in Services (GATS) commits WTO signatories to a set of general principles that includes most-favored-nation treatment (subject to specified exceptions), transparency with regard to any domestic laws or regulations affecting trade in services, and progressive liberalization in the services area

The key part of the services agreement consists of schedules of commitments by WTO members in which they set forth specific terms and conditions on market access, conditions and qualifications on national treatment, and the time-frame for implementing such commitments While most countries made commitments not

to impose new restrictions against foreigners, there was a lack of significant liberalization in such important sectors as financial services, air and sea transportation, and telecommunications However, as a consequence of negotiations that continued after the end of the Round, a WTO agreement on financial service was signed in July 1995, but without the participation of the United States, which maintained that the concessions of other countries were insufficient to warrant the granting of MFN treatment by the United States Thus, the main accomplishment has been to bring the services sector under international trading rules and set the stage for later, more significant liberalization

Intellectual Property Rights

The Uruguay Round agreement on trade-related aspects of intellectual property rights makes substantial progress in overcoming such drawbacks of the previous system as the lack of enforcement or dispute settlement mechanisms, the failure of a number of countries to participate in the earlier agreements, and the narrowness of coverage of the rules All WTO members are now required to provide copyright, trademark and patent protection for a specified number of years on the goods and services covered under the agreements to which most developed countries adhere, i e, the Paris Convention, the Berne Convention, the Rome Convention and the Treaty on Intellectual Property in Respect of Integrated Circuits The provisions of the agreement must be implemented within a year after the date of entry in force of the agreement, but developing countries and countries in transition from a centrally-planned to a market economy are given another four years In addition, if a developing country is obliged to provide parent protection in an area not currently covered in its laws, e g, pharmaceutical products, it may delay implementation of this protection for another five years The least developed countries need not apply the agreement's provisions for ten years

Specific enforcement procedures are also contained in the agreement For example, countries are required to establish civil judicial procedures whereby individuals and firms can seek to enforce their intellectual property rights Criminal procedures must also be put in place to deal with willful trademark counterfeiting or copyright piracy on a commercial scale A Council on Trade-related Aspects of Intellectual Property Rights is established to monitor the compliance of countries with their obligations under the agreement, and if a country believes its rights under the agreement are being violated, it can utilize the standard dispute settlement procedures of the WTO

The agreement represents an important step in encouraging additional research and development (R&D) expenditures by private firms The industrialized nations, where most R&D activities take place, will clearly gain While the developing countries as a whole will also gain in the long run as the increase in the level of technological knowledge leads to a greater supplies of goods and services that raise their rates of income growth and as these countries begin to develop new technologies themselves, some nations, such as India, are likely to suffer some short-run losses in real income as the costs of certain goods and services protected by patents and copy rights increase

Trade-Related Investment Measures (TRIMS)

An economically efficient global economy requires that direct investment among nations be as free from burdensome border and domestic controls as the movement of goods and services Fortunately, more and more leaders of developing countries have come to realize that their economies can benefit from the considerable economic growth stimulus associated with liberal direct investment policies without becoming unduly dominated by foreign influences However, there are still many countries that restrict foreign

direct investment in various ways and impose performance requirements on foreign firms operating in their territories

Negotiations on trade-related investment measures were aimed at eliminating discriminatory, trading requirements imposed on foreign enterprises located within a country By specifying that the principle of national treatment must apply to foreign firms, such practices as requiring foreign enterprises to purchase a certain proportion of domestically produced goods or export a certain proportion of their output have become illegal under the TRIMS agreement However, developing countries are given five years (least-developed countries seven years) to eliminate such measures and can apply for an extension if they demonstrate particular difficulties in implementing the agreement

While the TRIMS agreement represents an important step in eliminating discrimination against foreign investors, it did not deal with the issue of reducing barriers that prevent investors in one country from establishing production facilities in other countries A number of developing countries, who fear too much political influence by foreigners if direct investment is not controlled, strongly resisted efforts to deal with this issue in the Round However, the TRIMS agreement does contain a provision specifying that, in the course of reviewing the agreement within five years, the issue of including provisions on investment policy shall be considered

Agriculture and Textile/Apparel

The Uruguay Round was noteworthy not only for formulating international rules of "good" behavior in new areas such as trade in services and intellectual property rights, but in two traditional sectors that have long been excluded from the discipline imposed by GATT rules, namely, agriculture and textiles/apparel The exclusion of agriculture from GATT rules goes back to 1955, when the United States obtained a waiver permitting certain import practices that were illegal under the GATT but were mandated by U S agri-

cultural legislation While the agricultural sector was never formally removed from GATT discipline, other countries have engaged in similar practices on the grounds that what was permitted for the United States should also be allowed for them

The exclusion of textiles and clothing from GATT rules can be traced back to 1961, when the first of a series of multilateral agreements permitting bilateral quantitative restrictions went into effect These agreements were supposed to be only temporary, but the current agreement, the Multifiber Arrangement (MFA), went into operation in 1974 and has been renewed several times since then

Agriculture

In July 1987, the United State made the following proposal to the other Uruguay Round participants (a) the complete phase-out over ten years of all agricultural subsidies which directly or indirectly affect trade, (b) the freezing and phase-out over ten years of the quantities of agricultural products exported with the aid of export subsidies, (c) the phase-out of all import barriers over ten years, and (d) the harmonization of health and sanitary relations, insofar as animal, plant and human health and safety are not affected The European Community (EC) did not formally respond until December 1989, when, without mentioning a specific percentage figure, its negotiators proposed that support measures and protection be reduced However, in July 1990, Community negotiators stated that the EC was willing to reduce farm support levels by 30 percent over a ten-year period from their 1986 level Because reductions had already taken place since that date, the proposal meant, in effect, that the EC would only be required to reduce supports by about 15-20 percent from 1990 levels

The Community continued to offer to reduce support levels by only 30 percent at the Brussel Ministerial Meeting in December 1990, where the negotiations supposedly were to be concluded However, by this time the United States and the so-called Cairns

Group, which was composed of most other agriculture-exporting nations, had modified their position somewhat They proposed reductions of not less than 75 percent for commodity-specific support on a 1986/1988 average base period and a 30 percent reduction over the same period for noncommodity-specific support

At the Brussels meetings, neither the United States nor the EC were willing to make the significant compromises needed to bridge the wide gap between their two negotiating positions Consequently, no agreement on agriculture was reached Furthermore, since the United States insisted on an agreement in this sector as a condition for agreements in other issue areas in the negotiations, the meeting ended without any agreements being concluded

In November 1992, after nearly two years of difficult negotiations, U S and EC negotiators agreed to support a Uruguay Round agricultural agreement requiring a 20 percent reduction over a six-year period in the average level of farm supports from a 1986/1988 base Since the United States had already reduced its supports relative to the base period, no further cuts were required for U S commodities Direct income payments linked to production-limiting programs also were not subject to the reduction commitment The negotiators also agreed to support a 21 percent reduction in the volume of agricultural commodities that receive export subsidies and a 36 percent reduction in the value of export subsidies However, the French government balked at this arrangement on export subsidies and threatened to hold up the conclusion of the Round But, after obtaining concessions from other European Union members in the form of additional compensation to French farmers who might be hurt by the agreement and from the United States in the form of a less rapid phase-out of export subsidies, the French withdrew their objections

The market access features of the final agreement include replacing non-tariff border measures with tariffs and then reducing these by 36 percent in the case of developed countries and 24 percent in the case of developing countries Another important feature

is the establishment of minimum access commitments equal initially to 3 percent of the domestic consumption of a product and growing to 5 percent over the implementation period This provision will finally enable the United States to export rice to Japan and Korea The implementation period for the various provisions in the agreement is six years for developed countries and ten years for developing countries

While the pledged reductions are comparatively modest, the key point is that the agricultural sector is being brought under GATT discipline and will be subject to further cuts in support levels in future negotiations A number of developing countries—e g, Argentina, Brazil, Indonesia, the Philippines and Malaysia—were part of the so-called Cairns group that pressed vigorously for agricultural liberalization during the Round and they should be among those nations benefiting considerably from future liberalization India too may benefit, since it has recently increased significantly its exports of such commodities as rice, sugar and wheat

Textiles/Apparel

Other than agriculture, no commodity sector has been less subject to GATT rules than textiles and apparel Beginning in the early 1960s, an international system of bilateral quantitative import restrictions was established for these products which had become increasingly comprehensive and restrictive In launching the Uruguay Round, trade ministers took the bold step of declaring that the negotiations "shall aim to formulate modalities that would permit the eventual integration of this sector into GATT on the basis of strengthened GATT rules and disciplines, thereby contributing to the objective of further liberalization of trade" (GATT Press Release, September 25, 1986) The final agreement in this sector represents an important step in carrying out these objectives

The integration of textiles and clothing into the GATT system involves the gradual elimination of bilateral quantitative restric-

tions and, thus, the end of the Multi-Fiber Arrangement In the future, protection can only take the form of tariffs On January 1, 1995, each party must remove quotas on imports accounting for at least 16 percent of its imports of textiles and clothing in 1990 At the beginning of the second phase on January 1, 1998, quotas on an additional 17 percent of 1990 imports must be eliminated, followed by another 18 percent on January 1, 2002 All remaining quantitative import restrictions must be removed by January 1, 2005

For products remaining under quantitative import restrictions, at whatever stage, the agreement establishes a formula for increasing the growth rate of imports During the 1995 to 1998 period, the annual growth rate must be not less than 16 percent higher than the annual growth rate established for 1994 under the Multi-fiber Arrangement, and in the 1998 to 2003 period, this rate must be at least 25 percent higher than the previous period Between 2002 and 2004, the import growth rate must rise by 27 percent compared to the previous period

Since developing countries such as India have a clear-cut comparative advantage over the advanced industrial nations in textiles and apparel, it is crucial for their development prospects that the new agreement be fully implemented Two concerns about the implementation are that the developed countries will undermine the agreement by extensively utilizing the safeguard actions (in the form of quantitative restrictions) permitted under the agreement if increased import cause, or threaten to cause, "serious damage" to the domestic industry producing like or directly competitive products and that they will not carry through with the final stage of the agreement under which much of the liberalization takes place Developing countries like India, where full implementation of the agreement is very important for the success of their liberalization programs, must continue to exert strong political pressures on the developed countries to ensure full implementation

Traditional GATT Issues

Actions taken in the Uruguay Round with regard to the traditional issues of multilateral trade negotiations also affect liberalization efforts by countries such as India This section considers the changes in the so-called escape clause or safeguard provisions of the GATT (Article XIX) and in the dispute settlement procedures Changes in the antidumping and subsidy/countervailing duty provisions of the GATT are briefly mentioned in part IV

Safeguards

Perhaps the most important feature of the safeguard agreement concerns a provision not included Despite considerable pressure from the EC to abandon the most-favored-nation principle in safeguard cases, the agreement does not include a provision permitting the application of safeguard measures only against those countries from which imports have increased and caused serious injury to a domestic industry The developing countries strongly opposed this selectivity principle, and the United States, after seriously considering abandoning its traditional most-favored-nation position, also finally opposed selectivity

The agreement also specifies that GATT members must phase out existing selective safeguard measures, such as voluntary export restraints, within four years[1] Import quotas are permitted if administered in a nondiscriminatory manner and if they do not reduce imports below the average of the last three representative years However, an exception to nondiscriminatory quantitative restrictions is permitted if it is demonstrated to the Committee on Safeguards that imports from some countries have increased disproportionately over the representative period

Among other key parts of the proposed agreement are the requirements that safeguard measures last no more than eight years

[1]Each member can, however, retain one such measure through 1999

(four years at a time) and not be applied again for a period of time equal to that for which the measure had previously been applied (provided that this period is at least two years)[2] In addition, countries again whom safeguard measures are directed cannot demand compensation or undertake retaliatory action for the first three years that a safeguard measure is in effect

As in most of the agreements, developing countries are given special treatment In the safeguard agreement they are permitted to grant import relief for up to ten years and can reintroduce protection in the same sector after waiting for a period of time equal to only one-half of the period that the measure had previously been applied However, the Uruguay round agreements do little to curtail the widespread use by developing countries of safeguards for balance-of-payments purposes, although members agree to give preference to price-based measures, e g , import surcharges, for restricting imports for balance-of-payments reasons over quantitative measures

The major accomplishments of the safeguard agreement were the banning of such measures as voluntary export restraints and orderly marketing agreements and the establishment of a mandatory phase-out period for safeguard measures In addition, the agreement has the merit of spelling out in more detail the procedures that must be followed in article XIX determinations and in defining such key concepts as "serious injury" These changes tend to increase the degree of confidence on the part of export-oriented firms that successful performance in foreign markets will not penalized by erection of inflexible and arbitrary trade barriers However, developing countries are rightfully concerned about the possible abuse of the provision permitting the imposition of discriminatory quantitative restrictions under some circumstances

[2]This provision was introduced into U S law in 1988 Prior to the 1988 change, industries could petition for another eight years of protection two years after the expiration of the first eight-year period

Dispute Settlement Procedures

Although GATT rules state that, unless otherwise specified, the majority-voting-rule determines the outcome of decisions where joint action is called for, there is, as Jackson (1989, p 49) points out, "a decided preference for 'consensus' approaches" among GATT members While this principle has been important in preventing the organization from breaking up during times of difficult negotiations, it also made the GATT ineffective in some circumstances The dispute settlement process is an example of this ineffectiveness Under the consensus approach followed, a defending party in a request for the establishment of a GATT panel was able to block approval for the panel Moreover, the losing party in a panel report (or any party) was able to block the adoption of the report and even block the winning party's request to retaliate if the losing party did not comply with a panel report that had been adopted

The Understanding on Rules and Procedures Governing the Settlement of Disputes reached in the Uruguay Round significantly changes the previous dispute settlement process Most importantly, the principle of "automaticity" has been introduced into the new agreement (Hudec 1994) Now formation of panels, adoption of their reports, and, if a panel ruling is not complied with, retaliation are all automatic This change in itself greatly strengthens the disputes settlement process

There are several other ways in which the process has been strengthened A unified system to settle disputes arising under the various agreements replaces the various different procedures for settling disputes under the Tokyo Round Agreements This system even applies to disputes arising over issues on which there are not specific legal obligations under the GATT Time limits have also been established for carrying out the various steps in the settlement process For example, panels appointed by the Dispute Settlement Body to render a decision of the merits of a complaint must normally report their findings within six months and is no event longer than nine months Another important change is the creation of an

Appellate Body to review panel decisions that are appealed It will have seven members who are appointed for a four-year term The decisions of this body must be made within 60–90 days

It should be noted that panel rulings are not self-executing If a country chooses not to change its laws or regulations to conform to a panel ruling, the penalty it will incur will be the possibility of retaliatory actions by its trading partners However, such a country is likely to find it more difficult to persuade other countries of the merits of the cases it brings before the dispute Settlement Body

The reform of the dispute resolution mechanisms of GATT and the WTO represents another important change that makes it easier for countries like India to proceed with the opening of their economies with less fear that success in increasing their market shares in developed countries will be offset by new import restrictions Developed countries who employ this tactic are now very likely to lose their case in the WTO and be subject to sanctioned retaliation

THE GREATER USE OF UNILATERAL, BILATERAL, AND REGIONAL TRADE POLICIES

Although the Uruguay Round agreements are the most important policy manifestation of increasing globalization in recent years, an equally important development has been the greater reliance by the advanced industrial countries on unilateral, bilateral and regional means, compared to multilateral policies, to achieve their trade policy objectives It is important to understand the reasons for this policy shift in order to gain insights on how the multilateral arrangements embodied in the WTO are likely to be implemented and thus affect developing countries like India The shift is most apparent in the United States, and it is on this country that I will focus

The Rise of Multilateralism

From the end of World War II through the 1960s, the United States relied primarily on multilateral means in seeking its trade policy objectives The essence of multilateralism, which is the central principle of both the GATT and the new WTO is, first, nondiscrimination among foreign countries with respect to a country's trade barriers and international trade rules and, second, the goal of trade liberalization It is my view that there were two main reasons why U S political and economic leaders believed for many years that the United States should rely primarily on a multilateral approach One was that the political-economic experiences of the 1930s convinced most leaders that the discrimination involved in the regionalism and protectionism pursued during this period contributed to the low rate of economic growth in the 1930s and, more importantly, to the worldwide military conflict that broke out in the late 1930s and early 1940s They believed that providing a level playing field for all foreign suppliers through the multilateral approach and by reducing trade barriers to all foreign suppliers increased both economic and political stability among the community of nations

Secondly, the somewhat unexpected emergence after World War II of the United States as the dominant or hegemonic economic and political leader of the non-communist world and the appearance of the so-called Cold War made it evident that a multilateral approach was very much in the economic and political interest of the United States U S economic dominance meant that few countries were serious competitors to U S exporters Thus, lower worldwide trade barriers made U S exporters better off At the same time, U S import-competing industries had little to worry about from multilateral trade liberalization In addition, at a political level it was important for the United States to mobilize all of the so-called free world nations to turn against or, at least, be neutral toward the Soviet Union Lowering trade barriers in the United States and in other countries in a nondiscriminatory manner con-

tributed to building a unified block opposing communist expansion

One implication of adopting a multilateral approach for these reasons was the rejection of the use of regional and unilateral channels for achieving U S economic and political goals It was thought that the use of either of these routes would jeopardize the achievement of these goals by causing resentment among some nations due to their discriminatory nature For example, the United States tolerated, and in some cases supported, the formation of trading blocs by other countries, but this was because it was thought that such arrangements would enable these countries to resist communist expansion better However, the United States rejected any overtures for its own participation in free trade blocs or customs unions During this period, the United States was also lax in the enforcement of such unilateral trade measures as U S antidumping and countervailing duty laws that had long been in existence

Bilateral trade negotiations were fairly extensive during this period, but they were quite different from the form they have taken in recent years There are many occasions where a country has concerns about a trade matter that are relevant only for one or two other countries This quite naturally leads to bilateral or plurilateral negotiations among the relevant countries However, such negotiations were undertaken within the framework of the GATT If the United States could not reach a satisfactory agreement with the other country, it utilized the dispute settlement procedures of the GATT, rather than imposing sanctions outside of this process

The U S commitment to multilateralism as its dominant trade policy strategy began to weaken by the late 1960s and early 1970s However, the full-scale embrace of a fourfold trade-policy approach—namely, the extensive use of unilateral, bilateral, and regional means in addition to multilateral policies—to achieve U S goals came in the 1980s The basic reason for this shift in trade policy was, in my view, the decline in U S economic power associated with the increasing economic interdependence among nations

The Decline of U S Hegemony

The hegemonic actions of the United States, which were aimed at maintaining the liberal international economic framework established largely through its efforts and at turning back the expansion of the Soviet Union, succeeded very well By 1960 the export market shares of France, Germany, Italy, and Japan had either exceeded or come close to their pre-war levels, as increased trade, international flows of new technologies, and foreign investment stimulated economic activity in these countries Among the industrial countries, only the United Kingdom failed to regain its pre-war position by this time The restoration of peacetime productive capabilities in these countries meant that the exceptionally high market shares of the United States in the early postwar years declined correspondingly The 35 2 percent U S export share of 1952 had dropped to 29 9 percent by 1960, a figure that was, however, still higher than its 1938 share of 25 6 percent

Not only had the pre-war export position of the United States been restored by the late 1960s, but the lack of significant import pressures in major U S industries with domestic political clout had come to an end Stiff competition from the Japanese in the cotton textiles industry was evident by the late 1950s, and the United States initiated the formation of a trade-restricting international cotton textile agreement in 1962 A broad group of other industries also began to face significant import competition in the late 1960s The products affected included footwear, radios and television sets, motor vehicles and trucks, tires and inner tubes, semiconductors, hand tools, earthenware table and kitchen articles, jewelry, and some steel items

The reduction in U S economic power also became evident in the international monetary sphere After the end of World War II, the U S dollar became the key currency of the international monetary system It was the main currency used in international transactions, and countries held most of their international reserves in the form of U S dollars However, by the early 1970s most coun-

tries had lost confidence in the economic strength of the dollar, and the currency system based on the dollar collapsed and was replaced by a flexible exchange rate system in which the prices of countries' currencies in terms of each other were determined in the open market This meant that the United States was no longer able to finance trade deficits simply by printing up more money and expecting foreign countries to hold these dollars as international reserves

The Growing Importance of Unilateral, Bilateral and Regional Trade Policies

The official position of relying almost exclusively on a multilateral trade policy approach began to change under the strong import pressures of the late 1960s and early 1970s As more and more of their constituents complained about the international competitive problems they were facing, fewer members of Congress became willing to accept the standard argument that a liberal U S trade policy was essential to strengthen the free world against communism The intensity of congressional view on trade issues is indicated by the rejection by that body of President Lyndon Johnson's 1968 request for new trade authority and by the near approval in 1970 of protectionist legislation covering a wide variety of products The growing unwillingness of U S allies to accept the unquestioned leadership of the United States in international political, military, and economic affairs also caused officials in the executive branch to question the traditional American position on trade policies

The view that gradually gained the support of the major public and private interests concerned with trade matters was that a significant part of the increased competitive pressure on the United States was due to unfair foreign policies, such as government subsidization, dumping by private public firms, preferential government purchasing procedures, and discriminatory foreign administrative rules and practices relating to importation This argument

had appeal for several reasons No new legislation was required to provide import relief, a stricter enforcement of long-existing domestic legislation seemed to be all that was necessary After a material injury clause was introduced into the U S countervailing duty law in 1979, these laws were consistent with provisions of the GATT dealing with unfair trade practices Consequently, stricter enforcement of U S unfair trade laws was unlikely to lead to bitter trade disputes with other countries By placing the blame for their decline in competitiveness on unfair foreign actions, U S managers and workers could avoid the implication that this decline might be due to a lack of efficiency on their part Finally, government officials could maintain that the United States was still supporting the rules of the liberal international regime that the country had done so much to fashion

Thus, one of the first manifestations of a change in U S trade policy was a shift toward the greater use of a unilateral approach in pursuing U S trade policy objectives, specifically, the more vigorous enforcement of the antidumping and countervailing duty laws Between 1970 and 1979, there were 172 antidumping cases and 10 countervailing duty cases However, after the responsibility for determining the existence of dumping or foreign government subsidization was shifted in 1979 from the Treasury Department to the more protectionist Commerce Department, the number of cases exploded [3] Between 1980 and 1990, there were 494 antidumping and 306 countervailing duty investigations by the International Trade Commission The strengthening of the antidumping and countervailing duty laws in the Trade and Tariff Act of 1984 and the Omnibus Trade and Competitiveness Act of 1988 also contributed to this increase in such investigations

The basis for an aggressive bilateral approach to trade policy was also established in the early 1970s The best-known provision

[3]The responsibility for determining material injury as a result of dumping and subsidization remained with the International Trade Commission

of the 1974 Trade Act, Section 301, authorizes the President to impose new duties or other import restrictions as well as withdraw previous trade concessions unless foreign countries remove a wide variety of perceived unfair trade practices As amended by the 1979 Trade Act, these practices include the maintenance of unjustifiable, unreasonable, or discriminatory policies that burden or restrict U S commerce or deny benefits to the United States under any trade agreement The Omnibus Trade and Competitiveness Act of 1988 further extended aggressive bilateralism through the provisions of the so-called Super 301 and Special 301 Under Super 301, the Office of U S Trade Representative (USTR) is required to identify trade priorities, including priority countries and practices, to be investigated under Section 301 Special 301 sets up a more aggressive mechanism for enforcing intellectual property rights The Super 301 provisions expired, but were reintroduced by President Clinton in 1994 by means of an executive order

Between 1975 and 1993, there were 84 Section 301 cases The number in each of the five-year periods, 1975–1979 and 1980–1984 was 21, while in the 1985–1989 period, the number jumped to 31 However, only 11 cases were processed from 1990 through 1993

The shift in the U S position on regional agreements from one of rejecting such arrangements for the United States to promoting selected agreements between the United States and other countries occurred in the early 1980s An important event contributing to this policy change was the rejection by the European Union and most developing countries at a 1982 meeting of trade ministers of a U S proposal for a new round of multilateral trade negotiations aimed at extending GATT rules to services, providing better protection of intellectual property rights, and tightening the rules on dumping and government subsidization The executive branch of the U S government responded to this rejection not only by deciding to pursue the unilateral and bilateral trade policy routes more aggressively, but be seeking desired changes in trading rules by negotiating free trade agreements with selected countries Such agreements

were concluded with Israel in 1982, Canada in 1988, and Mexico and Canada jointly in 1993

Due in no small part to the embracing of regionalism by the United States, most of the countries who had opposed the 1982 U S proposal for a new multilateral negotiating round supported such a proposal when it was again made by the U S in 1986 This led to the launching of the Uruguay Round in 1987

As the preceding survey indicates, the relative importance of the multilateral route had clearly decreased for the United States by the 1980s The U S initiative in the Uruguay Round negotiations demonstrates that the multilateral route had by no means been abandoned, but it had been downgraded Indeed, many government officials believed that the United States should rely primarily on the other three routes While they were prepared to try the multilateral route again, they not only were pessimistic about the prospects for achieving U S goals via this means, but they were not particularly concerned about the prospects for success They believed that the other three channels were sufficiently effective to achieve these goals

The failure to conclude the Uruguay Round in 1990, as scheduled only strengthened the view of many U S public and private policy leaders that the United States could not expect very much from the multilateral approach At that time, it was evident that the major participants were far apart not just on the issue of agricultural liberalization—the reason usually cited for the failure of the ministerial meeting—but on several other key issues For example, the developed and developing countries were still far apart in the areas of providing greater protection for intellectual property rights and prohibiting certain trade-related investment measures Furthermore, the developed countries had not as yet agreed to phase out so-called voluntary export restraints and some were still considering whether "selectivity," i e , non-most-favored-nation treatment, should be permitted in safeguard actions There were also important differences in the negotiating positions of the partici-

pants on such issues as antidumping policies, subsidies and countervailing duties, and government procurement practices This failure led to the concern by many within the United States and in other countries that the world trading system was evolving into a group of trading blocs, each with protectionist policies toward nonmembers

IMPLICATIONS FOR LIBERALIZING COUNTRIES

It would be a serious mistake, in my view, to believe because of the successful conclusion of the Uruguay Round and the establishing of WTO that multilateralism has triumphed in the sense that the aggressive unilateralism pursued by the United States and other industrial counties has come to an end The Uruguay Round's changes in the antidumping rules, for example, only deal with administrative features of the process and are unlikely to bring about any significant change in the way antidumping laws are administered by the United States or the European Union Section 301 of the U S trade laws and similar measures in other industrial countries are also still likely to be employed extensively The United States is required by WTO rules to go through the organization's dispute resolution procedures before withdrawing trade concessions from other countries, but it is widely believed that most U S actions pursued in the past would have been upheld by WTO dispute settlement panels

Countries, like India, who are following outward-looking policies, must realize that as their exports increase substantially, they are now expected by the advanced industrial nations to open their own markets to increased exports and direct investment No longer will such countries be able to determine the pace of import liberalization with little regard to the interests of foreign exporters As their exports rise, they will be subject to strong bilateral pressures form various industrial countries to reduce trade barriers on items of export interest to producers in these countries Failure to do so

will trigger threats of concession withdrawals aimed at re-establishing a balance-of-trade concessions

The Uruguay Round agreements will also be utilized by the advanced industrial countries to achieve a greater balance of concessions than was the case with the East Asian economies For example, as we have already seen, pressures to open up internal markets for various services, e g, banking and insurance, and to accelerate the pace of granting full intellectual property rights now accompany increases in exports resulting from liberalization Furthermore, the changes in the subsidy and countervailing duty provisions of the GATT, which specify more clearly just what is and is not a permissible subsidy, are likely to be used more vigorously to force policy changes in liberalizing countries

In conclusion, newly liberalizing countries, like India, will, in my view, generally find it easier economically to lift their income levels through an outward-oriented development approach than their East Asian predecessors, but, in some respects, they will find it politically more difficult to do so The greater openness of world markets due to significant reductions in trade barriers, a strengthened institutional structure for reaching new agreements and resolving disputes, and the greater willingness of foreign firms to undertake direct investment in liberalizing developing countries and transfer new technology to them are examples of factors tending to make it easier to take advantages of the benefits of an outward-oriented development strategy However, the greater external pressure to open particular domestic markets to foreign competition as exports to foreign markets increase means the governments undertaking liberalization will be required sometimes to undertake politically painful domestic structural adjustments at an earlier stage than they would wish For example, it may be necessary to open domestic financial markets before domestic firms are as competitive as desired by the government or to open certain retail markets at the risk of driving some family shops out of business Un-

less carefully managed, the political fallout from such actions could endanger the entire liberalization process

By understanding the changed international environment, countries like India can better cope with the new strains on the liberalization process In particular, by anticipating market-opening pressures, they can fashion their development plans to minimize the economic and political hardships of the required structural adjustments Establishing credible long-run schedules for domestic liberalization can also often forestall foreign pressures for immediate liberalization Putting together a group of skilled international negotiators backed by a competent technical staff is another important step that can facilitate the liberalization process

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Can Accelerated Reform in India Proceed with a Human Face?

Deepak Lal

INTRODUCTION

This chapter first identifies the policies which need to be adopted in the next stage of Indian economic reforms It then notes a continuing philosophical divide between support for egalitarianism and poverty alleviation, and argues that what matters for reforms with a "human face" is the latter It then distinguishes between three different types of poverty by their causes, and uses the findings of a 21 country comparative study I recently completed with Hla Myint on *The Political Economy of Poverty, Equity and Growth* (Lal and Myint 1996) to show how there need be no conflict between the undoubted need for further and accelerated reform in India and alleviation of all three types of poverty

THE NEXT STAGE OF INDIAN REFORM

Whilst a great deal of unfinished business still remains in the areas of past reform—essentially dealing with commodity and financial markets most importantly in trade policy (e g , elimination of quotas on consumer good imports)—there are whole areas which the reform effort have not yet touched The common feature of this next phase of reform can be succinctly described as the rescinding of the unviable entitlements to income streams that past dirigisme has created These have both deleterious macro- and microeconomic effects

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On the macroeconomic front, the problem of large budgetary subsidies for fertilizers, energy, the public budgetary distribution system, and those implicit in carrying loss-making public enterprises and redundant labor in the central and state bureaucracies and parastatals remain On the microeconomic side, India's labor laws—a 19th century imperial heritage which have been described as a result of unease by ignorant English philanthropists and manufacturers—have hobbled Indian industry for much of this century (Lal 1988) and they need to be reformed if not repealed Without reform of the labor market, the essential privatization of the inefficient and still substantial public sector is well-nigh impossible Moreover, in the growing global competition for footloose direct foreign investment, these antiquated labor laws pose a serious disincentive for investors in India, when compared with the de facto privatized labor market that now exists in East Asia, most notably in southern China

The main argument still made against labor market reforms, as well as the rescinding of other unviable entitlements that have been created through past government interventions, is that this will worsen either the distribution of income or poverty There is sufficient evidence that these claims are unfounded (Lal 1988) Most of these entitlements have done little to improve income distribution or alleviate poverty, and their most discernible effect is to impair economic efficiency and corrupt the polity But precisely for the last reason, politicians can be expected to be wary of rescinding them for fear of losing support Thus, the convenient slogan "adjustment with a human face"

EGALITARIANISM VS POVERTY ALLEVIATION

To make sense of this slogan, it is first important to note that there is an important difference between improving the distribution of income (an aim favored by egalitarians) and alleviating poverty (one favored by most other people) A theoretical case for

a link between the two was made on the basis of the so-called Kuznets curve, but if this were the case, improvement in the distribution of income would merely be an instrument to alleviate poverty Hopefully after the events of 1989, socialists of various hue in India are at least chastened about the feasibility of promoting egalitarianism, even if they still think it is desirable

Without entering into sterile debates about the morality of egalitarianism, and various others about reconciling so-called "positive" and "negative" liberties, all we need to note is that the egalitarians have now retreated to a position where they claim only the establishment of full-fledged Western style welfare states in the Third World can alleviate its poverty This is particularly ironic given that the Western welfare state is everywhere on the defensive if not in retreat It is this contemporary socialist mutation which is now increasingly identified with the term blank (fill in any economic policy you like) "with a human face "

But is this "social democratic" case for dirigisme any more valid than the old socialist one for planning, and does India's accelerated reform of the type identified above need the simultaneous creation of a Western-type welfare state to alleviate poverty? That is the central question that is addressed in this chapter

THE THREE TYPES OF POVERTY

In answering the question, there are two distinctions worth noting The first is between "extensive" and "intensive" growth Extensive growth has occurred for millennia in most parts of the world with aggregate output rising, pari passu, with the expansion of population that has taken place since our ancestors came down from the trees Per capita income was, however, relatively low and stagnant during this phase By contrast, the modern era has been marked by intensive growth of output which has outstripped growth of the population There has been a two-centuries dispute whether such rises in per capita income will al-

leviate poverty, that is, whether the fruits of intensive growth will "trickle down" and alleviate poverty?

Answering this question is my first task In doing so, it is useful to distinguish between three types of poverty based on their causes These are mass structural poverty, destitution poverty, and conjectural poverty It is worth noting that though this distinction was well-known in the past—for instance, in discussions of the English poor law since Elizabethan times—one strategic linguistic move by socialists was to conflate all of them, so that structural poverty (about which nothing could be done until the era of modern growth) was conflated with destitution and for whose relief most societies adopted remedial measures A similar confusion, for instance surrounds the whole recent discussion by a distinguished NRI theorist of what he calls *An Enquiry into Well-being and Destitution* (Dasgupta 1993) What he is discussing is mass structural poverty reflected, for instance, in malnutrition and ill health, which though ubiquitous in the past and more widespread than it need be in India today, is different from true destitution

Mass Structural Poverty

Mass structural poverty has for most of history been mankind's natural state For, until recently, most economies were agricultural economies, or what the economic historian E A Wrigley has called "organic" economies, whose growth was ultimately bounded by the productivity of the land In such an economy, there is a universal dependence on organic raw materials for food, clothing, housing, and fuel Their supply is in the long run inevitably constrained by the fixed factor, land This was also true of traditional industry and transportation which depended on animal muscle for mechanical energy, and upon charcoal (a vegetable substance) for smelting and working crude ores and providing heat Thus, in an organic economy, once the land fron-

tier has been reached, diminishing classical economists were gloomy With diminishing returns to land, conjoined to the Malthusian principle of population, a long-run stationary state where the mass of people languished at a subsistent standard of living seemed inevitable Thus whilst there could be some extensive growth with both population and output growing at about the same rate—leaving a relatively constant level of per capita income till the land frontier was reached—thereafter the only remedy to prevent immiserization was some form of population control

But even in an organic economy, there was some hope of getting intensive growth which leads to a secular increase in per capita incomes The system of market "capitalism" and free trade outlined and defended by Adam Smith could increase the productivity of an organic economy somewhat over what it was under mercantilism, and also, by lowering the cost of the consumption bundle, would lead to a rise in per capita income, that is, intensive growth But if this growth in popular opulence led to excessive breeding, the land constraint would inexorably lead back to subsistence wages Technical progress could hold the stationary state at bay, but the land constraint would ultimately take hold

The Industrial Revolution led to the substitution of this organic economy by a mineral-based, energy economy This new economic regime escaped from the problem of the fixed supply of land and of its organic products by using mineral raw materials, in particular, coal, which began to provide most of the heat energy for industry, and with the development of the steam engine which provided virtually unlimited supplies of mechanical energy Intensive growth now became possible, as the land constraint on the raw materials required for raising aggregate output was removed Thus the Industrial Revolution in England was based on two forms of "capitalism" one institutional, namely, that defended by Adam Smith because of its productivity enhancing effects, even in an organic economy, and the other physi-

cal whereby the capital stock of stored energy represented by the fossil fuels which allowed mankind to create in the words of E A Wrigley (1988)

> A world that no longer follows the rhythm of the sun and the seasons, a world in which the fortunes of men depend largely upon how he himself regulates the economy and not upon the vagaries of weather and harvest, a world in which poverty has become an optional state rather than a reflection of the necessary limitations of human productive powers (Wrigley, p 6)

Not only the subsequent experiences of the industrial countries, but of many countries in the Third World have borne this out It is possible, as many countries in East Asia for instance have shown, to eradicate mass poverty within a generation, because neither of the twin foundations of the gloomy classical prognostications, diminishing returns, nor the Malthusian principle are secure A market-based liberal economic order which promotes labor-intensive growth can cure the age-long problem of structural mass poverty

A volume synthesizing the findings of a 21-country comparative study of the political economy of poverty, equity and growth, that Hla Myint and I have been engaged in with a battalion of collaborators over the last ten years, will soon be in print The authors in this study found that there was a clear positive effect of per capita income growth on mass poverty redressal in all their countries over the period 1950–1985 Gary Fields (1991) put together, for the same study, the available data on poverty redressal that were available for all the developing countries subject to some minimal criteria of consistency He found that in most but not all cases, poverty tends to decrease with growth and that poverty tends to decrease most the more rapid is economic growth Second, he finds that growth has not had a demonstrably greater

effect in reducing poverty in Asia than in Latin America, but rather the available evidence supports the opposite conclusion

For India, Tendulkar and Jain (1995) examined the effects of growth on poverty alleviation taking account of alternative social welfare orderings for the period 1970-1971 to 1988-1989 They conclude that "in comparison to the 1970s, the doubling of annual growth rate of per capita GDP in the 1980s was associated with improvement in both the poverty and social welfare situation" (p 40) In India, as elsewhere, growth thus does alleviate mass structural poverty In his famous "tryst with destiny" speech on India's independence, Nehru stated "the ambition of the greatest man of our generation has been to wipe every tear from every eye" But the policies he followed made this impossible because they damaged growth performance Even the slow retreat from this past dirigisme has led to higher growth rates and in consonance with all the international evidence, in turn, to some sustainable alleviation of Indian mass poverty If only India could sustain the spectacular growth rates that East Asia now has shown can be attained even by large economies like China, it is indubitable that mass structural poverty could be eliminated even in India within a generation This is the prize on offer Nothing stands in the way but political impediments that irrational past dirigisme itself has created Thus growth does alleviate mass structural poverty This is, I believe, an inconvertible conclusion In fact, there is no other sustainable way of doing so It is now also widely accepted that a market economy is essential to promote growth and I shall, hereafter, take this as given

We next consider the two other types of poverty that were distinguished earlier—that of destitutes, and of those, who due to conjectural problems, find themselves temporarily in poverty Both these sources of poverty have existed over millennia, though the sources of conjectural problems have changed

Destitution

It is worth noting that, traditionally, when mass structural poverty was the norm for mankind, the problem of "poverty" was seen as being confined essentially to destitution As, until fairly recently, most organic economies have also been labor-scarce and land-abundant economies, the primary cause for people falling into destitution was a lack of labor power (either their own—for instance, due to physical disabilities—or from family member, because they had no families) to work the land This remains a major source of destitution in land-abundant parts of Africa [1] In this world, the poor are the destitute who are recognized as "deserving," whilst, as the Elizabethan poor law noted, any "able-bodied" poor were to be classified as vagrants

With population expansion and the emergence of land-scarce economies in Europe and in many parts of Asia, there arose "the poverty of the able-bodied who lacked land, work, or wages adequate to support the dependents who were partly responsible for their poverty" (Iliffe 1987, p 5) Their poverty merges with mass structural poverty and growth will, as it has, lead to its amelioration

As far as I know, no estimates of the incidence of destitution in India has been done Michael Lipton's attempts to find some correlates of destitution, based on village studies, moreover, show the extremely heterogeneous composition of this group Thus, for instance Dasgupta's seemingly reasonable assertion that widows are "routinely forced into destitution" in India (Dasgupta 1993, p 323) has been shown to be false by Dreze and Srinivasan (1995) who find no evidence of widows being disproportionately concentrated in poor households, or for that matter of female-headed households being poorer than male-headed households

[1]See Iliffe (1987) to whom I owe the threefold classification of poverty

Conjectural Poverty

This leaves conjectural poverty For most of history, as economies have been organic agrarian economies, this form of poverty was linked to climatic crises or political turmoil Its most dramatic manifestation was in the from of a famine Since the Indian Famine Code was devised by the British Raj in the late 19th century, it has been known that to deal with what Sen (1982) labels "entitlement failures" precipitating a famine, it is necessary for the government to provide income directly (through public works or food for work schemes for instance) to those who have suffered this temporary loss of income-generating employment This administrative solution has eliminated famines in India But this solution does require political stability and a relatively competent administration, without these, it is not feasible Finally, the Industrial Revolution has introduced its own source of conjectural poverty in the form of the trade cycle and the unemployment that ensues in its downturns

Income Transfers and Poverty Alleviation

Income transfers are the only way to tackle destitution and conjectural poverty Traditionally, these have been provided by private agencies including the church, private charity, and, most important of all, transfers within extended families These private transfers were, however, replaced in most Western societies by public transfers through the welfare state In assessing the case for Western-style welfare states in dealing with the continuing problems of destitution and conjectural poverty, it is useful to first distinguish between social safety nets and welfare states

The distinction between the "welfare state" and a "social safety net" essentially turns upon the universality of coverage of transfers under a welfare state as opposed to the restriction of collectively provided benefits under a social safety net to the truly needy The World Bank's *Poverty Reduction Handbook* noted

two essential elements in any design of a social safety net "identifying the groups in need of assistance, and the means of targeting assistance to those groups cost-effectively" It went on to ask "Are these questions for public policy, or are they adequately addressed by the traditional family network?" (World Bank 1992, pp 2-13)

By contrast, welfare state advocates favor universality as it alone, in their view, provides a feasible means to achieve the ends sought to be subserved by a social safety net, because of problems concerned with obtaining the requisite information for targeting Some have argued that because of the ubiquitousness of imperfect information, markets for risk will be inherently imperfect (Barr 1992) Hence, universal welfare states are required as part of an efficient solution to deal with "market failure" To deal with this argument would take me too far afield [2] Suffice it to say that this is a form of "nirvana economics,"[3] which is currently fashionable on the left, but it provides no credible justification for a welfare state

TWO RIVAL PHILOSOPHIES

An implicit objective of those who argue against targeting and in favor of universal welfare states is distributivity To judge its validity, it is useful to contrast two rival ethical and political traditions the classical liberal and the distributivist egalitarian, which continue to jostle for our attention and color the various policies offered for alleviating poverty

[2]For more on this, see Lal (1993b)

[3]The term is due to Demsetz (1969) For an explication in terms of the recent controversy surrounding the minimum wage, see Lal (1995)

Classical Liberalism

For the classical liberal, it is a contingent fact that there is no universal consensus on what a "just" or "fair" income distribution should be, despite the gallons of ink spilt by moral philosophers on trying to justify their particular prejudices as the dictates of reason Egalitarianism is, therefore, to be rejected as the norm for deriving principles of public policy

But this does not mean that classical liberals are immoral! The greatest of them all Adam Smith after all wrote *The Moral Sentiments* Both of the great moral philosophers of the Scottish Enlightenment—Smith and Hume—recognized benevolence as the primary virtue, but they also noted its scarcity However, as Smith's other great work *The Wealth of Nations* showed, fortunately, a market economy which promotes "opulence" does not depend on this virtue for its functioning It only requires a vast number of people to deal and live together even if they have no personal relationships, as long as they do not violate the "laws of justice" The resulting commercial society promotes some virtues—i e, hard work, prudence, thrift, and self-reliance—which benefit the agent But by promoting general prosperity, these lower level virtues do unintentionally help others Hence, the resulting society is neither immoral or amoral

A good government, for the classical liberal, is one which promotes opulence through the promotion of natural liberty by establishing laws of justice which guarantee free exchange and peaceful competition The improvement of morality is left to nongovernmental institutions But from Smith to Friedman and Hayek, classical liberals have also recognized that society or the State should seek to alleviate absolute poverty

On the classical liberal view, as colleague Al Harberger (1986) has noted, there could be an externality, whereby the poor recipient's consumption of particular goods or services (for example, food education, medical care, and housing) or his/her attainment

of certain states (i e, being better nourished, better educated, healthier, better housed) are closely correlated with an adequate consumption of such goods enters the donor's utility function As it is the specific consumption of these commodities, and not the recipient's "utility" which enters the donor's utility function, there is no "utility" handle which can be used as on the alternative distributivist view to allow distributional considerations to be smuggled into the analysis of poverty alleviation programs

Thus the indigent and the disabled are to be helped through targeted benefits For various merit goods such as health, education, and possibly housing, these involve in-kind transfers This is very much the type of social policy package that was implemented in Pinochet's Chile, and which succeeded not only in protecting the poor during Chile's arduous transformation to a liberal market economy, but also led to dramatic long-term improvements in its various social indicators [4]

Distributivist Egalitarianism

The alternative technocratic approach to poverty alleviation is, by contrast, necessarily infected with egalitarianism because of its lineage At its most elaborate, it is based on some Bergson-Samuelson type social welfare function, laid down by Platonic Guardians Given the ubiquitous assumption of diminishing marginal utility underlying the approach, any normative utility weighting of the incomes of different persons or households leads naturally to some form of egalitarianism But this smuggling in of an ethical norm which is by no means universally accepted leads to a form of "mathematical politics" Poverty alleviation becomes just one component of the general problem of maximizing social welfare, where given the distributional weighting schema, all the

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[4]See Castaneda (1992) for a detailed account of these social policy reforms and their outcome

relevant trade-offs between efficiency and equity, including intertemporal ones, can be derived in terms of the appropriate distribution cum efficiency shadow prices (Lal 1988) If the concern is solely with those falling below some normative "poverty line," this merely implies a different set of weights with the weight of unity being set to say changes in consumption (income) above the line, and increasing weights to those who fall progressively below the poverty line [5]

But this is a thin edge of a very big wedge, as far as the defenders of the market economy are concerned Besides leading to recommendations for all sorts of redistributive schemes, it also leads to a vast increase in dirigisme To alleviate poverty, a second goal embraced by classical liberals, they are led to endorse the creation of a vast transfer state, which, in the long run, is incompatible with the preservation of a market economy

An usual riposte to the classical liberal position of separating questions of alleviating absolute poverty from inequality is that, in theory, a market-based growth process could lead to such a worsening of the income distribution that instead of the poor seeing a rise in their incomes as part of the growth process, they could be immiserized This view was strengthened by the so-called Kuznets hypothesis which stated that inequality was likely to worsen in the early stages of development before it improved, as per capita incomes rose towards current-developed country levels All the empirical evidence, to date, is against the Kuznets hypothesis, and its corollary that growth might not alleviate absolute mass poverty (Fields 1991, Squire 1993)

[5]See Ravallion (1992) for a full explanation of this approach in the design and evaluation of poverty alleviation programs in the Third World

PUBLIC VERSUS PRIVATE TRANSFERS

Since the welfare state advocates claim to deal with destitution and conjunctural poverty, and as some assert even to deal with mass structural poverty, are public transfers needed? We need to examine the relative efficacy of private versus public income transfers

Private Transfers

Kin-based transfer reciprocity arrangements and interlinked factor market contracts have been the major way that traditional societies have dealt with income risk and they have been fairly effective [6] With the inevitable erosion of village communities, it is feared that these private insurance arrangements will break down and that no private alternative will be available to counter destitution and conjunctural poverty in increasingly atomistic industrial economies

It is in this context that the role of private interhousehold transfers is of great importance Cox and Jimenez (1990) provide evidence that they are of considerable quantitative importance

> For example, among a sample of urban poor in El Salvador, Thirty-three percent reported having received private transfers, and income from private transfers accounted for 39% of total income among recipients Ninety-three percent of a rural south Indian sample received transfers from other households In Malaysia,

[6] As Platteau (1991, p 156) concludes "Even though empirical evidence is scanty (but not altogether absent), the case can reasonably be made that, barring exceptionally unfavorable circumstances traditional methods for controlling the risk of falling into distress have usually enabled the people to counter natural and other hazards in a rather effective way"

> private transfers accounted for almost half the income of the poorest households Nearly three-quarters of rural households in Java, Indonesia gave private transfers to other households About half of a sample of Filipino households received private cash transfers (p 206)[7]

Moreover since the oil price rise of the early 1970s, the poor in South Asia and parts of Southeast Asia have found remunerative employment in the newly rich oil states and their remittances to their Third World relatives have helped to alleviate their poverty

The motivation for these transfers is of some interest If they were purely altruistically determined (as in Becker's famous "rotten kid" theorem),[8] then it would imply that with intergenerational transfers between parents and children, there could be dynastic families which would behave as though they were a single, infinite-lived individual Barro's famous Ricardian equivalence would then hold, with public policies such as debt

[7]See Rempel and Lobdell (1978), Knowles and Anker (1981), Collier and Lal (1986), Oberai and Singh (1980), and Lucas and Stark (1985) on the significant size and effects of remittances within the rural and between the rural and urban sectors in other countries

[8]The rotten kid theorem states "when one member [of a family] cares sufficiently about other members to be the head, all members have the same motivation as the head to maximize family opportunities and to internalize fully all within-family 'externalities' regardless of how selfish (or indeed how envious) these members are Even a selfish child receiving transfers from his parents would automatically consider the effects of his actions on other siblings as well as his parents Put still differently, sufficient 'love' by one member guarantees that all members act as if they loved other members as much as themselves" (Becker 1974, p 270)

financing and social security being completely neutralized by countervailing private action [9]

As these implications seem to be highly unrealistic, attempts have been made to explain private transfers as part of an exchange process involving an implicit mutually beneficial contract, say between parents and children, who in exchange for their educational expenditure, are committed to looking after their parents in their old age (Kotlikoff and Spivak 1981, Bernheim, Shleifer, and Summers 1985) Lucas and Stark (1985) have developed an intermediate model in which both altruism and self-interested exchange are the motives for transfers, and found that it applies satisfactorily to Botswana [10] Most of the empirical evidence on the motives for private transfers finds them to be mixed [11]

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[9]Some economists have gone further and showed that as propagation necessitates the participation of two typically unrelated individuals, there will be a proliferation of linkages between families This gives rise to even stronger neutrality results In particular, no government transfer (including those between unrelated members of the same generation) has any real effect, and all tax instruments (including so-called distortionary taxes) are equivalent to lump-sum taxes In essence, the government can affect the allocation of real resources only by altering real expenditures The efficiency role of government is thus severely limited, and its distributional role is entirely eliminated Indeed if all linkages between parents and children are truly operative, then market prices play no role in the resource allocation process and the distribution of goods is determined solely by the nature of intergenerational altruism

[10]They found that the prediction of the pure altruism model that lower-income households will receive higher transfers is not borne out, and that instead, as the exchange model predicts, there is "a positive association between amount remitted and per capita income of the household from other sources" (p 910) For in the exchange model, the "greater wealth of the family should increase its relative bargaining strength" (p 906), and thus leads to a higher demand on its "migrants "

But as Lucas and Stark (1985, p 1167) recognize, their data do not allow the altruistic motive for transfers to be tested in a dynamic context

Some studies have instead tried to estimate the crowding-out effect of public on private transfers directly Most of these have been done for the U S and find some small crowding-out effect There are only two studies of developing countries For Peru, Cox and Jimenez (1992) found that in the absence of social security in urban Peru, private interhousehold old-age support would have been higher by 20 percent So there is considerable, but not complete, crowding out of private by public transfers A study of the Philippines by Cox and Jimenez (1993) is probably more relevant[12] They found that transfers were widespread and large They then simulated the effects on these private transfers of three public policies, namely, unemployment insurance, social security, and income grants targeted to the poor For unemployment in-

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Rosenzweig (1988) does so In a longitudinal study of six villages in three different agro-climatic regions in the semi-arid tropics of India, he found that kinship in a risky world not only tends to bond family members in a single location (in a particular way), but kinship ties are able to be sustained over time and space in implicit insurance-based transfer schemes which contribute to consumption smoothing in the face of covariant income risks

It is kinship and common (family) experiences which induce trust, knowledge and altruism among family members Hence, such income-pooling implicit contracts may be feasible even if it is spread across wide areas

[11]As Cox and Jimenez (1990, p 216) summarize "Some studies find an inverse relation between recipients' resources and transfer amounts received but others find a positive relation, which contradicts the altruism hypothesis "

[12]They state "Part of the reason for the low estimates of the degree of crowding out of private transfers by public ones might be due to the fact that the estimates discussed above are derived in environments where public transfers are already substantial These transfers may have already crowded out private transfers to a large extent, rendering the small samples of private recipients uninformative In contrast, the Philippines has almost no public welfare payments, which makes it an ideal case study for gauging the strength of private transfers " (p 6)

surance, they find "the reduction in private transfers is nearly as large as the boost in income that unemployment insurance gives to households Ninety-one percent of the increase in household income from unemployment insurance is offset by reductions in private transfers" (p 19)

For retirement income, they find that "private transfers would be 37 percent higher" if retirement income did not exist On a program to completely eliminate poverty by giving each household the difference between its actual income and poverty line income, they find that after private transfers adjust, 46 percent of the urban and 94 percent of the rural households below the poverty line before the program would still be below the line after the program! Moreover they give reasons to believe that their estimates of crowding out are biased downwards This study should certainly give anyone seeking the public transfer route to deal with poverty related to risks in the labor market, considerable cause for pause

These doubts are further strengthened by noting that private transfers, by relying on locally held information and on extra economic motivations like trust and altruism, can overcome many of the problems of adverse selection, moral hazard, etc, which have so exercised the "nirvana" economics 'market-failure' school For as Cox and Jimenez (1990) summarizing the empirical evidence conclude "private transfers equalize income, private transfers are directed toward the poor, the young, the old, women, the disabled and the unemployed" (p 216)

Public Transfers

Perhaps public transfers can do even better, so that we should not worry if they crowd out private transfers? Public subsidization of the two merit goods—health and education—are the major public transfers in nearly all developing countries In ad-

dition, social security is important in many Latin American countries

One question on which there is some empirical evidence is the incidence of the benefits from subsidies for merit goods Beginning with the pioneering studies of Meerman (1979) for Malaysia and Selowsky (1979) for Colombia, a number of other studies have addressed this issue Jimenez (1989), summarizing the studies done up to 1987, concluded

> Students from the highest quartile of the income distribution profile in Chile, Colombia, Indonesia, and Malaysia receive between 51 and 83% of all public expenditures on higher education, whereas those from the lowest 40% receive between 6 and 15% The effect is only partly counterbalanced by the concentration of primary education subsidies among poor families, which have most of a country's younger school children The net result is a distribution of overall educational subsidies roughly proportional to each income group's population share, with the exception of the Dominican Republic where the poor's share is still less The income bias is less for health Health subsidies for Colombia and Malaysia are roughly proportional to each income group's population share But in Indonesia, the poorest 49% capture only about 19% from public health centers and hospitals (p 114)

The general impression is that public transfers are generally regressive, and that they are very imperfect means of helping the poor

One revealing piece of evidence suggesting that public transfers not only are more inefficient in poverty redressal than private transfers, but also crowd them out, is provided by a 1990 World Bank study This traced public social sector expenditures for nine Latin American countries in the 1980s and found that real per

capita public social spending on health, education, and social security fell during some part of the 1980s in every country The share of health and education expenditures in total government expenditures also fell, even as that of social security rose In spite of lower funding, and no apparent increases in equity and efficiency, the social indicators generally improved in the 1980s

Apart from obvious statistical and other biases which might explain this anomaly, the most plausible explanation provided is that it might be due to the growing role of nongovernmental organizations, and the response of the market-oriented private sector to enhanced expectations and demand That is, there was probably a "crowding in" of more equitable and more efficient private transfers to replace the decline in public ones [13]

Political Economy of Transfer States

Enough has been said to suggest that public transfers are clearly not the panacea being touted by socialists of various hues [14] Their efficacy in achieving ends like improved educational and health outcomes are dubious and the incidence of their benefits tends to be regressive as compared with the evidence on private transfers summarized earlier My general conclusion, therefore, echo that of a World Bank (1992) report on Honduras

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[13]Another piece of evidence is provided by a simple regression that was run on the state-level data on per capita public expenditure on health and education between 1976 and 1986, and the changes in literacy rates and life expectancy and infant mortality rates for India, given in Ravallion and Subbarow (1992) In these cross-sections, I found no statistically significant relationship between changes in state-level health expenditures and health outcomes, and a statistically significant negative relationship between changes in educational expenditure and literacy!

[14]See Ahmad et al (1991) for a representative sample of this type of viewpoint

> Most social programs benefit primarily the middle class and rich, through spending on curative hospital care, pension benefits and higher education Social spending pays for services that might be financed by the private sector (Box A3 5)

This "middle class capture" of the benefits of social expenditure is not confined to developing countries, but it has also been documented for the welfare states of the OECD (Goodin and Le Grand 1987) A systemic process is clearly at work It is the political economy of redistribution in majoritarian democracies In a two-party majoritarian democracy, politicians will bid for votes by offering transfers of income from some sections of the populace at the expense of others Models of this political process (which do not need to assume a democracy, but rather the interplay of different pressure/interest groups) show that there will be a tendency for income to be transferred from both the rich and the poor to the middle classes, the so-called "median voter" Even if social expenditures are initially intended to benefit only the needy, in democracies such programs have inevitably been universalized through the political process leading to what are properly called transfer rather than welfare states, which primarily benefit the middle classes

The poverty alleviation that may occur as a byproduct of the expansion of the transfer state is, moreover, bought at a rising dynamic cost With the universalization of various welfare schemes, political entitlements are created whose fiscal burden is governed more by demography than the conjunctural state of the economy With the costs of entitlements rising faster than the revenues needed to finance them, the transfer state, sooner or later, finds itself in a fiscal crisis This process is discernible both in developing and developed countries

For developing countries, the Lal-Myint study shows how this process is clearly visible in those countries in our sample (Uruguay, Costa Rica, Sri Lanka, and Jamaica) which, under the

factional pressures of majoritarian democracies, have created and expanded welfare states All four welfare states were financed by taxing the rents from their major primary products With the expansion of revenues during upturns in the primary product cycle, political pressures led to their commitment to entitlements In closing the fiscal gap during downturns, the ensuing increase in the tax burden on the productive primary sector led to a retardation of growth and productivity, and in some cases, to the "killing of the goose that laid the golden egg" Thus while there was undoubtedly some poverty redressal as a result of the expansion of these welfare states, over the long run, the entitlements damaged economic growth on which they were predicated, and hence eventually became unsustainable Similar processes leading to the fiscal crisis of the state are to be found in many other developing countries [15] Not surprisingly, many of these countries with overextended welfare states are now seeking to rein them back

Very similar problems are also visible in the more mature welfare states of the OECD (Lal and Wolf 1986, Lindbeck 1990) In some countries which had gone furthest down the public welfare route, the late 1980s and 1990s saw a growing questioning of the welfare state in the West, and in some cases its partial or virtual dismantling

POLICY IMPLICATIONS

What are the conclusions for policy which follow from this discussion? The first conclusion is that nothing should be done to damage the existing private institutions and channels providing private transfers "Forbear" should be the watchword for every proposed scheme which seeks to alleviate poverty through public transfers

[15]See Mesa-Lago (1983, 1990) for Latin America

The second conclusion is that if, for whatever reason, public money is sought to be transferred to the "needy," this is best done through private agencies This is particularly true for "merit goods" such as primary health care and primary education, even if there is a case for public financing, there is none for public production As the World Bank's public sector expenditure review of Bolivia noted

> In the health sector, NGOs deliver the most effective service In education, several communities have asked the largest NGO to manage their public schooling, indicating the perceived better quality education offered, even with much higher student teacher ratios in NGO schools The public education system spends more than 10 times more per child than the largest NGO, which provides high-quality education (World Bank 1992, Box A3 1, Jimenez, Lockheed, and Paqueo 1991)

The third conclusion is that the very problems of moral hazard, adverse selection, and monitoring cited by "nirvana economics" as requiring public insurance, in fact, argue for fostering the alternative private route which capitalizes on the comparative informational advantage of private agents with local knowledge These private welfare channels can be promoted by various methods of co-financing with public funds

A radical proposal may be worth considering This would channel all foreign aid and domestic public expenditure on social programs and safety nets to alleviating destitution and conjunctural poverty through NGOS (national and international charities) But to avoid the crowding out of private by public transfers, this public funding should only be provided on a matching basis The only reservation I would have about such a scheme is the continuing economic illiteracy shown by so many NGOs as I noted at the outset

Fourth, in cases where for political reasons public responsibility for the needy has to be accepted, public policy should be concerned with alleviating real hardship and not with equalizing people The socialist distributivist end must be forsworn State help should be concentrated on the minority in absolute need, and the categories of prospective beneficiaries should not be allowed to multiply as 'need' assumes an elastic dimension in the name of 'relative poverty' (Harris 1988, p 18)

Fifth, universal provision of welfare and social security benefits should be eschewed For particularly in majoritarian democracies, such "universalization" will corrupt the polity with competing politicians showing their compassion by indiscriminately buying votes with other people's money This, in turn, will lead to the likely "middle class" capture of the transfer state, and could lead to endemic growth and fiscal crises

GUIDELINES FOR PUBLIC ACTION ON SOCIAL SAFETY NETS

If public action is considered desirable to deal with various labor market risks, what are the guidelines for specific types of risks that the application of the above principles can provide? We deal with the various elements of the safety net in sequence

For the merit goods of education and health, as noted in the last section there may be a case for financing the poor but none for public production On this point, John Stuart Mill (1848) suggested that there are sufficient numbers qualified to provide education under public auspices, there is no reason why it can't provide equally good education under private auspices For health, it can be argued that the poor are best helped by various means to allow them to purchase private care (Lal 1993b) These means include mutual aid societies, as well as private charities, and NGOs Matching public funds for these private institutions would be the method of channeling public funds to the poor For both type of

merit goods, if the country has an adequate administrative capacity, vouchers earmarked for purchasing these merit goods given to the preferred purchasers will be more efficient then subsidies to producers If, faut mieux, public provision of these merit goods is undertaken, then differential pricing to recover the costs of provision, while subsidizing the poor on the lines developed and recommended by the Bank, in the past, is desirable [16]

Social security pensions form the other major component of social expenditures, at least in the more advanced developing and former socialist countries As in most Western welfare states, they are pay-as-you-go schemes In light of demographic trends in most ex-socialist countries, they are, as in the West, an economic time bomb Given the danger in countries where the welfare ethos has become widespread that it may be rational to be feckless in providing for one's old age as "the rotten kid meets the good samaritan," some state compulsion in ensuring everyone provides for a basic pension may be desirable As in Chile, this could be done through earmarked taxes that are put into fully funded and actuarially fair private pension funds (Castaneda 1992)

This leaves various forms of income support programs—disability and unemployment insurance, and transfers to alleviate low-end poverty—which are common in many Western welfare states These schemes involve unavoidable "tax-cum-subsidy distortions" because lump sum taxation and subsidization is normally not feasible The econometric attempts to provide quantitative evidence of the effects on labor supply, consumption, and savings of these distortions has been inconclusive (Atkinson 1987)

Unemployment insurance is of little relevance for the majority of developing countries in which self-employment predomi-

[16]See Jimenez (1989) for a powerful restatement of the case for social sector pricing against the universalist welfarists

nates over wage employment Even in the so-called modern sectors of these economies where wage employment is the norm, measured open unemployment rates are relatively low, the unemployed rates are relatively low, and the unemployed are typically highly educated, relatively wealthy urban youth Their unemployment reflects, in part, the availability of "reserves" (from their relatively better-off families) to finance job search in the high-wage modern sector and, in part, the overexpansion of higher and secondary education because of economically unjustifiable public subsidies (Squire 1993) In addition, relatively high institutional wages in the modern sector encourage what can be termed Harris-Todaro type unemployment Given these "typical" features of developing country labor markets, unemployment insurance is only feasible for wage employees in the modern sector

In an excellent overview of the literature on unemployment insurance, Hammermesh (1992) argues that the only rationale for unemployment insurance programs is the "individual based goal of consumption stabilization For this goal to be valid it must be true that workers either estimate the probability of becoming unemployed correctly, but are so myopic that they do not save for the eventuality, or they underestimate the probability and thus have insufficient precautionary savings " (p 3)

If, however, for whatever reason a publicly funded program of unemployment insurance is introduced for the urban employees in the formal sector, what should be its features? We need to minimize the side effects in terms of the higher urban unemployment/expansion of the urban informal sector, and increased rural-urban migration that may be induced These effects will depend upon how the "tax" to finance the benefits is raised If the tax is levied on modern sector employers, while their wage employees receive the benefits, the net effect will be to raise the "effective" wage of such employees and this will, through the familiar Harris-Todaro type of dynamic process, lead to a reduction in modern sector employment, and increase the size of the urban

"informal" sector, as well as result in rural-urban migration If, instead, the tax is assessed on worker's earnings, there is no effect on the size of the urban sector, just as there is no impact on the employment or the unemployment rate Hence to the extent we believe that labor-market dualism characterizes developing economies, unemployment insurance benefits should be financed by taxes on the earnings of workers in the modern sector (Hammermesh 1992, p 35)

From a poverty viewpoint, the seasonal unemployment of landless labor in rural areas is likely to be of greater importance than urban unemployment Rural public work schemes like the Maharashtra Employment Guarantee scheme (Ravallion 1992) have been effective both in preventing famines and in dealing with problems of short-run income variability, but their success lies in the self-targeting that is made possible by offering a wage that only the truly needy will accept

Severance Payments

In many ex-socialist economies as well as those developing countries which created overextended and inefficient public sectors, an important part of structural adjustment is the privatization of such enterprises In addition, many bureaucracies which were set up to manage controlled economies need to be slimmed as they move towards market economies Such structural adjustment programs typically encounter political resistance from public sector workers who face retrenchment and/or cuts in their real wages Such workers can exert political pressure to prevent the rescinding of their politically determined entitlements to future income streams which are above what they would be able to obtain in the free market The capitalized value of the difference between their expected public sector earnings (including pensions and other benefits) and those they could get in the private sector (adjusted for the probabilities of being hired and fired in the mar-

ket) represent the rents public sector workers are currently receiving If their resistance is to be overcome, they might need to be compensated for these rents This is a political rather than an economic argument for severance payments, over and above those that might already exist in the contractual arrangements that may be in force in the respective labor markets How to deal with this problem will differ from country to country, depending upon the particular labor laws and the government's ability to rescind these enviable rents If the method of adjustment is to be voluntary, however, certain common problems will be faced The most important of these is that, given the heterogeneity of the labor force, the rents derived from public sector jobs will differ for different workers, being highest for the "bad" workers whose market opportunities relative to their entitlements in the public sector are the worst With imperfect knowledge of each worker's rents, and the difficulty in devising perfectly discriminating severance payment schemes, if the severance compensation is set to persuade the last "bad" worker to leave the public sector, the intramarginal workers will be receiving more compensation than the capitalized value of their public sector rents This could mean a very high cost to the fisc But in some cases, e g , where the public enterprise is producing negative value added at world prices, shutting down the enterprise even with this high cost may lead to a gain in net GDP In others where the enterprise might still be viable after restructuring and privatization, which involves retrenchment, the problem of tailoring a severance package remains [17]

The most attractive plan which would meet the objectives of limiting political opposition and reducing the fiscal burden would be one limited to workers not hired by the newly privatized en-

[17]Fiszbein (1992) and Diwan (1993) provide detailed analyses of the various options, as well as discussions, of severance payment schemes in a number of countries

terprise This tackles the adverse selection problem whereby the "good" workers take the severance package and the "lemons" are left with the new firm The severance package for those made redundant should be based on the principle of tailoring the benefits to the median redundant worker's public sector rents This would imply that, if the severance package offered uniform compensation at the level of the rents to the median retrenched worker, all those with lower rents would be better off, and they would provide the political support for the scheme to override those workers whose rents were greater than the median and would be worse off Little more can be said in principle about the specific terms of these programs which need to be tailored to local conditions, and, in particular, the relative bargaining power of public sector workers vis-a-vis the state

Transfers to alleviate poverty

We have already discussed the reasons for preferring the strengthening of private channels and institutions for the alleviation of low-end poverty (i e, destitution and conjunctural poverty) in countries where the welfare state ethos has not become widespread This is best done by the co-financing of local and international charities, as well as local mutual self-help associations

CONCLUSION

Thus, in conclusion, there are feasible ways of dealing with the inevitable pain that the necessary reform of India's labor market will involve But it is going to require political courage Lacking that, only a fiscal crisis which spills over into an inflationary and balance-of-payments crisis of the kind that led to the partial reform of Indian commodity and financial markets is likely to lead to these desperately needed reforms Without them, the

accelerated growth required to banish structural mass poverty from the subcontinent will not occur

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Indian Economic Reform and International Experience

S P Gupta

INTRODUCTION

India launched an ambitious reform program in 1991 The reform was triggered primarily by a foreign exchange crisis arising largely from a heavily protected and highly regulated economic regime The earlier regime was largely influenced by memories of the great depression, the bitterness about colonial exploitation, and the widening per capita income gap between developed and developing countries and by a general export pessimism among economists in India

Of late, however, the international experience has led India and many other developing countries to rethink their past strategies The days of colonialism are over The declining trend in world GDP and trade is seen to be reversing, from increased intercountry trade and investments to a greater integration with the prductive and distributive system of the world

The benefits of these changes have become particularly conspicuous when the growth of the developing countries and its combined share in the world GDP are increasing faster than that of the developed countries Many developing economies have opened up, deregulated and moved to the market system and are benefiting from faster growth The fastest growth center of the world is now the Asia-Pacific region This international experience is responsible largely for the changing attitude toward economic policy reform of the remaining developing countries including India But these countries do not have much past "in country" experience to guide them in this transformation Therefore, they have to rely largely on the experiences of other reform-

ing countries which have ventured through this transition Economists often argue that India, as a latecomer in the globalization process, has started with a handicap But they should remember that India is, in fact, deriving benefits from the recent recovery of world trade, the streamlining of the world legal system, the streamlining of the trade and investment laws under WTO and other world bodies, a faster development of communication technology and finally, the end of the Cold War and the acceptance, in principle, of multilateralism by a majority of countries, especially vis-a-vis trade and investment

Over the last five years, sizable effort has been made in India by changing many of the past rules and regulations to enhance the role of the market and open up the economy, as well as scale down bureaucratic interference to enable the growth and involvement of the private sector But the sequencing and pace of these changes have not always been optimal Besides, there are many unfinished tasks before the nation This is where a continuous review of international experience for assessing India's achievements and pitfalls will be needed Admittedly, no set recipe of reform has emerged Nor can a "one-to-one" replication of any country's experience advance itself But generalized lessons from successful and not-so-successful reforming countries have been drawn by development economists and policymakers The present series of discussion, dissemination and research have been initiated keeping this in mind

The common lesson drawn from the reform processes in different countries, as noted by Professor Harberger, is that "good policy does not carry with it any particular 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 govern-

ment power (in the non-communist parts of the world) in the foreseeable future"

Admittedly, a five-year period (since the initiation of Indian reforms in 1991) is too short a time to make a pragmatic assessment of the significant changes in the structure of an economy the size of India At the same time, the compulsions of a democratic political institution and the fact that the country has a large segment of poor population warrant that the cost of adjustment and the time of transition alike be minimized to ensure the continuity as well as the credibility of India's reform process But, India as a nation and Indians as individuals must realize that rapid growth comes mixed with pains and stresses of adjustment that are sharper and more severe than those of a traditional economy that changes only slowly Again as noted by Professor Harberger, "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, when it must yield to other forces and pressures, but a successful policy must find ways to minimize the sacrifice or compromise of sound economic objectives, and will avoid critical errors of macroeconomic policy"

Any review of the economic reform policy in India and its results will entail a hard look at its sustainability, viability and desirability A constant vigil on the appropriateness of the pace, coverage and sequencing of reform will always be asked for, for making any mid-course correction

REFORM IMPACT AND INTERNATIONAL EXPERIENCE

Macro and Sectoral Results

In drawing up a balance sheet of events since 1991, the positive factors seem to have exceeded the negative factors However, there is a general feeling that the achievements so far have fallen

significantly short of targets and expectations of reform The causes have been identified as (1) slowing down of the reform efforts, (2) many significant omissions or inaction, which constitute the "unfinished task" of the reform process, and (3) the partial nature of reform with many neglected areas which seem destined to remain so because of lack of any political consensus on the harder, and more painful, aspects of reform But there is complete unanimity among economists in India on the nonreversibility of reform although the need for proper checks and balances is widely recognized In this respect, India is not an isolated case but shares the global experience

GDP Growth

On the macroeconomic dimension, there is a positive sign of recovery of GDP since 1991–1992, though GDP is still well below the trend value of 5 3 percent The projected official growth rate for 1995–1996 is also not uniquely higher compared to many past individual years A welcome aspect of growth in the post-reform period is that it has turned the economy away from the declining growth rate in the four years preceding reform

It is often argued that scientifically the growth in the post-reform period should be compared against an estimated growth derived from a contrafactual model However, in this fast-changing world and with the complexities of large economies like India, it is extremely difficult to develop a general equilibrium model to test contrafactual trends On the other hand, there is a basic logic of comparing the actual with the trend values derived from a long past because the economy admittedly has been accustomed, over a period, to a certain growth tempo and any lower trend from that tempo, especially spread over a long period, will encounter some resistance from the people In fact, "any trend" which is not significantly higher than the past record will not be

able to justify the transitional discomforts and pains of restructuring

The heavy dip in growth in 1991-1992, i e , just after the reform was targeted, marked not only the culmination of the declining growth trend of the pre-reform period but also the strong contractionary fiscal policy adopted in that year The moot question in this context is whether this recent recovery of 1994-1995 and its consolidation in 1995-1996 are sustainable, given a declining growth trend in India's core infrastructure areas and construction activities over this post-reform period

Industrial Growth

The recovery of industrial growth overall, however, from the initial dip is clearly in sight It is higher than the historical trend growth rate of 7 5 percent over the past reform period and is showing all signs of a further increase

Money Supply/Interest Rates

The recent credit crunch, however, may dampen the recovery Any attempt to increase money supply for easing the credit squeeze on the private sector has to be carefully considered in relation to a possible inflationary impact on the economy, which, for the time being has largely been contained by avoiding any sizable hike in administrative prices (which though is not in conformity with the reform spirit) and by getting the benefits of a comparatively easy seasonal impact from agriculture The nominal interest rate is very high and the Latin American experience suggests that in light of distress borrowing and overestimation of future profitability, the banking system may be affected adversely Competition among banks for deposits, and among enterprises for loans, in fact, led to very high real lending rates of interest (using actual rather than expected inflation as the deflator) Ac-

cording to many, such a high interest rate in India is not sustainable—there is a massive chance of adverse risk selection, low-quality and high risk borrowings replacing more creditworthy ones

Agricultural Growth

As for agriculture, its growth is in line with past trends But there are some reservations regarding the sustainability of the trend for the future since in the past, growth has been based on some good and some bad monsoon years, whereas the post-reform period has witnessed four consecutive good monsoons

Export Growth

The best achievement in the post-reform era is the fast growth of exports, which has been significantly above the pre-reform trend and explained largely by India's increased penetration in the world market Additionally, this is due to the fact that export growth has benefited from recovery of world trade However, in 1996, India's exports are showing some signs of loss of competitiveness There is an apprehension over unfavorable real exchange rate movements that may be causing this In fact, it is not only essential that the exchange rate be realistic, but that exporters are confident that it can remain so The way this is most frequently done in many countries is by introducing a crawling peg so that the authorities frequently make small adjustments in the nominal rate to take into account any differences in the rates of price increase between their country and that of their major trading partners Alternative means for achieving the same objective include permitting the exchange rate to float and keeping the price level stable In India, an almost similar measure has been attempted by way of occasionally intervening in the foreign

exchange market, though with very little success judging by recent trends in the value of rupee vis-a-vis the U S dollar

Import Growth

In the area of imports, after a long sluggish period—partly due to import compression arising from several government measures, including a bout of devaluation—imports have started rising Indeed, a rate of import growth that is the highest its been in fifteen years has been achieved This has been helped largely by removing most of the quantitative restrictions, reducing tariffs and other protective measures The fast growth in imports in recent months also reflects the recovery of Indian industry in particular, and the economy in general It has crossed India's past trend values and the import elasticity to GDP now is more than twice what it was over the last decade There is also proof that the import intensity of Indian industry is rising under pressure of global competition and, with the search for advanced technology, this trend is certain to continue Besides, if a wider variety of foreign consumer goods is now suddenly available, imports not only will rise further, but also might, in this process, stimulate excess consumption and undermine private savings A large part of import increases in India in consumer durables is largely getting concealed or misspecified under capital goods imports Thus, there is some apprehension that unless imports are matched by higher export growth, there may be some risk of a substantial drain on India's foreign exchange reserves

Foreign Investment

The reform period has seen an unprecedented increase in total foreign investment inflows—much higher than in the pre-reform period, increasing by nearly 4 to 5 times per annum from the early 1990s There has been a major compositional change

Against this, the net external assistance (disbursement) has become negative in the first four-five months of 1995–1996 for which data are available The highest inflow of foreign investment comes in the form of portfolio investment followed by foreign direct investment However, there has been a recent decline in both portfolio investment and approvals of foreign direct investment According to some economists, this may reflect a wait-and-see attitude on the part of investors The main concern in this area is the continued bureaucratic attitude, state-level delays and infrastructure shortages But the ratio of DFI disbursement to approval is increasing, showing a satisfactory absorptive capacity in the economy The high volatility of portfolio investment and the comparatively poor performance of the secondary market vis-a-vis domestic money resulting in some problems of exchange rate management are, however, worrying It is believed that the flow of portfolio investment is countercyclical, it leaves when it is needed and comes in when it is not needed Its potential contribution to domestic investment would be high if it goes significantly to the primary market But, in India so far, it has only been in the secondary market One of the main reasons for this is that the procedural formalities for entering the primary market requires a wait of 70 days, most portfolio investors cannot afford to wait 70 days to make an investment, when their purpose is mainly to make a quick return in a highly mobile market

However, intercountry experience shows that capital inflows by themselves do not always pose a significant inflationary risk, even though they increase the money supply (and could, therefore, accommodate inflationary pressures arising from other sources) As long as India keeps a strong grip on domestic credit expansion by the government and the banking system, and keeps the exchange rate roughly stable, and as long as the real economy maintains a recovery, inflationary pressures are likely to remain under control Therefore, the general consensus is that one should not recommend actions to stifle foreign inflows

Regarding direct foreign investment in the global context, the increase in DFI in the past decade has substantially outpaced the increase in global trade, which, in turn, has consistently outpaced the increase in global GNP China so far has been the world's leading beneficiary of large-scale foreign direct investment flows DFI inflow in India is below that going to China and is below India's expectation This is partly explained again by the "wait-and see" attitude of foreign investors who are focusing on India's domestic socio-economic stability and the pace of reform Indeed, in India's reform process, a further unshackling of the private sector from state regulation and socially-responsible privatization of the state-owned enterprise sector will be needed

There are many misconceptions about the factors which encourage foreign investment Sometimes, it is felt that tax concessions and discriminatory treatment of foreign investment are needed to enhance their flows But general international experience suggests that foreign investors look for good social and physical infrastructure, good security, a transparent and efficient legal system, absence of bureaucratic hurdles, and liberalized repatriation facilities compared to other competing destinations, rather than discriminatory and favorable treatment in fiscal and monetary areas vis-a-vis domestic investors Indeed, a favorable infrastructure and less bureaucratic intervention better attract foreign investors than do exemptions or concessions in capital gains tax or other similar facilities

It is also important to realize that for transnational corporations (TNCs), the most scarce resource is the time of senior executives TNCs will lose interest in an investment if they cannot go into production quickly, under increasing globalization, TNCs have plenty of other investment opportunities

TNCs, much like domestic corporations, can be inefficient with regard to social responsibilities and economic returns, but if they are working in a healthy host-country framework, they always make a substantial contribution and attract others Often,

foreign investment is treated only as a supplement to domestic investible resources, especially in capital-scarce countries like India, but TNCs can also provide management know-how, technology and skill It can provide access to international markets At the same time, it is acknowledged that foreign investment cannot replace the need for growing domestic investment and technology in a large country like India The bulk of productivity growth must come from the domestic economy as trade barriers are reduced and regulation is liberalized Foreign investment can only be effective at the margin, but economics teaches us that what happens at the margin, rather than on average, is also important

Balance of Payments

The advantage of foreign investment from a balance-of-payments point of view, is that it has no servicing costs Whereas suppliers' credits and bank loans impose a fixed cost that must be paid whether the investment made is profitable or not, dividends on foreign investment become liable only if the investment is profitable, provided, of course, that such an investment is not protected by trade barriers or domestic regulations

Many of the difficulties faced by governments in handling foreign investment and by foreign investors setting up shop arise from the absence of a clear civil, commercial and criminal legal system This has been a particular problem in the formerly centrally planned economies Countries like India are different in that they have a comprehensive legal system

The ability to repatriate capital and dividends is also an essential component of financial reform In India this was not easily done in the past

The linkages between ownership and management are very complex In some cases, having 10 percent ownership of a company allows control, in others, even a 60 or 70 percent of share

ownership is not enough The optimum ownership structure should therefore be left to investors This is a matter that cannot, meaningfully, be decided by bureaucrats by formulating a set of standardized rules

Finally, as per international experience, if India wants to meet the challenges of a modernizing economy which is linked closely to the world market, India will have to reduce certain constraints such as its "exit policy" Indeed, a major gap in India's economic reforms, and one which also has important financial implications, is the rigid character of India's labor market

In the late 1970s, the early liberalization experience of Chile, the experience of New Zealand in the 1980s, and the dismal unemployment rates in European countries such as Spain today clearly demonstrate the failure to correct conditions in the labor market during widespread liberalization of commodity markets

Infrastructure

The investment growth in terms of constant prices in the 1993–1994 period was dismal at around -0 7 percent in terms of gross capital formation This was preceded by another period of low growth of -1 2 percent in 1992–1993 For 1994–1995, according to the government's quick estimates, it has increased by 28 5 percent This is a good omen given the shortages in the infrastructure and investment capacities in most areas However, the composition of the 28 5 percent growth in 1994–1995 shows that nearly 50 percent of this increase came from the household sector The growth in public sector investment accounts for only 23 percent Hence, the impact on infrastructure, which is mainly in the public sector, will be comparatively low, especially given the long gestation period in infrastructure before new capacity is generated Therefore, no immediate relief is visualized in the near future to alleviate the infrastructure shortage

Domestic Savings

Since 1993-1994, the market has been experiencing a severe credit-crunch in the banking sector The real interest rate has been unusually high, which has affected industry, especially the small and medium-sized firms Fortunately, estimates by the government for 1994-1995 indicate that that the declining trend in domestic savings has been reversed, reaching almost the same rate as it was in 1991-1992, i e , the beginning of the reform period It increased by 1 4 percent of GDP between 1992-1993 and 1993-1994 to 3 percent between 1993-1994 to 1994-1995 This comparatively large increase is expected to release some pressure on credit availability This is yet to materialize However, since 50 percent of the increase in domestic savings in 1993-1994 resulted from an increase in household savings in terms of physical assets (which is, in effect, outside the financial market), its favorable effect on the credit market will not be easily felt Indeed, increase in growth of domestic savings in 1994-1995 is explained only up to 10 percent by the increase in household financial savings

In contrast, an encouraging area is the sizable increase in public savings which accounts for nearly 40 percent of the total increase in domestic savings rates in 1994-1995 This largely stems from the savings of non-departmental enterprises, resulting from a hike in administrative prices For 1995-1996, indications are that given the need to control inflation, the customary hike in administered prices has been toned down

In 1994-1995, the fiscal deficit continued to be very high, both in the revenue and capital accounts, despite improvements in the negative savings of the public sector For 1995-1996 (being an election year), any significant improvement in this scenario is unlikely With respect to corporate savings, the marginal savings rate is still very high compared to the average savings rate This is a good sign But in comparison to 1993-1994, it has also de-

clined The higher tempo observed in 1993-1994, hopefully, will be revived in 1995-1996

Inflation

On the price front, inflation (as measured by the change in wholesale prices) fell from 13 7 percent in 1991-1992 to 10 1 percent the next year In 1993-1994, it slipped to 8 4 percent, however, went up again to 10 8 percent in 1994-1995 Currently (1995-1996), it is around 9 5 percent, although it has come down to around 5 percent on a month-to-month basis in recent months Indications are that for the year as a whole, it will be around 8 5-9 0 percent However, this continues to be very high as compared to world inflation and should be a matter of concern This is even more true given that the consumer price index is still higher (continuing at above 10 percent) with no sign of a decline It is apprehended that the present control over money supply by the RBI and its consequent manifestation in a credit crunch, is more likely to be felt in the intermediate and capital goods market, especially in the long term than in the short- and medium-term consumer goods market

Currently, the government's high borrowing is syphoning off large amounts of credit from the private capital market, through populist expenditure under the budget revenue account, thereby fanning the demand for consumption goods This may explain why consumer goods prices are rising much faster than are wholesale prices Nearly 30 percent of the weight of the wholesale price index comes from commodities that fall under administrative prices There is a temporary halt in the price hike of all these commodities in 1995-1996 which partly explains the slowdown in the wholesale price index Besides, the commodity composition of the wholesale price index also excludes many of the high-priced service sectors Thus, the prognosis in the price front is that inflation is likely to increase in the post-election period as

soon as the reform tempo picks up Over the last four years, India has had several good monsoons, which may not recur in future Finally, the declining external value of the rupee may further add to future inflation

Regarding the impact on poverty, the most recent estimates are given by the Planning Commission on the basis of a half sample in 1993-1994 The estimates show that the poverty ratio (i e, the percentage of people below the poverty line) has declined marginally from 22 4 percent to 21 7 percent in the rural sector and from 12 7 percent to 11 6 percent in the urban sector between 1992-1993 and 1993-1994 Compared to 1990-1991 (i e, the beginning of the reform period), however, it continues to be marginally higher In 1990-1991, it was 20 6 percent in the rural sector and 11 5 percent in the urban sector

Over the period from 1977-1978 until 1990-1991, the rural and urban poverty ratios declined very fast—from 51 2 percent in 1977-1978 to 20 6 percent in the rural areas and from 38 2 percent to 11 5 percent in the urban areas In contrast, in the post-reform period, there is no significant declining trend The fall in the growth of income and consumption immediately following the reform initiatives may a major reason for this fall In 1993-1994, growth in income and consumption revived For example, per capita consumption went up 2 4 percent This may have helped to marginally improve the poverty ratio

Improvements in poverty ratios have a growth element as well as a distributive element In the pre-reform period, the consumption distribution was continuously improving and thereby partly helped to reduce poverty Since the reform of 1991-1992, the inequality coefficients, both in terms of income and consumption, have started increasing Consequently, for a further reduction in poverty, a comparatively higher growth rate will be needed The deterioration in the consumption distribution has largely been due to changes in the relative prices and the inflation rate The higher inflation rate, and especially the increase in food

prices, has caused the consumption distribution to go against the poor

For 1994–1995, although GDP growth has been estimated at a high 6 3 percent, growth in per capita consumption has almost remained at the 1993–1994 level (around 2 4–2 5 percent) The inflation rate has also accelerated from 1993–1994 and the relative price of food (including the issue prices which affects the poor) is increasing faster This suggests that consumption inequality may increase further in 1994–1995 Hence, one cannot expect any marked improvement in poverty in 1994–1995 For the future, the prognosis is that to revive the declining poverty trend of the past, a very fast growth of about 7–8 percent per annum is needed in India Given the present slowdown in the reform process and the growing infrastructural constraints as well as the continuing inflationary potential, this task is a challenging one In the transition period, policymakers will have to find a means of targeting programs for those poor who are either genuinely affected adversely by removal of earlier subsidies or who are outside the main market system (since the transition cost should be reduced until benefits of accelerated growth can be enjoyed by the majority in India)

Privatization

If the government leaves the productive sphere to the private sector including foreign enterprises, it will be able to devote more resources and attention to actual social needs With the increasing availability of international capital for industry and infrastructure (roads, telecommunications, ports, etc), the government can redirect its own scarce resources to those areas which are distinctly within its purview, such as primary education and health This type of policy shift, which is underway throughout the developing world, is still to emerge as a strategy of development in India This is largely due to the "soft" approach of the Indian govern-

ment to privatization and fiscal discipline vis-a-vis wasteful revenue expenditure

Employment

There is some apprehension in India that economic reform could be socially iniquitous, especially to labor As noted by Jeffrey Sachs, "In the name of social justice, India spends tremendous resources and political energy to protect the few percent of workers in the organized sectors of the economy, but as an indirect result it hinders the chances for the other 90-plus percent of the population to find gainful employment outside of the subsistence agriculture or low-productivity informal employment"

It is very difficult to obtain a clear picture of employment growth in the informal sector According to the population census of 1991, employment growth in the manufacturing segment of the informal sector between 1981 and 1991 was 1 32 percent per annum as against 0 5 percent employment growth in manufacturing segment of the organized sector This clearly demonstrates the tremendous potential of India's informal sector in fulfilling India's employment goals

The post-reform unemployment situation has deteriorated in both the rural and urban areas The estimates of total employment growth in recent years, which are only available from Planning Commission reports, show that the unemployed pool has not fallen since 1991 and growth of employment is slightly slower than the growth of the labor force Even this estimate is based on the optimistic assumption of a significant increase in employment elasticity in the service sector of the economy The rate of growth in public sector employment has gone down significantly and has been compensated only partially by faster growth of organized private sector employment However, this trend is healthy since it shows the increasing role of the private sector as an economic agent

Separate employment and unemployment data between the organized and informal sectors are not available from any comparable source The organized sector employment data are available from the Ministry of Labor statistics which provides data up to March 1993 As per this data, since 1990-1991, there has been a very sharp decline in public sector employment (falling from 2 2 percent growth per annum between 1981 to 1990 to 1 2 percent between 1990 and 1992) If we add to this the quick estimates of 1993, then the growth rate further declines to 1 1 percent The growth of employment in the private sector, on the other hand, went up from 0 3 percent between 1981 and 1990 to 1 9 percent per annum between 1990 and 1992 However, if we add to this the quick estimates of 1993, this too comes down to 1 1 percent (mainly because in 1993, the growth rate of employment in the private organized sector was -0 2 percent per annum)

Fiscal Deficit

The most pressing concern of reform comes from fiscal performance The central fiscal deficit of 1995-1996 with all the populist expenditure (a result of the forthcoming national elections) may increase further since most of the expenditure was not budgeted for This fiscal gap is expected to widen further due to rising nominal interest rates and increasing government borrowing at the market rate More worrisome is the ever-widening revenue gap Independent studies show that the implicit subsidy as percentage of GDP is increasing faster in the postreform period and more so in the economic sectors, thereby increasing the revenue deficit through very low recovery rates in these sectors Thus, the fiscal discipline of the government is being fast eroded, especially with the central government recently borrowing much above its agreed MOU with the Reserve Bank of India

The lag effect of this fast expansion in government expenditure could be reflected in a future price rise and crowding out of the private sector

Foreign Exchange Reserves

On the external front, there has been substantial growth in foreign currency reserves, notwithstanding the drop in recent months The debt service ratio is decreasing quickly, but is still much above the desired level With respect to total external debt, the recent white paper by the government clearly shows that, measured in dollar terms, its growth is decelerating In rupee terms, however, as percentage of GDP, the ratio is showing some improvement Thus, overall, the reform target in the external sector is near fulfillment

Policy Changes

Public Sector Policy Reform

In 1991, investments in most areas of the Indian economy were reserved for the public sector At present, there is hardly a sector from which domestic or foreign private investors are excluded In 1994-1995, with the liberalization of telecommunications and pharmaceuticals, and further liberalization in the coal industry, investment restrictions are mainly confined to insurance and railways—the only two sectors still reserved for the public sector But even in railways, there have been efforts to involve the private sector in operations (through "own-your-wagon" schemes, for example) and maintenance As a first step towards implementation of the recommendations of the Malhotra Committee on reforms in the insurance sector, a regulatory authority has been set up under the Union Finance Ministry But in general, the drive for privatization in India has been characterized by the lack of political will

Trade Policy Reform

Import licensing restrictions on intermediates and capital goods have been virtually eliminated Tariffs have also been significantly reduced From 300 percent in 1990-1991,the maximum import tariff was reduced from 85 to 65 percent at the beginning of 1994-95, the average tariff also fell to 33 percent in 1994-1995, from 47 percent in 1993-1994 and 87 percent in 1990-1991 The 1995-1996 budget further reduced the maximum tariff level to 50 percent and the average tariff (according to World Bank estimates) came down to around 27 percent In August 1994, the rupee was made fully convertible on current account transactions and India achieved Article VIII status of the International Monetary Fund

Financial Sector Policy Reform

In the financial sector, barriers against the entry of private sector banks (domestic and foreign) have been eliminated, prudential regulations that meet international standards have been introduced, banks now have greater discretion in their lending decisions, and financial markets have been liberalized During 1994-1995, to further improve competition, the authorities licensed 10 new banks, including three foreign institutions In its Credit Policy Statement of October 1994, the Reserve Bank of India (RBI) removed the minimum lending rate applicable to commercial banks for advances exceeding Rs 200,000 This was an important step in interest rate liberalization To improve its capacity to enforce the new prudential guidelines, the RBI created a Board of Financial Supervision which started functioning in December 1994 And as part of its strategy to strengthen and broaden the ownership base of public sector banks, the government in 1994 provided $3 3 billion for the purpose of recapitalization to the 19 "nationalized" commercial banks directly owned by

the Ministry of Finance It also changed legislation to allow private ownership of these banks up to 49 percent of equity In October 1995, the RBI announced another credit policy for the ensuing six months the deregulation of interest rates on deposits over two years This is normally regarded as the last stage in interest rate deregulation But to discourage unrestrained bidding-up of interest rates and as a measure of caution, the RBI has restricted the deregulation to deposits of over two years This is expected to reduce the tendency to competitively bid up rates leading to short-term hot money supply This is also expected to stop funds from getting locked into excessively long deposit maturities which could create or aggravate asset-liability mismatches Finally, all banks will be required to adopt the same valuation technique for SLR as for their balance-sheets

There are however, no plans to privatize the existing nationalized banks This is unfortunate since there is clearly the risk of state banks becoming bankrupt and source of political headaches, scandals, and inefficiency, unless these banks are allowed to privatize There is also a case for extending further licenses to foreign banks, with a view to creating domestic competition There is also the potential for establishing Bombay as a key regional banking center for the whole of Asia

Most foreign firms, and particularly joint venture firms, rely on local facilities for short-term working capital (for wages and trade credit) Many developing countries have, therefore, permitted transnational banks to initiate competitive banking, often allowing foreign banks to at least undertake banking for foreign-owned companies Such financial sector reform—combined with prudential regulation, inspection and competitiveness—is essential to ensure high benefits from foreign investment

In view of the generally tighter liquidity conditions in recent times as compared to the past, the RBI has opted to leave the refinance facilities on export credit unchanged The same logic underlies the enhancement of the limit for refinance against gov-

ernment and other approved securities from the earlier 0 5 percent (for fortnightly average outstanding deposits) in 1991-1992, it was raised to 1 0 percent in 1994-1995 Here again, an attempt was made to popularize treasury bills by splitting the refinance facility into two parts—the first against holdings of dated securities (this is expected to lend greater liquidity to the government debt market) and the second against foreign exchange (on the basis of the Sodhani Committee recommendations which proposed, among other things, the abolition of the uniform Rs 15 crores overnight open position) Consequently, each bank will, henceforth, be permitted to fix its own limit after obtaining RBI approval Several procedural difficulties have also been eased to ensure compliance with CRR (recently CRR requirements of banks have been reduced to release pressure on the credit market)

Similar progress has been made in developing money markets In March 1995, the RBI issued guidelines for creating a system of primary dealers in government securities Together with the historic agreement (reached in 1994) between the Treasury and the RBI to phase out (over three years) the automatic monetization of the deficit, these developments established the basis for market-determined interest rates on government paper, and for a more flexible and independent implementation of monetary policy by the RBI However, of late, this has not been complied with

Tax Policy Reform

Since 1991, the tax regime has been simplified and strengthened considerably The 1994-1995 budget unified tax on corporate income at 40 percent, for widely held companies at 45 percent, and 50 percent for others Reforms were also initiated in the area of excise tax (to bring it closer to a value-added tax), and the government also extended the MODVAT (a modified value-added tax) coverage to include the manufacturing sector and, for the first time, some services

Of particular importance were the decisions to (1) shift most excise rates from specific to ad valorem taxes (to increase buoyancy), (b) reduce the number of rates, and (c) simplify the system by relying on invoices for value determination These reforms simplified and modernized considerably India's tax system and made it possible for the central government to focus its efforts on improving tax administration The 1995–1996 budget continued to reduce the peak excise rates Although it did not further reduce corporate tax rates, it did continue to emphasize "simplification, lower rates and greater buoyancy" To ensure compliance, the authorities proposed tax deduction at source on fees for professionals, technical services/service contracts and on interest income on time deposits All the foregoing policy reforms, articulated since 1991, must be followed through to completion

A quick review of the reform process to date clearly indicates the many unfinished tasks public sector reform and privatization, financial sector reform (including insurance sector reform), changes in labor laws, reform of the urban land ceilings act, strengthening of India's civil/commercial/criminal legal system, further trimming of bureaucracy, development of sound public finance are examples of things yet to be done The reform process must also percolate down to the state and grassroots levels The agriculture sector and rural development must be brought into the reform agenda to ensure that benefits of the reform lead to poverty reduction, employment generation and an improvement in the standard of living for the vast majority of Indians

GRAY AREAS AND CURRENT DEBATES

Most of the current debates on the Indian reform program pertain to its desirability, sustainability and viability The core debate brings into focus the government's frequent use of soft options in its reform process, always avoiding any introduction of hard measures in relatively sensitive areas There has been a con-

stant conflict in government budgetary measures between concerns for stability and the need for equitable growth Fortunately, this is not an inherent conflict area in public finance literature, this has arisen because of government's failure to take the right kind of measures to reduce its macroeconomic imbalances Attempts to reduce the budgetary fiscal gaps by cutting into capital expenditure and expenditure on human development, and by neglecting to prune the unnecessarily large size of the public sector and its corresponding current revenue expenditure are telling examples of this Attaining a fiscal balance by such "short-sighted measures" is unsustainable in the medium- and long-run perspective

Hard work is required to ensure micro level corrections in individual programs and projects to reduce budgetary expenditure Budgetary promises before every budget, professing self-discipline, need to be strictly adhered to Noncompliance with all such promises has affected public confidence and has reduced the capacity for implementation of the government's fiscal measures

Public finance covers not only the center but also the states There are clear indications of nonpercolation of the center's reform message to the states and lower down, which has reduced the effectiveness of many of the reform measures

One key problem the state governments face is their inability to settle infrastructure projects with foreign investors, since approval from the Union Government is required in many cases This is particularly true in telecommunications key regions could easily attract DFI for new local systems (e g , cellular phone systems in Bombay, Madras, etc), but are effectively blocked by Union laws and regulations Therefore, India has not yet freed its state governments sufficiently to enable them to add dynamism to the reform process In most key infrastructure areas, the central government remains in control, or at least has the veto power over state actions The progress of some states (coastal states like Maharashtra, Gujarat and the Southern states) will undoubtedly

have a demonstration effect on others, though the interior provinces are not expected to gain as fast The fast-runners, however, should be allowed to pull ahead

The Union Government should target enhanced transfer payments to the states to help support primary health and education This may be done on a matching grant basis to give the state governments an incentive to increase their own efforts in these areas

In Brazil, the Sao Paulo State and Minais Gerais are the reform leaders at the regional level, in China, the coastal provinces and the provinces farthest from Beijing are in the lead, in Russia, reform leaders in Nizhny Novgorod and in the Russian Far East have been major spurs to reforms at the central level In India, all the western states are the prime forerunners Such competition between states is healthy But too much competition does lead to undercutting of one another, at the expense of national interest, as seen in the case of China

To ensure success of the reform process, the message must be that reform is for the benefit of all, with equal sharing of responsibilities Consequently, the recent debate on achieving a "level playing field," though regarded as "temporary" or "misconceived" by some, needs serious attention Many of the micro issues like Enron, transparency in government action and more equitable treatment of all possible players in the business community should not be regarded as irrelevant The role of foreign investment is to be highlighted against the backdrop of the experience of other countries But before that, a preparation at the domestic end in terms of proper regulatory measures and a liberalized economic environment, with matching infrastructure and bureaucracy, is needed

To quote Professor Helen Hughes from a paper presented in a seminar in February 1995, "most of the costs of foreign investment are associated with the exploitation of protected domestic

markets Transnationals have been, and are still, attracted to highly protected domestic markets in many developing countries Highly protected domestic markets allow such companies not to build plants large enough to exploit economies of scale and not to choose technology appropriate to the factor endowment of the host country and yet still make high profits Behind 'tailor made' tariff protection these companies can form cozy noncompetitive oligopolies Enforcing competitiveness in closed markets is, as India has found, extremely difficult whether the firms are domestic or transnational In such cases, productivity tends to be low, value added at international prices tends to be low or even negative—but yet profits tend to be high, exports become retarded India's high tariffs rates—although much reduced since 1991/92—are still very high as compared to India's competitors "

The international experience also points to the folly of host countries which encouraged several entrants into limited markets to promote competition Thailand, for example, at one stage, had granted 28 motor vehicle licenses This type of inward-oriented foreign investment was extremely inefficient and led to a serious balance-of-payments drain Host countries, notably in Latin America, were extremely unhappy with foreign investment outcomes, blaming the transnationals for the low or negative value added at international prices created by their own policies

In the early days of foreign investment, it was also argued that transnational corporations did not pass on their "best practice" technology to subsidiaries in developing countries Subsequently, it was argued that transnationals did not pass on "appropriate technology" More recently, the complaint is that transnationals dump their "dirty'" industries and production processes in developing countries Research results suggest that market prices determine the techniques that foreign investors, like domestic firms, use (Mason 1970, Lim 1976) If an economy is highly protectionist and thus not competitive, there will be no incentive for domestic or foreign firms to search for appropriate

technology If environmental controls are lax, all firms will be lax about controlling pollution Host country policies again turn out to be pivotal

Given a set of laws, it is essential that foreign investors are treated equally with domestic investors Not only is this a moral issue, but there are strong practical arguments against giving foreign investors privileges that domestic firms do not enjoy (and vice versa) Domestic firms will launder money to become "foreign" investors if this will give them subsidies that they cannot otherwise receive Likewise, giving Indian entrepreneurs special privileges over foreign investors is equally inequitable and inefficient Continuing with the reform program will attract worthwhile investors a considerable body of evidence showed that more than 20 years ago tax holidays and other incentives did not attract foreign investors More recent studies have reached the same conclusion Only those "fly-by-night" firms that move from country to country, exploiting tax holidays and other incentives (only to leave when they expire) are attracted

The main beneficiaries from tax holidays are the bureaucrats who administer them (Low 1992) An efficient and equitable tax system with internationally competitive corporation taxes is far more conducive to long-run investment inflows than incentives

Foreign investors are attracted by market opportunities (domestic and international), a clear legal situation, administrative speed and efficiency, internationally competitive taxes and infrastructural services at international prices They expect to have to train workers and work hard to increase productivity In light of the above, the counter-guarantee given to foreign investors in India regarding rates of return should be seriously examined It would not be a commercially sensible proposition to correct the basic failures of cost recovery through a hidden subsidy

Although some transnational firms prefer wholly or majority-owned branches or subsidiaries in their foreign operations, it

is widely held that some form of joint venture with a host country partner is advisable because of the experience and insights local partners bring Local partners are particularly effective in managing labor and dealing with regulatory issues

The type of firm attracted—whether it is a "fly-by-night" or "in-for-the-long-run," domestic or export market-focused, environmentally conscious or not—depends on the host country's price signals Whether the benefits of foreign investment exceed the costs, therefore depend on the host country's economic policy framework For instance, the absence of a fully liberalized financial sector with proper regulatory measures may further deter foreign investors

Regional imbalances are a major concern in most of the current debates There is a general feeling that industrialization under global competition asks for the best techniques and market environment and, therefore, may bypass backward areas at least in the transitional phase Here, a positive role of the government is called for Many of the fast-growing economies under liberalization, for example, China, are facing similar problems

But at the same time, international experience shows that expensive industrial targeting policies by any government to promote industry in the "hinterland" has generally proved to be costly and corrupt for many countries that have tried it It is hard enough to get rapid industrialization where it really belongs India does not have the resources to squander on promoting industrialization where it is not otherwise viable

The dilemma has to be addressed by recognizing country-specific local conditions, aiming for a proper balance between market forces and measured state intervention Maybe, a time-bound "transition period" approach is what must be adopted

Global competition needs high and best technology It has been found by many cross-country studies that high-tech has lower labor intensity In India, a major portion of the labor force

is employed in the small-scale sector with low and medium technology Current discussion brings out that many small-scale sectors are now being taken over by large firms and a significant proportion of the labor force in the informal sector are being thrown out of their jobs Its rehabilitation is becoming a problem and is raising social tensions Further, the labor laws of the country need to be reviewed Under given laws, there is an in-built preference for capital-intensive production

The potential of high employment in the service sector is being increasingly realized Indeed, the demand for services is seen to increase with an increase in standard of living of people India has a huge reservoir of manpower and skilled labor Proper nurturing and implementation of human development programs are needed to tap this potential Human development should be conceived not in a narrow sense (i e, only in terms of training and imparting skills), but in a broader sense by covering education, health, shelter and the environment Here, the debate brings back the role of government along with the private sector in allocating their respective responsibilities

Mostly, developing countries in the pre-liberalization days had a large and inefficient public sector, acting as a burden on the budget and resulting in poor resource allocation with distorted welfare implications Because of its involvement in areas where the private sector has a better comparative advantage, the public sector failed to fulfill its many basic obligations in key areas such as necessary social and physical infrastructure for growth and development of the economy One can therefore proceed in two directions (1) reduce or eliminate the nonmarket constraints and encourage public sector enterprises to behave like private sector firms, and (2) turn to privatization as a device for restoring economic efficiency in public sector firms

This means a careful study of each case, and of the potential market for each company being sold It means a knowledge of the weaknesses of the company in its present state and of possible

ways to correct such weaknesses But sometimes the source of the problem lies within the hands of the government itself, thus government should take steps to rectify the problem before privatization takes place When parts of a firm are nonviable, they too should appropriately be separated from the firm and perhaps permanently closed before privatization takes place Likewise, cases of obviously superfluous numbers in the labor force should be dealt with by the government before putting a company on auction

Finally, the policymakers must clearly demarcate the borderline between the public sector and the private sector When the two compete in a given area, the same rules should govern their operations

Vast numbers of companies in these border areas have been privatized in most countries over the intervening decade, intercountry experience suggests that rarely any one has moved in the other direction This appears to testify to an emerging consensus that activities that can appropriately be in the private sector should be in that sector This would define a borderline in the area of natural monopolies, which require significant regulation in any event

In such countries, the policy dialogue moves to a different plane, how best to privatize state enterprises, how best to regulate in those cases, like electricity distribution and local telephone networks, where regulation is called for One area where there is a crying need for improvement in industrial and developing countries alike is the social and economic cost-benefit analysis Vast amounts of public funds are still being wasted, all over the world, on projects that will never repay their costs, let alone yield a positive economic return Often, this is simply the result of the inability of the authorities in question to quantify and judge the relevant benefits and costs Sometimes, and sad to say not infrequently, outright corruption rises to further bedevil what would be a complicated and difficult process anyway Here one can cite

the example of the education sector in India, where in 1993–1994 the recovery rate has been hardly 3–4 percent, and in irrigation below 10 percent of the total cost

One useful device for correcting this is privatization One of the lessons we have learned from other countries is that it is dangerous for a government to use the proceeds of privatization to bridge an existing gap between public revenues and outlays This only postpones the problem of facing up to the underlying fiscal deficit The lesson that has been learned is to keep a clear distinction between stocks and flows "Patching over" the problem by selling government assets only postpones these necessary adjustments India's recent budget management does not speak well on this count

The indicated use of the proceeds of privatization (the sale of part of the stock of public sector assets) is to reduce the stock of public sector liabilities, i e , to pay off the public debt This has been carried out very successfully by a number of countries, most notably Mexico which imposed a rigid rule of not using a single peso of the proceeds of privatization to cover the fiscal deficit, and devoted all of it to debt reduction or similar operations on stocks (balance sheet items) rather than flows (income and outlay items)

Deregulation of the private sector is even more important than privatization of the state sector, with the proviso that government monopolies in key sectors—such as finance, infrastructure—must be reduced (de facto as well as de jure) This is to be noted if India is to achieve maximum private sector growth

A competitive environment for private business requires (1) flexibility in the hiring and dismissals of workers, (2) the freedom of entry of capital, including foreign capital, (3) the ready availability of land for new business activities, and (4) adequate infrastructure, including power, ports, roads, and telecommunications Moreover, local and state governments must have the

freedom to facilitate infrastructure to meet local needs in a rapid and flexible manner

According to Professor Jeffrey Sachs, the government of India has so far resisted the worldwide trend towards privatization of nonfinancial enterprises, relying instead on partial ideas of corporatization, divestiture of shares of up to 49 percent, Memoranda of Understanding (MOUs) on the management of state enterprises, new managerial incentive schemes, a limited concept of green field privatization ,and so forth No country in the world has figured out how to manage a large state sector This is why state enterprises have lost money in all countries, not just in the developing world

As noted by Professor Sachs, "A tested way to privatize is that workers in the enterprises should receive shares of the privatized enterprise, to compensate them for their implicit stake in the enterprises This could come, for example, in the form of 15 percent of the shares given free to the workers (based on seniority, wages), or 30 percent at half prices, etc Workers should receive their shares not as a group (e g , held by the union or in trust for the workers), but as individuals The shares should be freely tradable, management teams should also receive a small proportion of shares, perhaps 1-2 percent, depending on the size of the enterprise "

As noted by Professor Rolf Luders, in the Chilean experience, "to gain worker support, among other reasons, the government usually offered initially to the employees of these traditional SOEs, a percentage of the equity of the enterprise at a lower than (estimated) market price The share of the net worth offered to workers varied from company to company, mainly in relation to the wage bill to equity ratio of the enterprise, and tended to average about 6 percent Workers paid for the stock with the advance of 50 percent of the severance payment they were entitled to, an operation which had to be authorized especially by law If at the time of retirement, or before if pertinent, the worker still owned

the stock, and if the stock was worth less than 50 percent of the severance payment he was entitled to, the firm was forced to 're-purchase' the stock " These offers were in fact "no loss" situations in which, because of the discounted price of the shares, the likelihood of gain was very high It is, therefore, not surprising that the overwhelming majority of the entitled workers accepted the offer, very often even against the "instructions" of their union leaders, who were politically motivated

This success story on privatization tells us that the privatization process for the general public should be highly transparent and competitive Private sales to single bidders should be prevented An international review board (e g , headed by the IFC) could be contemplated as a way to give additional public confidence to the process The government should earmark a portion of privatization revenues for social spending (e g , for the National Renewal Fund, or some comparable scheme), so that the general public can see itself as a beneficiary of the privatization process The government should aim, where practicable, to sell some of the enterprise shares in public offerings to small investors to foster a sense of direct public participation in the process, which proved to be attractive in the United Kingdom in the 1980s

Existing workers would continue to enjoy the protection of the current regime New enterprises would be governed by the new law China has adopted this route rather successfully Even under the existing regime, new opportunities would be sought for collective agreements between the unions and the enterprises to best serve the long-term health of existing enterprises

In practice, however, the transformation of infrastructural enterprises from public to private ownership, whether domestic or wholly or partially foreign-owned, is fraught with many difficulties The market valuation of an enterprise is likely to be much lower than its "book" value, the costs of making it efficient are likely to be very high, and output pricing that ensures cost recovery is difficult, particularly in industries which subsidized con-

sumers in the past This has been also the experience in India where some of the early disinvestment schemes in the post-reform period has been brought to political and legal scrutiny If these problems are not tackled, foreign investors will demand profit guarantees, which can be extremely costly and which encourage gross inefficiency The costs of foreign investment in these circumstances is likely to exceed the benefits Some such experience is becoming common in India also, starting with the much quoted "Enron Case"

The Chilean privatization process was successful in achieving its objectives Perhaps the two most important of these were the spreading of ownership and the transformation of the private sector into the engine of development, so as to accelerate the rate of economic growth of the country and make democracy viable

Privatization needs a strong leadership and has to be carried out using divestiture modes which increase the support of different interest groups (managers, workers, etc) Credit sale to controlling shareholders should be avoided since it creates a moral hazard Privatization does not affect employment levels, efficiency does, and net fiscal revenues are likely to be enhanced with privatization, while fiscal changes will tend to be determined by the use governments decide to make of privatization revenues

Finally, perhaps the most compelling argument for SOE divestiture during the 1970s was the need to raise resources to finance the budget deficit In this aspect, the Chilean experience is not too different from that of most other countries To reduce this deficit and eventually generate a surplus, the government eliminated the SOE sector deficit by, among other measures, allowing SOEs to charge market prices for their products, inducing SOEs to distribute dividends, drastically reforming the tax system, raising average rates in the process, improving significantly tax payment enforcement, raising revenues through privatization and reducing public sector expenses But unlike the Indian case, the government was not willing to cut social expenditures (such as housing,

health, education, and social security), in spite of the fact that this had been growing rapidly under the two previous governments and had reached levels relative to GDP similar to those in the OECD countries Moreover, in contrast, the revenues from privatization were used to finance the desired level of social expenditure

Another important lesson from the international experience of privatization is that from a policy point of view, divestitures on credit to controlling parties in a country with very scarce liquid assets and no foreign investment will invite higher than reasonable bids

Privatization is often associated with unemployment If private enterprises seek to maximize profits, economic theory tells us they will, of course, try to minimize costs, including labor, for any given output State-owned enterprises on the contrary, as public choice theory postulates, tend to seek at the same time several objectives responding to different constituencies, objectives which often do not include efficient labor use and thereby, propagate the explicit and hidden subsidies in the system

UNFINISHED TASKS

There are still many unfinished tasks public sector reform and privatization, financial sector reform (including insurance sector reform), changes in the labor laws, reform of the urban land ceilings act, strengthening of India's civil, commercial, and criminal legal system, further trimming of bureaucracy, and development of sound public finance The reform process must also percolate down to the state and grassroots levels The agriculture sector and rural development must be brought into the reform agenda to ensure that benefits of the reform lead to poverty reduction, employment generation, and an improvement in the standard of living for the vast majority of Indians

India's major cities are held hostage by antiquated land laws that block urban renewal, profitable commercial real estate development, and an adequate metropolitan tax system based on property taxes Extensive rent control leads to remarkable patterns of land misallocation, such as vacant factories and undeveloped land in the heart of Bombay, and leads to the dilapidation of the inner cities, where building owners and real estate developers lack incentives to upgrade and renovate properties Moreover, the urban land system is subject to notorious corruption in addition to inefficiency At the same time, ceilings on land holdings in the countryside can be a significant obstacle to the development of agro industry

The test of reform, finally, comes from improved living conditions based on improved technology and increase of allocative efficiency It is not the changes in policies alone which justify any economic reform, but it is their effects on the real economy in terms of growth, distribution and general welfare of the people which should be the real test In this context, the importance of increasing total labor productivity has been emphasized by Professor Harberger and other distinguished economists Indeed, the right indication of optimal resource allocation is the reduction of real costs in a completely open and competitive world order In the growth experience of some of the very fast-growing economies, especially those in the East Asia Pacific, however, "input-intensive" growth process is observed Many economists, including Professor Krugman, feel that this growth is not a healthy sign and will not be sustained after a long period Professor Krugman even compared the East Asian growth strategy with the "input-intensive" earlier growth experience of USSR, which could not be sustained But one should remember that the present East Asian growth strategy is against the backdrop of an open, competitive economy—barring a short initial transition period—in contrast to the totally closed and controlled economy set-up of the erstwhile USSR The "input-intensive" growth process in many countries at the early stage of development had the benefit of

lower labor costs and kept the capital cost artificially lower with open competition, this benefit may not last Indeed, signs are there that faced with a higher cost structure, the Asia-Pacific countries are also becoming cost-conscious and are seeking higher factor productivity In this context, if we review the present growth determinants of India, we notice that India is neither showing a sizable increase in its domestic savings nor any visible increase in her total factor productivity Profits in some sectors often have been increased at the expense of a hidden subsidy in their inputs drawn to other sectors For example, the subsidies both in the economic and social services in India since 1991 reform have increased tremendously Sectors like education and health have a recovery rate of less than 10 percent and in the power sector hardly 40 percent Therefore, the visible increase of profit in the organized manufacturing should not be taken as a reflection of success in their total factor productivity The same trend is noticed in the external sector where the unit dollar value of Indian exports is not showing any significant decrease No reliable data or study of the movement of total factor productivity in India are available in the post-reform period Positive action is needed in terms of advance technology policy for improving the total productivity of the economy, supplemented by an appropriate organizational and institutional structure

The government should allow the private sector (both domestic and foreign) to provide the capital, management, and decisions on personnel matters needed to fuel the growth of the economy But this reduction in the role of the state should be balanced by a strongly increased role in one area human development The government has a particularly urgent role in spreading literacy and access to primary health care for all citizens, so that they may actively participate and benefit fully from India's economic transformation

Thus, simply calling a process a "reform" effort does not make it one Sometimes the authorities are genuine in their desire

to undertake reform, but they are politically constrained from making the necessary changes and end up announcing "reforms" which stand little, if any, chance of success On other occasions, the authorities may be genuinely committed at the start of a reform program, but withdraw their support in the face of opposition or of an initial economic performance less satisfactory than had been anticipated

A second point, which seems universal, concerns the initial conditions There have been two common characteristics at the outset of the reform programs First, there has developed a national consensus that the old policies were no longer working Second, most policymakers and informed citizenry perceive that there is an economic crisis, sometimes in an accelerating inflation rate and sometimes in balance-of-payments difficulties However, that had happened twice before in Turkey and in 1980 there emerged a consensus that there was no point in simply repeating the measures that had been taken earlier In Mexico, it was not the debt crisis of 1982 which prompted reforms, but the failure of growth to resume by 1985 that brought the realization that a crisis was at hand and something had to change

A third point about reform is that, if it is to be successful in stimulating a more satisfactory economic growth, it will be an ongoing process Initial reforms can, and usually do, bring some benefits (albeit often with a lag), but sustaining economic growth at a satisfactory rate normally entails a series of reforms Korea is still in the process of liberalizing financial markets and capital flows, to name just two areas where reform continues Moreover, there have been reforms in public finance, in the tax structure, in regulations governing equity transactions, and a host of other areas since the early 1960s Even industrialized countries continue to reform the deregulation of U S airlines and of financial markets in the U S , Europe, and Japan are but recent instances

The fourth point concerns the policy domains in which action is normally required fairly early in the reform process These in-

clude changes to make sure that the overall macroeconomic framework (including the nominal exchange rate, monetary and fiscal policy, interest rate policy, and the foreign trade regime) can be conducive to growth currently and prospectively, and the correction of any other underlying major distortions

If reforms were straightforward and guaranteed to deliver immediate benefits to all, it would already have been undertaken everywhere In fact, there are a number of problems associated with reforms that inevitably make the process a difficult one First, and perhaps most important, is that earlier policies build up groups with a vested interest in the continuation of those policies

International experience demonstrates that, to a considerable degree, entrepreneurs are able to adjust to altered incentives with much less difficulty than normally apprehended They are naturally resistant to the process, in part because it is unknown, and there is bound to be political opposition, but also by the nature of circumstances in which reform is undertaken Thus there is bound to be uncertainty as to whether reforms will be successful This issue is termed the "credibility" issue in reform literature Until people are confident that the new incentive structure will persist, however, they will be reluctant to invest in activities which are newly profitable The upshot is very likely to be a period during which economic activity is either declining or growing very slowly

I would like to conclude by quoting Professor Jeffrey Sachs from a paper submitted at a workshop in August 1994 "The most unfortunate mistake of governments engaged in economic reform is the belief that economic reforms are a painful necessity that are likely to be costly at the polls This is a simplistic view of a more complicated reality As a general principle, the electorate can sense the difference between a dynamic, honest government attempting reforms, and time servers It is generally politically tricky to clean up an inherited financial crisis (such as India's in 1991), since budgetary austerity is rarely simple to manage At

the same time, however, the public is usually grateful for an end to high inflation and financial uncertainty Most other areas of reform trade liberalization, stimulation of new labor-intensive manufacturing, improved infrastructure, even privatization can be made popular, except with narrow groups of vested interests "

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Foreign Investment in Developing Countries: Costs and Benefits

Helen Hughes

INTRODUCTION

Private direct foreign investment in a firm in a host country by a firm from another (home) country has attracted a vast literature Unfortunately, much of the early writing was ideological rather than analytical The costs and benefits of foreign investment flows were obscured rather than clarified But research on the effects of foreign investment in developing countries began in the 1960s and empirical studies, particularly with reference to the experiences of East Asia (Hill 1990) now provide clear insights into foreign investment processes and their effects

The Role of Foreign Investment

Foreign investment enables a firm—a transnational corporation—to extend its business directly into another country to produce goods and services for the host country and export markets For a time, such a corporation may use inputs from the parent firm, but the long-term objective is to create a flow of profits for the transnational corporation In a competitive environment, this generally means a rapid expansion of local inputs A government has to design and administer a framework that implements national economic, social and other objectives within which both domestic and foreign firms must operate competitively Transnationals, like local corporations, vary in efficiency and social responsibility, but if they are working in a healthy host country framework, they will contribute to its growth and other targets

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Unlike other capital flows, foreign investment is a "package" It contains capital, but also has a management, technology, and skill content Foreign investment is a major source of transfer and adaptation of new technology and it contributes to the creation of a wide range of skills The management content affects the design of products, the management of the production process, and the sale of products in the host country market and abroad It can provide access to international markets

New skills, technology and management are constantly being adopted by domestic firms in the Indian as in other economies Technical and management staff are trained at high levels at home and abroad, equipment is designed, imported and adapted, and new practices are adopted Foreign investment does not replace this process overall, particularly in a large country The bulk of productivity growth must come from the domestic economy as trade barriers are reduced and regulation is liberalized Foreign investment can only be effective at the margin, but economics teaches us that what happens at the margin, rather than on average, is important

Experience in developing countries suggests that "unbundling" the foreign investment package by borrowing capital through the international banking system, purchasing technology through licenses, and negotiating management agreements is less efficient in terms of productivity outcomes than the foreign investment package Mining operations are a notable large-scale examples In Zambia, for example, copper mines have gone bankrupt as a result of nationalization which involved replacing equity by debt capital and using management contracts instead of direct transnational corporation management Some domestic firm can use capital inflows in the form of debt, import foreign technology in the form of machinery and through license arrangements and hire staff trained and experienced abroad All these can be highly profitable for the individual firm and have high socioeconomic

returns for the economy as a whole But such measures do not substitute for the critical mass of a foreign investment package

A Cost-Benefit Approach

The evaluation of the impact of foreign investment on a host country requires a socioeconomic cost-benefit framework Cost-benefit methodologies use competitive international prices as a basis of comparison They focus on socioeconomic prices in contrast to the commercial prices that would be used for the evaluation of projects from a firm's point of view Social effects such as income distribution are taken into account Cost-benefit analysis may be applied before an investment takes place Large-scale potential foreign investment projects or groups of projects with marked externalities that will create a differential between socioeconomic and commercial prices can be undertaken as a guide to likely outcomes But because the future cannot be known, too much reliance cannot be placed on such exercises Their main use is to rank project priorities For most commercial projects, such analysis is not necessary once liberalization brings socioeconomic prices into line with competitive commercial prices Ex-post costs and benefits are more reliable, but calculating the costs and benefits of all past foreign direct investments for an economy as a whole in a general equilibrium framework has proved too large a task to be undertaken even in small countries Partial indicators, organized according to socioeconomic costs and benefits, have to be used in practice

Key Issues

Some orders of magnitude of foreign flows by source, destination and sector provide an introduction to the material covered in this paper Issues of concern to host countries are then considered As research results indicate that the most important deter-

minant of foreign investment outcomes is the host country policy framework, the macroeconomic, trade, industry and manpower policies are then examined The policy problems created by natural monopolies and externalities in infrastructure sectors are discussed The potential of foreign investment for exports is analyzed because of the importance of exports to the growth of the Indian economy The paper concludes with an examination of the impact of foreign investment on growth and income distribution

ORDERS OF MAGNITUDE

The reduction of barriers to trade and capital flows in the world economy since World War II has created an encouraging environment for investment flows among countries Trade and foreign investment go hand in hand Even very large markets such as that of the United States and the European Union are not large enough to enable firms to take advantage of economies of scale, product differentiation and competitiveness within industries Foreign investment has grown fastest among the industrial countries which have participated fully in the multilateral trade negotiations that culminated in the Uruguay Round

Widespread suspicion of foreign investment in industrial countries thus preceded the concerns of developing countries In Canada and Australia, where foreign investment inflows traditionally exceeded outflows, a debate about the impact of foreign investment has taken place since the 1920s The host countries feared that foreign firms would "exploit" their resources and their markets, presumably through monopsonistic and monopolistic pricing, attract skilled workers from domestic firms by paying high wages, and have an unfavorable balance-of-payments impact through remittance of dividends Interference in domestic politics was also feared In West Europe (notably in France), there was considerable questioning of foreign investment coming in from the United States in the 1960s The Coca Cola colonization

of French culture by transnationals was feared Coca-Cola is widely consumed throughout Europe, but national cultures flourish Interestingly, Switzerland, which, despite its small size has long been a country of foreign investment outflows as well as inflows, was not affected by concerns about transnationals In the 1980s, as investment inflows became significant for the first time into the United States, fears and uncertainties that were similar to those expressed in Europe a decade earlier surfaced The American way of life was also not affected

Total Flows

International flows of foreign investment began in the 19th century with investment in mineral and infrastructural (such as transport, energy and telecommunication) sectors in semi-colonial and colonial countries Investment flowed from relatively capital- and technology-intensive countries to relatively capital- and technology-poor countries In the 1920s and 1930s, as barriers to trade rose, foreign investment in manufacturing and services began to defend global market shares (Hymer 1976) After World War II, with trade liberalization, direct foreign investment in industrial countries increasingly exploited economies of scale and product differentiation The industrial countries grew very rapidly in the 1950s and 1960s Their growth since the 1970s has been more modest, but at 2–3 percent a year, is still much higher than at any previous time in history It is widely accepted that the growth of trade and increasing foreign investment contributed markedly to this growth

Foreign investment followed suppliers' credits as the first commercial capital flow to developing countries in the 1950s, mainly into highly protected manufacturing and associated services High protection encouraged "discriminating oligopoly" Transnationals sought to maximize overall profits by exploiting each protected market, though by competitive standards each

plant was too small to be economic by international competitive standards Transnationals' caveats prohibiting exports were common The host countries encouraged several entrants into limited markets to ensure competition Thailand, for example, at one stage, had granted 28 motor vehicle licenses This type of inward-oriented foreign investment was extremely inefficient and led to a serious balance-of-payments drain The host countries, notably in Latin America, were extremely unhappy with foreign investment outcomes, blaming the transnationals for the low or negative value added at international prices created by their own policies The transnationals obviously could not export out of inward-oriented countries Export performance carrots (such as tax holidays) and sticks (such as mandatory export quotas) proved useless

In the 1960s, foreign investment for labor-intensive exports began in a few outward-oriented developing countries As trade increased, freight and other transaction costs fell The transnationals focused on breaking down production processes according to labor, skill, technology and capital to take advantage of differences in resource endowments Caveats on exports vanished as the transnationals sought to produce most efficiently on a global scale The countries which were able to take advantage of the new foreign investment inflow opportunities, notably Hong Kong, Taiwan and Singapore, flourished In the 1970s, more developing countries followed this trend Mauritius was among the most successful In the 1980s globalization widened, with Thailand, Malaysia, Indonesia and China joining the stream

Current global foreign investment flows amount to some $900 billion a year About $50 billion, that is 6 percent of this total, goes to developing countries and the European, formerly centrally planned economies The flows are firm and market driven, with national borders becoming less and less important as liberalization proceeds

The flows of foreign investment are not a fixed "pot" so that if flows to one country increase, flows to other countries fall If opportunities arise, as they have in East Asia and Southeast Asia, the total flows expand India does not have to compete for a limited amount "pot" of investment, but it must provide the environment in which long-term investment will flourish

Flows to Developing Countries

Until the 1970s, Latin American countries were the leading recipients of foreign investment flows to developing countries Until the 1970s, more than half of total foreign investment flows went to Latin America Asia's share was modest But as Latin American countries ran into economic difficulties in the 1970s as a result of their inward orientation and macroeconomic imprudence, their share of foreign investment inflows declined East and Southeast Asian economies, in sharp contrast, maintained and extended the high rate of growth on which several had embarked by the 1960s Foreign investment flows accordingly shifted sharply to rapidly growing Asian countries

The importance of foreign investment varies considerably among countries At one end of the spectrum, Singapore relies heavily on foreign investment At the other end, the Republic of Korea avoided foreign investment almost entirely It was initially heavily inward-oriented and so feared the exploitation of its heavily protected markets by transnational corporations Local producers were unwilling to face the competition of foreign firms as liberalization proceeded But excluding foreign firms had many costs For example, Korean firms were encouraged to borrow abroad, often in the form of supplier credits, to purchase equipment This retarded the evolution of the domestic capital goods industry (Westphal et al 1979)

Investment Flows as a Share of Total Capital Flows to Developing Countries

The share of foreign investment in private capital flows going to developing countries also varies among countries and fluctuates with conditions in the host countries and in international capital markets The blowout in international capital market liquidity following high petroleum prices in the 1970s expanded the flows from banks to developing countries so that the share of foreign investment fell, the flows recovered, however, in the 1980s Foreign investment has settled down to about 40 percent of capital flows to developing countries

Table 1 Annual Flows of Private Direct Foreign Investment to Developing Countries, 1973–1976 and 1990–1993 ($US billion)

	Average 1973-76	Average 1990-93
Africa	1 2	1 5
Middle East and Europe	-0 9	2 6
Western Hemisphere	2 3	12 3
Asia	1 4	27 7
Total	4 0	44 1

Source International Monetary Fund (1994)

From a balance-of-payments point of view, foreign investment has an advantage in the responsiveness of servicing costs to economic conditions Whereas supplier credits and bank loans impose a fixed cost that has to be paid whether the investment made is profitable or not, dividends on foreign investment are only liable if the investment is profitable, providing, of course, that such an investment is not protected by trade barriers or domestic regulations Balance-of-payments problems arise if the

commercial returns to private investment are higher than the socioeconomic returns

Table 2 Total Private Capital Flows to Developing Countries, 1973–1976 and 1990–1993, ($US billion)

	Average 1973–76	Average 1990–93
Private direct foreign investment	4 0	44 3
Total private capital flows	44 3	121 1
Private direct investment share (%)	13	40

Source International Monetary Fund (1994)

The National Origins of Investment Flows

The United States dominated foreign investment flows in the 1950s and 1960s, although the United Kingdom and France had some interests going back to colonial days In the 1970s, the European countries and Japan became more active and a new source of foreign investment emerged in Taiwan and Hong Kong, mainly to Southeast Asia, but also further afield (Wells 1983) A few Indian firms joined this movement, mainly from Southeast Asian bases because they could not expand from India Hong Kong and Taiwan firms initially dominated investment in China when it opened up to world markets in the 1980s At the same time, foreign investment in other countries in the region expanded Foreign investors from the region are among the top two or three foreign investors in most Southeast Asian countries as well as in China and Vietnam

Foreign Investment by Sector

Investment in minerals, including petroleum, has retained a share of total foreign investment Indonesia led the way in devising agreements that gave an equitable share in mineral "rents" to the host country while satisfying investors Forestry has attracted investors, mainly within the region, but with growing policy difficulties as the socioeconomic costs of forestry become evident and had to be funded The mainstream of investment has been in manufacturing (in protected markets and for export), and in service industries such as tourism, the financial sectors and, on a smaller scale, in professional services Investment in infrastructure is now beginning to take place

POLICY PRINCIPLES

Discussion of the rules that should govern foreign investment nationally and internationally has been considerable Some clear principles have emerged Many of the difficulties faced by governments in handling foreign investment, and by the foreign investors setting up in a host country, derive from the absence of a clear civil, commercial and criminal legal system If a legal and administrative framework is in place—as it is in India—a strong basis exists for the entry of foreign investment The absence of a legal system leads to many difficulties This has been a particular problem in the formerly centrally planned economies

Given a set of laws, it is essential that foreign investors are treated equally with domestic investors Not only is this a moral issue, but there are strong practical arguments against giving foreign investors privileges that domestic firms do not enjoy (and vice versa) Domestic firms will launder money to become "foreign" investors if this will give them subsidies that they cannot otherwise receive Chinese publicly owned enterprises use transfer pricing at other than arms' length to become foreign investors in China, or they form joint ventures with foreign firms to benefit

from subsidies to foreign investors Giving entrepreneurs of Indian origin special privileges would thus be inequitable as well as inefficient Continued reform will attract the worthwhile investors among them without incentives

The structuring of a foreign investment (legal and administrative environment) becomes easier as economic reforms take place The need for administration is diminished In open economies, such as Singapore, Hong Kong or Mauritius, only minimal special foreign investment laws and regulations are necessary Administrative costs are negligible But India, like most developing countries, is faced with a transition period The experience of countries such as Indonesia, Malaysia, Taiwan and Thailand suggests that the transition can be managed well, though many countries have and are managing it very badly The faster an economy is reformed, the easier the management of foreign investment Regulations can be simple and their administration transparent The administrators become convinced that foreign investment can bring major benefits The administration of foreign investment has to be seen to be efficient and equitable (World Bank 1993) In a country of India's very large size, some of the regulatory environment has to be devolved to the states to avoid duplication and delays If the states fail to act responsibly, they will fail to attract investors

The scarcest resource in a transnational firm is the time of senior executives They will quickly lose interest in an investment if they cannot go into production quickly A textile fiber plant, even if it gives rise to environmental considerations, cannot afford to wait for seven years for the national, state and local governments to make decisions The rewards of a well-managed foreign investment environment lie in attracting the most productive, competitive and socially responsible investors These corporations have plenty of other investment opportunities

Arbitrary nationalization of foreign investment (with or without compensation) was a major obstacle to attracting foreign

investors, notably in the days of high commitment to economic nationalism Such fears have been greatly alleviated by the worldwide movement toward market-oriented reforms, but any renewal of arbitrary measures will greatly weaken foreign investors' interest The ability to repatriate capital and dividends is an essential component of financial reform, particularly in India, which has had difficulties in this area in the past

Tax Treatment

The International Chambers of Commerce argued strongly in the 1960s that developing countries should attract foreign investors with tax holidays and other subsidies such as subsidized credit and privileged access to protected domestic markets The International Monetary Fund (IMF) took up the tax holiday suggestion, but advised that incentives should be extended to all investors Many developing countries began to compete for foreign investment with incentives

A considerable body of evidence showed that more than 20 years ago, tax holidays and other incentives did not attract foreign investors (United Nations 1968, Hughes and You Poh Seng 1969, Vernon 1971) More recent studies have reached the same conclusion (Guisinger and Associates 1985, Herderschee 1995) Only those "fly-by-night" firms that move from country to country, exploiting tax holidays and other incentives only to leave when they expire, are attracted

Most serious foreign firms take some time to become profitable so that they benefit little from tax holidays If tax holidays are effectual, they are costly for the host country Foreign firms are conscious that tax exemptions undermine fiscal policy and hence, macroeconomic stability, which is very important to them The wastefulness and ineffectiveness of tax holidays has led the United States and Australia not to practice tax "sparing" When profits are repatriated to these countries, they become subject to

the tax not paid during a tax holiday This leads to a transfer of revenue from the host country to the United States or Australian treasuries

The main beneficiaries from tax holidays are the bureaucrats who administer them (Low 1992) Even if the administrators are honest, administering tax holidays and other subsidies creates jobs and power Bureaucrats thus form strong lobbies for the introduction and maintenance of foreign investment incentives An efficient and equitable tax system with internationally competitive corporation taxes is far more conducive to long-run investment inflows than incentives

Foreign investors are attracted by market opportunities (domestic and international), a clear legal situation, administrative speed and efficiency, internationally competitive taxes and infrastructural services at international prices Transnational firms understand that infrastructural services are likely to take time to improve in a developing country They expect to have to train workers and work hard to increase productivity But they consider that regulatory and administrative tangles are of a country's own making

Transfer pricing at other than arm's length among subsidiaries of transnationals—that is, the shifting of taxes to countries where tax rates are low—has been widely discussed Transfer pricing at other than arm's length is also a mechanism for circumventing foreign exchange and capital transfer controls Such circumvention undoubtedly takes place, domestic producers follow similar practices where regulations or the overvaluation of the currency encourage them to do so Double taxation agreements, corporate tax levels that do not discourage investment, low inflation and equilibrium exchange rates are the only effective ways of ensuring that transfer pricing takes place at arm's length

Is Ownership Important?

An inordinate amount of time has been wasted by bureaucrats and politicians on the proportion of ownership that foreign firms can have in a firm in a host country Some countries insist on 49 percent maximum foreign ownership, at least in some industries Only a few countries, such as Singapore and Hong Kong, take no interest in ownership levels

Although some transnational firms prefer wholly or majority-owned branches or subsidiaries in their foreign operations, it is widely held that some form of joint venture with a host country partner is advisable because of the experience and insights local partners bring Local partners are particularly effective in managing labor and dealing with regulatory issues Some form of joint venture investment is becoming increasingly prevalent

The linkages between ownership and management are very complex In some cases, having 10 percent ownership of a company will give control, in others, even a 60 or 70 percent share is not enough The optimum ownership structure is a business decision for investors It cannot meaningfully be decided by bureaucrats

International Regulation

The amount of effort and experience that has been expended on attempts at international regulation of foreign investment (including the settlement of disputes) could have given one of the poorer Indian states an excellent education system The base for sizable and successful foreign investment flows can only be provided by a host country's laws, regulations and administration These will differ from country to country over time No country will, sensibly, give up national sovereignty over important foreign investment issues

The European Union does not have uniform foreign investment laws in practice Foreign investment laws are very similar in Canada and the United States, but they are certainly not the same as Mexico's It remains to be seen whether the North American Free Trade Agreement (NAFTA) will be effective in this area The OECD failed to evolve a common, universally applicable framework The attempt in APEC reflects nothing more than a bureaucratic and political desire to put a regulatory content into what is a very successful club for the exchange of nonbinding views on important issues International regulation of foreign investment is on the World Trade Organisation's (WTO) agenda, but the WTO will hopefully have more important items on which to work

THE POLICY FRAMEWORK

Much has been written about the national characteristics of transnational firms A theory of export orientation—the "flying geese" pattern—postulated that Japanese firms systematically moved from domestic to export market orientation as they moved abroad (Kojima 1978, 1990) The facts only partially fit the theory The evidence suggests greater variation within national groups than between them Some firms are attracted to particular industries, while some specialize in high technology and some prefer capital-intensive investment opportunities, and vice versa Cultural national characteristics of language and behavior that appear to differentiate firms by country of origin generally turn out to be very superficial and have a negligible influence on performance compared to the effects of the domestic policies of the home countries The type of firm attracted, whether a "fly-by-night" or "in-for-the-long-run," whether domestic- or export-market focused, whether environmentally conscious or not, depends on the host price signals that firms face Whether the benefits of foreign investment exceed the costs thus depends on a host country's economic policy framework

Macroeconomic Policy

Macroeconomic policy is the "sleeper" of the economic framework When fiscal, monetary and financial policies are working reasonably well, they attract little discussion When inflation becomes endemic or financial "repression" (McKinnon 1973) leads to distortions in capital markets, savings and investment, then macroeconomic policies undermine growth and equity and becomes a cause of concern

India has some thirty years' history of macroeconomic prudence Despite the inherent difficulties of managing such a large, disparate and poor economy, despite the "repression" of the financial system, and despite high protection, price rises have been kept under control Exchange rates have hence been relatively stable This does not mean that fiscal or monetary policies have been perfect Revenues are poorly structured and reforms have been slow On the expenditure side, devoting a large proportion of revenues to subsidizing public enterprises, instead of to building human capital through education and health, is now widely recognized as a serious problem But international investors will give a "tick" to the important macroeconomic question on their check list for India A reasonably stable exchange rate is particularly important for potential exporters The exchange rate will remain overvalued (compared to the situation in a liberal equilibrium environment) because protection is high, financial markets are "repressed" and inflation is a problem, but expectations are that overvaluation can decline with budgetary prudence, falling protection and financial reforms

India has taken an important forward step with the freeing up of the capital account Another financial problem for foreign investors is the absence of a competitive banking system Most foreign firms, and particularly joint venture firms, rely on local facilities for short-term working capital (for wages and trade credit) Many developing countries have, therefore, permitted transnational banks to initiate competitive banking, often allow-

ing foreign banks to at least undertake banking for foreign-owned companies Where banking has not been "repressed," as in Malaysia for example, such measures have been unnecessary Thailand has used foreign banks to stimulate competition in banking In Indonesia, which had a severely "repressed" financial system until the reforms began in 1983, foreign banks played a crucial role in the transition from state-owned to market-oriented, competitive banking (McLeod 1994)

Merely permitting foreign firms to service foreign firms has a limited impact Domestic firms are encouraged to form joint ventures with foreign investors to gain access to banking services Some domestic firms will "launder" money to be able to establish themselves as foreign firms at home Financial sector reform, combining prudential regulation and inspection with competitiveness, is essential to ensuring high benefits from foreign investment

The stimulus foreign firms provide to domestic suppliers is a major benefit of foreign investment They not only provide a market, but often make training, technology and management inputs into supplying firms so that the latter can meet quality product standards If supplying firms cannot obtain the range of banking services that they require to expand, such efforts will be stultified The foreign firms will produce all their inputs in-house or import them

Trade Policy

Most of the costs of foreign investment are associated with the exploitation of protected domestic markets Transnationals have been, and are still being, attracted to highly protected domestic markets, in many developing countries This means that they may be profitable, sometimes highly so, even though they do not build plants enough to exploit economies of scale, do not choose the technology appropriate to the factor endowment of the

host country, and, with "tailor-made" tariffs, form cozy noncompetitive oligopolies Enforcing competitiveness in closed markets is, as India has found, extremely difficult whether the firms are domestic or transnational Productivity is low, value added at international prices tends to be low and even negative, and yet profits are likely to be high Exports are retarded Latin America has been a large laboratory for foreign investment on these terms A large empirical literature reflects the costs The Philippines had the same experience as Latin America The costs were compounded in all these countries by imprudent macroeconomic policies that led to high inflation

Some East Asian countries limited foreign investment for domestic markets during their protectionist phases (Taiwan and the Republic of Korea) Although Indonesia, Malaysia and Thailand had high protection de jure, de facto protection, as indicated by customs collections as a share of imports, was quite modest In these countries, protection was introduced relatively late, its coverage was limited and reforms started to take place in the 1970s and accelerated in the 1980s, when the reduction of protection sharply reduced the costs of foreign investment and pushed many firms into exporting The transition from an "inward" to an "outward" orientation was managed successfully

China is still in the first stage of foreign investment inflow, with most investment from Japan, North America and West Europe flowing into import-substitution industries China is also attracting investment into infrastructure, though few such projects have advanced to the implementation stage As indicated later, the much larger investment in exports in China, largely from Hong Kong and Taiwan, is informal

India thus has a great deal of experience to draw on in managing foreign investment as protection declines The most important lesson, underlined by the Latin American and Philippines' experiences, is that difficult though trade liberalization may be when protection has been entrenched for some forty years, lib-

eralization must proceed reasonably quickly if foreign investors are not to become part of domestic protectionist lobbies Deregulating the "small" industry sector will have to be an important component of liberalization in India The experience of the East Asian countries that have reduced protection despite a strong protectionist tradition, suggests that reform requires widespread conviction that protectionism impoverishes a country so that economic reform becomes a national, multiparty policy If populist appeals are not to undermine reform, this will require a major educational effort to change public awareness and mobilize voters for reform

Sectoral Regulation

Locational, safety and environmental regulations are necessary for the efficient functioning of industry, but these are a relatively small component of sectoral regulation India's complicated regulations, as in most countries, have their origins in attempts to offset "market failure " India's "double protection" of small industries by reserving more than 800 categories of goods to "small firms" is an example Protection for small industries originated from the same fear of large firms that led to heavy public investment in manufacturing to prevent monopolies from dominating the "commanding heights" of the economy In as large a market as India's, small and medium-sized firms are competing in many industries The regulations that were meant to preserve competition become instruments preventing the healthy growth of firms Large firms shelter behind the ensuring "double protection" through their subsidiaries and associated firms While this regulation persists, the evolution of suppliers for foreign firms will not be able to take place Overall, the post-World War II experience indicates that more "market failure" results from government intervention than from market limitations

The financial sector, as already noted, transport and telecommunications, professional services and media all have special regulatory requirements But most of these regulations are excessively detailed and contain much that is out of date The reduction, simplification and greater transparency to reduce the need for bureaucratic intervention is needed to ensure that India can obtain benefits from foreign investment quickly

Mineral industries, including petroleum and gas, create particular problems for investment because resource rents have to be divided between local landowners, the states and the central government Private firms also seek a share of such rents to compensate them for the riskiness of mineral exploration and subsequent mine development The efficient and equitable apportioning of mineral rents is thus an important aspect of the economic policy framework Indonesia and Malaysia have been among world leaders in dealing with foreign investment in petroleum, gas and other minerals Papua New Guinea developed mineral resource taxes to tax mineral rents (Garnaut and Clunies Ross 1983) With such policies in place, project-by-project negotiation can be avoided or minimized Forestry, fisheries and hydroelectricity also generate rents that require special consideration All these industries have environmental aspects that should be taken into account on a nationwide basis rather than investment project by investment project

Agriculture presents difficulties for foreign investment because of land ownership complexities Opportunities for foreign investment tend to be limited In some circumstances, such as in plantation industries, foreign investment in nucleus estates and processing facilities can provide a market for farmers and at the same time enable them to improve their productivity

Manpower Policy

Foreign firms are expected to bring training as part of their investment package, thus raising a country's skill level as the trained workers spread through the economy Sometimes, however, foreign firms are accused of not training workers, particularly those that can replace expatriate staff They have also been accused of being able to afford higher wages and better working conditions than local firms, and thus be able to "steal" the best workers, leaving local firms with high training costs Studies of foreign firms in developing countries report a wide range of behavior with regard to skill The dominant factor is openness Improving skills provides a competitive edge so that firms place a great deal of emphasis on training in their own firms and in firms that supply goods and services to them As workers' productivity increases, higher wages become justified Such training percolates through the economy In some countries, transnationals have made joint efforts with local governments to raise the levels of training This could be a useful model for some Indian states Attempts to regulate on-the-job training by corporations, in contrast, turn out to be costly and lead to rent-seeking by firms and bureaucrats

FOREIGN INVESTMENT IN PUBLIC GOODS SECTORS

Even open, highly competitive economies have some areas where commercial prices are not identical with socioeconomic prices, thus distorting the costs and benefits of investment, including foreign investment

Natural Monopolies

Many public goods sectors are natural monopolies In the provision of water, sewerage or railways, for example, there is only one least-cost line between two points that provides the most

efficient source of supply Technological development is fortunately leading to greater competitiveness Air and road transport competes with railways, telecommunications are no longer dominated by single telephone lines, and an electric distribution network may be supplied competitively from many sources But some natural monopoly elements remain in many public-good, infrastructural industries Working out a policy framework for such industries that ensures efficiency, and at the same time encourages foreign investment, is proving challenging in all countries

In the past, subsidies to public goods have attempted to alleviate poverty Low or zero prices of water for agriculture are an example, so is subsidized rural power It has been clearly demonstrated that such subsidies lead to the wasteful use of the product supplied and do not reach the poor, but benefit middle- and upper-income groups If foreign investment is to participate in infrastructural industries, such subsidies will have to be eliminated to ensure clear accounting in commercial and socioeconomic terms Otherwise there is considerable danger that some of the subsidies will leak, as they do now, to producing enterprises which would include foreign investment interests

Externalities

Many public utilities, infrastructural industries are also subject to positive and negative externalities which cannot be captured by operating firms Roads, for example, provide access to markets, schools and health facilities Telecommunications aid the development of business and can be used for education Bus transport also creates pollution The differences between private and social costs and benefits lead to differences between commercial and socioeconomic prices The most efficient way of account for socioeconomic costs and benefits is through the pricing system All industries should be charged, and should in turn charge,

full costs of cleaning up pollution Main through roads should rely on tolls, just as railways and other public transport charges should reflect total, but efficient, costs Singapore is an urban transport model for industrial as well as developing countries It relies on prices to minimize traffic congestion and pollution Regulations may be necessary in some residual situations where prices cannot be reasonably expected to operate For example, general emission requirements can establish "clean air" rules within which industries have to operate They can be reinforced by a price system in the form of fines related to the clean-up costs of offenses General rules that are simple and transparent are much more effective than bureaucratic project-by-project intervention

Public Ownership and Regulation

In the past, public ownership was seen as the answer to natural monopoly problems and to many externally created wedges between commercial and socioeconomic prices But experience suggests that publicly owned monopolies are often more inefficient than a privately owned monopolies, greatly disadvantaging consumers Corporatization—i e, the running of a public enterprise as if it were privately owned—had mixed results In some cases management improves, in other it does not

In practice, the transformation of infrastructural enterprises from public to private ownership, whether domestic or wholly or partially foreign-owned, is fraught with many difficulties The market valuation of an enterprise is likely to be much lower than its "book" value, the costs of making it efficient are likely to be very high, and output pricing that ensures cost recovery is difficult, particularly in industries which subsidized consumers in the past If these problems are not tackled, foreign investors will demand profit guarantees which can be extremely costly They en-

courage gross inefficiency The cost of foreign investment in these circumstances would be likely to exceed the benefits

Foreign investors are now moving into joint ventures with public enterprises, preferring corporatized ones, but still wary of public ownership Foreign investment with its capital, technology and management "package" can make a considerable contribution to the vast investment required in infrastructure in India Existing plants can be made more productive and new facilities can be provided, often on the BOT principle (build, operate and transfer), but governments and investors are still at the beginning of managing this process

FOREIGN INVESTMENT IN THE DEVELOPMENT OF EXPORTS

The weight of foreign investment in exports varies In Taiwan and Hong Kong, transnationals have played a significant role at the margin, but the bulk of exports come from local firms Hong Kong was traditionally an outward-oriented manufacturing entrepôt, exporting manufactures from China and importing raw materials into China In the late 1940s, many mainland Chinese manufacturers emigrated to Hong Kong and Taiwan, often with some of their skilled workers, and began to manufacture for export Singapore, in contrast, was an inward-oriented manufacturing entrepôt, importing manufactures for its hinterland and exporting raw materials to the world When Singapore separated from the Malaysian Federation in 1965, after a brief flirtation with becoming the industrial center of protectionist Malaysia, open unemployment was a high 13 percent, British military forces were about to withdraw and Indonesia's *Confrontasi* policy threatened to cut off its raw material supplies for processing and transshipment Singapore saw transnationals, then looking for export bases, as the only way to start exporting quickly By 1970 unemployment had been wiped out and Singapore was recruiting tem-

porary immigrants from neighboring countries to employ in its export industries More than 75 percent of exports of manufactures still come from mostly wholly foreign-owned transnationals foreign investment is also important but less dominant in tourism and financial service exports Singapore learned through bitter experience that to attract foreign investment effectively, bureaucrats had to follow market signals (Low et al 1993) The Republic of Korea, in contrast, had almost no foreign investment in its exports until it began to export motor vehicles Local entrepreneurs developed labor-intensive exports in Thailand (Saad 1993) and Indonesia (Suphat Supchalasai 1989) Transnational firms followed in both countries

India's ample resources of low-cost and skilled labor could make it a major export platform for labor-intensive goods for world markets, providing competition to China, Vietnam and the large South Asian countries Hong Kong, Singapore, Taiwan and the Republic of Korea are moving rapidly up the skill and productivity "escalator" The phasing out of the Multifiber Arrangement as a result of the Uruguay Round negotiations over the next decade will accelerate this movement Thailand, Malaysia and Indonesia are also following the path towards rising skill and remuneration, although Indonesia still has a large reserve of low-productivity, low-cost labor Preferences by West Europe to East European countries, and by North America to Mexico and other Latin American countries, will lower the growth of industrial country markets for Asian labor-intensive goods, but this is no cause for export pessimism New markets are opening up in the rapidly growing East and Southeast Asian countries Past experience shows that export pessimism is a self-fulfilling prophecy Countries with a pessimistic outlook have failed to export (Panoutsopoulos 1992)

India's continuing low level of exports ($25 billion) is a critical problem for the economy China's exports have risen from some $20 billion in the late 1970s to $165 billion in the early 1990s,

that is, within a decade Contrary to pessimistic predictions (Cline 1982, Streeten 1982), this was accomplished without reducing the exports of other Asian countries, and with a positive overall economic impact on other Asian countries (Cabalu et al 1991) Because a high proportion (some 40 percent) of India's exports consists of worked precious metals and other jewelry, the ratio of value added in exports may be lower in India than in China Whatever the measurement, India has a long way to go to export on a sufficient scale to overcome its balance-of-payments constraints once and for all The question whether foreign investment can assist in this endeavor is highly pertinent

Large transnational firms based in Japan, Europe and the United States have contributed little to exports in China (Yang Gang 1993) They often exported at prices that were below cost, at negative value added, merely to be able to repatriate profits earned in protected domestic markets, so that their exports were frequently a cost rather than a benefit to the Chinese economy The "formal," that is officially approved and registered foreign investors, were channeled into Special Economic Zones which were created at great public cost and where infrastructure and labor costs were high (Lin 1991) The large government-owned state enterprises in China are so inefficient that they are able to export only with large subsidies Official statistics do not make this clear because township, village and cooperative (a euphemism for privately owned) enterprises often still have to export through central or provincial government-owned enterprises

The large and rapid buildup of exports from China began in the late 1970s, before the "opening of China's door to the international economy," because small Macau and Hong Kong entrepreneurs were being squeezed by rising wages They moved into the Pearl river delta in search of low-cost supplies to meet their export markets They took over factories, supplied second-hand machines that were appropriate for low-skilled and low-cost labor, and managed them under the benign eyes of local cadres whom

they generously recompensed Productivity was rapidly raised by introducing commercial hiring and firing, piece work, shift work and quality controls The enterprises were profitable, The workers learned skills and earned steadily rising incomes After 1979, the trickle became a flood Taiwan entrepreneurs joined those from Hong Kong, with many going to Fujien province just across the straits from Taiwan Other East and Southeast Asian entrepreneurs joined them After initially ignoring the "informal" investors, official statistics now claim them among some 100,000 foreign firms operating in China At least seven million workers are employed in Hong Kong and Taiwan in informally owned enterprises These informal foreign enterprises have also begun to produce for the domestic market where they have improved product quality and reduced prices Some Chinese cadres have followed the export lead in township, village and cooperative enterprises which are estimated to have contributed most of the other four million workers in exports, making a total of 11 million export workers Production for domestic markets has benefited Hong Kong has become the entrepôt for an ever rising proportion of Chinese exports because of the facilities available in its open economy (Sung 1991)

Investment in export production has spread elsewhere within the region and beyond, driven by rising wages in the rapidly growing countries High productivity management and marketing expertise have found profitable export sites Singapore firms have moved into Malaysia and the Singapore Economic Development Board is developing satellite export zones in Indonesia and China Hong Kong, Taiwan and Korean investment has spread throughout the region, ranging from Thailand to the small islands of the Pacific Vietnam has become a major target Indian entrepreneurs operate in the region Mauritius exports were developed by Hong Kong, Taiwan, Indian and Pakistan entrepreneurs Hong Kong firms operate as far afield as Panama and the Caribbean islands

The new Asian foreign investors have added appreciably to the inputs that investment can make to exports India has a need for both the new exporters and the more traditional firms from Europe, the United States, Japan and other industrial countries It has several advantages for the export of labor-intensive goods and services In the short run, its legal system may be something of a handicap compared to the "anything goes" authoritarian environment of China and Vietnam But if the legal and regulatory systems are simplified and sensibly administered, the short-term disadvantage can be turned into a major long-term advantage in the form of a stable, equitable and transparent economic policy framework Infrastructural facilities, though limited, are better in India per head of population than they are in China or Vietnam The use of English is widespread Although literacy rates are still low overall, there is an ample supply of literate, and in some areas, skilled labor This has already enabled India to become a serious actor in software exports India's democratic tradition is an asset The rapidly growing East and Southeast Asian countries' experiences indicate that bureaucrats can be trained to support foreign investment for export

THE IMPACT ON EFFICIENCY, GROWTH AND INCOME DISTRIBUTION

Foreign investment can dominate a sector in a small economy, although the only example in Asia is manufacturing in Singapore In most economies, however, even in small ones such as Hong Kong, foreign firms only account for a small proportion of total production It is unimaginable that foreign investment could dominate any of India's twenty-two states, let alone the economy as a whole, if the domestic regulation and protection that have stultified growth are removed But because the contribution of foreign investment is not in transforming average productivity but in changing practices at the margin, it can be quite a small proportion of total investment and yet be very effective The of-

ten expressed fears of political intervention by transnational firms have proved to be unwarranted The search for evidence of such intervention has been considerable, but the evidence is negligible Transnational corporations, quite properly, make their political inputs in their home countries Their main political impact has been to free up trade worldwide in pursuit of globalization objectives They have been the most ardent lobbyists for reduction of trade barriers in their various parliaments during multilateral trade negotiations to the great benefit of developing countries

The Choice of Techniques

The introduction of new technology is often regarded as the key input that foreign investment can make to an economy But new technology in the sense of "best practice" technology is not always the most appropriate one for a low-income country For India, for example, seeking to expand its exports, the appropriate techniques may be highly labor-intensive, not particularly skill-intensive, but yet management-intensive Experience suggests that a country that uses techniques that maximize the utilization of its resources, will achieve rapid growth In a country with huge reserves of underemployed people, this means utilizing labor as effectively as possible As workers become more skilled, their incomes rise, productivity rises, and wages increase, but so do overall savings, and more skill-intensive techniques can be adopted High labor intensity obviously does not apply to all industries Petrochemicals used little labor even in their early, relatively labor-intensive stages of development But research evidence indicates that in most production processes, the range of techniques available for the production (including design and marketing) of a given product is quite broad The concept of the choice of techniques includes the whole production and marketing process Handloom weaving, for example, may not be able to supply mass consumption goods competitively at reasonable wages, but it may be appropriate for specialized clothing and tex-

tile markets in high-income countries at higher wages For mass consumption goods, more capital-intensive techniques that are nevertheless still relatively labor intensive compared to techniques in use in high-income countries, may be appropriate The range of techniques available is constantly changing, with an overall movement up a skill, technique and capital "escalator" But at any one time, some production processes are relatively labor intensive foreign investment can help in the search for appropriate techniques and their relationships to products and markets For example, foreign investors may be able to develop products and markets that make labor-intensive production, such as handloom weaving, viable with rising wages

In the early days of foreign investment, it was argued that transnational corporations did not pass on their "best practice" techniques to subsidiaries in other, particularly developing, countries It was then argued that transnationals did not pass on "appropriate technology" More recently, the complaint has been that transnationals dump their "dirty" industries and production processes on developing countries Research results suggest that market prices determine the techniques that foreign investors, like domestic firms, use (Mason 1970, Lim 1976) The evidence about environmental practices is similar (Low 1992) Foreign firms are likely to have access to the capital and technology necessary to control environmental pollution If an economy is highly protectionist and thus not competitive, there will be no incentive for domestic or foreign firms to search for appropriate technology If environmental controls are lax, all firms will be lax about controlling pollution Host-country policies again turn out to be pivotal

Competitiveness and Efficiency

The traditional fear of transnationals was that they would monopolize markets and thus reduce competition In some highly protected markets, this happened in the 1960s and 1970s as

indicated earlier The situation changed dramatically with trade liberalization The elimination of protection led to the collapse of cartels The number of firms operating was reduced and the scale of production of the remaining ones was increased to serve a world market The transition has usually been difficult to manage because it involved the transfer of workers between firms, industries and regions In open economies, such transition costs are avoided because they are continuous as industries evolve The implications are that firms should be clearly advised that protection levels are planned to fall Firms that gamble on policy reversal would have to bear the costs of their mistaken judgment

The slow growth and ultimate collapse of centrally planned and semi-planned economies has demonstrated that the only way to achieve high productivity—that is, to ensure efficiency in individual firms and the system as a whole—is to allow markets to operate In the production of most goods and services, this will lead to a high degree of competitiveness and efficiency, particularly if the large Indian market is opened to international trade As discussed, not all markets are competitive But governments are well advised to avoid regulating what are essentially competitive markets and to concentrate their energies on carefully crafted, simple and transparent regulations for markets that are subject to natural monopolies or large externalities that cannot be dealt with by market measures In a competitive market environment, foreign firms can contribute markedly at the margin

Growth and Income Distribution

When Kuznets (1955) postulated that economic growth would in the first instance lead to a worsening of income distribution, to be followed by improved income distribution at a later stage of development, he relied on his assessment of trends in the established industrial countries and emerging trends in the highly protectionist countries of Latin America His hypothesis had little

factual foundation Nevertheless, his views were popular with populist schools of development which saw worsening income distribution at every turn Intuitive populist views suggested that the success of market-driven economies had negative income distribution aspects Early research supported the Kuznets' hypothesis (Adelman and Robinson 1978)

In the 1980s, however, different but factually based conclusions have been derived from a very considerable body of research It has been demonstrated that sustained rapid economic growth leads to reduction of poverty and improvement in income distribution Poverty cannot be reduced and income distribution cannot be improved without sustained rapid economic growth (Rao 1988, Fields 1989, Bautista 1992, Mehdi Kronkaew 1994)

The principal mechanism of poverty reduction and improvement in income distribution is rising productive employment in formal sectors and its multiplier effect on informal employment Unemployment is down to 2–3 percent in Singapore, Hong Kong, Taiwan, and Korea The proportion of people living below basic needs poverty lines is negligible in all four countries In Thailand, one of the poorest countries in the world in 1945, the proportion of people living in poverty declined from 57 percent in 1963 to 21 percent in 1991 (Mehdi Kronkaew 1994) In Indonesia, another very poor and very large country, the proportion of people living in poverty has also been reduced to about 20 percent (Booth 1993) Exports of labor-intensive products have had a major impact on employment and earnings (Corbo, Krueger and Ossa 1985) This is true even in as large a country as China The impact on raising the productivity of workers in the informal sector as consumption grows is considerable The main impact of foreign firms is to raise efficiency and hence lower costs so that consumers can buy additional goods out of a given income, and in the medium term, out of their rising incomes The immediate employment effects of greater competitiveness that results from foreign investment may lead to job losses in a given firm, but

lower prices and rising incomes lead to market expansion In an overall, general equilibrium context, employment rises

As employment opportunities rise, underemployed labor can leave agriculture so that farming can become more productive per remaining worker Off-farm work expands in rural areas In East and Southeast Asian countries, agricultural output rose (though its share of total output fell) as the proportion of the work force in agriculture declined This, of course, is also the pattern of development in the more rapidly growing Indian states But overall Indian growth has not yet been rapid enough to affect poverty and income distribution on a broad scale

CONCLUSION

Opening the Indian economy to foreign investment is not a simple policy issue because India has only started on its economic reform process It will take time to liberalize the economy It would be totally unrealistic to wait until the process is completed to encourage foreign investors to come to India Much can be gained immediately both in domestic and export markets But foreign investors must be put on notice that the reform process is proceeding so that they accumulate losses if their main aim is to exploit remaining protection and regulation

The change needed in the outlook of the bureaucrats in the central and state governments to attract foreign investors is far from accomplished A transition from attitudes that regard foreign investors as ill-intentioned, grasping tycoons who want to exploit India to a recognition that firms are organizations interested in maximizing income in a global context, is far from complete Foreign investors have many opportunities They will not come to India if they are met with hostility and mazes of red tape A businesslike approach is not servile

The faster the reform process proceeds, the higher will be the inflow of foreign investment, the lower will be its costs and the higher will be its benefits Informing political leaders and the voters that the costs of not pursuing reform diligently are very high, particularly for poor people, has the highest priority

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Economic Liberalization and Financial Reforms in India: An Outsider's Perspective

Ronald I McKinnon

INTRODUCTION

Starting with India's as yet incompletely liberalized commercial policies, this paper addresses parallel financial issues for increasing productivity growth What is the order of financial liberalization—in money and banking, taxation, and the foreign exchanges—that best complements the reforms in foreign trade and domestic commerce? Recent events in Mexico suggest that a liberalizing economy may overborrow in international capital markets, which leads to a precipitate fall in domestic private savings and overvaluation of the exchange rate Given the current pressure from capital inflows through India's foreign exchange, what financial controls might be appropriate to forestall similar Mexican-type events from happening?

India's macroeconomic crisis of 1990–1991 saw public sector deficits and monetary expansion spiral out of control while foreign exchange reserves disappeared The subsequent successful effort to restore macroeconomic equilibrium under an IMF program became the unexpected catalyst for India's wide-ranging microeconomic liberalizations in foreign and domestic trade that have so pleasantly surprised the outside world The Indian economy is being partially deregulated, and the monopoly powers of government-owned (largely heavy) industry are being reduced, both by freer foreign trade and by allowing private investment into what were exclusive preserves of the state sector Judging by India's rapid increase in foreign exchange reserves—which increased by more than US$9 billion in 1994 and was fueled by ex-

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port expansion and capital inflows—foreign bankers, mutual fund managers, and corporate executives are now willing to bet real money on India's future [1]

The list of commercial reforms since 1990 under the Rao Singh government is impressive the abolition of import licensing on producer goods, currency convertibility on current account so that exporters get the full foreign exchange equivalent from their overseas sales, a reduction in tariff lines and tariff rates with a maximum rate of 50 percent in the March 1995 budget, the general abolition of industrial licensing for new investment (except for eighteen "reserved" industries), and the easing of entry requirements for foreign direct investment [2] Foreign investment approvals (not necessarily disbursements) rose from $5 billion in 1991 to more than $89 billion in 1994

On the financial side, the devaluation of the rupee in 1991 made Indian exports more competitive leading to an expansion in industrial output and foreign trade The fiscal deficit fell from about 9 percent of GNP in 1990–1991 to a projected 5 5 percent in 1995–1996, although it seems likely to be higher if all relevant spending items are included Together, the devaluation and the fiscal consolidation were sufficient to cut India's current account deficit from almost 10 percent of GNP in 1990–1991 to less than 1 percent in 1994–1995 Consequently, substantial capital flows have been reflected in the increase in official exchange reserves to more than $20 billion by January 1995 after being virtually zero in 1991 The resulting expansion of money and credit has kept inflation high the wholesale price index (WPI) continues to increase at 10 to 11 percent per year into 1995 despite the nominal ex-

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[1]Taken from revised text of a lecture given for the Indian Council for Research on International Economic Relations at the Oberoi Hotel, New Delhi, March 23, 1995 Thanks to S P Gupta, Rakesh Mohan, Huw Pill, and Arjun Sengupta for their helpful inputs

[2]See the chapter by T N Srinivasan in this volume

change rate being fixed at approximately 30 rupees to the dollar since 1991

Outside of official "priority" sectors for directed bank lending, interest rates in Indian capital markets in the market for government bonds, bank lending to large borrowers, and commercial bills have been largely liberalized and are now largely positive in real terms However, important deposit rates of interest on small savings accounts and, of course, on coin and currency yield a negative 10 percent at the current inflation rate

Liberalization has been associated with recovery from the 1991 crisis GNP is now increasing at a healthy 4 to 5 percent per year However, overall productivity remains low and India's economy is not yet that of an Asian tiger

LOW FACTOR PRODUCTIVITY AND INCOMPLETE LIBERALIZATION

Consider the ongoing microeconomic problem of increasing factor productivity Since the economy settled down in the early 1950s after the upheavals associated with independence in 1947, India's savings effort and consequent investment have remained high and remarkably good for a poor country Until the crisis of the late 1980s, consolidated fiscal deficits rarely exceeded 5 percent of GNP Despite the heavy focus on state planning and intervention at the microeconomic level, this fiscal moderation allowed the Reserve Bank of India to keep inflation rates modest by Latin American standards, with the WPI rising 6 to 7 per year India's private gross savings was fairly robust at 21 to 23 percent of GNP, and the deposit base of the consolidated banking was (is) substantial By the mid-1990s, the M^3/GNP ratio had grown to about 47 percent of GNP

Instead of the quantity of savings, the internal problem has been the quality of investment The productivity of India's capital

stock and its general use of labor and land remains low by international standards As a result, despite the reasonable savings effort, the overall rate of economic growth has also remained modest at least in comparison to the East Asian economic tigers Because most new investment (before 1991) went into state-owned industry or into the private sector which was also tightly regulated, productivity was low and would be so no matter what the nature of the domestic financial mechanism

Since 1991, important aspects of this low productivity are, of course, being addressed directly by the Rao Singh reforms Indeed, increasing domestic factor productivity is the principal rationale for the reforms themselves However, they remain incomplete On the trade side, widespread prohibitions on importing consumer manufactures and agricultural products remain intact, although imports of producer goods have been liberalized

The failure to decontrol the importation of consumer goods reflects two government concerns First, in true Gandhian style, small firms (i e , those with assets less than $200,000) have long been protected by setting aside consumer goods production for the domestic Indian market as their exclusive domain including most of light industry (umbrellas, footwear, and so on) Not only are foreign goods kept out by outright bans or quotas, but larger domestic firms, whether state-owned or private, are prohibited from entering a multitude of domestic markets reserved for the small-scale sector [3] And this set-aside has deep political roots In virtually every parliamentary district in India, dozens of these small-scale producers lobby to protect their positions in much the same way that farmers lobby in the United States

[3]To retain their eligibility to sell these reserved goods in the protected domestic market, these small firms must stay small! This is no Silicon Valley with firms starting small in modest manufacturing quarters to later become giant international companies

Second, if a wider variety of (foreign) consumer goods were suddenly to become available, the Indian authorities would worry, probably correctly, that this might stimulate excess consumption and undermine private savings Against this, the central government fails to tap adequately an important part of its natural tax base imported consumer goods I return to this problem of financial control in my concluding comments on completing the trade liberalization

Another major gap in India's economic reforms, a gap which also has important financial implications, is the rigid character of the labor market As is well-known, current labor legislation makes it next to impossible to lay off workers (in the organized parts of the economy) as a general retrenchment or cost-savings measure Even firing someone for disciplinary reasons is difficult In the words of Arjun Sengupta

> It is obvious that a policy of free economic entry in any sector cannot be successful if it is not matched with a policy of free exit If a production unit finds that it cannot be viable in the given conditions of the market, it should be able to wind up its business at reasonable cost Similarly, if there is overstaffing (so that) the unit can produce the same level of output with a lower number of people, the unit must be able to shed those staff in order to play the competitive game with efficiency (Sengupta 1994, pp 4–5)

The early liberalization experiences of Chile in the late 1970s and New Zealand in the 1980s, and the dismal unemployment rates in European countries such as Spain today, all show the result of failure to get conditions in the labor market right during a widespread liberalization of commodity markets with new competition from foreign and domestic firms Potential productivity gains from the trade liberalization are not fully realized, and additional strain is put on the financial system as the profitability of existing cosseted enterprises deteriorates

Finally, India's land use laws particularly in urban areas seem to be a significant restraining influence on productivity gains once commodity market liberalization is attempted Incredibly, Bombay, the commercial center of India's new but modest private-sector boom, has the world's highest rents for new office space, about $145 per square foot, exceeding those of even Tokyo at $143 and far above New York's $39 (see Table 1)

Table 1 The Bombay Bubble

City	Annual Rent per Sq Foot ($)
Bombay	145 51
Tokyo	143 51
Hong Kong	137 46
Beijing	88 25
Shanghai	80 27
New Delhi	69 72
London-West End	66 36
New York-Midtown	39 06

Source *Wall Street Journal* (1995)

The problem lies with two very restrictive laws on land use in India The first is the Rent Control Act, which makes it virtually impossible for a landlord to evict a tenant or raise the rent Statutory tenancy enables several generations to remain without a lease on the property they inhabit which is often in decaying old buildings in what would otherwise be prime urban real estate

The second is the Urban Land Ceiling and Regulation Act, which strictly limits the development that builders can put on a site in order to avoid stress on already impacted roads, sewage systems, and other infrastructure The few urban sites that are

available (those not subject to pre-existing rent controls) are only modestly developed and can command sky-high rents from business firms which must operate cheek-by-jowl with old buildings whose inhabitants are paying negligible controlled rents The result is tremendous crowding among the clerical staff of even major multinational corporations, which can only afford small offices (Brauchli 1995)

Clearly, serious gaps remain on the "real side" of India's liberalization program, financial policy alone cannot address them and they seriously affect productivity But they can also have serious macroeconomic consequences Because of an unnatural scarcity of prime land sites, for example, a mild economic boom coupled with mild inflation seems to be setting off an urban land bubble even outside of Bombay

STATE-OWNED ENTERPRISES A GROWING BAD-LOAN PROBLEM FOR THE BANKS?

Once domestic trade and commerce are deregulated, the financial regime becomes a more important factor in determining the efficiency with which resources are used Not only are the quality of the banks' loan portfolios and softness of enterprise budget constraints important factors, but the level and structure of real interest rates on both deposits and loans will have a first-order impact on the economy's productivity Good statistics are not available on the quality of the banks' loan portfolios But forced lending to priority sectors covering at least 40 percent of the banks' lending capacity has contributed to a considerable bad loan problem, which is worsening Not only is there politically inspired debt forgiveness to farmers, but major defaults and forced rollovers of the debts of large state-owned enterprises (SOEs) are still commonplace

In the pre-1991 regime, this softness of enterprise borrowing constraints was not inconstant with cosseting the state-owned

enterprises with exclusive licenses to operate as monopolies in particular branches of industry Although government political directives such as preventing layoffs often reduced the profitability of enterprises, their monopoly positions sustained it Loans could be rolled over with some assurance that the enterprises would stay in business to meet the interest payments even if they could not repay the principal But once the value of exclusive licenses of these parastatals is diminished by the freer entry of foreign and domestic competitors, then continuing with a soft-loan option is a recipe for a more explosive loss of financial control in the future Unless radically restructured, these SOEs will become less profitable and will make bigger losses as liberalization proceeds, and thus could become a much bigger liability to the banks Insofar as old enterprises are prevented from revamping their labor forces in response to pressure from new domestic and foreign entrants, this financial pressure will be exacerbated

In Eastern Europe after liberalization in 1989, the financial drain from loss-making, state-owned enterprises has been the biggest problem faced by the monetary authorities In China's otherwise very successful market opening after 1978, the losses of the state-owned enterprises covered by "policy loans" from the banks are the most intractable financial problem facing the People's Bank of China today

So far in the 1990s, old-line Indian state-owned firms have not faced such radical changes in relative prices or in competitive pressure as have their counterparts in Eastern Europe or China But with the much-needed liberalization well under way, the problem would seem to be potentially similar If Indian banking policies were changed at the outset to greatly harden any new lending to SOEs while rationalizing the position of outstanding debt, a time bomb in the monetary system would be defused

Unfortunately, the new 1995–1996 budget may be exacerbating the banks' weakness In order to keep his official projection of the budget deficit to just 5 5 percent of GNP, Finance Minister

Singh has opted to shift financing for a number of his antipoverty programs to the banks

> Mr Singh has directed the banks to finance 20 billion rupees ($635 m) of rural infrastructure projects that state governments cannot afford to complete He will also get the banks to pay for new schemes for village industries for the backward northeastern states, for handloom weavers, and so on He says he wants an increase in the number of subsidized houses for untouchables from 400,000 to 1m houses a year (*The Economist* 1995, p 40)

Without more detailed information on the current bad loan positions of both banks and enterprises, we cannot judge the scale of the problem, but it would seem worthy of empirical investigation by the Reserve Bank of India or the Planning Commission

REAL INTEREST RATES

India's inflation rate is now a bit higher than it has been historically with the WPI in 1994–1995 at about 10 to 11 percent per year The nominal interest rate structure for deposits and loans is somewhat fragmented Nevertheless important deposit, interbank, and (subsidized) loan rates are substantially below the inflation rate, free market lending rates are, of course, much higher For example, the standard savings deposit rate is 4–5 percent, and the one-year deposit rate is 10 percent Along with those on naked cash balances and checking accounts, these rates are all negative in real terms Outside of the priority sector or small-scale loan sectors, lending rates have been freed and are positive, in the neighborhood of 15–18 percent per year But the wedge between the controlled deposit rates and the (few) loans at market rates is large, and, in a number of special loan categories, controlled interest rates are closer to zero or less in real terms

Now that the Indian economy is more liberalized, the case is stronger for both raising deposit interest rates in real terms in the state-owned banking system and making them much more uniform The empirical evidence from other Asian economies is that the productivity of capital increases substantially when real deposit rates move from being negative to being moderately positive Would-be investors, particularly those in rural areas, no longer need to hold unproductive inflation hedges or make low-yield physical investments if they can hold liquid financial assets bearing positive real yields The possibilities for, say, farmers to self-finance farm investments or hold funds for unexpected contingencies are much better if inflation is absent and real deposit rates are positive Populist pressure on the government to provide cheap (i e, heavily subsidized) credit to small farmers can then be reduced, and such benign circumstances could provide an opportunity to eliminate such programs altogether

Against this, however, the Reserve Bank of India must avoid allowing a completely deregulated banking system that gravitates toward the other extreme Very high real rates of interest associated with distress borrowing, or overly optimistic estimates of future profitability, have afflicted Latin American banking systems several times in recent decades In the late 1970s in the course of a major disinflation, Chile completely deregulated the lending and deposit-taking practices of the commercial banks in the course of implementing sweeping real liberalization of Chilean industry and agriculture [4] Competition among banks for deposits, and among enterprises for loans, led to "real" interest rates (using actual rather than expected inflation as the deflator) of 30 to 40 percent But these interest rates were not sustainable and

[4]For an up-to-date description on the cycle of repression and liberalization, boom and bust and boom, in Chile since the early 1970s, see Bosworth, Dornbusch, and Laban (1994)

there was massive adverse risk selection low-quality risky borrowers supplanted more creditworthy ones

Further aggravating the Chilean problem was a massive inflow of foreign capital beginning in 1978 and lasting through 1981 in response to the (falsely) high domestic real interest rates on the one hand, and to the slowing rate of exchange devaluation in the face of ongoing residual inflation on the other The result was a boom in consumer goods and real estate, a sharp decline in Chilean private savings, and overvaluation of the exchange rate As is well known, Chile's financial mechanism collapsed in 1982–1983 with massive defaults on bank loans, a withdrawal of external capital, and exchange devaluation In 1982, Chile's GNP fell an extraordinary 15 percent (Amazingly, Chile sustained its liberalization and recovered but with some important new features added to its arsenal of financial controls)

Although not yet as well documented, the Mexican crisis of late 1994 and early 1995 had many elements similar to ones in the earlier Chilean experience In the course of an otherwise well-constructed trade liberalization and privatization program for state-owned industry in the late 1980s, the Mexican government prematurely privatized and lost control of the banking system The banks began to make speculative loans and bid for deposits at rates of depreciation of the currency Foreign financial capital began to pour in at these (falsely) high "real" rates of interest,[5] leading to continued monetary expansion and real exchange rate appreciation Based on selling deposits to foreigners, the banks were encouraged to lend even more and to assume undue foreign exchange risk as well as credit risk This inflow of financial capital expanded, either directly or indirectly, private consumption in

[5]Mexico also had the misfortune of being caught in the emerging markets bubble when many developing countries were inundated with an unhealthy amount of foreign financial capital Schadler, Carovic, Bennett, and Khan (1993) have systematically documented this phenomenon

Mexico with an explosion in the use of consumer credit cards Private savings fell from about 16 percent of GNP in the mid-1980s to only about 8 percent in 1994 Gross investment was maintained at modest levels by developing a huge current-account deficit, amounting to about 8 percent of GNP in 1994

Clearly, in a liberalizing economy, interest rates should be neither too high nor too low in a regime of strong, prudential regulation of the banking system Critically important is proper control over the capital account of the balance of payments[6] What structure of real interest rates should the authorities aim for as trade and industrial liberalization proceed? Starting from a position of (wholesale) price stability and strong restrictions on capital flows through the balance of payments, the policies of the high-growth Asian economies are instructive

During Japan's very rapid economic growth in the 1950s and 1960s, when her WPI was virtually stable, deposit rates of interest were 4 to 5 percent and the banks' standard prime lending rate was closer to 8 to 9 percent In the 1970s, Korea suffered from erratic price inflation of 20 to 25 percent and negative real interest rates with a fall in domestic private savings covered by heavy foreign borrowing However, at the end of Korea's very successful stabilization of 1981-1984, when wholesale price inflation virtually disappeared, a uniform bank lending rate of 10 percent was established Deposit rates of interest on three-month instruments were closer to 5 or 6 percent, domestic financial savings recovered, and foreign debt began to be repaid More extreme and probably unattainable in all but the most productive and rapidly growing economies was the interest rate structure in Taiwan In

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[6]Both in my earlier book, *Money and Capital in Economic Development*, 1973 and the more recent *The Order of Economic Liberalization Financial Control in the Transition to a Market Economy*, 2nd ed (1993), I stressed the idea that, in the sequencing of financial reforms, the liberalization of the capital account normally comes last

its era of very high growth and stable wholesale prices of the 1960 and 1970s, long-term deposit rates were 8 to 9 percent and standard loan rates were about 11 to 12 percent

But such high real deposit rates are only feasible if the economy is liberalized and growing fast, and the banks are not encumbered with nonperforming loans or low interest assets Indian banks have a 15 percent cash reserve requirement to help finance the government, and they must hold secondary interest-bearing reserves equal to another 31 5 percent of total assets Therefore, bringing the fiscal deficit down further by allowing a reduction in reserve requirements would narrow the wedge between deposit and loan rates, (in the correct order of liberalization the government's fiscal position must be improved before reserve requirements can be safely reduced) But even if official reserve requirements were negligible, the bad loan positions of the banks would still require a large spread between deposit and lending rates Here, an assessment of the banks' bad loan position accompanied by possible restructuring becomes doubly important

The Indian government is trying to make progress with the bad loan problem and inject more capital into nationalized banks This is all to the good With the lifting of ceilings on lending rates of interest to large borrowers outside the priority sectors, however, the RBI has to be even more vigilant with prudent regulations to prevent adverse risk selection Although their repayment prospects are dismal, straightened borrowers in the previously protected industries might volunteer to borrow at high interest rates Or newcomers with highly risky prospects might agree to high interest bank loans, but it would be better if they get their finance from personal savings, the emerging primary securities markets, or the traditional informal curb markets as in Taiwan and Korea two decades ago

INDIA AND THE OVERBORROWING SYNDROME

Insular economies that embark on a major domestic liberalization and opening to foreign trade bear substantial risk of suffering from what I call "the overborrowing syndrome" First, foreign and domestic entrepreneurs are suddenly given the opportunity to combine modern production techniques with low-wage labor to produce a wide variety of good and services for world markets In these newly opened industries, substantial discrete start-up costs lead to major demands for foreign and domestic finance as well as foreign technology Second, if the reforms are credible, people project that their future incomes will be higher, and their prospects brighter, than previously believed Thus they may borrow against their imagined higher future incomes if the capital markets will accommodate them in order to increase current consumption

But nothing I have yet discussed indicates overborrowing If (1) these projections of high investment payoffs and higher future household income are fairly certain, (2) individual enterprises and households have hard-budget constraints where repayment of debt is strictly enforced, and (3) the banks and other financial institutions are free of moral hazard associated with deposit insurance and low or negative net worth, then otherwise unrestricted borrowing by households and firms should improve Indian welfare True, current domestic savings might fall even as an investment boom is taking place But if (1) and (2) hold, the capital market will naturally limit "excess" consumption in the form of say, consumer durables, and also limit "excess" investment in producer goods

However, if the three conditions are violated, then the economy is prone to the overborrowing syndrome as mentioned above for Chile in the late 1970s and Mexico in the last five years Too much foreign capital can generate huge current-account deficits,

exchange rate overvaluation, a collapse in domestic savings, and a future debt crisis [7]

At this stage in India's liberalization, massive private overborrowing in the mode of the full-blown syndrome is not evident In 1994, large inflows of foreign capital built up India's exchange reserves by $9 billion and contributed to excess monetary expansion, but this cooled in 1995 (Perhaps the Mexican crisis, which frightened foreign financiers, was good for India!) Relative to the size of the Indian economy, these private flows are not yet large However, they are large enough to pose a problem in properly aligning the exchange rate with domestic interest rates

Nevertheless, because weaknesses in the financial system caused conditions (2) and (3) to be violated, India faces a serious incipient or potential problem of private overborrowing That is, the failure to enforce repayment of debt leading to soft budget constraints for farm households and many enterprises and the shaky net worth position of the banks, together with considerable uncertainty about how successful the liberalization will be in raising incomes, mean that India could be prone to private overborrowing if the authorities relaxed their vigilance Thus, certain policy measures for inhibiting the overborrowing syndrome—such as reserve requirements and other restraints on inflows of foreign financial capital, limitations on consumer borrowing (particularly the spread of bank-based credit cards), and so on—are appropriate for India at the present time

[7] The nature of a full-blown business cycle based on excessive foreign borrowing, and what to do about it, is laid out in a much longer paper on the subject (McKinnon and Pill, forthcoming)

INDIA'S CURRENT MACROECONOMIC DILEMMA A CONCLUDING NOTE ON LIBERALIZING IMPORTS OF CONSUMER GOODS

More pressing, however, is the more traditional developing country problem of reining in government budget and off-budget deficits in the course of disinflating the economy and completing the liberalization of foreign and domestic trade Since early 1993, the exchange rate has been constant at about 31 4 rupees to the dollar, while the rate of inflation has proceeded at about 10 to 11 percent per year Whether or not this exchange rate is sustainable is one question, but closely related is the dilemma of getting Indian interest rates right

We saw that it was important for real deposit rates of interest to be positive in order to increase productivity, and to help small firms and farms to finance themselves without depending on subsidized credit Yet if the inflation rate remains at 10 to 11 percent, setting a nominal interest rate of 12 to 15 percent (to make rates positive in real terms to Indians) would allow foreigner depositors to see an apparently enormous real rate of return if the exchange rate remains stable, and unwarranted capital inflows would be provoked Even the existing free-market lending rates of 15 to 18 percent look unduly high and appealing to foreigners if they anticipate no change in the rupee/dollar exchange rate So there is a case for raising real deposits rates by strenuously disinflating rather than by raising nominal deposit or loan rates very much

But disinflation depends on the government greatly improving its revenue position on the one hand, and on the avoidance of a further increase in foreign exchange reserves that increase the monetary base on the other Progress can be made on both fronts if the government decides to replace its manifold quantitative restrictions on imports of consumer goods with a high and fairly uniform (revenue) tariff, say 50 percent Allowing consumer

goods imports could also significantly broaden the base of purely domestic sales taxes such as the VAT

So we have an outcome worthy of Dr Pangloss The opening in the balance of payments for consumer goods would help dampen any subsequent buildup of foreign exchange reserves, and the enhanced revenue position of the government would allow it to reduce its own debt issue while lessening burdens such as reserve and priority lending requirements on the banks In this best of all possible worlds, disinflation could proceed while keeping the stable rupee exchange rate as a (weak) nominal anchor

APPENDIX THE OVERBORROWING SYNDROME

When undertaking reform and stabilization programs, countries are prone to excessive foreign borrowing, which ultimately proves unsustainable This phenomenon has been variously labeled the "overborrowing syndrome" and the "Walters' Critique" This appendix is a nontechnical summary of a longer paper by McKinnon and Pill (forthcoming) on the subject

The McKinnon and Pill paper outlines a model, consistent with rationality on the part of private agents, where financial market failure causes short-run deviations from sustainable behavior Because banks fail as efficient information conduits between depositors and borrowers, excessively optimistic expectations about the success of reform are created among domestic residents, international investors, and the policy authorities Initially such optimism is borne out by improved economic performance and large inflows of foreign capital It is only later that sustainability conditions bind and the economy collapses into a recession, financial crisis, and capital flight

The boom-and-bust cycle associated with excessive foreign borrowing in Mexico (1989–1995) is a case in point But LDCs,

such as Chile in the late 1970s and early 1980s, offer many other examples Even mature industrial countries embarking on what seemed to be highly credible liberalization programs—such as Margaret Thatcher's Britain in the 1980s or Spain after 1987—were swamped with capital inflows as stock and property markets boomed, before having to devalue in an economic downturn with asset deflation as capital flowed out

Some Stylized Facts

Although all of these factors are not universally associated with overborrowing problems, the main distinguishing features of an overborrowing episode include

- Rapid growth of domestic credit, largely financed out of capital inflows intermediated through the domestic banking system, leading to higher levels of domestic consumption
- Widening of the current account deficit on the balance of payments, when greater availability of financing from abroad eases balances-of-payments constraints
- Weaker domestic monetary control and rising or sustained high domestic price inflation, typically associated with the inability to sterilize capital inflows
- Appreciation of the real exchange rate, appropriately defined, with higher inflation concentrated in the nontradable goods sector, prices of domestic assets, especially land or housing prices, typically increase
- Growing deposits from overseas placed with the domestic banking system increase pressure on the government to broaden the base of insured deposits

- Greater vulnerability to adverse shocks from the buildup of foreign debt, and increased likelihood that the stabilization program will be derailed
- The overborrowing episode culminates in a financial crisis, capital flight, and recession often forcing an uncontrolled, deep devaluation of the currency followed by a resurgence of inflation

A fiscal improvement (consolidation) would normally be expected to reduce capital inflows as the total public borrowing requirement falls and less public debt is sold abroad In the context of an overall liberalization program where the economy is apparently escaping from repression, however, fiscal consolidation apparently acts as a signal to international investors that the overall reform program is credible as if the government was indeed getting the order of economic liberalization right (McKinnon 1993) As such, it simulates capital inflows

The Model

An explicit two-period intertemporal optimization problem for consumption and investment decision is the heart of McKinnon and Pill's theoretical framework Its formal structure explicitly describes the nature of information conditions, the special role of the banking system, and the nature of market failure in the banking system This micro foundations approach focuses on a very specific form of market failure, namely, that induced by government guarantees of bank deposits Although future incomes are particularly uncertain in the liberalizing economy, deposit insurance or other bailout provisions for the banks induces economic agents to act as if bad outcomes were not possible Thus, they act as if their gains in expected income in the future are higher than any fair bet would suggest, and they borrow too much to support current consumption and investment This analytical approach does not, however, handle broader macro-

economic issues such as the control over the money supply or exchange rate policy Indeed, the results are robust in the sense that they would hold no matter whether exchange rates were fixed or floating

The formal structure introduced by the adoption of a microeconomic foundations approach focuses attention on the forward-looking aspects of the model If a rational-expectations approach to solving the model had been used, this would rule out the short -term deviations from sustainable behavior that appear to characterize the data In this context, the rational expectations paradigm is an intellectual straight jacket rather than an aid to understanding the issue at hand Because rational expectations require all participants in the economy to share the same structural model of economic behavior, it rules out the possibility that certain agents could become overenthusiastic about the nature of the reform process and thus undertake what turns out to be suboptimal intertemporal choices when the true underlying model of the economy is revealed Within the rational expectations framework, on average an individual's expectations of his future income will be correct the problems associated with overborrowing are just a manifestation of bad luck Yet overborrowing recurs in all types of countries undertaking reform programs This suggests that a more systematic force than pure luck is at work In explaining the self-sustaining macroeconomic forces underlying the creation and maintenance of a "triumphalist euphoria" among firms, households, and even the government in the reforming economy, the McKinnon and Pill paper suggests what these systematic effects appear to be

The rational beliefs approach,[8] if adopted, both encompasses and extends the notion of rational expectations Persistent deviations from long-run sustainable behavior are possible if the model

[8]Associated, in some unpublished paper, with Mordecai Kurz of Stanford University

on which they are based cannot be refuted with observable data Since our two potential models—one embodying market failure in the financial system and the other reflecting an especially favorable realization of the underlying productivity shock—are observationally equivalent when consumption and investment decisions are being made, neither can be refuted with observed data when decisions are made Therefore, both are consistent with the equilibrium implied by rational beliefs Individuals make intertemporal decisions that are ultimately inconsistent with long-run sustainability, but which appeared sustainable in the model of the economy believed to be true when the decisions were being taken There is nothing irrational about such behavior, it merely turns out to have been wrong ex-post

More important than this theoretical nicety, this approach appears to capture the essence of behavior during overborrowing episodes Domestic residents become enthusiastic about the success of the reform program The reasons for this enthusiasm include the loose state of domestic credit conditions, which are typically interpreted (explicitly or implicitly) as a signal from the financial system that the reform process is achieving its desired results Domestic firms and households borrow, consume, and invest heavily since they believe that the possible returns have increased The enthusiasm for the reform process is initially substantiated by the buoyant state of the macroeconomy and the associated large inflows of foreign capital

However, the signals from the financial system may have been wrong for several reasons We focus on market failure issues relating to deposit insurance Other explanations would include inexperienced and naive bank employees, poor management, internal control, and audit systems, and fraudulent behavior by bank staff Eventually, the true underlying state of the economy is revealed (possibly exacerbated by an unlucky shock) and the unsustainability of earlier behavior is apparent A sharp correction is then required, which is generally associated

with financial crisis among overextended banks, default on outstanding debt, exchange devaluation, falls in aggregate demand, and a prolonged recession

Policy Implications

How should policymakers respond to the possibility of overborrowing in the course of an otherwise successful liberalization program? Improved banking regulation with higher capital and reserve requirements could help However, such measures are unlikely to prove fully effective, given the banking industry's inherently asymmetric information structure The authorities may wish to undertake other financial controls to limit the potential for damage should overborrowing arise Controls on cross-border movements of financial capital are one appropriate tool This summary of policy options draws on the experience of East Asian countries that have successfully liberalized

- *Restrain short-term capital flows,* particularly those intermediated through the domestic banking system (as in Japan in the 1950s and 60s) The preferred policy instrument is probably reserve requirements rather than direct administrative controls These level the playing field between domestic and foreign sources of funds and are harder to evade Marginal reserve requirements could be increased if capital inflows become unduly large
- *Be more liberal with "direct" investment,* perhaps in the form of joint ventures with domestic partners Direct investment brings new technology into the economy and bypasses the banking system—thus avoiding the market failure problems discussed above
- *Limit organized consumer borrowing* say on bank credit cards and restrict access to mortgage finance (as in Japan and Taiwan through the 1970s) Such measures

should help to prevent runaway excess demand for consumer durables and nontraded services that may reignite inflation

- *Consolidate compulsory social security contributions into a Singapore-style provident fund* A fully funded compulsory savings program geared toward preventing the dramatic falls in private savings seen during overborrowing episodes should be considered earlier rather than later in the liberalization process

After the overborrowing debacle in the late 1970s through 1981, all of these measures were subsequently introduced into Chile during the 1980s During Chile's successful recovery in the 1990s, these measures have helped to sustain domestic savings and prevent exchange rate overvaluation when pressure from capital inflows, now largely incipient, again becomes very great Earlier, the example of several successful East Asian economies in avoiding the overborrowing problem during their liberalization programs in the 1960s and 1970s suggests the policies conclusions of our analysis are appropriate in the context of stabilization and liberalization policies currently being introduced in Latin America, India, Egypt, and else where

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Development and Trade Policies in Stages: Pathos and Logos of Development

Shinichi Ichimura

INTRODUCTION

This paper presents a summary and reflection of the development policy experiences of Japan and other Asian countries during the post-World War II period and thereby tries to offer a frame of reference for examining and designing the development policies of other Asian countries, including transitional economies

The Japanese economy grew in terms of per capita GNP from $300 in 1948 to $12,750 in 1987 and nearly $30,000 in 1992 in terms of constant dollars (using the official exchange rate prevailing around 1990) This implies that the average growth rate of the Japanese economy over the past 45 years is about 11percent The Japanese economy achieved this growth while transforming itself from a war-time controlled economy to a predominantly free, private enterprise economy and from a poverty-stricken, pre-modern state to a modern, post-industrial society in only several decades Perhaps this demonstration is the greatest contribution of Japan to other Asian economies In addition to being a demonstration of growth performance, Japan's experiences also offer a rich jewel box of policy instruments An authoritative study (the Hla-Myint report) undertaken by an Asian Development Bank study group just before the 1970s predicted only a modest 5 5 percent growth rate for the East and Southeast Asian countries for the 1970s Yet, the actual performance turned out to be 7 4 percent Moreover, the East and Southeast Asian countries achieved faster growth

than any other economies in the world, whether industrialized or underdeveloped and including the oil-rich Middle Eastern countries This suggests that the performance of Japanese and Asian economic development was successful and satisfactory on the whole, but there have been many failures in the past or there can be much to improve upon Indeed, with better policies, Asian development could be far better than it was in the past

To explain the issue that Japan faced in each period and the policy instruments that she employed to resolve problems is the main purpose of this paper Japanese economic policies differ from the policies of the United States and Europe in many ways While the latter's policies followed, more or less, standard textbook Keynesian economics—in the case of the English Labor Party, the ideas of the welfare state—Japanese policies have basically reflected a search for the ways and means to develop an underdeveloped economy to a prosperous, industrialized economy that is comparable with the West In this sense, Japanese policies would be much more relevant to the Asian and other developing countries than the policies advocated in American textbooks

The postwar Japanese economy has gone through characteristic periods The economic performances of the Asian countries over the last several decades have surprised everyone in the world Asia was once known as the place of oriental despotism and was characterized by widespread, irreducible poverty Even as late as 1968, the Asian drama was conceived as a tragedy of stagnation by the best-known authority, Dr Gunnar Myrdal (1968) It did not take much time, however, for this pessimism to gradually yield to optimism as most Asian underdeveloped countries began to follow the lead of the fast-growing Japanese economy

FACTORS BEHIND JAPANESE AND ASIAN RAPID ECONOMIC GROWTH

A summary of the main factors explaining the successful development of the Japanese and Asian economies would be useful in explaining which policies are relevant

Ten Factors behind Japanese Economic Growth

The rapid growth of the Japanese economy may be attributed to the following ten factors (1) a high rate of capital accumulation, (2) a high rate of saving, (3) an industrious and well-educated labor force, (4) a high rate of growth of agricultural production, (5) quick learning and improvements on foreign high technology, (6) excellent management and labor relations, (7) adequate fiscal and monetary policies, (8) an excellent guidepost of government industrial policy, (9) the banking sector's excellent counseling functions with private enterprises, and (10) political stability

Most of these factors require no explanation and clearly explain the mechanism or logos of rapid growth What is relevant and important is that the factors responsible for the economic development of the Asian economies are very similar to those mentioned above [1]

Ten Factors Behind Asian Economic Development

In another context, I had occasion to discuss the factors behind the Asian economic development experiences in "The Pattern and Process of Asian Economic Development," in *Challenge of Asian Developing Countries* The following ten factors were identified with the Asian development experience (1) a high rate

[1]The interested reader may be referred to Ichimura (1970, 1989)

of capital accumulation, (2) a high rate of saving, (3) the successful transfer of technology that is appropriate for Asian agriculture and manufacturing industries in each stage of development, (4) good quality of the labor force and a declining fertility rate, (5) export-oriented, development strategies in open economies, (6) the locomotive roles of the United States and Japan, (7) relatively sound fiscal and monetary policies, (8) tolerable distribution of income, (9) a steady buildup of bureaucracy and private enterprise as required in every stage of development, and (10) infrequent occurrence of social unrest and political instability

The relative importance of these factors differs from one country to another and from one stage of development to another In the early stage of development, the contribution of mobilizing surplus labor or disguised unemployment is very significant But the surplus labor will be exhausted quickly unless the economy successfully reallocates various domestic resources and investment from abroad to more efficient industries The success of the Green Revolution in most Asian countries was brought about not just by mobilizing the surplus labor in rural areas, but also by introducing new technology and new inputs like chemical fertilizers to remote areas including paddy villages in Java The pessimistic views of Paul Krugman or Kunio Yoshihara do not seem to be supported by evidence from the East and Southeast Asian countries thus far

The human elements included in reason (4) are especially noteworthy in comparing the experiences of the other Asian economies with the underdeveloped countries in the rest of the world A brief discussion of the economic policies of respective governments is given, though there remains much to be desired After the discussion of these aspects, some remarks will be added as to the common features of Japanese development and Asian development These are (a) acceleration and deceleration of the growth rate and (b) income distribution in Asian economies

Seven Levels of Policies for Economic Development

In order to realize the factors mentioned above, the Japanese government carefully designed its overall economic policies at seven levels (Table 1) It may be a unique feature of Japanese policymaking in development programming that policies are made distinctively at these seven different levels, and that the different government policies are reported in different official documents, respectively

Table 1 Postwar Japanese Development

Year	Period	Characteristics	Income Level
1945–1952	Occupation Period	3 D's, labor unions	500
1952–1960	Reconstruction Period	Economic and political	1,000
1960–1970	Rapid Growth Period	Income doubling plan	3,500
1970–1980	Shocks Period	Nixon shock, oil shocks	10,000
1980–1990	Internationalization Period	Liberalization, trade	20,000
1990–2000	Political Economy Period	Political contribution	30,000

First, macro demand management policies are nothing but the standard macroeconomic policies found in American textbooks They are well-known fiscal and monetary policies mainly designed to control the business cycles of the market economy The so-called Keynesian policies to control aggregate demand and money demand and supply are the main instruments and require careful analysis of the market conditions not only in each country, but also with respect to the global conditions of the world econ-

omy The Japanese government publishes two papers—the *Economic White Paper* and the *World Economy White Paper*—for this purpose and offer their careful analyses of the domestic economy and world economic conditions These documents usually act as the guideposts of the government's analyses and policy orientation to the business community In addition, the Japanese government publishes, from time to time, "medium-term economic plans" which predict the likely course of the Japanese economy in five to seven years to come and offer guidelines for macro fiscal and monetary policies to the government agencies and private enterprises These plans are widely circulated and read by government officials, businessmen, bankers, and university students Often the typical questions for the entrance examinations of government ministries and leading enterprises are taken from the white papers of the government

There are numerous discussions on the macroeconomic policies in Japan The success of those policies is clearly shown by the achievement of high growth rates with little inflation while the serious recessions of recent years are related to the failure of fiscal and monetary policies attendant with liberalization of the financial sector (the two oil shocks playing contributing roles)

Second, the country's industrial policy is unique to postwar Japan and has attracted much attention even from American economists and government It may be regarded as the supply-side policy that was practiced successfully in Japan, long before the debate in the United States and its somewhat unsuccessful introduction under the Reagan Administration The essence of Japan's industrial policy is to help the private sector develop new industries as the Japanese economy moves up the world market and many private enterprises restructure their production activities with shifts in consumer demand and the composition of exports The macro management of aggregate demand alone cannot create quickly enough the corresponding supply of necessary products in the domestic economy Japanese industrial policy

had two clear purposes First, it was designed to develop the export industries at each critical stage of development Second, it tried to help the declining industries restructure themselves, as well as the medium-scale and small enterprises improve their technologies and management As a result, the medium-sized and small enterprises survived to maintain a high level of employment in the ever changing industrial world The tools and measures of industrial policy have changed over time, but it must be emphasized that somewhat substantial support to some selected industries, such as the shipbuilding industry in its early stage or the electronics industry in its later stage, were always undertaken under special laws which permitted the government to provide preferential treatment to those industries However, support to some relatively less important industries and coordination or reconciliation of industrial interests were often undertaken by "administrative guidance" by the Ministry of International Trade and Industry (MITI) One cannot claim that the government's industrial policies have been successful in all cases, but in many cases, they seem to have guided the future course of Japanese industrial restructuring well, and particularly did so in making the declining industries die less painfully and making the small and medium-sized enterprises adjust their production lines soon enough to survive and move up the market with better technologies There are many valuable studies on this subject (in Japanese) and I shall not repeat their results, but the importance of this type of Japanese economic policies should be noted [2]

In this connection, the most important problem is the selection of a few key industries for promotion in each stage of development Table 2 clarifies the problems and its related aspects In the stage of underdevelopment, domestic production is limited to agricultural production, some limited light industries, and, in

[2]The interested reader should read the following books (in Japanese) Ueno (1987), and Komiya (1984) A brief exposition is Ichimura (1980, 1982)

Table 2 Policy Levels and Government Offices In Charge

Policy Levels or Aspects	Government Office in Charge
1 Macro Demand Management Policies	Ministry of Finance (MOF) Bank of Japan
2 Industrial Policy	MITI
3 Distribution Policy	MOF, Ministry of Welfare
4 Regional Development Policy	National Land Agency, Ministry of Construction
5 Man Power and Education Policy	Ministry of Education, Ministry of Labor
6 Research and Development Policy	Science and Technology Agency
7 Regulatory Changes and Institutional Reforms	Prime Minister's Office, Special Committees

some countries, the production of natural resources In the country's early stage of industrialization, exports consist of light industrial products, but imports consist of products of heavy industries Capital is imported and it is better if the exchange rate remains weak In some cases, the exchange rate is deliberately kept too strong even in this stage due to the need to repay the debt of imported capital for industrialization In the later stages of development, however, the balance of payments becomes favorable and it becomes easier to import under favorable conditions Government subsidies and other forms of support must be given to the new industries to be developed In a country such as Japan where the economy is not large enough, it was not possible to follow the American pattern to develop one set of industries of every kind, taking the U S manufacturing sector as a model As industrialization proceeds, the country faces the problem of selecting old industries to give up as well as new industries to develop The former is more difficult than the latter In the case of a

national economy of smaller scale, the selection of industries is sharper and specialization is an economic necessity

Third, the Japanese government paid careful attention to egalitarianism in the welfare of its people A simple comparison of the income distribution of major countries in the world shows how egalitarian the Japanese economy has been throughout the postwar period Indeed, the Gini ratios show improvement even in the early stages of the postwar reconstruction period, which runs counter to the famous Kuznets' thesis Policies to prevent the distribution of income and wealth from deteriorating or improving the income distribution may be defined here as "distribution policy" The most fundamental step in the early stage of postwar development was, as is well known, is land reform This was also done in Korea, Taiwan, and mainland China In addition, the Japanese tax system, which levies a heavy inheritance tax, has made the distribution of wealth very egalitarian, while a progressive income tax made the income distribution very egalitarian There is a well-known expression, "*Ku-Ro-yon*" (Nine-Six-Four) in Japan, however, which means that 90 percent of the wages and salaries are caught for taxation purposes, 60 percent of corporate profits of medium- and small-scale enterprises are caught, and for farmers, 40 percent of incomes are caught Some empirical studies support these popular guesses Yet, the tax evasion in Japan is not as bad as in most Asian countries (Konishi 1992), and it has had the effect of improving, good or bad, the distribution of incomes among different professional groups, since those evading taxes are the relatively poorer groups

The Japanese distribution policy has several other aspects, besides working on the incomes of households and corporations There are many other policies in Japan that work to improve income and wealth distribution such as transfer payments to unfortunate families, a carefully designed welfare system, particularly the public Medicare system which is generous to aged persons (medical expenses to those above 70 years of age are

practically free in Japan), subsidies and support to small and medium-sized companies, and other supplementary policies, as well as similar support to relatively poor regions such as Hokkaido and Okinawa with regional development plans

Fourth, regional development policy is mainly concerned with the use of national land—in particular, the policy addresses the question of where to locate industries and which districts are to be developed with public investment There is no doubt that the most scarce factor for Japanese economic development is land, so that the efficient use of land is the number one problem for the long-run development of the Japanese economy Efficiency in production, almost by necessity, leads to concentration of industrial activities and urbanization The Japanese government has had, from the very beginning of postwar development as well as in the pre-war days, plans regarding land use, though they have not necessarily been successful Still these regional development plans have guided industrial activities and domestic migration for the past four decades

The regional development policies must also include appropriate ways of guiding the location of industries and habitation of people on the small islands Four National Total Development Plans (*Zenkoku Sogo Kaihatsu Keikaku*) were formulated in 1962, 1972 and 1988, although the government had some regional development plans long before 1960 In fact, there are many other regional plans prepared not only by the central government, but also by the prefectural government under the guidance of the Ministry of Construction and later the National Land Agency These plans have served as national guideposts in allocating the enormous amount of public investment in the reclamation of land or development of highways and industrial special zones throughout the economy The chosen localities receive great benefits so that the choice is politically very sensitive

In relation to these regional development plans, the postwar period is sometimes subdivided into six periods that correspond

to the subperiods presented in Table 1 The title of each subperiod suggests the issues that were targeted in each National Total Development Plan beginning with the third period It must be emphasized that any preferential treatment in expending public investment was based on some special laws, otherwise, any regionally differential treatment would have been very limited Thus, the government has tried hard to mitigate the concentration of industrial activities in certain areas, particularly around the established urban centers like Tokyo, Nagoya, and Osaka It is well-known, nevertheless, that the Japanese economy could not avoid excessive concentration of industrial and other activities around Tokyo, this is why the Fourth National Total Development Plan has at last explicitly admitted the idea of "Multi-Polar Dispersed Use of National Land" It does not seem, however, that the latest Fourth Plan can materialize itself unless it is substantiated by the political decisions in the form of some laws to promote decentralization or dispersion of industrial and political activities in Tokyo by even moving the capital out of Tokyo

Fifth, Japan's manpower and education policy is concerned with the improvement of human factors in economic development and was in place long before supply-side economics was brought up in the United States Japanese economists and policymakers have long recognized the need for and importance of policies affecting the supply side of national product, these include not only industrial policy which was discussed earlier, but also policies regarding education, science, and technology There are also many official documents recording these policies and the related analyses of the demand for and the supply of labor of various qualities The best documentation on these policies are the *White Paper On Labor* [*Rodo Hakusho*] and the *White Paper on Education* [*Kyoiku Hakusho*] The basic information on education is collected by the *Fundamental Survey of Education* [*Kyoiku Kihon Chosa*] which not only covers the various matters in school education as such, but also factors relating to the demand for education including the industrial composition of

graduates from high schools, colleges and various departments of universities There is also the corresponding *Fundamental Survey of Labor* [*Rodoryoku Kihon Chosa*] The efforts of the Japanese government and private enterprises were made to match the supply of various labor and human resources to the demand of the economy or the society at various stages of development This is nothing new or special, because the emphasis on education and training on and off the job was noncontroversial ever since the very beginning of modernization in the Meiji Era

The improvement of labor quality has two aspects first, education, and second, morale of the representative or average citizen Improvements in education of the nation in pre-war and postwar Japan is clear The percentage of junior high school graduates proceeding to high school was almost 95 percent in 1989, and the percentage going on to universities and junior colleges was 36 3 percent This is comparable with the U S figure of 42 percent of the same age group enrolled in colleges and universities (However, since the U S figures include part-time students, the figures may be interpreted to be comparable with one another) This high enrollment ratio was achieved around 1975, long before Japan's per capita GNP had caught up with that of the U S Historically the Japanese government spent a large share of the government's expenditures for education right after the Meiji Restoration The number of primary schools increased from 12,597 in 1873 to 24,303 in 1875, the number of middle schools increased from 20 to 116, and the number of colleges rose from 26 to 110 in the same two years Today, government expenditures on education in Japan is at about the same level as those in most Western countries (Table 3)

This does not mean that the expenditures of Japan is about the same as that of the U S per capita, because of the predominance of private schools, at least at the higher educational levels, in Japan as compared with Europe or even the United States Table 4 shows the statistics for private schools and public (national and

Table 3 Public Expenditure for Education
(as a percentage of national income)

Year	Japan	United States	U K	France	Germany	USSR
1961	4 6	6 9	4 5	3 0	5 1	7 1
1970	4 7	7 2	7 0	4 7	4 7	8 6
1975	6 5	7 6	8 2	5 0	6 4	9 0
1980	7 2	7 2	7 5	5 4	6 3	8 7
1983	7 1	7 3	6 0	6 4	8 2	
1994	8 2	3 2		17 0	4 1	

Table 4 Enrollment in Public Schools (vs Private Schools), 1989

	Schools		Students		Teachers	
	No	%	No	%	No	%
Total	65,613	27 6	26,770	24 3	1,354	20 5
Kinder-garten	15,080	58 3	2,037	77 4	100	75 0
Primary School	24,853	0 7	9,606	0 7	445	0 7
Middle School	11,264	5 4	5,619	3 5	286	3 2
High School	5,510	23 7	5,645	28 4	284	22 7
Eng Jr College	62	6 5	52	5 7	4	4 4
Junior College	584	83 9	462	90 1	20	82 5
University	499	72 9	2,067	72 6	121	50 8
Grad School	-	-	85	31 8	52	30 6
Other	7,760	82 3	1,197	92 7	42	76

local governments) schools The figure in the percentage columns

show the proportion occupied by private schools in all levels of educational institutions in Japan Clearly, except for the primary and junior high schools that are compulsory in Japan, private schools are predominant This does not mean that all the expenses of private schools are completely supported from private sources Approximately one-half of the expenses for teachers in private universities are subsidized by the government, so that a fair amount of public expenditure for education goes to private educational institutions Nevertheless, it is true that a predominant portion of the expenditure for education has been borne by the private sector

The dominance of private schools, particularly for higher education, has its pros and cons One advantage is that education could respond more quickly to changes in demand, but a disadvantage was that the inexpensive fields of education are developed beyond social needs Examples of the former are the engineering departments, whereas examples of the latter are the development of too many easy-going liberal arts colleges On the whole, the advantages seem to outweigh the disadvantages by responding very efficiently to the social requirements and offering various kinds and levels of education to Japanese families and the ever-growing industrial requirements The response to social needs seems to be more clearly observable at the graduate school levels At the same time, inflexibility of departmental composition of universities seems to show different degrees of correspondence to social requirements The improvement in labor quality has been mainly achieved by on-the-job and off-the-job training within private enterprises and government offices The Japanese style of management is based on a lifetime or stable employment practice, so that training and job rotation are inseparable from employment and management style This requires the solid establishment of the enterprises themselves and excellent management The degree of practice in Japan is 86 0 percent for stable

employment and 51 6 percent for job rotation[3] The quality of labor is also observed in the morale of workers in their jobs This is evidenced in the number of hours lost in one year, the rate of accidents, labor disputes, absenteeism, or, in general, the social crime rate In all of these respects, the Japanese rates are significantly lower than in most advanced economies

Sixth, Japan's research and development policy is an important aspect of the Japanese economic policies for economic development It is often said that Japan borrowed Western technology and improved on it Analysis of the so-called technological balance of payments shows that Japan is still far behind the U S in technological balance, but is well ahead of most European countries

As another indicator, expenditure on R&D has increased in Japan as well as in many advanced countries, but that in Japan jumped in the 1970s and 1980s in comparison with other countries Moreover, from 1966 to 1987, while GNP of Japan increased 8 9 times, R&D expenditure increased 18 4 times—the annual rate of increase is 14 8 percent—of which government funds increased 11 5 times From 1970 to 1988, the number of researchers increased 2 6 times, growing at an annual rate of 5 5 percent With these remarkable increases in R&D expenditure and the number of researchers, one should certainly expect high returns resulting in an increase in technological innovations This is showing up in an increase in patents obtained in Japan and abroad

Japanese policies for economic development have been coordinated at these six levels The first macro-policies were primarily the responsibility of the Economic Planning Agency, the Ministry of Finance, and the Bank of Japan Industrial policies were mainly

[3]The interested reader may refer to Ichimura (1990) which shows that the so-called Japanese-style management is practiced in larger corporations more widely than small and medium-sized enterprises, and the difference is significant among enterprises

undertaken by the Ministries of International Trade and Industry (manufacturing industries), and Agriculture, Fishery and Forestry (for primary industries) Distribution policy is a mixture of various fiscal and other government policies In Japan, there is no ministry solely responsible for consumers, only a bureau in Economic Planning Agency is responsible for monitoring the living conditions of the nation and issuing a white paper on the nation's living conditions every year (from time to time, it has issued an excellent report such as the *Economic Growth and Income Distribution, 1987),* and reports on changes in the distribution of income and wealth Social welfare policies are taken care of by the Ministry of Welfare Social welfare in Japan has now reached a high standard, particularly in medicare and unemployment insurance, and may have contributed to the recent stability in labor relations and reduction in social unrest in Japan in recent years Regional development policies are the responsibility of the Ministries of Construction, Transportation, and Communication In order to coordinate their respective policies, a new agency, the National Land Agency, was created in 1980 The country's manpower and education policy has been the responsibility of the Ministries of Labor and Education Japan's research and development policy has been primarily handled by the Science and Technology Agency, but MITI has been extensively involved in connection with its industrial policy MITI has a special Institute of Industrial Technology which employs more than 1,000 scientists and engineers for developing industrial technologies All of the policies and their evaluation are well-documented by the ministries in charge, usually in the form of some white papers They are well-organized as a whole

INVESTMENT IN HUMAN CAPITAL AND JAPAN'S LIBERALIZATION POLICY

These six aspects of Japanese policies are very important as a whole two that are absolutely essential to economic development

are the policies for education and the liberalization of foreign trade and capital movement Asian development has been very impressive, but there are some differences among the Asian economies The reasons for the differences seem to be attributable to two elements First, investment in human capital, particularly in terms of education, is very impressive in most Asian countries There is no doubt that all Asia-Pacific countries have emphasized education and, thereby, improvement in the quality of workers, engineers, salaried persons, executives, government officials, and intellectuals The result is that the majority of workers in these countries now have secondary education, and there are enough middle-level managers and engineers to facilitate the transfer of higher technologies Korea is particularly outstanding In most East and Southeast Asian countries, the spread of secondary education is so wide that most factories have no difficulty in employing workers with secondary education As a result, the transfer of technology and training for new technologies can be done with little difficulty, and introduction of recent devices is possible with little difficulty Even countries in South Asia, notably Sri Lanka and Burma, have made extraordinary educational efforts and have thereby achieved respectable literacy rates The health of workers has also improved substantially It is known now that while calorie intake differs among the different groups of economies, the majority of workers in every country now get more than the required minimum daily amount of calories so that they can work as hard as they are willing to

Another important feature contributing to improvement in the quality of labor in Asia is the demographic transition that has occurred, notably the decline in the fertility rate in most Asian countries Here again, however, the gaps among the groups are significant enough to reflect the policy difference on population There seems to be a high mutual correlation between the level of per capita GNP and the fertility rate, with the exception of China, where a population policy has been very aggressively pursued

Thus, it may be summarized that as the basic orientation of economic policies, three domestic directions and three external conditions seem to be crucial for the successful realization of economic development On domestic economic policies

1 It is fundamentally important to open the national economy to the outside world and adopt liberal policies for international trade, foreign direct investment, and international finance

2 Government policies must be basically oriented to growth, especially export-oriented growth

3 The foreign exchange rate should be maintained below the purchasing parity level for exportable price-elastic products, so that exports are promoted, imports are restrained, and capital inflow is encouraged

On the international environment

1 Trading partners' markets must be open for imports under conditions of free competition

2 The supply, offer or transfer of capital equipment, technology, management know-how, and capital funds should be freely and generously made to developing countries

3 The law and order needed for free and fair trade and transactions should not be disturbed by political or military conflicts

Since the external conditions are more or less common to all countries, what is more important for the purpose of development is, therefore, the domestic policies of the country After 1987, significant steps were taken towards liberalization for trade and foreign direct investment in most Asian countries There is no doubt that some Asian countries liberalized the restrictions and regulations on trade, direct investment, and loans to a greater degree than did other countries Needless to say, the more restrictive the policies, the less successful the country has been in terms of eco-

nomic performance It appears crucial to have liberal open policies for direct investment at an early stage of development against some special interest business groups in each country Some Asian countries will need to reconsider their policies on these matters

ACCELERATION AND DECELERATION OF THE GROWTH RATE IN DEVELOPMENT

A noticeable feature of Asian development is its acceleration in growth rates since the 1960s In the 1950s, even the East Asian countries did not give the impression that they would achieve such an impressive growth as has been observed This is not only due to the high rate of capital accumulation and the high rate of savings, but is also due to the increase in those rates as per capita incomes of those countries rose In programming the future development of any country, an important consideration is how high the expected rate of growth in GDP should be set In this connection, the trends of growth in the process of development must be carefully analyzed

A steady increase in the rate of capital accumulation is a characteristic of Japan's history for the past 100 years Nevertheless, the pre-war Japanese rate of capital accumulation did not exceed 15 percent of GNP, whereas in postwar years, the ratio has risen from 14 6 percent in 1953 to a high of 32 percent in 1965, and has leveled off at 28–30 percent in the early 1980s In the NIEs and the ASEAN-4, the ratio of capital formation to GNP has increased from below 20 percent in the 1960s to nearly 30 percent or even higher in the early 1980s

The rates of saving have also been very high The savings ratio went up quickly from about 16 percent in the late 1960s to over 20 percent of GNP in the early 1980s In Taiwan and Singapore, it has been even above the Japanese gross savings ratio of about 30 percent, the special policies of the government in these

two countries played an important role In Singapore, forced savings through the Central Provident Fund is responsible, whereas in Taiwan, it is government savings that is particularly high Apart from this, however, the household saving rates are also very significant This steady increase in the rates of capital accumulation and saving with rising per capita income over the past three decades is the most fundamental characteristic of the Asia-Pacific economies and is the basic cause of acceleration in the growth rate of the Asian countries One should not take this fact as something which automatically accompanies economic growth in any country For instance, in the case of Latin American countries, these ratios have not increased with the rise in per capita income In some countries, the saving ratios have stabilized at around 20 percent, and in some countries, they are coming down This contrasts with the Asia-Pacific countries with the exception of the Philippines which shows a savings behavior similar to that of Latin America Except for Singapore and Taiwan, household saving rates reach a ceiling slightly below 30 percent regardless of per capita income level Significant though this is for the relative success of the growth strategies for all these countries, the effect of the disparities in per capita income level among our four types of economies is clearly reflected in the resource gap each has characteristically experienced, and consequently in the extent to which each has had to borrow from abroad to sustain its rate of capital accumulation and growth

Even if the rate of capital accumulation is high, rapid growth may not result unless capital is efficiently utilized The so-called incremental capital-output ratio (ICOR)—the amount of additional capital required to increase an additional unit of gross domestic product—is an overall index of efficiency in the use of capital Usually as per capita income goes up, the ICOR increases, this was true for most Asia-Pacific countries But the increase has been relatively mild owing to their successful learning of modern technology Taiwan, in particular, has kept an impressively low ratio of 3 7 Indonesia's ICOR of 3 1, though relatively low, must

be considered relatively high for a country with a low per capita income South Korea with a per capita income slightly lower than Taiwan's nevertheless has an ICOR that is slightly higher (4 0), mainly because it has adopted deliberate policies to emphasize heavy chemical industries Malaysia (4 0) and Singapore (4 6) have high ICORs corresponding to their high and rising per capita incomes The Philippines, with an income level similar to Thailand, has an ICOR (5 4) which is as high as Japan's (5 2)

Despite the variations in the rates of capital accumulation—the ratios of capital formation to GDP and the values of ICOR—there seems to be a general trend in most Asian economies including Japan The trend is that the ratio of capital formation first increases and then decreases as per capita GDP goes up The ICOR follows a rising trend as per capita GDP goes up, but the degree of increase seems to differ significantly from one economy to another This implies, then, that if the demand for GDP matches more or less with the increasing level of capacity of the national economy, the rate of growth in productive capacity (expressed in terms of real GDP) in each national economy has a trend of acceleration at an early stage of development and deceleration in later stages A simple formula describes this pattern

$$DY/Y = D(I/Y)\, I/dY$$

That is

Growth Rate of Y = Rate of Capital Accumulation * ICOR

where the rate of capital accumulation has the reversed U-shape as a function of per capita GDP, fundamentally reflecting the similar shape in the savings function depending on per capita income The incremental capital output ratio (ICOR) is an increasing function of per capita GDP[4] From the equation, it is clear that

[4]Since the growth rate of GDP minus the rate of increase in population is the growth rate of per capita GDP, this equation can be reduced to a simple nonlinear differential or difference equation for per capita GDP,

the growth rate of GDP will go up if I/Y increases, while ICOR remains unchanged or increases only slightly This seems to have been the case for most Asian developing countries

Fortunately most of the countries had high saving ratios and could grow fast without relying on foreign loans as did the Latin American countries But if the ICOR goes up, as was the case in the Philippines and most South Asian countries, acceleration in the growth rate cannot take place As per capita income rises further, I/Y begins to taper off and the ICOR starts to rise, so that growth slows down This has been the case of Japan and some newly industrializing economies in recent years

From these observations, one may get the impression that even in the Asia-Pacific countries, capital may be excessively utilized, and the ideal value should have been something like Taiwan's But India has an extremely high ICOR despite its low income level, implying an inefficient use of capital ICOR values in Latin America are also particularly high [5] With the exception perhaps of the Philippines, it is clear that the usage of capital has been much more efficient in the Asia-Pacific region than in South Asia or Latin America

As for technological innovation in Asia during the period under investigation, the most remarkable is the Green Revolution, which introduced high-yielding varieties of cereals, including rice, the most important crop in the Asia-Pacific region New technology offered new opportunities to increase productivity in Asian agriculture, where the use of land was already very inten-

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ignoring the difference between GNP and GDP for the time being If the functional shapes of I/Y and ICOR as a function of per capita GDP are not too complicated, one can derive the passage of Y over time by solving the equation

[5]Even if we take into account the conditions of debt-ridden recession, the ICORs of Latin America are still too high Even if the growth rate for 1974–1983 remained the same as that for 1965–1973, the ICORs for Argentine, Peru, and Venezuela are 5 3, 5 0, and 5 1, respectively

sive and the potential for extensive expansion of production was very limited With the Green Revolution, it became possible to increase agricultural production without too much of a capital requirement, although an introduction of high-yielding varieties of rice required additional investments in fertilizer and irrigation The Green Revolution also made it possible to absorb the enormous surplus labor in the rural areas in Asia, and as a result, the distribution of income and social stability improved in many agrarian areas in Asia

ECONOMIC GROWTH WITHOUT SERIOUS POLITICAL DISRUPTION

Japan's economic development was not achieved without political disruption but considering the speed of growth, the degree of political stability maintained is impressive Alfred Marshall warned that too rapid growth might lead to social unrest Simon Kuznets mentioned that economic growth had to be thought of as a process of social disruption as well as improvement of social welfare Since the growth of the Japanese economy has been so rapid, it is no surprise for Japan to have experienced the kinds of political turbulence discussed earlier What is surprising is that the country managed to go through the hardships with only that much political disruption The explanations as to why serious political instability did not result from Japan's rapid growth may be explained by the following formula adopted from Deutsch's (1961), Huntington's (1968), and Weiner and Huntington's (1987) formula which are somewhat more complex (Ichimura and Morley 1992)

Economic Discontent = Material Want/Consumption

Social Discontent = Economic Discontent/Income Distribution

Social Frustration = Social Discontent/Social Mobility

Political Instability = Social Frustration/Political Participation

Economic discontent of the representative Japanese household did not increase very much thanks to the fact that most Japanese households kept their material wants modest, and that rapid economic growth increased per capita consumption more than most families expected Of course, there were some dissatisfied families, but their discontent did not spread and reach a high degree of social frustration because the income distribution in Japan remained surprisingly egalitarian The Gini ratios throughout the postwar years indicate that the income distribution of Japanese households did not deteriorate very much after the war but, in fact, soon improved Nevertheless, some degree of social discontent remained and was particularly significant in urban areas where living conditions were poor This is also proven by the fact that the opposition parties usually obtained more support in the urban areas than in the countryside

In other Asian countries except for Taiwan, income inequality is much more serious (Table 5) There are good reasons to believe that these figures underestimate the inequality of income in most countries in Asia as well as in other parts of the world Distribution of income such as those shown here may be regarded as an index expressing the sharing of welfare among the various social groups to be derived from the growth of national income Comparison with the degree of inequality of Japan's income distribution is perhaps an improper comparison, since Japan's is extraordinarily low even by world standards If one compares the income distribution of Asian countries other than Japan with other developing countries, one finds the Asia-Pacific economics to have reasonably equitable distribution of income Although the study years differ from one country to another, they do give a rough impression that the income share of the richest 10 percent in Asia is in the 30 percent range, whereas that in Latin America is between 40 and 50 percent The income share of the poorest 20 percent in Asia-Pacific countries ranges from 3 5 to 6 6 percent whereas in Latin America, except for Argentina, it varies from 1 9 to 2 9 percent If we define an index of inequality as the average

Table 5 Income Inequality of Selected Asian Economies and Latin American Countries

Country	Year Studied	Lower 20%	Upper 20%	Upper 10%	Degree of In-equality
Japan[a]	1979	8 7	37 5	22 4	5 1
Asian NIEs					
Singapore	1975	5 4	48 9	28 7	10 1
Taiwan[a]	1979	8 6	37 5	22 0	4 4
South Korea	1976	5 7	45 3	27 5	9 6
Hong Kong	1980	5 4	47 0	31 3	11 6
Developing Economies					
Malaysia	1973	3 5	56 1	39 8	22 7
Thailand	1976	5 6	49 8	34 1	12 2
	1981	5 4	51 5		(9 5)
	1986	4 6	55 6	(12 1)	
Philippines	1971	5 2	54 0	38 5	14 8
	1985	5 2	52 5	37 0	14 2
Indonesia	1976	6 6	49 4	34 0	10 3
South Asia					
India	1976	7 0	49 4	33 6	9 6
Sri Lanka	1981	5 8	49 8	34 7	12 0
Bangladesh	1982	6 6	45 3	29 5	8 9
Latin America					
Argentine	1970	4 4	51 4	34 6	15 8
Brazil	1972	2 0	66 6	50 9	50 9
Mexico	1977	2 9	57 7	40 6	28 0
Peru	1972	1 9	61 0	42 9	45 2

Sources World Bank (1986, 1987, 1989), IDRI (1984)

income of the richest 10 percent divided by the average income of the poorest 20percent, the indexes derived are those shown in the last column of the table Argentina seems to be exceptional among the Latin American countries for its relative equality, while the Philippines and Malaysia seem to be exceptional among the Asia-Pacific countries for their relative inequality It is also

true that inequality in the Philippines and Indonesia may be underestimated It is not reasonable to suppose, therefore, that income distribution poses no problems in the region Nevertheless, even with these qualifications, one cannot escape the conclusion that, in general, income distribution in the Asia-Pacific societies is much more egalitarian than that of Latin America As for the relationship between economic growth and income inequality, Kuznets' inverted U-shaped relation is well-known, that is, income distribution tends to worsen in the early stages of industrialization until a turning point is reached at some level of per capita income By comparing the income inequality indexes of Asian countries with fertility rate, share of employment in agriculture, and improvement in the level of education and other economic variables, one seems to obtain the following correlations in the region

1 The famous Kuznets' hypothesis seems to hold for most countries, but not for Japan and Taiwan Japan may have already passed a critical point Taiwan may have a special circumstance whereby land ownership is in the hands of Taiwanese farmers, and they could obtain a significant share of industrialization from the rising prices of land and rent This contrasts with the conditions of land ownership in the Philippines and Thailand

2 Countries with higher fertility rates tend to have worse income distribution

3 Countries at similar per capita income levels with higher shares of employment in agriculture tend to have worse income distribution

4 Improvement in the level of education is positively correlated with an improvement in per capita income and income distribution This relative inequality was mitigated when the economies developed primarily by successful agriculture and labor-intensive manufacturing industries

> in the Asian economies, which included a wide range of small and medium-size farmers, proprietors, and enterprises Taiwan and Japan are the typical cases In other countries where large corporations or state enterprises are conspicuously dominant, income inequality will increase social frustration which has no outlet to be released Serious social unrest has to be expected under such circumstances

Such social discontent was mitigated by the high degree of social mobility in postwar Japanese society Very few Japanese would doubt that graduates from good universities had equal opportunities in the best private businesses and government bureaucracy The share going to higher education in Japan is almost as high as in the U S and higher than that of any representative European country in terms of enrollment Needless to say, some social frustration, especially among the urban workers and sometimes dissatisfied farmers, has been reduced by political participation in various forms like strikes, demonstrations, or occasional success of obtaining power in local elections by the opposition parties But free and fair voting seems to have permitted most frustrated citizens to participate in politics in many ways This sense of participation mitigated the political discontent and kept Japan's and other Asian domestic politics reasonably stable

As was argued earlier, the decisionmaking of political economics always requires the coordination of policy alternatives and the related vested interests of all those concerned The participants and the process of this policymaking must be carefully observed This paper provides an example of the conceptual framework of such policymaking observations [6]

[6]For additional reading on this topic, see Ichimura (1989)

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International and Domestic Perspectives in Indonesia's Reform Process, 1966–1995

Mohammed Sadli

HISTORICAL SWEEP OF THE REFORM PROCESS

The economic reforms which started in 1966 are still continuing today In the time span of almost 30 years, a lot of major changes in policy and in the actual situation took place A major structural transformation was the result of important policy changes and of high economic growth of over 6 percent per annum Through policy measures and natural response to prosperity, the growth of the population decreased from 2 7 percent per annum in 1966 to nowadays 1 6 percent each year A number of individual policy changes could be called drastic, like the dismantling of the foreign exchange regime in 1970 which did away with all controls, including capital accounts But even this radical decision was prepared and executed step-by-step in three years The first step was taken in 1967 when the runaway inflation of some 600 percent per annum was to be brought under control by balancing the budget But a 600 percent inflation cannot be killed in one year and at one stroke

Concomitantly the very much overvalued exchange rate of the rupiah was liberalized through a few stages At first, exporters were allowed to retain a certain percentage of the foreign currency earnings and they could dispose of it the way they wanted The amount of retained earnings was gradually increased On the other hand, the government, to procure goods and services abroad, did not immediately have to go to the free foreign exchange market Meanwhile, most of imports remained subject to

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foreign exchange and other administrative licensing, but the amount of free imports was gradually loosened

What makes the Indonesian experience probably unique is that results, in terms of improvements in general economic conditions, were forthcoming in a relatively short time so that the new government of General Suharto did not come under serious criticism domestically

But here again, the overall political and economic situation, was unique The Suharto, the so-called New Order, government came up through a political upheaval and in the midst of economic chaos In and since 1966, there has bee a political as well as an economic regime change The political change was violent and fast The old-order political balance of power, dominated by the communists and leftist parties, was swept away by the military and their civilian allies, with the students movement playing a crucial role, and a "pragmatic" new regime took over

"Pragmatism" became the new guiding ideal with a distinct anti-communist basis Strident economic nationalism, with autarkic and anti-Western overtones as pursued by President Sukarno, was discarded The new policymakers realized that nothing was gained by pursuing such policies because the country was still very agrarian and, like before World War II, prospered from producing and exporting primary commodities Between 1942 and 1965, this structure was not changed at all, as a matter of fact, the productive capacity, especially factories and infrastructure, was damaged by war and revolution

Hence, the turnaround in economic and political policies was facilitated by the collapse of the old system and the desperate condition of the people There was, for a few years, a political "honeymoon" between the new government and its political supporters, and importantly, the students' movement But international circumstances played a major role also, working to the advantage of the new government to make the "delivery" of the

results of the new regime more quickly, so that the first political reaction only occurred in 1974, that is, after about seven years It took the form of a students' demonstration which criticized the perceived dominance of Japanese investments and the privileges given to handful of Chinese entrepreneurs In other words, the first negative reaction to the government's economic policies were related to be distributional aspects of the otherwise new prosperity In Sub-Saharan Africa, the reaction to structural adjustments took the form of objections, for instance, the elimination of subsidies killed babies as milk distribution was curtailed In Indonesian, it took the form of awakened economic nationalism among young urban intellectuals

Actually, the role of these international agents (i e , foreign direct investments) and the domestic "aliens", i e , the Chinese, and also developments in the international economic scene, have been crucial for the economic recovery between 1967 and 1975

The new government of Suharto realized that the country's savings were abysmally low in 1966, while part of this savings was parked abroad Hence the economic stabilization policy and reconstruction, among others, aimed at inviting new foreign direct investments If the latter succeeded, it was perceived, then the domestic savings of the domestic Chinese community will be repatriated and plowed back in the country The complete abolishment of the foreign exchange regime was conceived with this aim in mind if the domestic Chinese were assured that at any time they can move out (again) their wealth, they would feel comfortable bringing it in, in the first place The guarantees given to foreign investors were a path breaker and had to underpin the new confidence in the country The new government also realized that in the short to medium run, stabilizing the government's finances required significant injections of new aid from friendly donor countries, i e , the West and the multilateral financial institutions (mainly the Fund and the Bank) which were spurned during the Sukarno regime

The international situation was very favorable for the new government The political turnaround in Indonesia was greeted with great relief in Western circles because Indonesia was seen as narrowly escaping the international communist trap The country is large and strategically located in the Asia-Pacific region and the new political situation was a welcome change to Japan as it has always seen Indonesia occupying a very strategic role sitting across vital sea lanes and being a producer and exporter of oil and other primary commodities The early willingness of Japan to support the new government was a very important circumstance The United States moved to provide adequate financial aid to the new government The first amounts were, looking backward, insignificant being a few hundred million U S dollars on an annual basis More important was the effort to find a solution to the large foreign debt (actually minuscule compared to the present government indebtedness of some US$50 billion), much of it owed to the Soviet Union Through international diplomacy of the new government, but also through the support and involvement of Dr Schacht, at that time governor of the German bank, in the end (that is, in 1973) Indonesia achieved what would now be called an "exit program" under which its debts were rescheduled under a general formula, a "once-and-for-all" arrangement under which the country did not have to go back to the Paris Club every year This arrangement worked out very well and Indonesia never had to go to the Paris Club again The last time Indonesia wrote a "letter of intent" to the IMF for a standby agreement was in 1974 This type of international settlement was lobbied by Indonesia during a time when it presided over the Non-aligned Movement (1993–1995), which was to be applied to debt-distressed and low-income countries, mostly in Sub-Sahara Africa This advocacy, however, has not borne fruit although promising but slow progress can be seen in the G-7 deliberations and resolutions and in the thinking of the IMF and the World Bank

The United States insisted that the consortium aid to Indonesia (whatever the size required and endorsed by the Bank and

Fund) should be subscribed by the U S, first of all, up to one third Japan should then subscribe another third, while the rest of the consortium should come up with the remaining third Today, with the amount of new aid being over US$5 billion a year, the U S share is minuscule, while the lion's share comes from Japan, the World Bank and the Asian Development Bank That is, bilateral aid to Indonesia has shrunk, except from Japan, while multilateral aid has become more important

The Indonesian government has always been cognizant of the connection between international aid on one hand and foreign direct investments on the other In the long run, the role of foreign direct investments should be greater than that of foreign aid, at least in net terms Today, for instance, new consortium aid is over US$5 billion a year This figure is greater than the annual amount of realized FDI, except in 1995, but in terms of "resource flows" international aid has become negative because of the large interest component in the annual debt service payments On the other hand, net resources flow on account of international investments is significantly positive In 1995, the current account deficit will bulge to US$8 billion (twice the normal figure) but international reserves are still up

The other favorable international circumstance during the reconstruction period is the vast increase in the price of oil in the 1970s But without early entry of the international oil companies, since 1967, the country would not have been able to cash in on this bonanza

Actually, the major international oil companies were at first reluctant to enter under the strict nationalistic conditions of the "Production Sharing Contract" pioneered by Pertamina, the national oil company Investments of foreign oil companies was not covered by the general foreign (direct) investment law, which was a political matter The leadership of Pertamina did not wish to abandon complete state control over the oil sector The new regime of President Suharto did not, in principle, embrace a private

enterprise or capitalistic doctrine It was, however, "pragmatic" and it did away with the command economy and overregulation in favor of the working of the market However, it did not abandon the socialist bent in the country's outlook which was rooted in its independence movement Hence it retained almost all state enterprises but decided that these should now be more autonomous administratively and managerially, and earn a profit The entry of foreign direct investments was also circumscribed by a number of closed sectors and the insistence on engaging in joint ventures with local companies The mining sector, however, could be entered by a "Contract of Work" with the government, but in the oil and gas sector, the incoming foreign company should become a "production sharing contractor" of Pertamina, recognizing Pertamina as the overlord Pertamina controls the operation through a "management clause" in the PS contract which obligates the foreign contractor to have Pertamina's approval for certain decisions and procurements In practice, however, General Ibnu Sutowo, presiding over Pertamina, could instill the confidence of the foreign contractors as a pragmatic overlord who will not make unnecessary difficulties for the PS contractors The so-called "management clause" was executed in a liberal and practical way and everybody could live with it This is an example of the practical outlook of the new masters, who felt that they could not neglect the 1945 Constitution of the country (with its socialist flavor), but had to find accommodations with the realities of the time There is often a significant difference between the written rule and practice, which for Westerners is often disturbing but is more comfortable for the natives

The 1970s

The1970s—more specifically, after 1973—was a time of financial abundance, mainly because of rising oil prices, but also because other primary commodities were faring well The balance of payments was strong because international aid from the con-

sortium was still rising and debt service payments were still low But the country was not spared occasional financial crisis In 1974, Indonesia suffered from the Pertamina crisis when the national oil company became insolvent under the huge short-term debts it accumulated during the first oil boom But this was a payments problem with foreign private banks and suppliers which the government could resolve without having to resort to international rescue Pertamina was a company but because it is government-owned, the government in the end felt it had to guarantee all of Pertamina's financial obligations At stake was US$10 billion and a rescheduling of payments, contracts and projects was negotiated The result of this exercise was a system of tighter financial control over state enterprises, especially for foreign borrowing The president of Pertamina was replaced by a less flamboyant civil servant from the mainstay of finance Meanwhile the inflation reared to double-digit levels, but that phenomenon was also experienced by a number of other OPEC countries It was a supply bottleneck, inflation rather than excess demand related

By 1978, the Indonesian government was faced with a threatening financial crisis because of declining oil prices and the start of bulging debt service payments because of the very strong appreciation of the yen (while exports prices remained denominated in U S dollars) The result was a devaluation of the currency because the exchange rate was fixed during the previous inflationary period The devaluation was a one-time adjustment in the price mechanism but did not go beyond that, i e , practically no other reforms were undertaken Soon the economy was lifted by the second oil boom and things looked rosy again There was no need yet for a wholesale reform of trade and industrial policies, that came only in 1983 and stronger yet in 1986 The lesson from the 1970s is that a country awash in oil money and enjoying a commodity boom with foreign direct investment inflows for the domestic market is not so agile to reform early in anticipation of adverse external conditions Maybe that will never be the case

anyway and the test of agility of a country is to what extent it can react to a crisis with resolute actions The example of Indonesia is that government policymaking can be said to have been at its best in times of impending crisis crises and adversity, while during good times it tended to be lax

There was of course some influence on policy orientation from the aid consortium, but it was never very strong By and large, the World Bank, which became the spokesman for the bilateral donors, was content with the priorities in economic development because the government could easily subscribe to the current fads of the Bank, such as reducing poverty, prioritizing agriculture and the food sector, rural and regional development, reducing the population growth rate, etc The role of the IMF became marginalized, to the extent that the Fund at one time wanted to close its representative office in Jakarta, but the economic ministers (especially finance, central bank and planning) at that time persuaded IMF not to do so The motivation was that the role of this institution could be very important in times of crisis, and for that, it would be better that the agency retains its representation in Jakarta as a monitoring device Moreover, it would be embarrassing for the government if the IMF office had to be reinstated later Periodically the IMF sends a mission from Washington D C for consultations and to prepare a report for the annual aid consortium meeting Such consultation visits could highlight the agency's concern about the financial health of the country and its related policies The economic ministers probably find the annual policy dialogues and the annual constitutions and reporting for the aid consortium by these multilateral institutions on balance a positive factor It could strengthen the hand of the relevant economic ministers vis-a-vis other parts of the government which are more inclined to spending A national government is never a very homogeneous entity, but consists of conservative ministers and departments, as well as more expansionist colleagues In Indonesia there has been a long-standing "tug-of-war" between conservative economic ministers heading finance,

the central bank and planning, on the one hand, and more expansionary or protectionist ministers and their bureaucracy on the other The President sits in the middle, but does not always side with the conservative ministers In times of (financial) crisis requiring urgent reforms, however, he often gives the financial and planning ministers the free hand

The World Bank in the 1970s and early 1980s on various occasions tried to lecture to reduce protection and state control over prices But during good economic times, the Indonesian audience tended to listen attentively, but the situation did not produce pressures or incentives for reform The inward-looking and domestic market-oriented industrial policy produced 11 percent annual growth in manufacturing for almost two decades But in 1983, all of a sudden, the textiles could no longer be absorbed in the domestic market and were not competitive in world markets Perhaps at that time the ministers and their staff remembered the lectures of Helen Hughes and Anne Krueger of the World Bank and started taking actions along the recommended policy lines

Policy Reforms in Trade, Industry and Investment

Trade and industrial policy in the first period of the Suharto government—that is, from 1967 until the middle of the 1980s—was based mainly on a protected domestic market There was no absence of an export policy, but the natural resources sector had the primary responsibility, i e , oil and gas, minerals and timber

Why did the government from the outset not follow an export orientation in the development of manufacturing industries? Perhaps because of the perceived advantages of the country, i e , having a large domestic market which was served by imports during the previous era Countries with a smell domestic market, such as Singapore and Malaysia, did not have such options In those days, Thailand and the Philippines followed the same industrial development strategy

The policy worked fine for some time Growth in manufacturing output averaged 11 percent per annum, only slightly lower than in South Korea Because of the oil and commodity boom in the 1970s, there were no pressures from the balance of payments Moreover, the protected domestic market attracted many Japanese and other investments in manufacturing, which, in turn, buttressed the new foreign investment policy

The first signs of crisis came in 1983 when oil prices dropped and the balance of payments came under pressure There was a quick response from the government, in the form of a significant devaluation which corrected the balance of payments for the time being In the meantime, the textiles industry, which grew very fast in the previous period, based on the domestic market, found itself for the first time with surpluses that it could not sell to the domestic market and could not export because it was not competitive

The devaluation helped the restructuring of the textiles industry Three years later, in 1986, the government undertook another, and bigger, devaluation because the end of the oil bonanza was clear However, the 1983 devaluation turned out to be not enough and the policy of pegging the exchange rate required another correction Apart from devaluation, the government launched a package for an export drive for non-oil commodities The exchange rate was put on a floating basis (although still somewhat controlled) and an effective export drawback system was installed to reimburse exporters for the duties paid on imported raw materials and components The mid-1980s were crucial years in that the government initiated serious efforts to revamp the economy The process of deregulation and liberalization in trade policy was kicked off The year 1986 became a real watershed

Tariffs were cut and nontariff barriers were dismantled But this process was not completed overnight It was a step-by-step exercise because a lot of domestic vested interests were skeptical

and not enthusiastic The government took the lead in the reform and did not wait for the support of the business sector

Fortunately, the supply response was quick Production and exports of textiles, garment, plywood and footwear went up quickly Perhaps the country was assisted by the start of relocation of these labor-intensive industries from Korea, Taiwan, Hong Kong and Japan, where entrepreneurs started looking for developing countries which still have unused quotas in Europe and the U S But these companies only decided to come to Indonesia when they saw the trade and investment climate improving through liberalization

Malaysia had always been more open to FDI and the country attracted export-oriented electronics and electrical goods industries through its very liberal entry requirements Those industries working for exports could enter the special industrial areas as 100%-owned FDI, i e , they were exempted from the requirement to engage a local partner Indonesia did not pursue a similar policy until the late 1980s and early 1990s with the result that these electronic industries did not enter Indonesia They found the labor laws in Indonesia too stringent because lay-offs for industrial retrenchment and exit were not easy Electronic sub-assemblies are very sensitive to the business cycle and needed flexibility in employment, which apparently was available in Malaysia in the industrial parks In the early 1990s, the investment regime for foreign direct investment was further liberalized, e g , for export-oriented ventures a wholly-owned subsidiary is possible, and for domestic market investments, the minimum capital investment requirement was loosened to allow for smaller and medium-scale ventures to come in

By now the influx of foreign direct investment has been so great (in realized terms in 1995) that it contributed to the overheating of the economy The East Asian industrial countries, such as Korea, Taiwan, Hong Kong and Singapore, became the new investors Japan also came in very strongly in 1995, driven by

"second generation" industrial relocation In the second half of the 1980s, domestic investments were greater than foreign investment, but the dividing line between the two becomes blurred If the domestic Chinese business undertakes major investments and register as domestic investments, from where the finances come is difficult to trace because of the completely free foreign exchange system Lately, there has been strong Western entry into the infrastructure sector which is now open for foreign investments But U S, Canadian and European companies tend to go in partnership with Japanese companies and banks, so that the ventures are, in fact, multinational

The Role of International Commitment

In the process of deregulation and liberalization of the economy, international commitments going in the same direction, such as commitments in the context of the WTO, APEC and ASEAN, play an important role The domestic thrust at times tends to slip back, because of reactions of vested interest groups and other political pressures A powerful argument of such groups is the specter of "deindustrialization," or the wiping out of "strategic sectors" because of foreign competition—for example, domestic shipping fearing the onslaught of competition from Singapore One really has to have faith that in the end domestic industries and services will rise up again and with greater strength after having been exposed to international competition On the other hand, one often hears the echo that "in the long run we are all dead "

The international commitments have the "standstill and roll back" clause, or tariff binding, of which the standstill commitment is presently the most important part At the signing of the new GATT agreement in Marrakesh, however, the minister representing Indonesia made the commitment for binding at a high level of 40 percent, though existing levels are already lower He

was not convinced that the country could live up to the commitments and wanted to play safe

Indonesia and President Suharto himself has been a strong proponent of the APEC vision to create a free-trading community in the Pacific, although the realization will take a generation to materialize But what is important for the moment is to change the state of mind, which traditionally has been protectionist

The APEC and AFTA (ASEAN Free Trade Agreement) processes commit senior officials and ministers to meet regularly and trash out a converging course for lowering trade and investment barriers In the process, such interactions could produce a "concerted voluntary, but individual actions " Peer pressures develop over time among those senior officials and ministers

Another important influence, or force, in the region is the "contagious effect" of countries in the same geographical area Indonesia looks at Malaysia and Thailand and finds the courage to do the same, but Thai and Malaysian officials also look at what Indonesia is doing in certain sectors (say, tax reform or banking deregulation) and that also could produce an emulation effect

SOME INTERNATIONAL PERCEPTIONS AND PERSPECTIVE WITH RESPECT TO THE PROCESS OF OPENING UP AND LIBERALIZATION OF THE ECONOMY

Perception of Foreign Investors

When Indonesia changed its stance towards direct foreign investments in 1967 and gave incentives and guarantees to foreign investors, the new law and its implementation had the desired effects American oil companies and international mining companies, mostly North American, came in early The logging business attracted Philippines and Koreans The Australians were among the first entering manufacturing The Japanese were very interested and crowded the information seminars but waited a

few years because before 1968, Tokyo was not ready yet for overseas investments But after that, Japanese entry into the manufacturing sector was strong The Japanese trading houses also established representative offices in Jakarta early in the game Trade always comes before investments How can one explain that the welcome mat in Indonesia was soon trampled by would-be investors, international consultants and representatives of foreign banks, where in (sub-Sahara) Africa, and even in India, it took awhile? Credibility of new policies? Perhaps so, but what makes credibility? A few years ago, if one would ask Japanese companies why they did not move into India and Africa their answer was that they felt that they were not really welcome In Jakarta soon after 1967, one could see the neon advertisement light for Toyotas and Sony products Not so in New Delhi or Bombay These may be trivial signals, but they create a perception among the concerned parties

The multinational companies desires safety and security when they set up operation in a new environment Their primary interest is whether they can fully control the operation, meaning that 100-percent ownership is the ideal If they must oblige a local partner, they have to feel comfortable with him If they can hold a controlling majority, and if the local partner was their sales agent for a long time, that would do In Indonesia, the rules for foreign direct investments in the beginning period of the late 1960s allowed 100-percent ownership After that, a local partner became obligatory, but it could be a small minority partner There was absolutely no foreign exchange controls and no limits for the price of technology (as was the case in India) Moreover, the domestic market was heavily protected and hence provided a strong incentive for "tariff jumpers" The bureaucratic process of getting approvals for entry was centralized, even so, the process required three to six months for final approval, sealed with the presidential decision After that, however, investors still had to go through the ordeal of securing numerous approvals for acquiring land and setting up the factory in a locality controlled by the local govern-

ment The consolation, probably, was that land and labor were still pretty cheap at the time

The government also gave permission to ten international banks to set up branches in Jakarta, while foreign companies nationalized by the previous regime were returned Tax holidays of up to five years were granted, as were duty exemptions for importation of capital equipment and raw materials for a limited period All of this was done under the assumption that it would increase the credibility of the new policies

A legitimate question is whether or not the Indonesian (new) government went completely overboard with its incentives which resulted in some unnecessary giveaways, e g , the tax holidays While this was the theory held in certain Western academic circles, it must be remembered that a developing country suffering from the stigma of a leftist and anti-capitalistic policy orientation has to bend over backwards to prove to the outside world that it has changed its complexion In the process, it may exaggerate and even give away unnecessary incentives If one has to err, it is better to be on the liberal side The Vietnamese have been practicing the same rule in recent times

In the African and perhaps South Asian cases, the incentives offered to foreign investors looked timid and not quite forthcoming and the results were inferior to that in Southeast Asia

Bureaucracy, Corruption and the Legal System

International perceptions, especially among Western business, about the bureaucracy, the legal system, and the prevalence of corruption in developing countries often do not encourage entry Or does it? China has been a hot object for Western countries to enter and to do business with Yet, this country appeared on the top of a list of countries with corruptive practices, according to the perceptions of businessmen polled Indonesia ranks num-

ber two China, Vietnam and Indonesia are also known as countries where the legal system is not transparent and recourse to the law and the courts for foreign business is undependable

Yet China attracts much, much more international business than does India where the legal system, modeled after the British system, should offer more comfort to Western business India does not rank high on the honor list of corrupt countries, although no country is free of this disease Some countries go under because of the corruption while other developing countries apparently can live, and grow, with this disease How should one explain such paradoxes?

Corruption can be linked to taxes or levies imposed on business i e , levies imposed on business transactions or on citizens who need some licenses or legislation from government agencies Part of these are very legal but there are other payments on top of them In effect, they only increase the official rates On certain occasions, these effective rates remain bearable, perhaps because the official rates are low The economies can continue to flourish under such "high costs" because other costs are comparatively low For instance, labor costs can be comparatively low because labor is not effectively protected Government salaries may be low (perhaps also the defense budget), so that there is no swelling of the budget deficit and hence no fueling of inflation

If the economy is growing well, there will be a lot of investment opportunities, and the illegally, acquired wealth tends to be invested in the country rather than stacked in a Swiss bank That is the main difference between the situation in Zaire on the one hand and China or Indonesia on the other hand

There are (industrial) countries where the tax burden is so high that if affects savings, investments and economic growth For the same reason, corruption in a developing country can also stifle investment and growth What or where is the limit and are there telltale signs? We do not know

On the other hand, a developing country's economic growth, i e , investments and doing business, can be stifled also, not by "corruption" but by an overdose of bureaucracy A relatively non-corrupt bureaucracy, perhaps in the old Soviet system, can be a greater impediment to economic growth than the new "corruption" associated with the Chinese system An Indonesian Chinese prominent businessman who deals frequently in China comments that the corruption in mainland China is exaggerated by Western businessmen He maintains that there is "corruption" in Taiwan, but the forms are different In a number of East Asian (fast-growing) countries, corruption takes the form of payments by business to the ruling party for favors received or expected, often in relation to government contracts or other facilitations A Dutch businessman confided that he has to pay fees in China to the organizing agencies for services rendered in connection with the arrangements of business tours and visits, and that these payments are subject to negotiation, once the foreign party has experience The Chinese business friend in Indonesia likes to compare the payments he has to make with traveling a toll road when you want to move faster you should be willing to pay a fare

All of these "rational explanations" of corruptive practices do not deny the fact that corruption can easily become a political issue domestically which ultimately can cause the downfall of governments or regimes On the other hand, one can sometimes hear a cynical remark from Western circles that the admonitions of European ministers to African governments about "lack of good governance" (euphemism for gross corruption) is partly to conceal the current inability or perhaps fatigue to provide further financial aid to those poor African countries

The legal system and the working of the judiciary are important aspects of the business environment, especially for foreign and particularly Western business Operating in a strange country, away from their domestic cultural and legal environments, they have to rely on the protection of the law of the host country

as well as cope with the vagaries of the policy and political regime

In a country like Indonesia, Western and especially American companies suffer from the uncertainty of the legal system and the decisions or verdicts of the courts Business people from these countries feel much more comfortable in Singapore But of course they cannot stay away forever from countries like Indonesia, China and Vietnam On the other hand, Asian enterprises and businessmen know the ropes better and can live with the situation Hence there is something like unfair competition this legal uncertainty is a similar problem as corruptive practices American companies feel handicapped because of the legal system back home, which has an anti-corruptive practices law, which serves as a handicap overseas in their competition with companies from Europe and Asia On the other hand, because domestic parties in the host country know this limitation, American companies, including non-U S companies listed in the U S stock exchanges, are more free from corruptive intrusions This has been the case for the large oil and mining companies operating in Indonesia Legal reform in the end is just as important as economic reforms But often the emphasis is on economic reform Legal reform is much more slow because the urgency is not felt as acutely by the host government, it is also true because Asian companies and other actors have found ways around it and are not pressing the government In Indonesia, U S -AID has given technical assistance in this otherwise slow process The urgency of legal development and reform has been recognized and appears in the latest State Guidelines, i e , it is prioritized in the current five year plan

CONCLUSION

The Indonesian and the Indian cases have a number of similarities including the size of the country (both are large, develop-

ing countries), their colonial past, and socialist inclinations of the independence movement

There are also important differences Indonesia suffered economically more during the first twenty years of independence The political situation became more polarized and radicalized In the end, Indonesia had a traumatic break in 1966 and because of this, a new regime that was much more practical or pragmatic could come up and reform the old economic policies in a radical way

India never had such a traumatic experience When Indonesia turned around its major economic policies in the late 1960s, the international situation worked to its advantage Moreover, a strong leadership emerged in Indonesia, and although it was rooted in the military, it could strike an alliance with a technocratic group of economists and policy managers The current regime in Indonesia is less "democratic" than in India Such a political background does not exist in India

Hence, how could India learn from the experience of Indonesia? We do not know, but in Southeast Asia we have what can be called "neighborhood effects" or the "contagious effect," i e , the ASEAN countries are learning from each other For instance, Indonesia admires the low inflation in Malaysia and Thailand, and behind that the more autonomous position of the central bank

Could India learn an experience, or an institution, or two from East and Southeast Asia? Not in big way, but perhaps marginally If the interaction of people and ideas grows between the two regions, some of these contagious effects will start working The ASEAN framework and process have spawned a lot of such interactions The economic policies of the ASEAN countries tend to converge, over time, although their political and cultural histories differed a lot In today's globalized world, interactions between South and East Asia will grow in volume and quality

The Successes and Failures of State-owned Enterprise Divestitures in Chile

Rolf J Luders

INTRODUCTION

Chile was one of the first countries to engage in a massive State-Owned Enterprise (SOE) divestiture program This meant that the country necessarily had to experiment with the process, which led to some failures The lessons from these, however, allowed the government to engage in a very successful second round of privatizations of large traditional SOEs, most of them providing public services Since large-scale privatization began in 1974, the country has a relatively long experience with privatized enterprises, which has allowed researchers to do quantitative work to evaluate the effects of the divestiture program This paper describes the privatization process and its objectives, environment and major effects

Tables 1 and 2 provide a very good overview of the Chilean privatization process Up until 1970, Chile did not have a large number of SOEs, but most of them were very significant in terms of either capital, employment, or both Their value added was over 14 percent of GDP, and their contribution to the public services and transport sectors exceeded 24 percent Allende, a Marxist Socialist, was elected President in 1970, and carried out a massive nationalization process The number of State-managed enterprises rose to almost 600, and the value added to 30 percent of GDP In late 1973, after a severe socio-political crisis, the military took over the government and started to privatize During this privatization process, two periods can clearly be distinguished

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Table 1 State-Owned and/or Managed Enterprises, 1970–1989

		1970	1973	1983	1989
1	Enterprises related to CORFO	46	571	24	24
	a Subsidiaries	(46)	(228)	(23)[d]	24[e]
	b Intervened	–	(325)[c]	(0)[b]	0
	c Banks	(0)	(18)	(1)	
2	Other State-Owned Enterprises	20	22	21	18
3	Other Financial Institutions	2	2	2	2
4	CODELCO	0[a]	1	1	1
	TOTAL	68	596	48[f]	45

Source Hachette and Luders (1992)

Notes

a Although CODELCO did not exist, the State owned 50 percent of the "big copper companies" This percentage was acquired when the State invested in foreign-owned companies during 1970 as a result of the "Chilenization" process

b After September 1973, 350 intervened enterprises were returned to their owners, most of them during 1974

c Excludes intervened enterprises in which CORFO had a minority interest, which are included in the groups of subsidiaries

d During 1979, two enterprises in which the State participated were created Litio and Telex

e Between 1983 and 1989, 14 new SOEs were formed as a result of the breaking up of existing companies The fourteen SOEs were Empresa Electrica de Aysen, Empresa Electrica Colbun Machicura, Empresa Electrica del Norte Grande, Empresa Maritima del Sur, Empresa de Servicios Sanitarios de Tarapaca, Empresa de Servicios Sanitarios de Atacama, Empresa de Servicios Sanitarios de Coquimbo, Empresa de Servicios Sanitarios del Libertador, Empresa de Servicios Sanitarios del Maule, Empresa de Servicios Sanitarios del Bio-Bio, Empresa de Servicios de la Araucania, Empresa de Servicios Sanitarios de Los Lagos, Empresa de Servicios Sanitarios de Aysen, Empresa de Servicios Sanitarios de Magallanes

f Does not include over 50 "odd-sector" enterprises that were indirectly managed by the State, and which fell into government hands during 1983 as a result of the government intervention of some financial institutions, and which were privatized before 1989

Table 2 Share of State Enterprises in Output (percent of GDP)

Sectors	1965	1973	1981	1988
Mining	13 0	85 0	83 0	na
Industry	3 0	40 0	12 0	na
Utilities	25 0	100 0	75 0	na
Transport	24 3	70 0	21 0	na
Communications	11 1	70 0	96 3	na
Financial	–	85 0	28 3	na
All State Enterprises and Public Administration	14 2	39 0	24 1	15 9

Source Hachette and Luders (1992)

vatized, and value added by the SOE sector dropped from 30 to about 24 percent of GDP, and during the 1980s relatively few enterprises were divested, and value added fell to almost 16 percent of GDP The difference between these two privatization rounds, as will be evident during the description of the divestiture process, go well beyond the number of privatized enterprises or the changes in the value added by the SOE sector

The Chilean privatization process was successful in achieving its objectives Perhaps the two most important of these were the spreading of ownership and the transformation of the private sector into the engine of development, so as to accelerate the rate of economic growth of the country and make democracy viable Very significant is the fact that at the end of the military regime, privatization, even of the large public services, which in most de-

veloping countries as well as in many developed, are considered "natural" monopolies and are State-owned, was fully acceptable to practically all segments of society A reversal of the process is at this stage unthinkable

The lessons obtained from the Chilean divestitures are many Among the most important are the following large-scale privatization can be successful in a developing country, privatization does not require any special resources, since enterprises can be transferred free of charge, and if it is decided to sell to foreigners, this can be done in such a way as to avoid that these latter eventually dominate the economy, useful privatization can take place in almost any sector of the economy, including social services such as education, housing, health, social security, etc , as long as the right regulations are first put into place, privatization needs a strong leadership, and has to be carried out using divestiture modes which increase the support of different interest groups (managers, workers, etc), credit sales to controlling shareholders should be avoided since it leads to moral hazard, privatization does not affect employment levels, efficiency does, and net fiscal revenues are likely to be enhanced with privatization, while fiscal wealth changes will tend to be determined by the use governments decide to make of privatization revenues [1]

The rest of the paper is divided into four main sections The first describes briefly the environment under which the divestitures took place The second section analyzes the privatization objectives Section three focuses on the divestiture modes, and the last section discusses some of the most important and controversial effects of the privatization process in Chile

[1]For an expanded description of the lesson from the Chilean privatization process, see Hachette and Luders (1992)

STRUCTURAL CHANGE AND EXTERNAL SHOCKS

State-owned enterprise (SOE) divestitures took place while the Chilean economy was in the midst of structural change and affected by strong external shocks Like most Latin American economies, Chile had followed an increasingly protectionist and interventionist economic policy since the 1940s This process culminated during the Allende period (1970–1973), when the government attempted to centralize the economy Custom duties were raised to 90 percent on average, about 550 medium- and large-sized enterprises were either nationalized or intervened, almost all prices (including wages and interest rates) were fixed by the government, and all credit was allocated by the central bank The poor results of this experiment contributed to the strong public pressures on the military to overthrow Allende, although the decisive factor probably was the implicit threat to individual economic and political freedoms

The military regime, which took over the government in September 1973, set out to introduce drastic changes to the socioeconomic and political structure of the country The overall objective was to generate the necessary conditions for a viable and stable democracy Two necessary conditions for this were the deconcentration of economic power and a rapidly growing economy It was believed that in Chile, as in many other Latin American countries, protectionism and rent-seeking government intervention were responsible for the slow rates of growth of the last decades, if compared with those of some Asian economies

Therefore, after a brief initial period of doubt, the government aimed to restructure the existing economy into an "open social market economy " In this expression, "social" stands for government intervention to correct market imperfections whenever the costs to do so are expected to be below the anticipated benefits from doing it As a result, non-custom barriers were eliminated and custom duties were reduced Today, they stand at 11 percent for all products, markets are generally completely deregulated—that is prices, wages and interest rates are freely determined in the

hat is prices, wages and interest rates are freely determined in the market—and the private sector became the sole agent responsible for growth The government—besides the traditional functions of defense, justice and order—regulates, according to rules established by law and not as discretionary authority, some aspects of what are considered natural monopolies (electricity, telecommunications, water and sewerage) and gives a very high priority to finance social expenditure (health, education, housing and social security) to tend to equalize opportunities for all citizens

This process of structural change, which given the high degree of centralization achieved under the Allende regime, was very deep and took over a decade to be completed Up until the late 1970s, most of the effort was concentrated on deregulation and privatization of SOEs, except the large public services sector During the late 1970s and early 1980s, the operations of natural monopolies, which in those years were all still SOEs, were regulated by law, and the existing programs in the social sector were reformed to introduce private participation and competition wherever possible During the rest of the 1980s, emphasis was put on developing exports and increasing savings through macro economic management, on managing the foreign debt problem, and on privatizing the large traditional SOEs, most of them public services

As a result of this structural change, including privatization of most of the SOEs, radical changes have taken place in the role of the public and private investment in the country, and is effectively leading a dynamic growth process According to Pfefferman and Madarassy (1992), the percentage change in private investment as a proportion of GDP during 1985–1990 was highest in Chile among 40 developing countries studied, so was the growth of its share in total investment This is allowing the public sector to concentrate its efforts in those activities in which it has no substitute, and to do it in a manner in which it also has become very effective Wherever possible and convenient, it regulates, controls

and/or finances, but leaves the actual production of goods and services to the private sector

Table 3 presents some of the results of the Chilean economy over the 1970-1990 period The table highlights the effects of the 1975-1976 and 1982-1983 recessions, as well as the fast recoveries from both periods It also shows the impressive export growth record, as well as the significant reduction in foreign indebtedness after 1987

The effects of the structural changes can best be evaluated by comparing Chile's performance with that of other Latin American countries that were affected by external shocks of about the same intensity during the last decade Table 4 compares some performance indicators of the Chile economy with those of Argentina, Brazil, Mexico and Peru during the 1980-1991 period These indicators strongly suggest that the Chilean economy has been more successful in coping with the extreme debt shock of the 1980s than the other economies

In any event, it is within this background of radical structural change and strong external shocks that the Chilean privatization took place

PRIVATIZATION AND THE SEARCH FOR A VIABLE DEMOCRACY

In Chile, SOE divestitures took place to achieve broader than economic objectives The SOE sector had come about in part the traditional way a few enterprises were created to offer public services (railroads, post-office, ports, etc), others just fell into the hands of the State when they were rescued from going broke usually under the excuse that employment had to be saved), and later on, others were taken over with the argument that they were monopolies and could be run more efficiently in public sector hands (telephones) or were of strategic importance (copper) However,

Table 3 Some Indicators of the Chilean Economy

	1971	1975	1980	1985	1990
Real Sector					
GDP growth (%)	9 0	-12 9	7 8	2 4	2 1
Gross Investment/GDP (%)	14 7	13 6	21 7	13 7	20 2
National Savings/GDP (%)	12 4	7 9	13 9	5 4	17 5
Unemployment Rate (%)	5 5	16 2	11 8	16 4	6 4
Price					
Inflation Rate (%)	26 7	232 8	19 7	19 5	
Real Wages Index	119 3	62 1	89 4	84 5	
Real Short-Term Interest Rates (Lending Rate)	na	16 0	11 9	11 0	16 4
Real Exchange Rate (1977=100)	71 1	149 7	88 4	128 8	147 9
Terms of Trade (1977=100)	150 6	103 6	87 4	66 3	na
Monetary and Financial Secto					
Total Change in Monetary Base	na	7 2	2 3	0 6	na
M2/GDP (%)	na	11 2	19 3	18 4	22 5
Consolidated Banking Credit to the Private Sector/Total Credit (%)	28 5	15 2	54 7	79 8	82 7
Fiscal					
Public Sector Expenditures (% of GDP)	31 1	27 4	23 1	32 5	na
Fiscal Deficit Central Gov't (% of GDP)	10 7	2 6	-3 1	6 3	na
Foreign Sector					
Real Export Growth (%)	8 6	7 9	18 5	6 9	97 6

Table 3 Some Indicators of the Chilean Economy (continued)

	1971	1975	1980	1985	1990
Current Acc't Surplus/ Exports (%)	-17 8	-27 1	-33 9	-34 9	-9 5
Ann Change in External Debt (US$)	7	80	2600	441 0	-241 0
Ann Change in Foreign Reserves (US$)	Annu	-73	1256	17	-437 0
External Debt Service/ Export (%)	36 8	31 2	39 6	65 4	30 7

Note na = Not available

Sources Central Bank of Chile (1984), Romos (1986), Luders (1986), de is Cusdra and Hachette (1986), Ministerio de Hachienda, and Banco Central

Table 4 Selected Economic Indicators of Latin America

	Per Capita Growth	Inflation Rate, 1991	Export Vol, 1991 (1980=100)	Terms of Trade, 1991 (1980=100)	Balance of Trade, 1991	External Debt, 1991
Latin America and the Caribbean	-8 1	202 4	1,786	73 0	11 900	22 3
Colombia	17 5	29 0	221	79 0	2 685	15 6
Mexico	-5 4	19 9	260	64 0	-10 360	23 0
Peru	-28 3	185 4	97	7 5	55 000	34 8
Argentina	-20 3	91 3	178	6 5	4 340	35 0
Brazil	-6 6	465 8	184	82 0	11 000	23 7
Chile	16 0	17 8	217	83 0	1 600	15 5

Source ECLA (1991)

mainly during the 1940s and 1950s, several SOEs were created by the State to generate the necessary infrastructure in the country for its industrial developments, which at the time was believed to be the source of economic growth In this way, steel, petroleum and electricity, among others, became predominantly State-run industries The process reached its climax under the Allende government, as described earlier

Although SOE management was strongly criticized by some, the sector as a whole was moderately profitable up to the late 1970s which considering its reasonable size, made it acceptable to the majority (Larrain and Selowsky 1991) Allendes Popular Unity, however, used SOEs as a key vehicle of its massive incomes policy (higher wages, lower prices for wage goods), which increased consolidated SOE losses to over 15 percent of GDP during 1973 At the same time, the government was intervening and nationalizing hundreds of enterprises, whose management was then changed from experienced professionals to political, student or labor leaders More often than not, this resulted in gross business mismanagement, within an economy strongly affected by socio-political instability All this resulted in rapidly falling incomes and accelerating inflation rates (see Table 3)

Matters were made worse by the Popular Unity's explicit desire to centralize the economy, of which nationalization was generally believed to be a part of This was perceived as the way to gather the necessary economic power to eventually transform the existing Western-style democracy into a Marxist regime This latter, perhaps even more than the economic disaster, became the basis of support for the military takeover of September 1973 [2]

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[2]The influence of intellectuals like Friendrich von Hayek, on one side, and Leon Trotzky, on the other, was clearly recognizable at the time Hayek, in the *Road to Serfdom*, stated that "Economic control is not any control over one part of human life which can be separated from the rest, it is the control of all means for all objectives" Wile Trotzky wrote dur-

ECONOMIC AND POLITICAL POWER

The new regime set out to introduce drastic changes into the socio-political and economic system For its leaders, the Allende crisis represented but the culmination of the existing institutional arrangements, which resulted in a rent-distributing state and a relatively stagnant economy These, in turn, had produced poverty for most, and an extremely uneven wealth distribution, the main cause of the existing socio-political crisis [3] It was therefore, decided to implement a (social) market economy, in which the private sector was going to lead the growth process Such an economy was consistent with political democracy and had proven elsewhere to be effective in raising living standards and producing economic justice Since at the time the SOE sector was so significant, a massive privatization process was the logical consequence

In late 1973, however, the government was only in a position to decide to privatize those enterprises the Allende regime had

ing 1937 that "The old principle those which do not work will not eat, has been replaced by a new one those which do not obey will not eat"

[3]In fact, it was the relatively stagnant economy and its consequences (poverty, inflation and uneven income distribution) which divided the country almost evenly into three ideological camps the conservative right, which favored the existing arrangements which benefited its members directly, the Christian Democrats, which advocated in favor of a reform program to redistribute land, make taxation more progressive, increase expenditures in housing, education, health, etc, and the radical left (communists and Marxist socialists), which pretended to centralize the economy completely and create a Marxist political regime Since 1958, each one of these groups had come to power the conservatives with Alessandri (1958–1964), the Christian Democrats with Frei (1964–1970), and the radicals with Allende (1970–1973) The fact that none of the programs tried satisfied the expectations of a majority of the country, and that the last regime eventually threatened the economic and political freedoms a large majority did want, created the conditions for the military takeover

intervened or nationalized, nor did the military probably want to go beyond that Although a high proportion of the population favored privatization, very few believed the "traditional" SOEs (public services, steel, petroleum, copper, etc) should be divested This was also true among those civilians who supported the military regime, especially some nationalistic groups Although these latter never changed their position, Pinochet decided during the early 1980s to allow privatization of most traditional SOEs, except CODELCO (copper) and ENAP (petroleum) This policy reflected the view of a growing proportion of the population which had switched position as a result of (1) Chile's own experience with privatization, (2) the need to attract resources to expand investments in infrastructure, and especially (3) the President's perception that he would probably soon have to turn power over to a democratic regime In such an event, he wanted to make sure that the public sector would not have at least initially the resources to fall again into the same ill of the past, especially that of widespread rent distribution Privatization of the large traditional SOEs was one way used to try to achieve his objectives

Efficiency

Although there is no doubt that the main driving force of the Chilean privatization program was political, economic aspects also played a very important role One of these was efficiency The economic team of the military regime[4] restructured the economy to subject all enterprises (private and State-owned) to strong competition This was achieved by opening-up the economy to

[4]During most of his presidency, Pinochet chose as his main economic policymakers relatively young, foreign trained economists Since a significant proportion of these had received degree from the University of Chicago, they are generally known as the Chicago Boys In fact, many of the team's best-known members made post-graduate studies in Columbia, Harvard, MIT, and other top U S schools

foreign trade, freeing prices and entry into different industries, reinforcing anti-monopoly institutions, etc It was believed that in general this was sufficient to assure that private enterprises (except natural monopolies) would seek an efficient internal allocation of resources and maximize profits It was also believed that, especially in the longer run, this would not be the case with SOEs [5] Governments, for political reasons, could always decide to subsidize their enterprises to be able to achieve other goals, especially the implementation of a certain incomes policies with populist overtones (lower prices of certain goods and services), and patronage Therefore the economic team was always a strong advocate of privatization

Social Expenditures and Investments

In spite of the above, perhaps the most compelling argument for SOE divestiture during the 1970s was the need to raise resources to finance the budget deficit In this respect, the Chilean experience is not too different from that of most other countries One of the legacies of the Allende regime was a budget deficit of over 20 percent of GDP To reduce this deficit and eventually generate a surplus, the government eliminated the SOE sector deficit by, among other measures, allowing SOEs to charge market prices for their products, induced SOEs to distribute dividends, drastically reformed the tax system raising average rates in the process, significantly improved tax payment enforcement, raised revenues through privatization and reduced public sector expenses The government was not willing to cut social expenditure (housing, health, education, and social security), in spite of

[5]Under the Military Regime, political interference with the management of SOEs was very limited, and these enterprises were subject to a "hard budget they were required to auto-finance themselves, had to distribute 100 percent of their profits in dividends, and were not able to receive a government guarantee for loans

the fact that they had been rapidly growing during the two previous governments and had reached levels relative to GDP that were similar to those in the OECD countries Hachette and Luders (1992) conclude that revenues from privatization were used to finance the desired level of social expenditures Moreover, it can be argued that given the top priority for balancing the budget during the 1970s, and considering the level of other public sector expenditures, in the absence of the existence of privatization revenues, social expenditures would have been cut back

Later on, during the privatization of the traditional SOEs, the budget was well under control, and revenues from privatization were used, according to Hachette and Luders (1992), to finance infrastructure investments This type of investment had been reduced to a bare minimum during the 1970s, and the government was under considerable pressure to improve infrastructure As before, it is highly unlikely that in the absence of SOE divestitures, the government would have been willing to incur a deficit or to raise taxes to finance that infrastructure In fact, at that time, the government was in the process of reducing taxes to crowd the private sector in, while making sure the budget was balanced

THE CHILEAN PRIVATIZATION PROCESS

Between late 1973 and 1989, about 550 enterprises were privatized in Chile, some of them twice! Total revenues from privatization were about 15 percent of GDP,[6] spread unevenly over the mentioned period In fact, privatization of SOEs in Chile concentrated in two rounds, the first covering the 1974–1978 period and the second in 1985–1989 Before describing the different phases of the two SOE divestiture rounds, other forms of privatization in Chile should be mentioned In this respect, privatization of land

[6]In addition, it is estimated that the equity in the intervened corporations, which were given back to their legal owners during 1974, amounted to about US$1 billion

and of some of the social sector services stand out The institutional changes which affected the latter were called "modernizations," and were put into practice during the late 1970s and early 1980s, among others, in the educational, housing, health and social security subsector

Land, Education, Health, Housing and Social Security

Allende had accelerated the agrarian reform process, and by the time the military took over, about 50 percent of the irrigated land had been expropriated and handed over to institutions resembling cooperatives, but without land ownership,[7] since the latter belonged to the State The Pinochet regime decided to privatize the land, offering it in the form of individual parcels to farm-labor in these cooperatives Machinery was to be held collectively The price of the land was set close to the market price, but payment conditions were concessional About 40 percent of those who received land in this way have since sold the land Moreover, land transactions, which were heavily regulated before, have been almost completely liberalized, and land ownership has been separated from water rights, facilitating an optimum allocation of water

In the field of education, reform was also significant For primary and secondary education in which most students attended State-owned schools before 1974, some went to schools run by nonprofit organizations (mostly the church), and only a small minority went to fully paid private schools (supervised by the State)—a variant of the voucher system was adopted State-owned schools were municipalized and competing private for-profit schools were allowed to exist Both municipal schools and

[7]These institutions managed by farm-labor but under state supervision were called *asentamientos* The original idea had been to transfer land to the members of the *asentamientos*, but this intention did not materialize until the military regime

those private schools which do not charge students tuition or other fees have been entitled to receive a payment from the State for each day of effective student attendance Programs and acceptable teaching materials are still dictated by the State Today about 60 percent of primary and secondary school enrollment is private At the higher education levels before 1974, a limited number of institutions existed, and these were 100-percent financed by the State Now State financing has become less significant and to some degree competitive for the "traditional" universities, while a large number of fully private institutions have been allowed to be created

Reform in the health care field has been less effective, with the exception of those segments which have been clearly decentralized or privatized Up to 1974, health services were almost exclusively provided by the public sector, and private practice was limited to upper-income segments The government decentralized basic health care functions to municipalities, and contributed to their financing on the basis of services rendered In addition, it allowed employees to use the health insurance tax (7 percent of salaries) to finance the purchase of health insurance in private corporations (ISAPRES) created especially for that purpose[8] These corporations operate on a competitive basis Some own their own hospitals and other health care units, while the remainder finances services provided by third parties The State still finances, with the health insurance tax, general tax revenues and fees which cover part of the costs of the services rendered and the operations of its large hospitals It is generally argued that the quality of service in these hospitals has fallen significantly behind The services offered through the ISAPRES is generally considered excellent, but is in practice only available to those families which

[8]These institutions are called ISAPRES (Instituciones de Salud Previsional (Health Provident Institutions), and they are regulated by the Superintendencia de ISAPRES (the ISAPRES Superintendency) ISAPRESS are free to propose health plans and rates

have an income exceeding the equivalent of US$1,000 per month Therefore, only about 1 5 million people, out of a population of over 13 million, are covered by it

The organization and management of public housing programs was also changed under the military regime, increasing private participation In the past, governments would allocate houses directly to lower-income families and sell them at subsidized prices and interest rates Collection of debts was nearly impossible These houses were either built directly by a State-owned construction company, or ordered to be built by the authorities, in what turned out to be typical "gray" housing projects Today the government allocates, on the basis of an objective point system, free of charge, a certain amount of money among low-income families to be used to buy a house With this "capital," the favored families look in the market for a house of their preference They are even able to improve on the house they get by borrowing from a commercial bank on market terms As a result, for given government expenditures on public housing and average subsidies per family, more and substantially better houses are being offered to the needy Of course, only part of this improvement can be attributed to a more efficient system, since the benefited families also have to make a larger voluntary savings efforts

By far the most important, and novel, "modernization" was that of social security, specifically that of the pension system Like most countries, Chile had adopted decades ago a "pay-as-you-go" pension system These systems have many disadvantages, among them a tendency to invite pressures for constantly raising benefits, which results in deficits In addition, since the system is financed with a tax on wages, higher benefits imply sooner or later, higher taxes, and therefore lower levels of employment Moreover, when the system is run as it usually is by the public sector, it does not provide any incentives for efficient management Chile experienced all of these problems in a rather

acute way, and therefore, the military government decided to replace the existing system with a "capitalization" system, in which the funds are privately managed and employees are required to pay 10 per cent of their salaries into individual pension accounts at a number of alternative pension funds These funds are managed by pension fund administrators (one for each fund), which are private corporations especially created for that purpose Employees freely decide to which fund to thrust their pension savings on the basis of the fees charged by the administrators, which are market-determined, the expected returns, which are a function of the quality of portfolio management of the administrators, and the quality of the service The whole system is closely supervised to avoid fraud by a Superintendency of Pension Fund Administrators, the portfolio composition of the funds is highly regulate and a very conservative risk evaluation system (partly privately operated) was developed, and several measures including a government guarantee of last resort exists to limit the losses of the pension savers Public acceptance, as well as the impact of the new pension system has been impressive The funds have accumulated about US$10 billion, about one-third of GDP, and this amount will reach eventually over 60 percent of GDP[9] Pension funds have purchased about 25 percent of the shares of the traditional SOEs which have been privatized Furthermore, the port-

[9]The switch from a "pay-as-you-go" pension system to a "capitalization" system leaves the retired without any pensions, and most of the active population with various degrees of inadequate pension levels, unless the government intervenes to solve the problem In Chile, the government decided to finance the pensions of the retired at the time of the change in pension system, and to issue a promissory note for those active at the same time, equivalent to their estimated contributions up to that time under the old system These promissory notes carry a real interest rate of 4 percent, and become due at the time of retirement The government finances these expenditures in part with the paper it sells to the new pension funds, whose portfolio has been invested in part (on average up to now about one-third) in government debt papers

folio managers of these large institutional investors have contributed significantly to the improved functioning of the capital market

The Privatization of the Intervened Firms

During the first found (1974–1978), the contribution of the 550-strong SOE sector fell, as mentioned, from 39 percent in 1973 to 24 percent, and its employment from about 161,000 to 90,000, not all of which can be attributed to the divestitures In spite of this, and that during this period over four-fifths of the number of existing SOEs was divested, only about one-twentieth of the sector's net worth at estimated market prices was privatized (Hachette and Luders 1992) This is mainly so because CODELCO, the huge and profitable State-owned copper company remained in public hands

During 1974 alone, almost 325 firms were privatized, when management of most of the intervened enterprises was returned to their legal owners This process was relatively fast and easy, since ownership, as opposed to the case now in Eastern Europe, was well established, and as a rule, additions to equity had not been significant during the Allende period To the contrary, most of these enterprises had lost their working capital Therefore one of the conditions the government placed on returning these enterprises was that the owners would refrain from legal actions against the State to regain the lost working capital Other conditions referred to employment level maintenance and to a prohibition to merge with other enterprises within the same industry These latter two conditions, however, were never enforced, especially after the government decided soon after to open the economy up to foreign trade to enhance efficiency

The Debt-led Privatization Phase of 1975-1978

During this phase, 207 enterprises were divested, generating revenues of about US$1,200 million Most of these enterprises had been nationalized under Allende, and they included all but one of the commercial banks All of the enterprises were CORFO subsidiaries, which made divestiture a simple process from a legal point of view, since it only required an agreement of its Board of Directors, whose members were all government appointed Three divestiture methods were used liquidation, bidding-at-auction, and direct sales

Liquidation

A number of enterprises were liquidated This happened when a preliminary evaluation of an enterprise suggested that its going concern value was below its liquidation values, or when the enterprise could not be divested at a price above the estimated liquidation value Both of these occurrences were not strange even if the firms had been profitable before 1974, since the enterprises had been created when the structure of the economy was very different from the one that prevailed once the reforms announced by the military regime were implemented

Direct Sales

A few enterprises were sold directly This was usually done whenever CORFO did not receive any qualified offers in a bidding process, for smaller enterprises, or in the exceptional instances in which it was decided to sell the enterprises to the employees, like the Empresa de Computacion, ECOM (Computation Enterprise) ECOM had been created to handle the information handling needs of the public sector, most of its hardware was leased, and it was felt that its main "capital" was its employees Turning over ECOM to the employees at a relatively nominal

charge, at their own request seemed therefore natural Something similar was done with other high-level manpower intensive enterprises [10]

Bidding-at-auction

Most enterprises, however, were divested using a bidding process regulated by Decree No 1068 According to the decree, bidders could either offer cash or credit terms, and CORFO was allowed to reject all offers without any expression of cause, accept the best offer, or if it so wished, negotiate with the two highest bidders Over time, this last form became the norm, which on average probably resulted in somewhat lower prices than those it could have obtained just by accepting the highest offer In a country in which at the time at most two or three firms were effectively participating in each bidding process, the expectation of a further negotiation is likely to have induced lower initial offers by all participants In the negotiation, the winner probably only offered a price slightly above that of his contender, since he was in a position to "feel" the latter's willingness to pay, a feeling he could not have before the bidding

Most of these divestitures took place on credit terms, and therefore the second phase of the first round is known as the "debt-led" privatization phase After the Allende regime, very few Chileans had liquid assets of any amount (although some of them had considerable wealth) since inflation had wiped out most financial assets, corporations had lost all their working capital, and Chileans have traditionally had low investments abroad Moreover, at the time foreigners considered the country to be a very risky place to make investments, in part because the military regime was not consolidated, but also because the economy was

[10]In general, in Chile control of very few enterprises was transferred directly to the workers, although worker participation in privatized enterprises became very important during the Second Round (1985–1989)

not performing well Under those circumstances, cash sales would have generated very low prices Since the government needed resources to balance its budget, it expected to get significantly higher revenues by offering controlling interests in SOEs on credit terms (eight to twelve years, 7 to 12 percent real rate of interest, very low down payment) It has to be recalled that at the time, due to the liquid resource scarcity, the credit market was very short (most credit operations did not exceed 30 days) and real interest rates were extremely high (64 percent in 1976, 42 percent in 1978) In addition, to increase the number of bidders, but also to widen the entrepreneurial base of the country, the government did not pre-classify bidders on the basis of their solvency or management experience

The result of this process was a disaster Risk-takers were attracted by these conditions and usually acquired several enterprises Since the down-payment requirements were modest, they tended to form highly leveraged conglomerates Given that the commercial banks were also divested (although with shorter credit terms), most of these conglomerates acquired at least a commercial bank, or if they did not do so, they created one later [11] Bidders, who in fact risked very little, were probably inclined to offer "high" prices for the SOEs to be divested,[12] and were there-

[11]Initially the government limited the participation of any one natural person to 1 5 percent of a commercial bank's shares, or 3 percent in the case of corporations However, conglomerates, through their network of holding companies, had no problem in getting around the intention of this limitation and acquired absolute control of the commercial banks The government later on repealed these limits arguing that it could not enforce them In fact, at the time the economic team probably felt that, if anything, such limits to the exercise in economic freedom were not warranted

[12]It is therefore ironic that around 1980, when at the peak of a boom, these conglomerates appeared extremely successful, many attributed their success to the "low" prices at which the government had divested the SOEs See Dahse (1980)

fore later on likely induced to take above reasonable risk to be able to pay for the different installments This might be a typical case of "moral hazard" Moreover, this process of indebtedness and excessive risk taking was aggravated by an exaggerated degree of "asset monetization" during the last years of the decade of the 1970s High and rapidly rising asset prices (at a rate significantly exceeding the still very high domestic real interest rate) induced some to sell land and stock to acquire commercial bank deposits, while risk-takers bought the land and stock with commercial bank credit This indebtedness with the banking system was further increased when the net (after investments) operational revenues from the privatized SOEs turned out to be insufficient to pay for the installments to the State While most conglomerates initially diversified their sources of credit, when conditions changed, especially during 1981–1982, they tended to turn increasingly to their own financial institutions, up to the point where most of these financial institutions ended up with highly concentrated credit portfolios (de la Cuadra and Valdes 1989) When the effects of a foreign recession hit the country during the early 1980s, and later on when the foreign debt crisis emerged, indebted firms and persons, conglomerates and others, became insolvent, and deeply affected the banking sector

The government then decided to take over the insolvent banks, which included the most important private financial institutions controlling over 60 percent of the sectors assets, to liquidate some and rescue others [13] In the short run, the government through a central bank swap operation, took over for all practical purposes the "bad" portfolio of the financial system to restore its solvency and effectiveness No doubt, the intervened financial institutions—which were re-privatized later on—are in principle

[13]Large-scale interventions of financial institutions took place in late 1981 and early 1983 (Luders 1985) In all of these cases, the bank interventions were managed in such a way that control of the banks changed hands, and stockholders lost, for all practical purposes, all their equity

committed to repurchase the "bad" debts over time with a high proportion of their profits,[14] which they have to allocate for this purpose In spite of this commitment, it is now clear that at least two large banks are unlikely to be able to repurchase their bad debt (Silva 1991) and in addition, these swap operations, and other refinancing schemes for small and medium-sized borrowers, imply heavy interest rate subsidies from the government and the central bank Since the government used privatization revenues to finance higher levels of expenditures of education, health, housing and social security, it can now be argued that part of these expenditures were financed by borrowing at the extremely high interest rates prevailing in the country at the time, and it is of course difficult to justify those expenditures under such conditions

More important from a policy point of view, divestitures on credit to controlling parties in a country with very scarce liquid assets and no foreign investment will invite higher than reasonable bids Under such circumstances, it should be expected that purchasers will at one time or another resort to credit to pay at least part of their installments If the government decides to spend all installment revenues, it might create upward pressures on an interest rate which is already high, precisely because of the scarcity of liquid resources In Chile, the government received between 1974 and 1978 privatization-related payments of US$582 million, while it increased its financial assets by about US$300 million, which should have at least neutralized some of the upward pressure on the interest rate (Hachette and Luders (1992)

[14]This is in itself a source of moral hazard, and might induce these banks to incur higher than optimum costs, since their effective rate of "taxation" on income becomes very high

The "Odd Sector" Privatizations[15]

Although some modest efforts to privatize a few traditional SOEs were begun during 1982–1983, the next wave of SOE divestitures started in late 1984 The first phase of this second round consisted in the privatization of those enterprises which had fallen into the hands of the intervened financial institutions Among the more significant of these enterprises, a majority were enterprises which had been privatized before, while others were either recently created firms or traditionally private firms Only a handful of these enterprises had gone bankrupt, while the rest belonged to conglomerates which either had gone bankrupt or had negotiated their liquidation with the government to avoid bankruptcy The expression "odd" was used to signal that these enterprises no longer belonged to the private sector (since they or their holding companies had gone bankrupt), nor to the public sector, since the financial institutions had been intervened by the government, but did not belong to the State

Bidding Pre-qualification and Cash Payment

All but four of the larger "odd sector" enterprises were privatized using a bidding process, which in this case was managed either by the financial institutions directly, or in the case of negotiated settlements, by special commissions in which the owners had a minority representation In those cases, the government played an important indirect role through the appointments of those responsible for carrying out the process During this phase, to avoid some of the problems generated by the divestitures of the

[15]For a definition of ' odd-sector, see following paragraph Unfortunately in the case of most of these "odd sector" divestitures, little public information is available on the privatization transactions, which are considered by the responsible parties to be strictly "private transactions," which from a legal point of view is correct

first found, care was take to pre-qualify bidders, especially on the basis of their solvency, and divest on a cash payment basis

Part of these divestitures took place when foreigners already had been invited to purchase shares in enterprises to be privatized through debt-equity swaps This mechanism (Article XIX of the Central Bank Statute) was developed to attract "foreign investment" to reduce the foreign debt of the country Under Article XIX, capital could not be repatriated for ten years, versus three years for standard foreign investments, which was to compensate for the fact that investments could be made with Chilean debt paper valued at the time at around 60 percent Although initially the government did not "tax" these operations in any other way, it did so later on when "foreign investors" had to exchange Chilean foreign debt papers for long-term central bank bonds carrying a significantly lower-than-market real interest rate, and then had to discount these bonds in the market to pay for the shares of the divested enterprises The swap mechanism was used to pay for over 20 percent of the shares of the SOEs privatized during the second round However, as a rule, foreign investors did not participate directly in the "odd-sector" divestitures, but bought into the enterprises after privatization This happened, for example, in the case of Carter-Holt (New Zealand), which acquired 50 percent of the shares of the holding company Angellini, one of the most important Chilean entrepreneurs, which had been created to control COPEC, a large concern operating in gasoline and electrical appliances distribution, cellulose and fish-meal production, and other lines of business The same process took place in the case of Paulaner, one of the large German beer producers, who bought into Compania Cervecerias Unidas (CCU), briefly after Luksic had won the bid and gained control of CCU In general, in spite of a debt-swap mechanism which favored foreign over local investment in the case of privatizations,[16] the case of the Compania

[16]Since foreigners were allowed to pay for shares in privatized SOEs with Chilean debt papers accounted for at par value, but they could purchase

de Telefonos de Chile (CTC), to be described later, stands out as the only significant wholly owned foreign acquisition, while in other cases, joint ventures have been formed

Popular Capitalism

Among the "odd-sector" enterprises were the two largest former private commercial banks—Banco de Chile, which had been controlled by the Vial or BHC conglomerate and a group of other investors, and Banco de Santiago, wholly owned before the crisis by the Cruzat-Larrain conglomerate—and the two largest AFPs (pension fund administrators)—Santi Maria and Provida—controlled by the same conglomerates To privatize these enterprises, the government developed a mode called "popular capitalism," which in essence was nothing but a free transfer of ownership to taxpayers The banks, which had to be capitalized, issued new shares which were offered to the general public on the basis of a long-term credit offered by CORFO[17] at zero percent real interest,[18] and a down payment equivalent to a year's expected dividend Moreover, initially purchasers were allowed to deduct each year from the income base for tax purposes the total

these at less than par, they were in a position to offer higher prices than the Chileans, who had to pay cash Given competing foreign and Chilean bidders, the former should have offered higher prices exactly to the extent of the effective discount on Chilean foreign debt papers

[17]The issue of these shares was accompanied by a round of paper exchanges between CORFO, the central bank and these two commercial banks which in the short run implied a capitalization of the commercial banks, a reduction of their debt with the central bank, and left CORFO with part of the debt of the central bank, offset by the debt of the share purchasers In the long run, both of these latter debts would be eliminated, not affecting CORFO's balance sheet

[18]Later on popular capitalism was used to privatize part of some of the electric companies, but in these cases, a lower-than-market interest rate was charged

amount of their investment in these shares, as long as they did not sell them Although this latter provision was later repealed, and in spite of the fact that those banks were among those forced to assign a part of their income to repurchase bad debt from the central bank, the expected net price of these shares for taxpayers in the upper-income brackets was zero or negative However, since the government was interested in spreading property of these shares, they limited sales as a function of past tax payments, which turned out to be a limit of about US$7,000 per person per firm The shares issued were easily underwritten and generated tens of thousands of new shareholders Although many "popular capitalists" have since sold their shares, and some people seem to be accumulating larger holdings, ownership is still extremely widespread and the annual shareholders meetings are held in large theaters or stadiums, while effective control of these two banks is in the hands of management

A similar process was used to privatize the two mentioned AFPs, although in this case only a part of the existing shares were offered to "popular capitalists" The Aetna Insurance Company, a 49 percent partner with the Vial or BHC Group in the AFP Santa Maria since its creation, acquired an additional 2 percent as a result of a directly negotiated purchase, the rest of the shares (another 49 percent) were offered to "popular capitalists" under similar conditions as those described in the previous paragraph Bankers Trusts also bought, through a debt-equity swap, 40 percent of the shares of Provida, the largest AFP, after a direct sale that was intended to generated a controlling shareholder in this company The rest, 60 percent of the equity of Provida, was offered to "popular capitalists" As in the case of banks, the shares of these two AFPs were easily placed and generated thousands of

shareholders Management, of course, in these cases was controlled by the two foreign partners [19]

THE PRIVATIZATION OF TRADITIONAL STATE-OWNED ENTERPRISES

The last phase of the Chilean SOE divestiture program began in 1985 and consisted of the privatization of around 30 of the large traditional SOEs This generated public sector revenues exceeding US$1,200 million

The privatization of these enterprises was more sensitive, since the nationalists, which included some of the most ardent supporters of the military regime, the Marxists and the socialists, and even many belonging to the parties of the political center, did not support these divestitures Therefore, the government acted with extreme caution The first step was, in general, the transformation of the SOEs into corporations, subject to the supervision and informational requirements of the corresponding Superintendency This was done, it was argued, to improve control over these enterprises and therefore management Who could object to such an aim? The next step was to announce the sale of up to 30 percent of the enterprises (a part of that went to workers and managers), by no means to privatize eventually the enterprise, it was said, but to collect resources to finance some of the needed infrastructure investments and to improve the quality of management even further through the pressure generated by private sector board members, and stock exchange quotes of their

[19]Many felt at the time that control of the two largest AFPs in the hands of foreigners might become controversial In fact, at the time of the discussion of the political platform of the parties now controlling the government, many party members favored the transformation of the AFPs in general into nonprofit, or at least worker-controlled, corporations However, the general satisfaction with the functioning of the new pension system eventually led to accepting the status quo

shares [20] Again, who could object to this? Later, the divested percentage was raised to 49 percent, but by that time with very little opposition, given the positive impact of the previous percentages of equity divested And then usually very quietly, two additional points were sold in the stock exchange, and the enterprise had been privatized Complete divestiture followed then usually swiftly

Labor Capitalism

During this last phase, the government made an effort to spread ownership of the privatized enterprises They used a battery of divestiture modes, which included especially "popular capitalism" as already described, "labor capitalism," "institutional capitalism," and "traditional capitalism"

To gain worker support, among other reasons, the government usually offered initially to the employees of these traditional SOEs, a percentage of the equity of the enterprise at a lower than (estimated) market price [21] The share of the net worth offered to workers varied from company to company, mainly in relation to the wage bill-to-equity ratio of the enterprise, and tended to average about 6 percent Workers paid for the stock with the advance of 50 percent of the severance payment they were entitled to,[22] the operation of which had to be authorized especially by law If at the time of retirement, or before if pertinent, the worker still owned the stock, and if the stock was worth less than 50 percent

[20]In some cases, the percentage of equity was immediately fixed at 49 percent See Luders (1991)

[21]In some cases, the price subsidy was replaced with other incentives, for example, credit at subsidized interest rates or cash advances on the right to severance payments

[22]In most of these traditional SOEs, workers were entitled to receive one month of salary per year of service at the time of retirement, if the employer decided to end the contract earlier

of the severance payment he was entitled to, the firm was forced to "repurchase" the stock These offers were, in fact, "no less" situations in which, because of the discounted price of the shares, the likelihood of gain was very high It is, therefore, not surprising that the overwhelming majority of the entitled workers accepted the offer, very often even against the "instructions" of their union leaders who were politically motivated In some enterprises, workers used the capital they had, after acquiring these shares, to provide collateral for (commercial bank) loans to purchase additional shares In this way, in enterprises like CAR (steel), SOQUIMICH (Chilean nitrate), ENERSIS, the holding company of some of the privatized electric companies, and some others, workers acquired over 35 percent of the equity Moreover, to privatize ENDESA, the large electric generating and distributing company, the government divided it into a large number of independent corporations, some of which became wholly worker-owned

Table 5, taken from Hachette, Luders, Tagle and others (1992) shows, perhaps better than many words, the impact of "labor capitalism" in some enterprises In this case, the divided income from CAP shares represented in 1989–1990 almost 4 percent of the average workers' labor income

Institutional Capitalism

Stock was also sold indirectly to workers through a mode known as "institutional capitalism" As mentioned earlier, the new pension system provided an opportunity for the government to sell shares of the SOE to be divested to the pension funds By statute, these funds were allowed to invest a fraction in stock of corporations, as long as the supervising authorities would allow it Initially the authorities were reluctant to permit pension funds to invest in shares of private corporations However, once the risk classification mechanism was developed and proven, they decided to allow funds to purchase shares in SOEs to be privatized,

Table 5 Average Income of a Capworker (US$ 1990)

Year	Labor Income	Yearly Dividends (7,000 shares)	Yearly Dividends/ Labor Income (%)
1986	4 453	116	3
1987	4 557	394	9
1988	4 482	955	21
1989	4 467	1 967	44
1990	4 407	1 392	32

Source C A P S A de Inversiones

as long as these fulfilled the legally required conditions [23] As a result, pension funds soon became a significant source of funds for the privatization process, acquiring about 25 percent of the shares in most of the divested traditional SOEs Moreover, as a rule, the government would offer shares to the AFPs, normally in a bidding process at the stock exchange, immediately after having offered them to the workers Sales to the pension funds thus became a way of creating a market for these shares, in those cases in which the shares had not been traded before, or their market had been very thin, which was the norm This was important, since the remaining shares of the privatized SOEs, after "labor" and

[23]This was not always a trivial requirement For example, in the case of ENDESA, its debt-to-equity ratio was so high (22 9 times in 1986) that, given the risk classification procedure, its shares would have been classified below the acceptable risk level As a result, the government decided to capitalized US$500 million of its debt, through a swap operations carried out between CORFO (ENDESA's owner) and ENDESA itself This operation was later criticized arguing that it implied a subsidy to ENDESA share purchases, which was not the case See Hachette, Luders, Tagle, and others (1992)

"institutional" capitalism, were usually sold at the stock exchange

Traditional Capitalism

Although "popular capitalism" was only used in a few privatizations of this phase (notably ENDESA and a few electric distribution companies), and "labor" and "popular" capitalism was applied to most privatization, "traditional capitalism" was always present It consisted of sales through the stock exchange, most of in the form of auctions of relatively small stock package This form of capitalism also included sales to foreigners, as in the case of the Compania de Telefonos de Chile (CTC), where 30 percent of the shares were bid-at-auction internationally, with the commitment of the winners to invest additional US$337 million to raise their share in the company to 50 percent Overall, "traditional capitalism" was used to privatize over 50 percent of the shares of the divested traditional SOEs, and became another important factor in the development of the Chilean capital market

Overall Accomplishments

The accomplishments of the privatization process can be judged from many points of view Some of its specific effects on a number of economic variables will be discussed in the next section, while here only some general comments are made On the one hand, the value of the divested equity did not exceed US$4 billion, including the estimated value of the free of charge returns of the first phase, while only the estimated present value of the cash flows of CODELCO, still in State hands, exceeds that amount Moreover, the value added by the SOE sector during 1988—that is, towards the end of the privatization process—was over 15 percent of GDP Although since then this ratio must have fallen slightly, it is probably still above that of the late 1960s and

significantly above that of the average of countries with market economies (Hachette and Luders 1992)

On the other hand, while at the end of the Allende government, the State controlled almost 600 enterprises, in late 1989 that number had fallen to less than 50, and it should not be forgotten that a significant proportion of those represent the former water and sewerage service which was broken down into more than ten regional corporations The SOEs of 1973 were, in general, the major firms in practically all economic sectors, while in 1989 only a handful of large enterprises remained in State hands, in particular, CODELCO (copper), ENAP (petroleum) and Colbun-Machicura (electricity generation) Moreover, although the value added after the divestitures is still as high as that of the late 1960s, it has fallen significantly from that of 1973 (39 percent of GDP), and is estimated to be below 5 percent of GDP if only CODELCO is excluded [24] As a result, except for mining (copper and petroleum), the private sector has become the major player in all other economic sectors, which was not the case before privatization Within mining, petroleum is a declining industry in Chile for lack of reserves, and the overwhelming majority of the expansion in copper is taking place within the private sector As a result of a recently approved law, CODELCO will be able to exploit its vast mining rights on the basis of joint ventures with private enterprises, which can even have a controlling majority in them [25]

That is, privatization has been one important instrument of an economic policy which has transformed the private sector into the principal agent of economic growth in the country, and a stagnant economy into a dynamic one In this sense, it fully re-

[24]During the late 1960s, CODELCO did not exist, and the large copper companies were foreign-owned This means that the value added by the SOE sector in the rest of the economy fell by more than two-thirds as a result of the privatization

[25]According to the Chilean Constitution, CODELCO and ENAP are the only two SOEs which cannot be privatized

sponded to government expectations However, without deregulation and the opening of the economy to international trade and capital flows, among other complementary measures, these effects could probably not have been accomplished The whole structural reform package assured the social usefulness of private enterprise, which now has to seek profits by satisfying the needs of the population producing the goods and services demanded at the lowest possible cost In the past, especially for the larger concerns, rent-seeking activities, like pressing for higher custom tariffs and fixed prices, limiting entry into the industry, obtaining subsidized credits, etc were more profitable than efficient production As a result, the image of the private sector has changed, and the whole privatization process, including that of traditional SOEs, has become legitimate [26]

WEALTH, EFFICIENCY, EMPLOYMENT AND CAPITAL MARKET DEVELOPMENT EFFECTS OF THE PRIVATIZATIONS

Divestiture of SOEs affects many economic variables Four of these variables have been chosen here for a brief analysis, because of their significance in relation to this issue, or in view of the controversy which arose around them in Chile

Did Privatization Reduce Public Sector Wealth?

Privatization will normally affect both fiscal cash flows and its wealth In Chile, SOEs as a group tended to be marginally profitable, except during the Allende period, but generated nega-

[26] Although some aspects of the privatization procedure of a few firms have been questioned, and Congress launched some time ago an investigation into them, the present government (in the opposition during the military regime) has indicated clearly that this will not result in a reversal of said divestitures

tive cash flows, due to reinvestment requirements (Larrain and Selowsky 1991) If one projects those circumstances, it could be argued that privatization reversed cash flows for the public sector from the operation of these enterprises Initially the Government received the revenues from divestitures, and thereafter a steady tax stream Revenues from SOE divestitures averaged over 3 4 of the central government budget between 1974 and 1989, and exceeded 10 percent of it in 1975 and 1988 As a percentage of GDP, they averaged in excess of 9 percent over the same period In addition, of course, the government was receiving taxes on the income generated by the divested enterprises

The wealth effects of privatization depend crucially on the expected efficiency gains (or losses) with privatization, the divestiture modes used, and the use the government makes of the privatization revenues If the enterprise is run as efficiently in the private sector as in the public sector, if the sales mode is competitive bidding, and if the government reinvests privatization revenues, no changes in wealth will take place If the private sector runs the divested enterprises more efficiently, everything else equal, the State will be richer to the same extent as the country If, in addition, the transfer of ownership is free of charge, a wealth transfer from the public to the private sector will take place, although the country might still gain the same

In Chile, the wealth redistribution effects of the privatization process became an important issue There is, of, course no reason why privatization should necessarily leave public sector wealth unchanged, as some pretended However, those same people did not oppose subsidized sales to workers, while criticizing the significant capital gains generated by most of the divestitures to other non-institutional purchasers of shares In the first serious attempt to measure the wealth loss of privatization to the public sector, Marcel (1989) compared the present value of the estimated cash flow (discounted at 9 percent) of a sample of ten divested traditional SOEs, with the present value of the privatization reve-

nue, all estimated and measured as of the end of 1987 On the basis of this, he estimated the wealth loss to average over 40 percent

Cabrera, Hachette and Luders (1991) obtained very different results by working with a longer period, and by questioning the discount rate used, as well as the fact that Marcel implicitly assumed that purchasers of shares in divested enterprises during the 1986-1987 period had always all the information available at the end of the period[27] Since during those years the economy improved very rapidly, cash flow estimated as of late 1987 differed significantly from those estimated with the same methodology in early 1985, when the economy was only beginning to recover very timidly from one of its two largest recessions of this century Cabrera, Hachette and Luders (1991) tried to come as close as possible to market values as of the date of divestiture of each stock package, estimating cash flows given the information available at the time of divestiture for each one of those packages Instead of taking an arbitrary discount rate, as Marcel did, Cabrera, Hachette and Luders estimated the pertinent discount rate for each divested package, taking advantage of the fact that at that time the country was already relatively open to international capital flows, and using the "law of one price," adjusted for the risk differential between Chile and the U S A Not surprisingly, for the initial years of the exercise, discount rates about doubled the 9 percent rate Marcel had used Moreover, as Cabrera, Hachette and Luders show, discount rates would have been much higher (and therefore estimated market values much lower) than those used by the latter, if they would have been obtained directly from the stock exchange, where stock prices had been very volatile

[27]Marcel added up the percentages of equity in his sample of SOEs divested during the years 1985-1988 and then estimated the present values of the cash flows with the information available at the end of 1987

Table 6 shows the results Hachette and Luder (1992) obtained applying the methodology described above to the 1986–1989 period, which covers the whole privatization process of the ten traditional SOEs analyzed by Marcel Overall, prices effectively paid were 15 4 percent below those estimated by Hachette and Luders However, the estimates were carried out in such a way that the expected bias of the estimates would always tend to turn out against the hypothesis of the authors, that is, that prices offered would be close to competitive market prices Moreover, as can easily be noticed from Table 6, it is highly likely that during 1986 the discount rate was significantly underestimated, probably due to a risk of re-nationalization, a factor not considered That is, even if abstraction is made of the subsidy to workers, the use of an unbiased estimate and a corrected discount rate would have at least reduced, if not eliminated, the 15 4 difference between the estimated competitive market price and the effective price of the privatization In conclusion, the analysis of the divestitures of this sample of SOEs suggests that, on average, the wealth transfers between the public and private sectors were in all likelihood relatively insignificant, if they existed at all There are, however, significant differences among the firms in the sample with respect to this issue, which still have to be investigated on a case-by-case basis

Independently of the wealth effect of the divestiture transactions themselves, the State reduced its wealth when it decided to use during the first round privatization revenues to finance some of the social expenditures During the second round of divestitures, those revenues were instead reinvested in infrastructure

Table 6 Sale of Stock of Ten CORFO Subsidiaries, Annual Summary[a]

	1986	1987[c]	1988[d]	1989[e]	Total
Est Price (UF thousands)[b]	12,838 3	20,226 4	40,278 5	11 816 2	85,159 3
Real Sales Price (UF thousands)	7,453 7	18,610 7	38,131 9	9,901 5	74,097 7
Difference UF thousands	5,384 6	1,615 7	2,146 6	1,914 7	11 061 6
%	41 9	8 0	5 3	16 2	13 0
Interest Subsidy (%)[f]	-	4 8	2 5	0 9	2 4
Total Difference (%)[g]	41 9	12 8	7 81	17 1	15 4
Workers and Capitalists					
Diff in favor of workers (%)	44 8	23 3	8 9	–	18 7
Diff in favor of capital (%)[h]	41 7	9 9		17 1	15 0

Notes

a Included are ENTEL, CTC, CAP, ENDESA, SOQUMICH, CHILGENER, CHILMETRO, CHILQUINTA, IONS AND LABORATORIO CHILE

b The UF is a unit of account that is adjusted monthly according to the change in the Consumer Price Index Therefore, the values expressed are in real terms As of April 15, 1989, the UF was equivalent to US$18 50

c Includes one sales, with subsidized credit, of a package of shares of ENDESA (12/87) approved by Law 18681 to public employees

d Includes the sale of two packages of shares of ENDESA (3/88 12/88), with subsidized credit approved by Laws 18 747, the sales were made directly to public employees and indirectly through popular capitalism

e In 1989, CORFO sold stocks only of ENDESA, CTC and ENTEL among the ten firms considered here Includes the sale, with subsidized credit, of two packages of shares of CTC (3/89 and 4/89)
f Include sales to public employees
g This line indicates the subsidy secured by purchasers of stocks when using subsidized credit from CORFO to buy those shares
h This line represents the sum of the difference between estimated and actual prices and the interest subsidy

Are Private Enterprises More Efficient than SOEs?

From the point of view of the well-being of society as a whole, the answer to this question is crucial However, a comprehensive answer is very complex, since it has to address not only questions about the use of resources within the enterprises, but also the effect of ownership patterns on the allocation of resources among different sectors, subsectors and so on As a matter of fact, often the existence of SOEs is justified precisely on the grounds of market failures in the allocation of resources, whose costs overshadow, it is argued, any internal inefficiencies SOEs might have In Chile, perhaps more so than in any other country, an effort was made during the military government to separate these two issues, on the basis of generating a set of rules and regulations applicable to all types of enterprises, which would be conductive to an optimum allocation of resources Free prices for competitive industries and marginal cost pricing for monopolies, open international trade and capital flows, neutral taxation, and many other policies were designed to achieve a good resource allocation Redistribution, in the form of opportunity equalization, was and is carried out mainly through government expenses Within that environment, without any discrimination whatsoever, private and SOEs alike had to survive and prosper

Under such conditions it is possible to test relatively easily differences in enterprise behavior, including efficiency Hachette and Luders (1992) report on work done with Sebastian de Ramon,

applying multivariate and discriminant analysis to a set of financial ratios, obtained from balance sheets and income statements of a large sample of private and SOEs for the 1980–1987 period Although private enterprises turn out to be, as a group, slightly more efficient than SOEs, the difference is not significant from a statistical point of view The explanation is that during that period, political interference in the management of the SOEs was at a minimum, and they faced a hard budget[28] Both conditions should not be expected, as public choice theory tells us, to hold over the long run[29]

Using a completely different methodology, the case method, Hachette, Luders, Tagle and others (1992) came to the conclusion that in five out of six cases of large privatized firms studied, internal efficiency was enhanced as a result of privatization[30] This conclusion was based on financial data (similar to the that used for the above-mentioned statistical analysis) and some indicators of physical efficiency

Did Privatization Produce Unemployment?

Privatization is often associated with unemployment If private enterprises seek to maximize profits, as economic theory tell us, they will of course try to minimize costs, including labor for

[28]SOEs had to self-finance themselves and distribute 100 percent of their profits in dividends Investments which exceeded depreciation were, and still are, subject to a very strict and technical evaluation process

[29]Yarrow (1989) comes to a similar conclusion with respect to firms in England during the 1980s, so the Chilean case is not unique in this respect

[30]The firms studied were Banco de Chile (First and Second Round) CAP (the only large steel mill in the country), Celulosa Arauco (the largest paper pulp producer in the country), CTC (by far the largest company operating in telephone communications) and ENDESA (the largest electricity generator)

any given output State-owned enterprises to the contrary, as public choice theory postulates, tend to seek at the same time several objectives responding to different constituencies, objectives which often do not include efficient labor use

Chile's experience helps to clarify the issue, that is, to associate employment levels to internal efficiency and growth rates of the enterprises Research reported in Luders and Hachette (1992) shows that at the beginning of the military regime, when SOEs were beginning to be subject to the same rules and the same management criteria as private enterprises, employment levels fell more rapidly in the SOEs than in the private sector Laterm when growth rates accelerated during the second half of the 1970s, employment grew much faster in the private sector than in the public sector The behavior of a small sample of large privatized enterprises, already referred to while discussing the efficiency effects of the divestitures, also helps to throw light on this issue

Did Privatization Contribute to the Development of the Capital Market in Chile?

The Chilean capital market experienced rapid growth during the 1974–1989 period Several factors contributed to this growth including the development of the economy and some regulatory and institutional changes, besides the divestiture of SOEs The contribution of these factors has not been quantified yet, but undoubtedly the introduction of the new pension system and privatization have played a significant and mutually reinforcing role The pension fund administrators (AFPs) purchased, as mentioned above, about 25 percent of the stock of the large traditional SOEs privatized during the 1980 More important, they developed competent professional portfolio management departments, which are permanently in the market to take advantage of arbitrage opportunities Privatization provided the supply of stock the market needed to grow Stock in privatized enterprises traded

in the Santiago Stock Exchange rapidly grew from 6 2 percent of total stock tradings in 1962, and less before that, to over 60 percent in 1967 and following years These results are another excellent example of the impact of the privatization modes During the first round, most enterprises were divested to controlling stockholders and the percentage of these stockholdings traded thereafter was very reduced In contrast, the labor, popular and institutional capitalism mode used during the 1980s spread stock ownership to over 150,000 new stockholders, especially to institutions which actively trade in the market Considering that the divested values were similar in both rounds, the difference is striking

Other effects of Chilean privatization have been studied, including those on savings and investment, the results are not conclusive Overall, quantitative economic research, which in Chile has been possible because its massive privatization have a long enough history to allow it, tends to confirm the positive effect of the SOE divestitures on well-being, efficiency (slight), and capital market development, and does not support the hypothesis of its highly negative distributive and employment effects These rather auspicious results depend, however, to a large extent on the rules and regulations adopted by the military regime to create a competitive environment, or in the case of a few natural monopolies, to implement relatively efficient regulations

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The Mexican Experience in the Privatization Process

J Rogozinski

The privatization process of State-owned entities is a phenomenon which has developed practically at the global level since the 1980s It has not been limited to developing nations Developed economies and semi-planned economies have joined the group of nations interested in and concerned about reducing the State apparatus

Despite the generalized privatization process worldwide, each country has had to carry out its own divestiture program for State-owned companies based on its own need and on the specific conditions of its companies In Mexico's case, the divestiture process started in 1985 and intensified in 1989 This process has been part of a policy of economic reorganization, whereby the government sets aside its role as entrepreneur, frees limited resources, and dedicates its efforts to governing and meeting the demands of the people which include drinking water, health, investment in agriculture, food, housing, environment and justice

THE DEVELOPMENT OF PRIVATIZATION

The growth of the State sector in Mexico did not follow a previously established guiding program State activities dealt more with solving short-run problems and meeting the needs of the historical moment it was experiencing than with planning the long-term orderly growth of the public sector This situation quite frequently resulted in a duplication of efforts

The State substantially increased its size, among other reasons, by rescuing private companies which for some reason

ceased to operate efficiently or economically In order to sustain employment and the production plant, the State incorporated entities as diverse as hotels, restaurants, football teams, bicycle, cigarette, soft-drink and textile factories, airlines, mining companies, steel mills and sugar mills, participating in 45 of the 73 fields of economic activity

This policy of rescuing companies, which seemed to be valid at its time, did not take into consideration the opportunity cost implicit in creating jobs Although the State did sustain a source of income for many employees by rescuing bankrupt private companies, the same resources could have been used for more productive activities such as building highways, generating a greater number of jobs and preventing inefficient companies from subsisting through expensive subsidies This would have led to a more efficient and balanced development of the nation

This policy of job preservation, applied in other countries as well, continued as long as the governments had the resources necessary to sustain their role as entrepreneurs, strongly subsidizing the companies In Mexico, this situation changed in the 1980s The country suffered the consequences of the drop in international oil prices and the contraction of foreign credit Since that time, the Mexican government has followed a policy of financial order where the sale of public companies occupies a fundamental role

In Mexico's case, a resizing of the public sector implies not only selling companies, which is one of the alternatives of divestiture The characteristics of public companies have required different ways to decrease the participation of the State including the following options mergers, closing-down, transfers, liquidation, and sale

In effect, the companies that have met their objectives or that lack economic viability are liquidated or closed down Other companies are merged in order to make better use of their re-

sources such as in marketing and complementing the production processes Companies of regional or local importance that participate in development programs are transferred to State governments Nonstrategic or nonpriority companies, in terms of their economic situation and feasibility, are sold to the social or private sector

As a result of the reform of the State's role in the economy, at the end of 1994 there were 220 State-owned entities This decrease is considerable if we take into account that in 1982 there were over 1,155 State-owned entities

The First Divestitures

In Mexico, unlike other countries, the first to be privatized were small companies This meant that the first companies sold to the private sector faced little objection to divestiture and expedited the sales process Most of the companies were small, profitable, and operated in relatively competitive markets Moreover, their appraisal was relatively simple and the acquisitions did not require large investments, which was why it was not difficult to find buyers Prior to divestiture, approximately half of the companies had a high percentage of private capital The companies sold included hotels, restaurants, petrochemical plants, auto parts, metal products, textile, food, beverage and tobacco factories

The first privatizations were important in number but not in economic returns The most significant aspect is probably reflected in the learning curve which made it possible to mature in the privatization process and begin the sale of more complex companies By August 1991, only 4 of the 16 public companies listed among the 100 largest in Mexico had been divested

In 1990, the sale of large companies began This was of paramount importance to Mexico's development The first stage

involved the privatization of the airlines, sugar mills and mining companies The privatization of Telefonos de Mexicon, S A de C V and of the National Credit Associations (Sociedades Nacionales de Credito) followed These divestitures are different from the former in terms of size, political and economic importance, and in the complexity of the privatization process

One of the complex aspects consists of making privatization efficient not only in the use of the resources, but it also must contribute to the economic development of the country and generate conditions that enhance social well-being Thus it is important to prepare regulatory mechanisms to incorporate the organized participation of different private and public sector entities

Another adjustment which was necessary, given the magnitude of the companies, was the design of forms of restructuring of the company and financial engineering strategies allowing foreign investment, but always strictly complying with Mexican legislation

PRIVATIZATION PROCEDURES

The divestiture process via the sale of companies is very extensive and complex, as a good part of the paperwork carried out is the same for all companies, regardless of their size The procedures used in the divestiture of State-owned enterprises are as follows

1 Proposal by the coordinating agency

2 Finding of the Intersecretarial Commission on Financing Expenditure

3 Divestiture agreement

4 Designation of the agent bank

5 Sales guidelines

6 Sales profile and prospects

7 Technical and financial assessment

8 Receipt and evaluation of offers

9 Authorization and resolution for sale

10 Formalization of the sale

11 Divestiture

12 Creation of the "White Paper," official documents and procedures of the sale

THE RESULTS OF PRIVATIZATION

In all the sales processes, without exception, the workers' preferential right has been respected, they have been offered the opportunity to bid and, wherever possible, to match the highest offer (Articles 32 of the Federal law on State-owned enterprises)

By the end of 1994, the income in nominal terms resulting from the sale of the State-owned companies, in accordance with the account statement of the 251 processes completed, reflects an amount in excess of $23 billion including the resources received from the sale of the banks

One of the effects of the divestiture process can be observed in the level of sound public finances The decrease in State participation in the companies has led to a significant drop in government expenditure via transfers The resources that the public sector has saved since the divestiture process started is over $7 billion in nominal terms

The participation of the 935 divested companies in the Gross Domestic Product was not very significant (it did not include Compania Minera de Cananea or Telefonos de Mexico) In 1983, the share of the public sector in the gross domestic product was 17 4 percent in real terms and in 1991, this proportion was 10 4

percent (INEGI System of National Accounts, Production Accounts of the Public Sector)

Despite the fact that the contribution of these companies to production was not significant, they did receive an important proportion of the transfers of the federal government The resizing policy of the public sector led to a decrease in the transfers of the gross domestic product from 8 9 percent in 1983 to 4 5 percent in 1993 (Secretariat of Finance and Public Credit)

The effects of the decrease in the State apparatus are not only expressed at the macroeconomic level in economic activity and public finances, but also at the microeconomic level (that is, in the specific case of the privatized companies) In other words, there has been an increase in the capitalization of the company, horizontal and vertical integration, technological progress, increased installed capacity, improved conditions and benefits for the workers, penetration in international markets and increased tax collection

Similarly, the resources that have been tapped as a result of the sale of State-owned companies have been channeled to priority areas and have been used to finance social programs The resources have also been earmarked for the integration of the Fund of Economic Contingencies that the Mexican government created to deal with exogenous circumstances in the national economy

SPECIAL CASES

As previously mentioned, these are the general procedures whereby State-owned companies are divested Nevertheless, other additional mechanisms have also been designed for those companies requiring a special sales strategy Listed below are some of the outstanding examples

Compania Mexicana de Aviacion

In the case of this airline company, an option was sought whereby the government did not have to use its own resources to cover the enormous investment requirements, but rather the company was simultaneously developed and a fair price was obtained for the shares The decision was reached to implement the capital increase mechanism, whereby the resources resulting from the sale were not delivered to the federal treasury, but were destined to the capitalization of the company With this strategy, the State boosted the growth and modernization of Mexicana de Aviacion, and since there was no need to transfer the budget to this State-owned company, it was channeled to priority areas The company capitalized on $140 million

Sugar Mills

Most of the sugar mills that the federal government decided to divest had run a deficit in the last harvests and reported a lower yield than the national average As a sales incentive, balanced packages were created and a payment scheme was devised based on "obligations adjusted to the price of sugar"

As was the case in the rest of the divestiture processes, the sales operations were formalized by means of a sales contract Twenty percent of the payment was made in cash and the remaining 80 percent was payable through the issuance of the above-mentioned obligations Sixteen sugar mills were divested using this mechanism

Divestiture of the Banks

This process was formally started with the issuance of a Presidential Agreement, which established the principles and bases of the divestiture of the national credit associations and multiple bank institutions To this end, the Bank Divestiture

Committee was created and presided over by the Secretariat of Finance and Public Credit

The technical specifications, the complexity of these banks divestiture process, and the Presidential Agreement led the Committee to design a sales mechanism consisting of the following stages (1) appraisal of the institutions, (2) listing and authorization of potential buyers, and (3) the divestiture of the shares belonging to the federal government

In order to complete the first stage, the Committee decided to request two appraisals one prepared by the bank themselves, backed by different consultants or investment banks, and the other prepared by the consultants employed by the Committee To this end, the services of prestigious national and international consulting firms with ample experience in the banking system were employed and collaborated in preparing the sale prospectus

To date, eighteen banks have been divested They include Multibanco Mercantil de Mexico, Banpais, Banca Cremi, Banca Confia, Banco de Oriente, Banco de Credito y Servicio, Banco Nacional de Mexico, Bancomer, Banco BCH, Banca Serfin, Multibanco) Comermex, Banco Mexicano Somex, Banco del Atlantico, Banca Promex, Banoro, Banco Mercantil del Norte, Banco Internacional and Banco del Centro Sales of these banks have generated $12 billion

Telefonos de Mexico, S A de C V (TELMEX)

In order to divest TELMEX, the coordinating agency of the sector proposed to privatize the company by carrying out the following objectives outlined by the President of Mexico

- Radically improve the service
- Sustain expansion of the current system
- Strengthen technological research and development

- Guarantee workers' rights and allow them to share in the company capital
- Guarantee majority control by Mexicans

From the time the divestiture was announced, efforts were made to ensure that each and every one of the above-mentioned objectives were met The divestiture process of TELMEX made it necessary to work on three fundamental aspects

In the first place, the urgent need to grow and modernize the company made it indispensable to immediately carry out a series of administrative, financial and fiscal measures which could not wait until the privatization process was completed In the second place, it was necessary to analyze and modify the legal status of Telefonos de Mexicon, especially regarding the concession title of the company and the design of telecommunications regulations Lastly, given the magnitude of the operation, it was indispensable to design and implement financial engineering mechanisms to optimize the income from the sale and facilitate the transaction

Administrative, Financial and Fiscal Measures

TELMEX faced the challenge of beginning an ambitious expansion and modernization program that could not wait for the privatization process to conclude Thus, it was necessary to couple the management of a company immersed in long-term growth and undergoing dynamic change with the divestiture These measures included

- The transfer of TELMEX from the Secretariat of Communications and Transportation to the Secretariat of Finance and Public Credit
- Tariff adjustment
- Fiscal adjustment (a 29 percent tax on income from basic telephone service)

- Financial operations (repurchasing of $629 million of its own debt, sale of accounts receivable of $570 million, and the issuance of bonds with a value of over $150 million)
- Agreement with the Workers Union

Concession Title and Growth Goals

Given the importance that telecommunications play in national development, the transfer of TELMEX to the private sector required the design of a regulatory framework to guarantee the State guidance in this sector and to insure that growth and technological development objectives were met In order to accomplish this objective, the concession title was updated Programs were established whereby the telephone service could be expanded, improved and modernized, and technological and industrial research could be carried out to improve the competitiveness of the company and the country in the field of telecommunications

TELMEX must grow at an average annual rate of 1 percent in terms of the number of lines from 1990 to 1994 As of 1995, every town of over 500 inhabitants must have at least one public telephone for long distance By 1995, public telephone booths must be installed to cover a density of five phone booths per every 1,000 inhabitants By the year 2000, the waiting period for having a telephone line installed should drop to one month in cities having over 5,000 inhabitants

At the same time, the concession establishes detailed goals for the quality of service, the appointment of a consultant, by the Secretariat of Communications and Transportation, until August 1993, and the creation of a system regulating tariffs by setting ceiling prices This system, which started operating in 1991, established that TELMEX must comply with a ceiling price, in real terms, based on a package of basic telephone services

Financial Engineering

Given the size of the company and the opinions of the potential participants, a financial scheme was designed to include a specific capital structure in order to guarantee the administrative control of TELMEX by Mexicans Thus, the TELMEX structure was modified as follows

- 20 4 percent "AA" shares accounting for 51 percent of the common stock
- 19 6 percent "A" shares, accounting for 49 percent of the common stock
- 60 percent "L" shares

Workers' Share in the Company Capital

The union workers' rights were fully respected, allowing for a share of $292 million in the company capital, payable over eight years This was possible by means of a pledge loan granted by Nacional Financiera, which received 4 4 percent of the capital in the form of "A" shares sold to them by the federal government Throughout the duration of the loan, the shares will be the pledge in the possession of Nacional Financiera and payment to the workers will be determined by the workers themselves, using actuarial services and taking into account criteria such as seniority and the responsibility entailed in the job performed In December 13, 1990, a sales contract was signed with the group who won the auction of the "AA" shares, with an offer of $1,76 6 million

In regard to the public offering of the "L" shares, in May 1991, the federal government received payment exceeding $2 billion as a result of the sale of 16 49 percent of the capital stock of the State-owned company It is important to mention that this is the first time a Mexican company has sold shares simultaneously in the markets of over 20 countries and this is the first company to

carry out an operation whereby a high percentage of shares is placed outside its country of origin

CONCLUSION

The human and financial resources that have been made available, as a result of the rationalization of the presence of the State in the economy have been reassigned to priority areas The divestiture has contributed to the modernization of the industry and to the appropriate and efficient use of the State as a guide in the new national and international market reality and to strengthening the State's capacity to service the social demands of the people

The Mexican experience, in terms of the divestiture of State-owned companies within the international framework, has been positive In addition to the number of companies sold, we must take into account the transparency, efficiency and strict adherence to the legality of the processes carried out The divestiture of the State-owned companies has constituted one of the facets of economic modernization aimed at contributing to the achievement of the main national goals

As a result of this process, we now have a government which focuses on the basics, it is the motor of the social infrastructure which responds most efficiently to the demands of the people We now have a government which consolidates and complies with its constitutional obligations, and places national development above all in order to guarantee improved living conditions for all Mexican citizens

China's Economic Reform: Implications for India and Other Transition Economies

Justin Yifu Lin

INTRODUCTION

China is the first among the socialist countries to engage in wide-range economic reforms and so far the most successful one China's reforms started at the end of 1978 Since the reform started, the country's GNP has grown continuously at a phenomenal rate while the price level has been relatively stable China's approach to reforms is characterized as gradual, experimental, and piecemeal Reforms in other socialist countries, especially the Eastern European and former Soviet Union, started much later These countries generally adopted a "big-bang" or "shock therapy" approach which emphasizes the simultaneous implementation of stabilization, liberalization, and privatization programs in the economy The reforms in these countries resulted in unexpected sharp and prolonged declines in GNP with extraordinarily high inflation rates [1] In spite of the dramatic contrast between the results of China's reform and those of other socialist countries, whether China's approach to reforms provides any general lessons for other reforming economies is hotly debated in academia Some economists argue that China's success poses a challenge to the conventional wisdom about stabilization, liberalization, and privatization as being necessary keys to successful reforms, and demonstrates the superiority of evolutionary, experimental, and bottom-up reforms over the com-

[1]Certainly the collapse of international trade due to the demise of CMEA has also contributed to the decline of GNP in these countries However, the ' shock therapy" was undoubtedly a major cause of these downfalls (Brada and King 1991, Csaki 1994)

prehensive and top-down reforms of "the shock therapy" (McMillan and Naughton 1992, Singh 1991, Chen et al 1992, Harrold 1992, Perkins 1992, McKinnon 1993) Other economists argue that it is neither gradualism nor experimentation but rather China's unique initial conditions—namely, a large agricultural labor force, low subsidies to population, and a rather decentralized economic system—that have contributed to China's success (Woo 1993, Sachs and Woo 1993, Qian and Xu 1994) According to these economists, China's experience does not have general implications because China's process cannot be duplicated in Eastern Europe and the former Soviet Union, due to their different initial conditions

In this paper, I would like to argue that whether or not China's experience has a general implication depends on whether the nature and cause of the problems which China and other transition economies attempt to solve are similar, and I will argue that, in fact, they are The economic problems in China, other former socialist economies, and many other developing countries resulted from the low incentives to workers and the misallocation of resources among sectors, which appeared, in turn, because a capital-intensive, heavy-industry-oriented development strategy (HIODS) was pursued in a capital-scarce economy As a result, the given stock of resources was not used efficiently "Shock therapy" attempts to provide an institutional framework that would improve incentives and would induce the shift of part of the existing stock of resources from low-productivity sectors to high-productivity sectors However, the shift of resources from one use to another is costly (Brada and King 1991), and establishing new institutions is a time- and resource-consuming process (Murrel and Wang 1993) A "J-curve," or worse an "L-curve," is unavoidable for "shock therapy" Instead of attempting to reallocate the existing stock of resources from the low-productivity sectors to the high-productivity sectors, China's reform first improved the incentive mechanism, which resulted in a stream of new resources, and then allowed the newly created stream of resources to be allocated to the sectors that were sup-

pressed under the original HIODS Because the production of the "existing stock" of resources was not disrupted and the newly created "stream" of resources was allocated to the sectors that were more consistent with the comparative advantages of the economy, China's approach to reform avoids the "J-curve" effect of "shock therapy" and enables China's national economy to achieve a high rate of growth throughout the reform process The distortion of the incentive mechanism and the suppression of nonpriority sectors are common features of India and other developing countries which adopt a development strategy that is oriented toward capital-intensive, heavy industry when capital is relatively scarce in the economies Therefore, China's approach to reform provides useful lessons for India and other economies with a similar development strategy

The organization of the paper is as follows Section 2 discusses China's economic development strategy before the reforms and presents a simple economic model to analyze the problems associated with this strategy Section 3 provides an analytical review of China's reforms China's approach to reforms is compared with the "big bang" approach in Section 4 The chapter closes with some concluding remarks

THE MAJOR PRE-REFORM PROBLEMS IN THE CHINESE ECONOMY

The traditional economic structure in China was shaped by the adoption of a HIODS in the early 1950s The structure had three integrated components (1) a distorted macro-policy environment which featured artificially low interest rates, overvalued exchange rates, low nominal wage rates, as well as low price levels for living necessities and raw materials, (2) a planned allocation for credit, foreign exchange, and other materials, and (3) a traditional micro-management system of State enterprises and collective agriculture These three components were endogenous to the choice of a capital-

intensive HIODS in a capital-scarce agrarian economy, although the specific institutional arrangements that were adopted in China were also shaped by socialist ideology, the Chinese Communist Party's experience during the revolution, and the Chinese government's political capacity of pursuing its intended goals [2]

At the founding of the People's Republic in 1949, the Chinese government inherited a war-torn agrarian economy in which 89 4 percent of the population resided in rural areas and industry consisted of only 12 6 percent of the national income At that time, a developed heavy-industry sector was the symbol of the nation's power and economic achievement Like government leaders in India and in many other newly independent developing countries, Chinese leaders certainly intended to accelerate the development of heavy industries After China's involvement in the Korean War in 1950, with its resulting embargo and isolation from Western nations, catching up to the industrialized powers became a necessity for national security In addition, the Soviet Union's outstanding record of nation-building in the 1930s, in contrast to that of the Great Depression in Western market economies, provided the Chinese leadership with both inspiration and experience for adopting a HIODS Therefore, after recovering from war-time destruction in 1953, the Chinese government planned to set up heavy industry as the priority sector The goal was to build, as rapidly as possible, the country's capacity to produce capital goods and military materials This development strategy was shaped through a series of Five-Year Plans [3]

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[2]Perkins and Yusuf (1984, p 4) noted that a unique feature of China's economic development under socialism was the government's capacity to implement village-level programs nationwide through bureaucratic and party channels Therefore, the Chinese government was able to impose certain institutional arrangements in the economy, deemed as important by ideology or by economic rationality, which may not be feasible in other economies (Perkins 1966)

[3]The Five-Year Plan was disrupted from 1963–1965, the period

Heavy industry is a capital-intensive sector The construction of a heavy industry project has three characteristics (1) it requires long gestation period,[4] (2) most equipment for a project, at least in the initial stage, needs to be imported from more advanced economies, and (3) each project requires a lump-sum investment When the Chinese government initiated this strategy in the early 1950s, the Chinese economy had three characteristics (1) the available capital was limited, and, consequently, the market interest rate was high,[5] (2) foreign exchange was scarce and expensive because exportable goods were limited and primarily consisted of low-priced agricultural products, and (3) the economic surplus was small and scattered due to the nature of a poor agrarian economy Because these characteristics of the Chinese economy were mismatched with the three characteristics of heavy industry projects, spontaneous development of capital-intensive industry in the economy was impossible[6] Therefore, a set of distorted macro-policies was re-

immediately after the agricultural crisis of 1959–1962 The first to the seventh Five-Year Plans covered, respectively, the periods from 1952–1957, 1958–1962, 1966–1970, 1971–1975, 1975–1980, 1981–1985, and 1986–1990

[4]The construction of a light-industry project, such as a small textile factory, takes one or two years to complete The construction of a large heavy-industry project, in general, takes much longer For example, in China the average construction time for a metallurgy plant is 7 years, for a chemical plant, it is 5–6 years, and for a machine-building plant, it is 3–4 years (Li and Zheng 1989, p 170)

[5]Three percent per month was a normal interest rate in the informal financial markets that existed before the adoption of the development strategy It is equivalent to 36 percent per year

[6]A spontaneous development of heavy industry was impossible for several reasons First, the high interest rates would make any project that requires a long gestation unfeasible For example, it takes on average 7 years in China to complete the construction of a metallurgy plant, as indicated earlier The market interest rate in the early 1950s in China was about 30 percent per year (2 5 percent per month) Suppose the fund for the project was borrowed at market rate and repayment was made after the completion of the project The principal and interest payment, calculated at a compound rate, for each dollar borrowed at the first year of the project

quired for the development of heavy industry At the beginning of the first five-year plan, the government instituted a policy of low interest rates and overvalued exchange rates to reduce the costs of both interest payments and of importing equipment[7] Meanwhile, in order to secure enough funds for industrial expansion, a policy of low input prices, including nominal wage rates for workers[8] and prices for raw materials, energy and transportation, evolved alongside the adoption of this development strategy The assumption was that the low prices would enable the enterprises to create profits large enough to repay the loans or to accumulate enough funds for reinvestment If the enterprises were privately owned, the State could not be sure that the private entrepreneurs would reinvest the policy-created profits on the intended projects[9] Therefore, private

would be $6 27 It is obvious that no project would be profitable enough to shoulder such a high interest burden Second, since most equipment needed to be imported from advanced countries, the limited supply of foreign exchange again made the construction of heavy industry expensive under the market-determined exchange rate Third, because the agricultural surplus was small and scattered, it was difficult to mobilize enough funds for any lump-sum project

[7]For example, the interest rate on bank loans was officially reduced from 30 percent per year to about 5 percent per year For a one-dollar fund borrowed at the beginning of a 7-year project, the principal and interest payment at the time that the project was completed would be reduced from $6 27 to $1 41

[8]Although the real GNP per capita tripled between 1952 and 1978, the nominal wage was kept almost constant, increasing only 10 3 percent, during the same period (*China State Statistical Yearbook 1987*, p 151) For a more detailed discussion of the formation of low nominal-wage policy, see Cheng (1982, chap 8) and Wu (1965, chap 4) However, it is worthy mentioning that because of in-kind subsidies, the real wages to urban workers were not as low as the nominal wages suggested Urban wage rates might have declined sharply if the restriction on the rural-urban migration had been removed (Rawski 1979, p 67)

[9]Even with all the above price distortions that facilitated heavy industry development in China, the time period required by a heavy industry project to earn back the capital investment was, on average, about 4 to 5

enterprises were soon nationalized[10] and new key enterprises were owned by the State to secure the State's control over profits for heavy-industry projects Meanwhile, to make the low nominal-wage policy feasible, the government had to provide urban residents with inexpensive food and other necessities, including housing, medical care, and clothing The low interest rates, overvalued exchange rates, low nominal wage rates, and low prices for raw materials and living necessities constituted the basic macro policy environment of the HIODS [11]

The above macro policies induced a total imbalance in the supply and demand for credit, foreign exchange, raw materials, and other living necessities Because nonpriority sectors were competing with the priority sectors for the low-priced resources, plans and administrative controls replaced markets as the mechanism for

times longer than the period required by a light-industry project (Li 1983, p 37) Therefore, a profit-maximizing private owner would have higher incentives to invest in a light industry project

[10]Under the New Democracy Policy adopted by the Communist Party in the late 1940s, private enterprises were supposed to co-exist with State-owned enterprises for an extended period after the revolution However, the enterprises were nationalized soon after 1952 when the government adopted the HIODS The attempt to secure profits for the heavy industry projects was the motivation for the government's change in position toward private enterprises

[11]Theoretically, the government could use subsidies instead of distorting the price signals as a means to facilitate the development of capital-intensive, heavy industry in a capital-scarce economy It can be shown that the subsidy policy is more efficient economically than the policy of price distortion However, with the subsidy policy, the heavy industry would incur a huge explicit loss and the government would have to tax other sectors heavily to subsidize the loss Under such a situation, the government would find it difficult to defend its position of accelerating the development of heavy industry Moreover, the government in an underdeveloped economy may not have the ability to collect huge taxes This may explain why governments, not only in socialist economies but in capitalist economies, use price distortions instead of subsidies to facilitate the development of priority sectors

allocating scarce credit, foreign reserves, raw materials, and living necessities, ensuring that limited resources would be used for the targeted projects Moreover, the State monopolized banks, foreign trade, and material distribution systems [12]

In this way competition was suppressed and profits ceased to be the measure of an enterprise's efficiency [13] Because of the lack of market discipline, managerial discretion was potentially a serious problem Managers of State enterprises were deprived of autonomy to mitigate this problem [14] The production of State enterprises was dictated by mandatory plans and furnished with most of their material inputs through an administrative allocation system The prices of their products were determined by pricing authorities Government agencies controlled the circulation of their products The wages and salaries of workers and managers were determined not by their performance, but by their education, age, position and other criteria according to a national wage scale Investment and working capital were mostly financed by appropriations from the

[12]In the literature on China and other socialist countries, many authors presumed that the distorted policy environment and the administrative controls were shaped by socialist doctrines The socialist ideology might play a role in the formation of these policies, however, the existence of these policies and controls also have an economic rationale They facilitate the implementation of a HIODS in a capital-scarce economy This explains why non-socialist developing economies, such as India, also had a similar policy environment and administrative controls when they adopted the same development strategy

[13]An enterprise is bound to be loss-making if its outputs happen to be inputs to the other sectors—for example, energy and transportation—because the prices of its outputs are suppressed On the contrary, an enterprise is bound to be profit-making if its outputs are at the low end of the industrial chain, because the enterprise can enjoy low input prices and high output prices at the same time

[14]State enterprises were granted some autonomy after the reforms in the late 1970s As expected, one of the results of this reform was a rapid increase in wages, bonuses and fringe benefits at the expense of the enterprise's profits

State budget or loans from the banking system according to State plans The State enterprises remitted all their profits, if any, to the State and the State budget would also cover all losses incurred by the enterprises In short, the State enterprises were like puppets, they had no autonomy in the employment of workers, the use of profits, the plan of production, the supplies of inputs, and the marketing of their products

The development strategy and the resulting policy environment and allocation system also shaped the evolution of farming institutions in China In order to secure cheap supplies of grain and other agricultural products for urban low-price rationing, a compulsory procurement policy was imposed in the rural areas in 1953 This policy obliged peasants to sell set quantities of their produce, including grain, cotton, and edible oils to the State at government-set prices (Perkins 1966, chap 4)

In addition to providing cheap food for industrialization, agriculture was also the main foreign-exchange earner In the 1950s, agricultural products alone made up over 40 percent of all exports If processed agricultural products are also counted, agriculture contributed to more than 60 percent of China's foreign exchange earnings up to the 1970s Because foreign exchange was as important as capital for the heavy industry-oriented strategy, the country's capacity to import capital goods for industrialization in the early stage of development clearly depended on agriculture's performance

Agricultural development required resources and investment as much as industrial development The government, however, was reluctant to divert scarce resources and funds from industry to agriculture Therefore, alongside the HIODS, the government adopted a new agricultural development strategy that did not compete for resources with industrial expansion The core of this strategy involved the mass mobilization of rural labor to work on labor-intensive in-vestment projects, such as irrigation, flood control, and land reclamation, and to raise unit yields in agriculture

through traditional methods and inputs such as closer planting, more careful weeding, and the use of more organic fertilizers The government believed that collectivization of agriculture would ensure these functions The government also viewed collectivization as a convenient vehicle for effecting the State's low-priced procurement program of grain and other agri-cultural products (Luo 1985) Income distribution in the collectives was based on each collective member's contribution to agricultural production However, monitoring a member's effort is extremely difficult in agricultural production due to dimensions of time and space The remuneration system in the collectives was basically egalitarian (Lin 1988)

The distorted macro-policy environment, planned allocation system, and micro-management institutions outlined above all made the maximum mobilization of resources for the development of heavy industry possible in a capital-scarce economy Since most private initiative in economic activities was prohibited, the pattern of the government's investment was the best indicator of the bias in the official development strategy Table 1 shows the sector shares in State capital construction investment from the first Five-Year Plan (1953–1957) to the sixth Five-Year Plan (1981–1985) Despite the fact that more than three-quarters of China's population lived from agriculture, agriculture received less than 10 percent of State investment in the period 1953–1985, while 45 percent went to heavy industry Moreover, heavy industry received a lion's share of the investments that fell under the heading "other," including workers' housing and infrastructure As a result, the value of heavy industry in the combined total value of agriculture and industry grew from 15 percent in 1952 to about 40 percent in the 1970s (Table 2) [15]

[15]When the reforms started in 1979, the government initially planned to increase agriculture's share in the State's fixed capital investment from 11 percent in 1978 to 18 percent in the following 3 to 5 years Due to the rapid agricultural growth brought about by the rural reforms, agriculture s share in the State fixed capital investment actually declined sharply to only about 3 percent in the late 1980s and early 1990s However, the share of total fixed capital investment in agriculture in the nation as a whole did not

Table 1 Sector Shares of State Capital Construction Investment (percentage)

Five-Year Plan	Agri-culture	Light Industry	Heavy Industry	Other
First	7 1	6 4	36 2	50 3
Second	11 3	6 4	54 0	28 3
1963–1965	17 6	3 9	45 9	32 6
Third	10 7	4 4	51 1	33 8
Fourth	9 8	5 8	49 6	34 8
Fifth	10 5	6 7	34 9	36 9
Sixth	5 1	6 9	38 5	49 5
1953–1985	8 9	6 2	45 0	39 9

Source State Statistical Bureau (1987)

Judging from China's sectoral composition, the trinity of the traditional economic structure—a distorted macro-policy environment, a planned allocation system, and a puppet-like micro-management institution—reached its intended goal of accelerating the development of heavy industry in China However, China paid a high price for this The economy is very inefficient due to two factors (1) low allocative efficiency because of the deviation of the industrial structure from the pattern dictated by the comparative advan-

decline so much as the figures suggest, because part of the decline in the State investment was compensated for by an increase in farmers' investment (Feder et al 1982) Similarly, the share of heavy industry in the State's fixed capital investment did not decline after the reforms in 1979 However, the State's share in the total investment declined from 82 percent in 1980 to 66 percent in 1990 The non-State sectors' investments are mostly on projects that are less capital-intensive Therefore, the share of heavy industry in the nation's fixed capital investment is less than the share in the State investment

tages of the economy, and (2) low technical efficiency due to managers' and workers' low incentives to work

Table 2 Sector Composition (in current prices)

Year	Agriculture	Light Industry	Heavy Industry
1952	56 9	27 8	15 3
1957	43 3	31 2	25 5
1962	38 8	28 9	32 3
1965	37 3	32 3	30 4
1970	33 7	30 6	35 7
1975	30 1	30 8	39 1
1980	30 8	32 6	36 6
1985	34 3	30 7	35 0

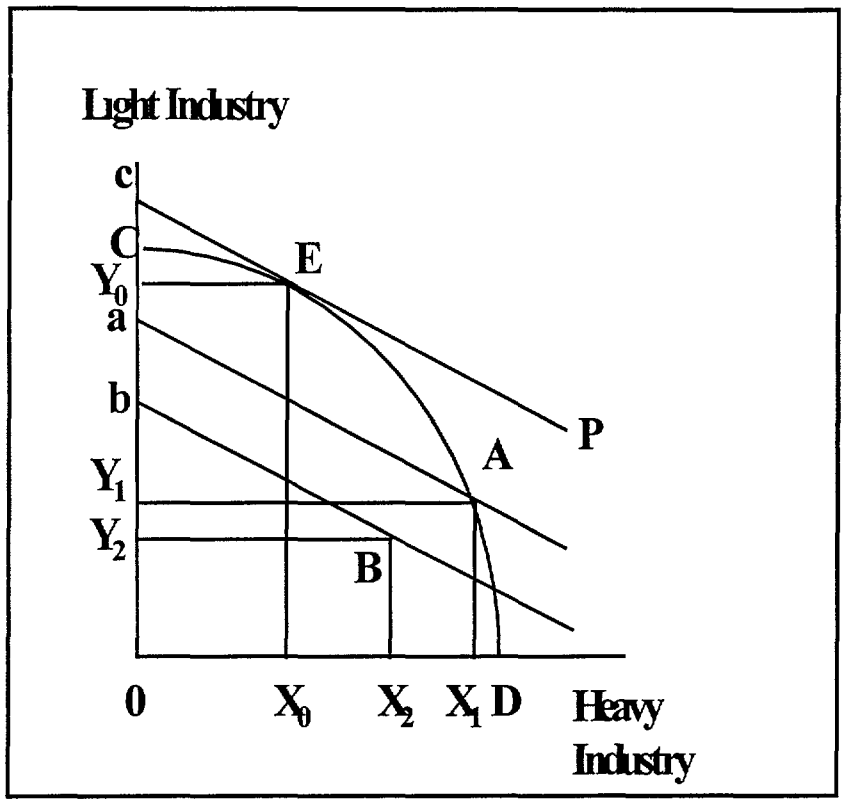
Source State Statistical Bureau (1990)

1 Low allocative efficiency In the current stage of China's economic development, capital is relatively scarce and labor is relatively abundant If prices were determined by market competition, capital would be relatively expensive and labor relatively inexpensive Therefore, the comparative advantages of the Chinese economy lie in labor-intensive sectors If investments had been guided by market forces, profit incentives would have induced entrepreneurs to adopt capital-saving and labor-using technologies and to allocate more resources to labor-intensive industries The effects of the HIODS on the industrial structure can be illustrated by Figure 1

Let us assume there are only two sectors in the economy—namely, labor-intensive, light industry and capital-intensive, heavy industry Given the endowments, the production possibility frontier is OCD EP represents the market-determined relative prices line, which existed before the imposition of the HIODS Under the

which existed before the imposition of the HIODS Under the undistorted relative prices, the economy will produce OY_0 of light industry products and OX_0 of heavy industry products

Figure 1 Development Strategy and Truncated Frontier



However, for the development of heavy industry, the State monopolized the allocation system and used administrative measures to direct the allocation of resources If we suppose the target of the development strategy is to expand the heavy industry from OX_0 to OX_1, then the State would need to limit the production of the light industry from OY_0 to OY_1 in order to shift resources from light industry to heavy industry The production possibility frontier is

truncated to Y_1AD If there is no technical inefficiency, the production mix of the economy would locate on A, corresponding to a quantity of OY_1 light-industry products and OX_1 heavy-industry products [16]

As can be seen, the static consequence of the strategy is that the economy, based on the prices before distortion, suffers a loss of ea in absolute magnitude or ea/eO in relative measure [17] The income loss due to allocative inefficiency implies the reduction of surplus available for investment If we assume that a fixed portion of the national income is used for investment, the decline in investment would further diminish gross investment However, if we assume that the government's plan is to develop light and heavy industry in a fixed ratio of OX_1/OY_1, then each production cycle would repeatedly generate an income loss of ea/eO in relative measure All these factors significantly dampen the growth of the whole economy To maintain the growth rate, it is necessary to raise the accumulation rate, resulting in insufficient consumption and long-lasting low living standards for people [18]

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[16]Similarly, the development of a service sector was suppressed so as to facilitate the development of heavy industry Agriculture, except for grain and cotton, was also suppressed The reason that grain and cotton were treated differently was because the government also pursued a grain self-sufficiency policy, and cotton was the basic raw material for industry

[17]Studies by Desai and Martin (1983) and Whitesell and Barreto (1988) estimate the misallocation of capital and labor among the sectors of the Soviet economy, which also adopted the heavy industry-oriented development strategy Desai and Martin find losses from misallocation in the range of 3 to 10 percent—possibly up to 15 to 17 percent of the inputs employed in industry Whitesell and Barreto find that in the early 1980s output gains equivalent to 4 to 6 percent could have been achieved by a reallocation of capital and labor among the sectors of Soviet industry

[18]The average annual rate of accumulation was raised from 24 2 percent of national income in the first Five-Year Plan to 33 0 percent and 33 2 percent in the fourth and fifth Five-Year Plans, respectively, whereas the average annual growth rate of national income dropped from 8 9 percent to 5 5 percent and 6 1 percent As a result, wages for State employees were held

2 Low technical efficiency Because profits ceased to be a measure of efficiency and the planned allocation system often failed to distribute materials in time, managers were forced to keep large reserves and had no incentive for utilizing resources economically Overstaffing, underutilization of capital resources, and overstocking of inventories characterized China's puppet-like State enterprises [19] Moreover, managers had no authority over worker wage rates and bonuses A worker's payment was not related to his/her effort in the enterprise nor to the enterprise's profits The remuneration system hence meant low work incentive Similarly, in the agricultural collectives, the farm worker's incentive to work was low because the link between reward and effort was weak [20] Losses resulting from these technical inefficiencies mean that actual production will locate on some point inside the production possibility frontier, such as point B in Figure 1

almost constant between the years 1952–1978 As Deng Xiaoping admitted to visiting overseas Chinese in October 1974, wages were low, the living standard was not high, and workers in China only had enough clothing and a full stomach (Cheng 1982, p 248)

[19]Brada (1989) estimates that overstaffing in Czechoslovak industry was as high as 15 percent The State Economic System Reform Commission in a recent report estimated that the total number of overstaffing in China's State enterprises was more than 30 million, about 30 percent of the total labor force in the state sectors (Zhonghua Zhoumo Bao 1995) Studies by the World Bank (1985a) show that for the production of per unit gross domestic product, the consumption of energy, steel, and transportation in China were, respectively, 63 8 percent to 229 5 percent, 11 9 percent to 122 9 percent, and 85 6 percent to 559 6 percent greater than those of other developing countries In the structure of total capital, the working capital accounted for the largest share in China and was 4 8 to 25 7 percentage points higher than that of other countries This implied that inventories of inputs and outputs were larger and inventory was kept longer in China than in other countries

[20]Lin (1992) estimates that losses due to low incentives in the agricultural collectives were as much as 20 percent of total factor productivity For a theoretical model of the monitoring problems regarding incentives in a collective farm, see Lin (1989a)

Because of the above two factors, the Chinese economy was very inefficient The most important indicator that reflected this inefficiency was the extremely low rate of total factor productivity growth in China A World Bank study shows that, even calculated with the most favorable assumptions, the growth rate was merely 0 5 percent between 1952–1981, only a quarter of the average growth rate of 19 developing countries included in the study (World Bank 1985a) Moreover, the total factor productivity of China's State enterprises was in a state of stagnation or even negative growth between 1957–1982 (World Bank 1985b)

AN ANALYTICAL REVIEW OF CHINA'S ECONOMIC REFORMS

As Perkins (1988, p 601) pointed out, it is unlikely that China's leaders had worked out a blueprint when they set out to reform the economic structure However, retrospectively, China's reforms followed a logical process that is predictable from the above theoretical model The trinity of the traditional economic structure is endogenous to the adoption of a HIODS in a capital-scarce economy The main fault in this economic structure was low economic efficiency arising from structural imbalance and incentive problems Before the late 1970s, the government had made several attempts to address the structural problems by decentralizing the allocative mechanism[21] However, the administrative nature of the allocative mechanism was not changed and the policy environment and managerial system were not altered, and thus the attempts to rectify the structural imbalance and improve economic incentives failed The goals of the reform in late 1978 were also to rectify the structural imbalance and improve incentives However, what set the reforms apart from previous attempts were the micromanagement system reforms that made farmers, managers and

[21]The first attempt was made in 1958–1960, the second in 1961–1965, and the third in 1966–1976 (Wu and Zhang 1993, pp 65–67)

workers in State enterprises partial residual claimants This small crack in the trinity of the traditional economic structure was eventually pried open, leading to the gradual dismantling of the traditional system

The Micro-management System Reforms

The most important change in the micro-management system was the replacement of collective farming what is now known as the household responsibility system In the beginning, the government had not intended to change the farming institutions Although it had been recognized in 1978 that solving managerial problems within the collective system was the key to improving farmers' incentives, the official position at that time was still that the collective was to remain the basic unit of agricultural production Nevertheless, a small number of collectives—first secretly and later with the blessing of local authorities—began to try out a system of leasing a collective's land and dividing the obligatory procurement quotas to individual households in the collective A year later, these collectives brought out yields far larger than those of other teams The central authorities later conceded to the existence of this new form of farming, but required that it be restricted to poor agricultural regions, mainly to hilly or mountainous areas, and to poor collectives in which people had lost confidence in the collective system However, this restriction was ignored in most regions Production improved after a collective adopted the new system, regardless of its relative wealth or poverty Full official recognition of the household responsibility system as a nationally acceptable farming institution was eventually given in late 1981, exactly two years after the initial price increases By that time, 45 percent of the collectives in China had already been dismantled and had instituted the household responsibility system By the end of 1983, 98 percent of agricultural collectives in China had adopted this new system When the household responsibility system first appeared, the land lease was only one to three years However, the

short lease reduced farmers' incentives for land-improvement investment The lease contract was allowed to be extended up to 15 years in 1984 In 1993, the government allowed the lease contract to be extended for another 30 years after the expiration of the first contract

Unlike the spontaneous nature of farming institution reform, the reform in the micro-management system of the State enterprises was initiated by the government These reforms have undergone four stages The first stage (1979–1983) emphasized several important experimental initiatives that were intended to enlarge enterprise autonomy and expand the role of financial incentives within the traditional economic structure These measures included the introduction of profit retention and performance-related bonuses and permitted the State enterprises to produce outside the mandatory State plan The enterprises involved in exports also were allowed to retain part of their foreign exchange earnings for use at their own discretion In the second stage (1984–1986), the emphasis shifted to a formalization of the financial obligations of the State enterprises to the government and exposed enterprises to market influences From 1983, profit remittances to the government were replaced by a profit tax In 1984, the government allowed State enterprises to sell output in excess of quotas at negotiated prices and to plan their output accordingly, thus establishing the dual-track price system During the third stage (1987–1992), the contract responsibility system, which attempted to clarify the authority and responsibilities of enterprise managers, was formalized and widely adopted The last stage (1993–present) attempted to introduce the modern corporate system to the State enterprises In each stage of the reform, the government's intervention was reduced further and the State enterprises gained more autonomy

The reform of the micro-management system has achieved its intended goal of improving technical efficiency Empirical estimates show that almost half of the 42 2 percent growth of output in the cropping sector in the years 1978–1984 was driven by produc-

tivity change brought about by the reforms Furthermore, almost all of the above productivity growth was attributable to the changes resulting from the introduction of the household responsibility system (Fan 1991, Huang and Rozelle 1994, Lin 1992, McMillan et al 1989, Wen 1993) Production function estimates in several studies find that for industry the increase in enterprise autonomy increased productivity in the State enterprises (Chen et al 1988, Gordon and Li 1989, Dollar 1990, Jefferson et al 1992, Groves et al 1992) Therefore, the reforms in micro-management system in both agriculture and industry have created a flow of new resources, an important feature of China's reforms

The increase in enterprise autonomy under a distorted macro-policy environment, however, also invited managers' and workers' discretionary behavior Despite an improvement in productivity, the profitability of the State enterprises declined and the government's subsidies increased due to both a faster increase in wages, fringe benefits, and other unauthorized expenditures (Fan and Schaffer 1991) and the competition from the autonomous township-and-village enterprises (TVEs) (Jefferson and Rawski 1995) [22] However, once the enterprises had tasted autonomy, it would have been politically too costly to revoke it The decline in the profits of State enterprises and the competition from TVEs forced the government to try other measures that further increased the autonomy of State enterprises in the hope that the new measures would make the enterprises financially independent

Resource Allocation System Reform

The increase in enterprise autonomy put pressure on the planned distribution system Because the State enterprises were allowed to produce outside the mandatory plans, the enterprises

[22] We will discuss the emergence of TVEs and its impacts on the reform of State enterprises in the following subsection

needed to obtain additional inputs and to sell the extra outputs outside the planned distribution system Under pressure from the enterprises, material supplies were progressively de-linked from the plan, and retail commerce was gradually deregulated At the beginning, certain key inputs remained controlled, however, the controlled items were increasingly reduced Centralized credit rationing was also delegated to local banks at the end of 1984

An unexpected effect of the relaxation of the resources allocation system was the rapid growth of the non-State enterprises, especially the TVEs [23] Rural industry already existed under the traditional system as a result of the government's decision to mechanize agriculture and develop rural processing industries to finance the mechanization in 1971 In 1978, the output of TVEs consisted of 7 2 percent of the total value of industrial output in China Before the reforms, growth of TVEs was severely constrained by access to credits, raw materials and markets The reforms created two favorable conditions for the rapid expansion of TVEs First, a new stream of surpluses brought out by the household responsibility reform provided a resource base for new investment activities Second, the relaxation of rigidity in the traditional planned allocation system provided access to key raw materials and markets In the period 1981-1991, the number of TVEs, employment, and the total output value grew at an average annual rate of 26 6, 11 2, and 29 6 percent, respectively TVEs annual growth rate in total output value was three times that of the State firms in the same period In 1993, TVEs output accounted for 38 1 percent of the total industrial output in China The share of industrial output from non-State en-

[23] Non-State enterprises include TVEs, private enterprises, and joint venture enterprises, overseas Chinese enterprises, and foreign enterprises Among them, TVEs are the most important in terms of output share and number of enterprises It is noteworthy that TVEs, although different in many aspects from State enterprises, are public enterprises that are funded, owned, and supervised by the township or village governments

terprises increased from 22 percent in 1978 to 56 9 percent in 1993 (State Statistical Bureau 1995, p 73)

The rapid entry of TVEs and other type of non-State enterprises produced two unexpected effects on the reforms First, non-State enterprises were the product of markets Being outsiders to the traditional economic structure, non-State enterprises had to obtain energy and raw materials from competitive markets, and their products could be sold only to markets They had budget constraints and they would not survive if their management was poor Their employees did not have an "iron rice bowl" and could be fired As a result, the non-State enterprises were more productive than the State enterprises, as the comparisons of growth rate in output and total factor productivity between the State and collective sectors in Table 3 shows The dynamism of non-State enterprises exerted a pressure on the State enterprises and triggered the State's policy of transplanting the micro-management system of the non-State enterprises to the State enterprises and of delegating more autonomy to the State enterprises Reform measures for improving the micro-management system of State enterprises—such as replacement of profit remittance by a profit tax, the establishment of the contract

Table 3 Growth in Output and Total Factor Productivity

	1980–1988	1980–1984	1984–1988
State sector			
Output	8 49	6 77	10 22
TFP	2 40	1 80	3 01
Collective sector			
Output	16 94	14 03	19 86
TFP	4 63	3 45	5 86

Source World Bank (1992)

responsibility system, and the introduction of the modern corporate system to State enterprises—were responses to competitive pressure from TVEs and other non-State enterprises (Jefferson and Rawski 1995) Secondly, the development of non-State enterprises significantly rectified the misallocation of resources In most cases, non-State enterprises had to pay market prices for their inputs, and their products were sold at market prices The price signals induced non-State enterprises to adopt more labor-intensive technology and concentrate on more labor-intensive small industries than did State enterprises[24] Therefore, the technological structure of non-State enterprises was more consistent with the comparative advantages of China's endowments The entry of TVEs mitigated the structural imbalance caused by the HIODS

Macro-policy Environmental Reform

Among the trinity of the traditional economic structure, the distorted macro-policy environment was linked most closely to the development strategy, and its effects on allocative and technical efficiency were indirect The reforms of the macro-policies were thus the most sluggish We will argue later that most economic problems that appeared during the reforms—for example, the cyclic pattern of growth and the rampant rent seeking—can be attributed to the inconsistency between the distorted policy environment and the liberalized allocation and enterprise system Therefore, the Chinese government constantly faced a dilemma to make the macro-policy environment consistent with the liberalized micro-management and resource allocation system or to re-centralize the micro-management and resource allocation system for maintaining

[24]For example, in 1986 an average industrial enterprise in China had 1,79 9 workers, and the fixed investment per worker was 7510 yuan (*China Industrial Economy Statistical Material 1987*, p 3), whereas an average TVE in the same year had 28 9 workers, and the fixed investment per worker was 1709 yuan (*Statistical Yearbook of China 1987*, p 205)

the internal consistency of the traditional economic structure The deprivation of enterprise autonomy would definitely incur the resistance of employees of State enterprises A return to the traditional economic structure would also mean return to economic stagnation Therefore, no matter how reluctant the government was, the only sustainable choice was to reform the macro-policy environment and make the macro-policies consistent with the liberalized allocation and micro-management system

Changes in the macro-policy environment started in the commodity price system After the introduction of profit retention, the enterprises were allowed to produce outside the mandatory plan The enterprises first used an informal barter system to obtain the outside-plan inputs and to sell the outside-plan products at premium prices In 1984, the government introduced the dual-track price system, which allowed State enterprises to sell their output in excess of quotas at market prices and to plan their output accordingly The aim of the dual-track price system was to reduce the marginal price distortion in the State enterprises' production decisions while leaving the State a measure of control over material allocation By 1988, only 30 percent of retail sales were made at plan prices, and the State enterprises obtained 60 percent of their inputs and sold 60 percent of their outputs at market prices (Zou 1992)

The second major change in the macro environment occurred in the foreign exchange rate policy In the years 1979–1080, the official exchange rate was roughly 1 5 yuan per U S dollar The rate could not cover the costs of exports, as the average cost of earning one U S dollar was around 2 5 yuan A dual-rate system was adopted at the beginning of 1981 Commodity trade was settled at the internal rate of 2 8 yuan per U S dollar, the official rate of 1 53 yuan per U S dollar continued to apply to non-commodity transactions After 1985, the yuan was gradually devalued Moreover, the proportion of retained foreign exchange, which was introduced in 1979, was gradually raised, and enterprises were allowed to swap their foreign exchange entitlement with other enterprises through

the Bank of China at rates higher than the official exchange rate Restrictions on trading foreign exchanges were further relaxed with the establishment of a "foreign exchange adjustment center" in Shenzhen in 1985, in which enterprises could trade foreign exchanges at negotiated rates By the late 1980s, such centers were established in most provinces in China and more than 80 percent of the foreign exchange earnings was swapped in such centers (Sung 1994) The climax of foreign exchange rate policy reform was the establishment of a managed floating system and unification of the dual-rate system on January 1, 1994

Interest-rate policy is the least affected area of the traditional macro-policy environment Under the HIODS, the interest rate was kept artificially low to facilitate the expansion of capital-intensive industries After the reforms started in 1979, the government was forced to raise both the loan rates and the savings rates several times [25] However, the rates were maintained at levels far below the market-clearing rates throughout the reform process In late 1993, the government announced a plan to establish three development banks with the function of financing long-term projects, import/export, and agricultural infrastructure at subsidized rates and to turn existing banks into commercial banks The three development banks were established in 1994 The commercialization of the existing banks is expected to take at least another three to five years Moreover, it is unclear whether after the reform the interest rate will be regulated or will be determined by markets The mentality of the HIODS is deeply rooted in the mind of China's political leaders To accelerate the development of capital-intensive industry in a capital-scarce economy, a distorted macro-policy environment—at the very least in the form of a low interest rate policy—is

[25]To stop bank runs, the savings rates were indexed to inflation rates in October 1988, but the policy was revoked in 1991 In May 1993, the interest rate for a one-year time deposit was 9 18 percent, and for a one-to-three year basic investment loan it was 10 80 percent (*China Statistics Yearbook 1993*, pp 670-71) However, the market rate for a commercial loan was between 15 and 25 percent

t the very least in the form of a low interest rate policy—is essential It is likely that administrative interventions in the financial market will linger for an extended period

Because the reforms in macro-policies, especially those regarding the interest rate, lagged behind the reforms in the allocation system and micro-management institutions, there were several economic consequences The first one was the recurrence of a growth cycle The interest rate was maintained at an artificially low level The enterprises had incentives to obtain more credits than the supply permitted Before the reforms, the excess demands for credit were suppressed by restrictive central rationing The delegation of credit approval authority to local banks in the autumn of 1984 resulted in a rapid expansion of credits and an investment thrust As a result, the money supply increased 49 7 percent in 1984 compared to its level in 1983, and this caused the inflation rate to jump from less than 3 percent in the previous years to 8 8 percent in 1985 In 1988, the government's attempt to liberalize price controls caused a high inflation expectation Because the interest rate for savings was not adjusted, panic buying and a mini-bank run occurred Loans, however, were maintained at the previously set level As a consequence, the money supply increased by 47 percent in 1988, and the inflation rate in that year reached 18 percent During the periods of high inflation, the economy overheated Bottlenecks in transportation, energy, and the supply of construction materials appeared Because the government was reluctant to increase the interest rate as a way to check the investment thrust, it had to resort to centralized rationing of credits and direct control of investment projects—that is, a return to the planned system The rationing and controls gave the State sectors a priority position The pressure of inflation was reduced, but slower growth followed

As mentioned earlier, although the reforms in the micro-management system improved the productivity of the State sector, deficits increased due to the discretionary behavior of the managers and workers in the State enterprises Therefore, fiscal income in-

creasingly depended on the non-State sectors During the period of tightening State control, the growth rates of the non-State sectors declined because the non-State sectors' access to credits and raw materials were restricted Such a slowdown in the growth rate became fiscally unbearable Therefore, the State was forced to liberalize the administrative controls in order to make room for the growth of the non-State sectors A period of faster growth followed Nevertheless, conflicts between the distorted macro-policy environment and the liberalized allocation and micro-management system arose again

A second consequence of the inconsistency between the distorted policy environment and the liberalized allocation system and micro-management institutions was a rampant rent-seeking phenomenon After the reforms market prices existed, legally or illegally, along with planned prices for almost every kind of input and commodity that the State controlled The difference between the market price and the planned price was the economic rent It is estimated that the economic rent from the controlled commodity price, the interest rate, and the exchange rate was at least 200 billion yuan, or about 21 5 percent of the national income in 1988 In 1992, the economic rent from bank loans alone reached 220 billion yuan (Hu 1994)[26] The non-State enterprises as well as the autonomous State enterprises certainly had incentives to engage in rent-seeking activities through bribes and other measures to obtain the underpriced resources from the State allocation agencies It is reported that under competitive pressure, the State enterprises in the heavy industries, which were given priorities in obtaining the State-controlled resources, also needed to give certain side payments to the banks and other allocation agencies in order to secure the earmarked loan and materials or to obtain them promptly

[26]The total credit of the State banks was 2,161 6 billion yuan (US$248 5 billion at the swap market exchange rate) The difference between the official interest rate and the market rate was about 10 percent The rents from bank loans alone were as high as 216 billion yuan

Because of the rent-seeking activities of other types of enterprises, State enterprises were often unable to obtain the credits and materials indicated in the plans The rent-seeking activities also caused widespread public resentment and became a source of social instability To guarantee the survival of the State enterprises and to check social resentment, the government attempted to reinstitute tight controls on the allocation system in the austerity programs of 1986 and 1988 However, the controls were relaxed later to allow the growth of the non-State sectors Except for the interest rate, administrative controls on the prices of most materials and commodities have been removed

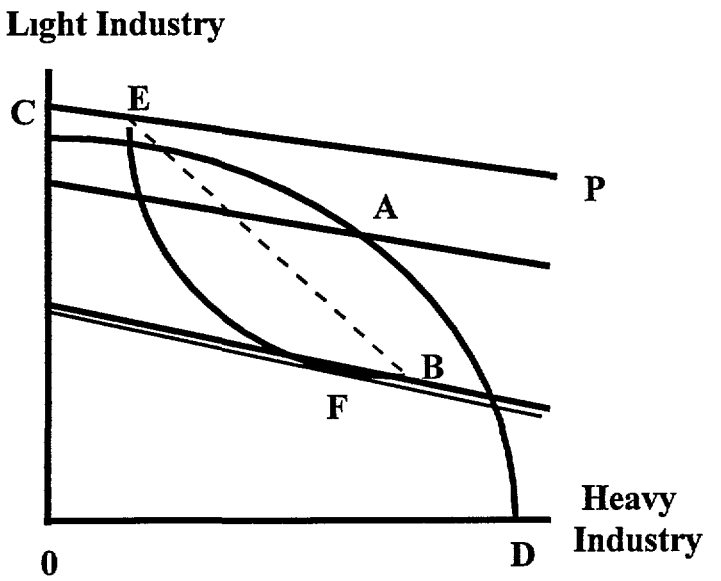
THE REFORM APPROACHES A COMPARISON

There has been much discussion as to why China's reforms have been more successful than the reforms in Eastern Europe and the former Soviet Union (Chen et al 1992, Qian and Xu 1993, Harrold 1992, McMillan and Naughton 1992, Gelb et al 1993, McKinnon 1994) Except for the desirability of gradualism, the studies emphasized China's initial industrial structure (China has a large agricultural sector) or its decentralized regional economic structure If China's success was mainly the result of her unique initial conditions, then that success does not have any implications for other economies, where the initial conditions differ Nevertheless, the economic problems in pre-reform China—namely, the structure imbalance and the low incentives—are common to all socialist economies because they all adopted a similar economic development strategy and because they all have a similar macropolicy environment, planned allocation system, and puppet-like State enterprises Empirical evidence shows that, as in pre-reform China, Eastern European and Soviet economies were all overindustrialized with oversized State enterprises, their service sectors and light industries were underdeveloped, and employee incentives were low (Newbery 1993, Brada and King 1991, Sachs and Woo 1993)

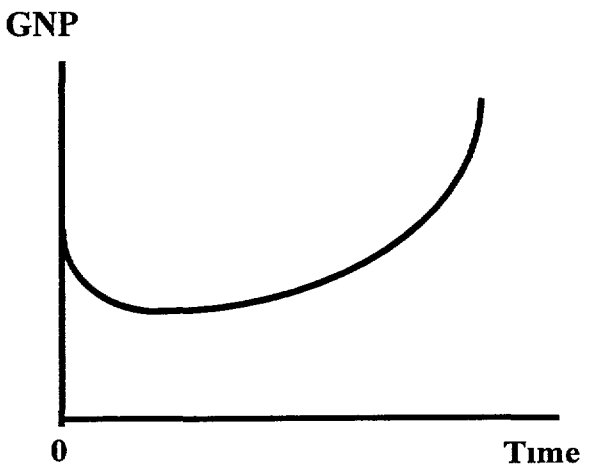
For an economy with a given stock of resources, the efficient point in the production plan is point E, however, under the HIODS, the actual production point is B, as illustrated in Figure 1 "Shock therapy" attempts to reform the economic structure so that the existing stock of resources can be utilized more efficiently Diagrammatically, the reforms attempt to move production from point B to point E Stabilization, marketization, and privatization are necessary conditions for achieving this goal This is because to induce economic agents to move from B to E voluntarily, the agents should have a stable expectation about the economy, correct relative-price signals, and the incentives to respond to these price signals The prescription of stabilization, price liberalization, and privatization is internally consistent The scheme is equivalent to a replacement in a short sequence of the whole traditional economic structure, which is endogenous to the HIODS

If the transitional costs of reform were free, "shock therapy" would enable the economy to jump from point B directly to point E, as the dotted line in Figure 2a shows However, some fixed equipment in heavy industries cannot be used for production in light industries, for other equipment, modifications are required for new uses (Brada and King 1991) Workers in heavy industry also need retraining before they can be assigned to new jobs Moreover, the establishment of new market institutions takes time and resources (Murrel and Wang 1993, Lin 1989b) During the initial stage of reforms, an increase in light industry would not be able to compensate for the decline in heavy industry Therefore, instead of moving directly from point B to point E in Figure 2a, the economy moves first from B to F before reaching E The resulting GNP path of growth is a "J-curve," as shown in Figure 2b How large the decline in GNP would be and how long it would take before recovery would depend on how severe the initial distortion is and how quickly the necessary institutions can be established, which can only be determined empirically The experiences of Eastern Europe and the former Soviet Union suggest that a decline can be more

Figure 2 The Big Bang Reform



(a)



(b)

than 50 percent of the GNP and that it will take several years before a turning point is reached The government is certain to encounter a legitimacy crisis when the results of reforms are so dreadful (Dewatripont and Roland 1992) The leadership may not be able to hold a consensus on the course of further reforms, and political instability is likely to follow Instead of a "J-curve," the result of "shock therapy" may be a big "L-curve"

When China started its reforms in the late 1970s, the political leadership did not question the feasibility or desirability of the traditional economic structure It simply attempted to improve incentives in the State enterprises and collective farms by giving agents in State enterprises and collective farms some autonomy so that a closer link between personal rewards and individual efforts could be established The empirical studies cited show that the attempt was successful and a new stream of resources was created by the micro-management system reform The granting of partial micro autonomy was only a small crack in the traditional economic structure However, the partial autonomy also implies that entrepreneurs gain partial control over the allocation of the newly created stream of resources The suppressed sectors in the traditional economy are the sectors that are consistent with the comparative advantages of the economy The unexpected results of the micro-management reform are that, driven by profit motivation, the autonomous entrepreneurs allocated the new stream of resources under their control to the more profitable suppressed sectors Since the planned allocation system and distorted macro-policy environment were preserved, the State still had control over the old stream of resources and guaranteed that these resources would be allocated to the priority sectors Therefore, throughout the reform process, the economy enjoys continuous growth Moreover, as the economy grew, the proportion of resources that was allocated according to the planned prices became increasingly small Therefore, by the time the price of a commodity was liberalized, the

shock was much smaller than the gap between the market price and plan price would have suggested [27]

If the above descriptions are a reasonable explanation of why China was able to enjoy continuous economic growth during the reform process, we can expect the following First, the expansion of the suppressed sectors would not result in a decline in the priority sectors because the expansion of the suppressed sectors was supported by a new stream of resources Second, the economy should reach a higher rate of economic growth than the rate before the reforms because the new stream of resources was allocated to the more efficient sectors Both assertions are confirmed by the empirical evidence Table 4 shows the indexes and the growth rates of the major sectors in the national economy It can be seen that no sector has declined since the reforms started and, except for the State enterprises, each sector's growth has accelerated

CONCLUDING REMARKS

Even though China's leaders did not have a blueprint in mind when reforms started, China's reforms have followed a path that can be explained by the theory of induced institutional innovation (Lin 1989b, North 1990) The traditional economic structure was itself a product of institutional innovation induced by the government's attempt to pursue a HIODS in a capital-scarce economy The traditional system made the mobilization of resources for building up the strategy-determined priority sectors possible However, its economic efficiency was low Therefore, once the integrity of the traditional economic system was cracked by the in-

[27]The official exchange rate was 5 7 yuan for one U S dollar and the swap market rate was 8 7 yuan for one U S dollar when the exchange rate in China was unified to the swap market rate at the beginning of 1994 However, the shock was very small because before the unification about 80 percent of the foreign exchanges had already been traded in the swap markets

troduction of enterprise autonomy, institutional changes occurred in a way that was self-propelling toward the replacement of the traditional system with a more efficient market system. In the process, the efficiency of the State enterprises was improved through greater autonomy and by meeting competition from the non-State sectors However, the dynamism of the economy came mainly from the swift entry of new, small, non-State enterprises The old planned allocation system and distorted macro-policy environment gradually became unsustainable and were discarded During the reform process, the State, the enterprises and the people have had sufficient time to make adjustments to the new market system The reforms benefit the majority of people as the economy has maintained strong growth throughout the whole process

The "big bang" approach in Eastern Europe and the former Soviet Union also attempts to replace an inefficient economic system with a more efficient market system The privately owned small firms emerged immediately after the lifting of the ban on private enterprises However, the privatization of medium- and large-scale State enterprises was prolonged and proceeded slowly (Murrel and Wang 1993, Wang 1993) This resulting enterprise mix is, in fact, similar to what emerged in China However, China's approach did not disrupt the production in the State sectors Therefore, China's gradual approach to reform achieved the same positive effects of the "big bang" approach but avoided its costs[28] If

[28]The opportunity cost for the workers to move from the State sectors to the non-State sectors might be higher in Eastern Europe and the former Soviet Union (EE/FSU) than in China because the subsidies to the workers were higher and the economies were more decentralized in EE/FSU than in China, as Sachs and Woo (1993) and Qian and Xu (1993) correctly emphasized However, the higher opportunity cost is not a sufficient condition for nullifying the applicability of the Chinese approach In China the differences between the State-regulated prices and the market prices in general were less than 30 percent and at most 100 percent before the reforms However, the differences for many commodities in EE/FSU often reached factors of 10 Therefore, the expected returns for a worker to move

transitional costs and the path-dependence of institutional changes are taken into account, China's gradual approach can be argued to be both theoretically and empirically preferable to the "big bang" approach (Wei 1993)

So far, most elements in China's reforms were induced rather than designed However, the experience of China's reforms may provide a useful lesson for designing reform policies in India and other economies where the heavy industry-oriented strategy or other similar development strategies have been adopted under capital-scarce conditions[29] Certainly, stages of development, endowment structures, political systems, and cultural heritage differ from one economy to another To be effective, actual reform measures should take the economy's initial conditions into consideration and exploit all favorable factors within and without the economy[30] Therefore, the specific design and sequence of reforms in an economy should be "induced" rather than "imposed" However, in ad-

from the State sectors to the non-State sectors were much higher in EE/FSU than in China The existence of a large secondary economy in EE/FSU before the reforms suggests that resources would have quickly flown into the suppressed sectors if the activities had been legalized The rapid emergence of small private firms after lifting the ban on private enterprises confirms this proposition

[29]In essence, the HIODS is a forging-ahead strategy in which the government distorts the macro-policy environment in order to facilitate the development of some industries which exceed the stage of development dictated by the comparative advantages of the economy's endowment structure Similar to China, India also adopted a forging-ahead, heavy industry-oriented development strategy The import-substitution strategy widely adopted in Latin America is another example of the forging-ahead development strategy

[30]The presence of overseas Chinese, the existence of a large stock of industrial resources in the rural sector prior to the start of reform, and the continuation of substantial marketing activity throughout the agricultural sector during the entire socialist period are among the important initial conditions that contributed unequivocally to the success of China's reforms

dition to the general advice of maintaining economic and political stability and to move the reforms in a path-dependent manner, the following advice may be useful for a government attempting reforms in an economic system similar to that of pre-reform China

1 Grant autonomy to the micro-management unit so as to improve the incentive structure and to create a new stream of resources by improving productivity

2 Allow the new stream of resources to be allocated by the autonomous enterprises outside the plan and at market price to the suppressed sectors while maintaining the survival of the old priority sectors with the resources still under the State's plan control

3 Liberalize the distorted policy environment and planned allocation system to make them consistent with the autonomous micro-management system when the new stream of resources allocated under market outweighs the stream of resources allocated under the plan

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Understanding China's Economic Performance

Wing Thye Woo
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INTRODUCTION

China achieved the impressive average annual growth rate of 9 5 percent between the start of its market reforms in 1978 and 1994 This successful performance, perhaps the highest in the world during this period, has dramatically transformed China's economic structure The proportion of the labor force engaged in agriculture dropped from 71 percent in 1978 to 56 percent in 1993, and the proportion of gross industrial output produced by State-owned enterprises (SOEs) declined from 78 percent to 43 percent in the same period The integration of China into the world economy has been equally dramatic trade (exports plus imports) rose from 10 percent of GNP in 1978 to 36 percent in 1993, and direct foreign investment was $28 billion in 1993 compared to $2 billion in 1983 Human development indicators—life expectancy, literacy, infant mortality, per capita income, and the incidence of poverty—all show a dramatic improvement, in line with the rapid economic growth

This paper discusses the nature of this rapid growth performance and the prospects for future rapid economic growth China presents various paradoxes that have become the subject of heated debate within the economics profession For example, while there is little disagreement about the role of market reforms in spurring rapid growth, there is heated debate about the character of those reforms Have they been gradual or rapid? Has the gradualism been a source of success or a hindrance? Are the nonmarket aspects of China's economy, such as the large State

ownership that persists today, a source of potential destabilization in the years ahead? What lessons, if any, does China's experience offer for other countries in the transition from central planning to a market economy?

We suggest in this chapter that China's rapid growth can best be explained as the result of a few key characteristics of Chinese economic structure and economic policy First, China began the rapid growth period extremely poor, and therefore has benefited from the "advantages of relative backwardness" China has been able to import modern technology, management and capital from abroad to use alongside very inexpensive domestic labor, in order to produce highly profitable, labor-intensive manufactures As a result, China has enjoyed one of the greatest export booms in history Moreover, China began the reform period with a legacy of profound inefficiency in agriculture, so that there was a natural one-time boost in agricultural output and productivity in the first years of reform

Second, China's economic policy has benefited from its economic structure, as an overwhelmingly rural-based, agricultural, labor-intensive economy Despite being a "socialist" economy, less than 20 percent of the Chinese labor force was in State-owned enterprises at the start of market reforms, almost all of the rest were in peasant villages throughout the Chinese hinterland For political reasons, but in conformity with the basic economic structure, the Chinese government adopted a two-track approach to reforms in which the countryside and the coastal provinces were substantially liberalized to engage in market activities, while State-owned enterprises were kept under State control This was expensive from the point of view of the budget, since the State-owned enterprise sector required subsidies to cover losses, but it was affordable since the vast majority of the labor force was outside of the State-owned sector This situation contrasts starkly with that of Eastern Europe and the former Soviet Union, where the State dominated the economy at the start of market reforms

The market sector was substantially deregulated, and in fact became, de facto, a laissez-faire economy Taxation of private activity was low, as were regulations governing labor markets, environment, competition policy, and other areas of market activity The non-State enterprises actually paid less income taxes as a proportion of GDP as their share of GDP increased non-State enterprises paid income taxes equivalent to 1 2 percent of GDP in 1985 and 0 5 percent in 1993 (World Bank 1995b, Table 7 3) While the legal infrastructure of the marketized part of the economy is underdeveloped, the regulatory intrusion is also low

Labor market participants in the non-State sector expected little from the State in the form of social protections and, in fact, received very little Once again, the situation differed markedly from that of Eastern Europe and the former Soviet Union, where the public's expectations were for continued guarantees of jobs, income, retirement benefits, and other social benefits, which had long been promised, if imperfectly delivered, by the government The non-State sector has boomed, while the State sector continued to experience serious problems, not least of which are the continuing low productivity growth of the State-owned enterprises and their large financial losses, even in boom years Thus, the success of China's reforms should be attributed mainly to the success of the non-State sector, and the good fortune that problems in the State-owned sector have not destabilized the overall macroeconomy China's macroeconomic situation has remained delicate for years, and, in fact, the extreme inflationary pressures in 1988–1989 certainly contributed to the political unrest that culminated in the Tiananmen disaster in June 1989 Overall, however, China's monetary and banking policies have protected the real income of savers, thereby contributing to China's remarkably high saving rates These high savings, in turn, have helped the government to finance its budget deficits in a non-inflationary manner

China's extraordinary growth performance should not take attention away from the deep problems that China will face in the coming years While China's State sector is too small to drag down the non-State sector, it still imposes large financial and allocational costs on the economy China's underdeveloped legal system will be more of a drag on the economy as the complexity of economic life increases, unless legal reform can keep pace with economic growth Property forms that have worked in the past 15 years, such as the township-and-village enterprises (TVEs), are likely to be less effective in the future, especially as village-based life is supplanted by a highly mobile, non-agricultural population Political legitimacy will also be under serious stress Growing income inequalities across regions will raise demands for compensatory policies from the center, which will prove hard to satisfy At the same time, continuing corruption and misuse of State assets further undermine public support for existing political institutions These political problems will play out against a backdrop of continuing serious pressures on the State budget, arising from low tax revenues and losses of State-owned enterprises

These issues are taken up in this chapter which is organized as follows Section 2 outlines the gradual (dual-track) reform program that was implemented after 1978 We attribute the gradual reform strategy to the logic of political compromise and the complexity of political and economic change in a country of more than one billion people, rather than to the logic of experimentation as sometimes asserted in the official rhetoric Section 3 identifies the main sources of growth We put the basis of China's impressive economic performance in the context of a liberalizing, surplus-labor economy Section 4 discusses the nature of the non-State but collectively-owned TVEs Section 5 describes the shortcomings of attempted reforms of the SOE sector Section 6 discusses the performance of the agricultural sector after reforms Section 7 briefly reviews the remaining challenges for economic reform in China

THE STRATEGY OF PARTIAL DECENTRALIZATION

The basic strategy for moving from economic planning to a market system has been the partial decentralization of economic decision-making, including the liberalization of the non-State-owned economy [1] The most common form of partial decentralization is the dual-track approach of establishing a market track parallel to an existing plan track in a particular sector or aspect of economic activity The dual-track approach pervades almost every area of economic policymaking sectoral reform, price deregulation, enterprise restructuring, regional development, trade promotion, foreign exchange management, central-local fiscal arrangements and domestic currency issuance

Dual-track Production and Pricing

The dual-track approach started at the end of 1978 with rapid and comprehensive liberalization of the agricultural sector while the industrial sector remained under traditional central planing management The agriculture communes were disbanded in a two-year period by distributing the land with multi-year (usually 15-year) leases to the peasants, and allowing the leases to be relatively freely tradable, in fact if not in law State procurement prices for agricultural products were raised, and free markets for some agricultural products were allowed [2] Farmers now enjoy a large range of production freedom, only 5 percent of their production in 1993 was set by the State plan

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[1]For more details of the early reform measures, see Perkins (1988, 1992)

[2]While the State maintained its monopoly over the grain trade for many more years, it re-introduced the pre-Cultural Revolution two-tier price system for grain procurement (a quota price and a (higher) above-quota price) to encourage production See Sicular (1985) and Chang and Tsang (1994)

In 1984, this dual-track arrangement was extended to industrial goods, with State procurement quotas for consumer goods being much lower than for producer goods The proportion of planned production of total industrial output value has been reduced from over 90 percent in 1978 to 5 percent in 1993

The typical process of dual-price transition is as follows (1) opening the free market while keeping State supply unchanged at the (lower) plan price, and (2) adjusting the plan price incrementally over time to approach the market price The supply offered at the plan prices is normally fixed by quota, if not reduced, over time Generally, no "shock" is observed when convergence of the two prices occurs

Dual-track Ownership Structure

An SOE is a nationally-owned enterprise in the sense that the central government is the ultimate authority for the operations of the enterprise and the disposition of its assets, even though the SOE in most cases has been assigned to the provincial or county government for supervision and management The non-State enterprises are those enterprises in which the central government lacks final authority over the disposition of assets The non-State sector consists of community-owned (i e , collective-owned) enterprises (COEs), cooperatives, individual-owned enterprises, private corporations, and foreign joint ventures COEs are owned by all the residents of the city or township or village, and cooperatives by a small group of persons At the end of the Cultural Revolution in 1976, there were heavy restrictions and discrimination against enterprises that were not State-owned

The most important component of the dual-track strategy has been the radical restructuring of the ownership pattern by the explosive growth of the non-State sector since 1984 The most prominent type of non-State enterprises is the community-owned enterprises in the rural areas known as township and village en-

terprises (TVEs) The non-State sector produced 57 percent of total gross industrial output in 1993 compared with 1 percent in 1984 and 22 percent in 1978 [3]

Under the planning system, China had a great shortage of small enterprises Therefore, as soon as small rural industries were allowed to develop, they tended to grow rapidly to fill the gaps This explosion of small businesses in a liberalized economy is not unique Post-communist Poland provides a similar example of rapid growth of small enterprises in an economy that had formerly discriminated against small enterprises The number of small businesses in Poland grew from 700,000 in 1989 (the eve of Poland's radical reforms) to 1,800,000 in 1993 In 1993, both Polish small businesses and Chinese TVEs employed around 20 percent of the labor force, with the difference being that Poland achieved most of this employment transformation in four years compared to the fifteen years taken by China

The big difference between China's TVEs and Poland's small businesses lies in their ownership structure In contrast to the "community-owned" TVEs, Polish small businesses are unambiguously private and are established under a normal company law We insert quotation marks around the term "community-owned" in the case of TVEs because we want to highlight that while TVEs are legally registered to be community property, the actual exercise of property rights in most TVEs is increasingly indistinguishable from that under private ownership Detailed discussion of the variety of property rights in TVEs is provided in Section 4

[3]Strictly speaking, the 1984 reclassification of industrial activities within agricultural production units from "agriculture" to "industry" renders comparison prior to that year invalid The COE share of gross industrial output went from 30 percent in 1984 to 38 percent in 1993, and the share of private corporations, individual enterprises and joint ventures from 1 percent to 19 percent

It must be emphasized that the SOE sector has not been withering away, as might be implied by claims that China is "growing out of the plan" (Naughton 1995) The SOE sector has actually retained its relative standing in overall employment 18 percent of the 1978 and 1993 labor force As noted by Broadman (1995, p 2) "There were 35 million more SOE workers in 1993 than in 1978 Furthermore, SOEs accounted for 70 percent of total industrial investment in 1993, an increase from 61 percent in 1989 "

What has happened, instead, is that the non-State sector has drawn resources from agriculture rather than from State industry In other words, the new non-State sector has grown by siphoning off rural employment into non-State enterprises, especially rural and coastal TVEs Most workers in SOEs chose not to shift to non-State enterprises because SOEs were able to offer more generous package of wages and social protection, largely as a result of the huge subsidies and other benefits that the State continued to bestow on the SOE sector SOEs provided generous pensions and heavily-subsidized housing, medical coverage, child care, food and recreational facilities Contrastingly, Chinese peasants receive none of these benefits and consume only one-third of what urban residents consume The peasants, therefore, were only too glad to shift out of low-income agricultural activities to the new higher-income jobs in the non-State sector, notably in the TVEs

This is the basis of Fan's (1993, 1994) and Sachs and Woo's (1994) arguments that the different fates of gradualism, or two-track reform, in different countries at various times were actually pre-determined by their initial economic structures Two-track reform was possible in China because of its under-developed (i e , underindustrialized) economy Labor could migrate from agriculture to non-State industry without disrupting the subsidies or political commitments to the State-owned enterprises [4] In Eastern

[4]State Councillor (cabinet member) Chen Junsheng reported that in 1995, 17 years since reforms began, there were 120 million surplus rural work-

Europe and the former Soviet Union, by contrast, there was no agricultural hinterland to provide labor for the non-State sector The growth of the non-State sector required the decline of the State sector almost as a matter of accounting, since the State sector dominated the economy Only by ending the subsidization of the State sector was it possible to free resources for the new sectors in the economy

Table 1 provides a stark quantitative reminder of the differences in the structures of China and the Soviet Union at the start of market reforms While only 18 percent of China's workers were in State-owned enterprises, the share in Russia was effectively 99 percent (counting the State collective farms as State-owned enterprises) This makes clear that the Soviet Union and Soviet-type economies in Eastern Europe had no reserve of labor outside of the SOE sector that could provide the engine of growth for a new non-State sector Two-track gradualism could not work in that context Thus, the main aspect of China's distinctive transition course does not translate to the Eastern Europe or post-Soviet context Moreover, gradualism was actually tried in Eastern Europe and the Soviet Union, but it failed miserably The liberalization there unleashed financial destabilization, without promoting the growth of a new private sector

Global Opening and Regional Implications

One of the most crucial aspects of economic decentralization was the opening of the Chinese economy to international trade and financial flows Trade and financial liberalization was absolutely vital in allowing the newly liberalized non-State sector to engage in highly profitable, export-oriented activities The trade liberalization took two main turns First, various regions were

ers out of a total rural labor force of 440 million (*China Daily* 1995a) Chen and Hu (1993) estimate that 35 percent of rural labor in 1981 was surplus labor

given special privileges to engage in international trade outside of the still restrictive practices of the planned economy One key goal was for these regions to attract foreign direct investment into export-oriented activities to allow them to become export platforms for multinational enterprises seeking inexpensive labor Second, the government liberalized other more general aspects of the trading system, including the freedom of individual enterprises to engage directly in trade transactions, and the ability of trade-oriented enterprises-to buy and sell foreign exchange Various forms of trade taxation were also reduced

Table 1 Distribution of Employment by Type or Organization (% of total employment)

	China			Russia	
	1978	1984	1991	1985	1991
State enterprises	18 6	17 9	18 3	93 1	86 1
Collective agriculture	72 0	67 0	63 9	6 0	5 3
Urban collectives	5 1	6 7	6 2	NA	NA
Industrial TVEs	4 3	7 6	10 0	NA	NA
Private and other	0 0	0 8	1 6	0 9	8 6

Source Sachs and Woo (1994)

In 1980, four southern coastal cities (Shantou, Shenzhen, Xiamen and Zhuhai) were designated Special Economic Zones (SEZs) The SEZs were given autonomy to experiment with new institutions, mainly related to the international economy SEZs could not only approve foreign-funded enterprises (FFEs), but could also extend generous tax exemptions to them The pre-1994 income tax rate for FFEs was 15 percent compared to the 55 percent for SOEs outside SEZs, and FFEs had a two-year tax holiday

from the first profit-making year and then faced a 7 5 percent income tax rate for the following three years SOEs that operated within SEZs were not only exempt from the central plan and had complete autonomy in hiring and firing, they could even get exemptions from various business and trade taxes Of the 20,000 enterprises operating in Shenzhen, the biggest SEZ in 1992, 5000 were FFEs (Bell, Ihor and Kochhar 1993)

The resulting phenomenal growth of the SEZs spurred other regions to demand the special privileges granted to SEZs there are now 14 open coastal cities, 20 economic and technological development districts, and 72 comprehensive reform experimenting cities Hainan province became the fifth SEZ in 1988

Besides setting up export platforms like SEZs to attract foreign investment, China also liberalized its trade and exchange regimes [5] In 1978, all foreign trade was conducted through 12 State-owned foreign trade corporations (FTCs) as specified by the central plan In line with the general liberalization of the economy, plan trade diminished in importance and the management of the FTCs were given to the provincial governments There were 4,000 FTCs in 1989 and enterprises were increasingly allowed to engage directly in foreign trade In place of a trade plan, there was a licensing system to control trade There were several reductions in export and import taxes in 1991-1992 as China sought to rejoin GATT The average tariff rate in 1993 was 36 percent (Tseng, Ihor, Kochhar, Mihaljek and Burton 1994) At the 1995 APEC meeting, China announced significant (almost) across-the-board reduction in tariff rates

The liberalization of the exchange system took the form of allowing enterprises to retain part of their foreign exchange earnings, and reducing the number of official exchange rates as they were being devalued steadily Two years after the unifica-

[5]See Lardy (1992) for details and Shirk (1994) for the politics of opening up

tion of the official exchange rate in 1984, a foreign exchange adjustment center (better known as the swap market) was established to allow some enterprises to trade their retained foreign earnings Participation in the swap market was widened in 1988 to include all enterprises that were allowed to retain foreign earnings, and in 1991, to all domestic residents In 1994, the official exchange rate was unified at the existing swap rate

The opening of the economy to foreign trade and investment has caused Chinese exports to boom, especially exports from the TVEs in recent years (Table 2) Note that TVE exports include exports that were produced under subcontracts from FFEs and SOEs, and so the export share of the non-State sector (which includes the private sector and joint ventures among domestic firms) may be less than the sum of the shares of TVEs and FFEs In any case, the rising export-GDP ratio shows that, with the opening to the outside world, export-processing has become a major component of China's industrialization strategy (the ratio was 4 percent in 1984) It is possible that the non-State sector has become the major foreign exchange earner since 1993 If so, China is replicating the phenomenon that occurred earlier in the successful East and Southeast Asian economies where their non-State sectors generated export-led growth by exploiting their countries' comparative advantage in labor-intensive goods

Jian, Sachs, and Warner (1995) have reviewed the consequences of the economic reforms on regional inequality During the first phase of the reforms, 1978–1984, the laggard agricultural regions experienced the fastest growth, as agricultural reforms allowed a significant, one-shot increase in productivity levels After 1985, however, the gains have gone mainly to the coastal regions, initially in the south of China and then after 1990, in Shanghai and the northern coastal regions The rise of the coastal province is, of course, a reflection of China's remarkable export

Table 2 Exports of TVEs and FFEs

	TVE Exports	Total Exports	TVE Exports	FFE Exports	Ratio of Total Exports to GDP
	(billions of yuan)		(as % of total exports)		(%)
1987	16	147	10 9	3 0	13
1988	27	1 77	15 3	5 2	13
1989	37	196	18 9	8 3	12
1990	49	299	16 4	12 5	17
1991	67	383	17 5	16 8	19
1992	119	468	25 4	20 4	19
1993	235	529	44 4	27 5	17

Sources TVE export data are from TVE yearbooks State Statistical Bureau (1995), Lardy (1995, p 72)

boom The overall pattern of regional wage dispersion (measured as the standard deviation of the logarithm of per capita income of the individual provinces) is interesting Regional income inequalities widened significantly during the Cultural Revolution (as the poorer agricultural regions fell further behind) After 1978, the regional inequalities began to diminish First, the poorer agricultural regions began to narrow the gap, then, the poorer southern coastal regions began to catch up with the national average By 1990, however, the dispersion of regional incomes began to widen once again as rich Shanghai began to grow rapidly, while the rest of the coastal regions, by this point richer than average, continued to grow faster than the interior provinces

The Decentralization Reforms in the Fiscal System

Fiscal decentralization occurred on two fronts the Budgetary Contracting System (BCS) between the different layers of government, and the Contract Responsibility System (CRS) between the government and the SOEs [6] Under the BCS, which started on an experimental basis in 1980 and then spread to the rest of the country, each province signed an individually negotiated revenue contract with the central government that specified the amount of annual revenue remittance for an agreed period The CRS, which started in 1985, is the urban imitation of the successful Household Responsibility System which restored family farming in 1979 Under the CRS, each SOE committed itself to paying a fixed annual amount of tax-cum-profits for a number of years, and, in return, the SOE had decisionmaking powers over prices, production techniques, employee compensation, and investment [7]

The government had expected the decentralization of fiscal responsibilities to lower the revenue-to-GNP ratio (as the price of stimulating economic initiative), but it has been surprised by the enormous fall in the ratio from 34 percent in 1978 to 14 percent in 1993 (World Bank 1995b) There are two major reasons for the decline The first is that the financial performance of the SOE sector has gotten steadily worse over time The second reason is that, until January 1994, the central government depended on the local governments to implement the tax code that it set Given the desire of the local governments to boost local investment for local

[6]For details, see Zhong and Hong (1990), World Bank (1990a, 1993) and Wong, Heady and Woo (1995)

[7]The loss in the discretionary fiscal power of the State can also be seen in the sharp rise of "extra-budgetary" revenue which went from 10 percent of GNP in 1978 to 16 percent in 1991 Extra-budgetary revenue consists mainly of retained earnings and depreciation allowances of SOEs, funds that the Ministry of Finance had no control over under CRS The Ministry of Finance controlled 75 percent of the sum of budgetary revenue and extra-budgetary revenue in 1978, but only 52 percent of the sum in 1991

economic development, they retained the funds at the local level by dispensing illegal tax exemptions

In January 1994, China undertook comprehensive restructuring of the tax system The annual bargaining between the central government and the local governments was replaced by an explicit assignment of different types of taxes to different levels of government, and by an explicit sharing formula of the remaining taxes, e g , 75 percent of the new simplified and comprehensive value-added tax (VAT) would go to the central coffer and 25 percent to local coffers The annual bargaining between the government and the enterprises was replaced (with some exceptions)[8] by a single income tax rate of 33 percent, regardless of ownership The annual amount of after-tax profit to be turned over to the State by an SOE continued to be determined by negotiations

Existing locally-controlled tax bureaus were split into two parts The first part comprised a nationwide branch network of the new National Tax Service, and the second part is the tax department of the local government The former collects all central and shared taxes, and the latter collects local taxes

The Decentralization Reforms in the Financial System

Under central planning, the banks were primarily the cashiers of the government, dispensing working capital and investment capital as directed by the national credit plan The financial system was in essence an appendage of the fiscal system, which, in turn, was a part of the overall plan The movement toward a market-oriented financial system began in 1978 with the separation of the central bank from the Ministry of Finance and its es-

[8]Foreign-funded enterprises that were established prior to 1994 would come under the new rate only in 1988 There are two lower tax rates (18 percent and 27 percent) for small enterprises, and a higher tax rate (62 percent) for banks

tablishment as a ministerial-level organization The major decentralization of the financial system started in 1984 when the commercial activities of the central bank were transferred to a new State-owned bank (SOB),[9] and SOBs were granted autonomy in their loan decisions The financing of SOE investments by budget grants was replaced over time by loans from SOBs

The decentralization of the financial system occurred, however, with little liberalization of banking activity (Bowles 1989, Woo 1995a, Yi 1994) There has been little competition among the SOBs, especially outside of the big cities, because each SOB is assigned an economic sector to focus on—e g , the Agricultural Bank of China has virtual monopoly over banking services in the countryside Interest rates have remained centrally controlled and much of the bank loans are extended under government directives to "strategic" industries and unprofitable enterprises The result of these "policy loans" to loss-making enterprises is that in 1995 "more than 30 percent of State banks' loans are bad, with no hope of repayment" (*The Economist* 1995) In July 1995, a law was passed to permit SOBs to focus entirely on commercial banking, and the provision of policy loans was transferred to three new policy banks

The administrative structure of the financial system has been even slower to change Local branches of SOBs are required to promote the development of the local economy and subordinate themselves to the guidance of the local government Bank branch staff depend on the local government for housing allocation and medical and social services, and it is common for the manager of the local branch to be appointed on the local government's recommendation These logistical and administrative ties with the local government were also true, until recently, of the local branches of the central bank

[9]SOB refers to State-owned banks other than the central bank

Although the credit quotas set by the central financial authority were pretty much left intact by the 1978–1989 reforms, local banks after 1984 faced greater incentives and pressures to expand credit beyond their quotas The incentives follow from the fact that the personal incomes of the local banks became dependent on the volume of their lending and on the overall prosperity of the local economy Pressure came from the local governments, which are often co-investors in the local SOEs, and which also oversee the management of the local SOBs

This confluence of self-interest and external pressures has resulted in many SOBs not only ignoring the credit quotas when they had excess reserves, but also resorting to ingenious ways to "squeeze" more reserves from the central bank A common method was to lend to local enterprises the funds designated for projects in the central plan When a centrally directed project began to draw on its centrally allocated credits, the local bank would present the central bank with the dilemma of supporting or stopping the fulfillment of the central plan The usual central bank response was to provide more credit to enable the completion of the central plan projects A recent example of such a diversion of targeted funds toward SOE loans involved the onlending of funds that had been allocated for the procurement of grain by the State Fan (1995a) and Huang (1996) provide independent empirical evidence of such locally-initiated monetary expansion

In the summer of 1993, PBC attempted to reduce local influence on the its branches by making key personnel appointments from the center However, the situation does not seem to have improved The Deputy Governor of PBC revealed in 1995 that "the situation of local governments forcing banks expanding credit or expanding investment through public financing cannot be controlled easily" (Chen 1995)

Decentralization Reforms in the State Enterprise Sector

There have been three stages in the decentralization of the Chinese State industrial sector 1979–1983, 1984–1993, and 1994 onward

The four key changes during the first stage (1979–1983) were

(a) Enterprises were allowed to retain part of their profits By mid-1980, the 6,600 SOEs that participated in the profit-retention scheme produced 60 percent of the output and 70 percent of the profits under the State plan (Tidrick and Chen 1987, p 3)

(b) The bonus system was introduced to provide incentives for workers in SOEs to improve labor productivity The bonus was generally required to be less than 25 percent of the centrally-set basic wage

(c) In 1983, the government transferred the financing of working capital from budgetary grants to bank loans

(d) In 1983, the system of profit remittance was replaced by an income tax (*ligaishui*) in order to separate the two roles of the State as tax collector and enterprise owner The amount of remitted profit was individually negotiated periodically

The results of the preceding reforms were disappointing as enterprise efficiency did not improve significantly The two major reasons were that there was little change to the system of price controls and production quotas, and the bonuses were distributed in quite an egalitarian manner

The second stage of SOE reforms began with the 1984 unveiling of the "Provisional Regulations on Expansion of Self-Management Powers in State-Run Enterprises" which gave the SOEs greater autonomy in production mix, production level, labor compensation, investment, and use of retained profits The 1984

reforms had three components, of which individual SOEs could pursue various combinations

(a) the contract responsibility system, which separated ownership from management by giving operating autonomy to the enterprise in return for contracted profit remittance from the enterprise

(b) the managerial responsibility system, which separated management from politics by reducing the power of the Party secretary within the enterprise over economic decisions

(c) the internal contract system, which linked compensation with performance at each level of the enterprise The manager signed a performance contract with each division director, who would, in turn, sign performance contracts with the personnel within that division [10]

The amount of activities directed by the central plan was significantly reduced over the 1984–1993 period Another important change in 1984 was the introduction of a progressive bonus tax to control the generous dispensation of bonuses that began in 1979 An annual bonus of up to four months of basic wages was exempted from the bonus tax, but a fifth month bonus would require the SOE to pay a 100-percent bonus tax, a sixth month bonus would be subject to a 200-percent bonus tax, a seventh month bonus would be subject to a 300-percent bonus tax, and so forth

None of the above reforms fundamentally altered the ownership structure of the enterprises, though they did significantly affect the control structure The effects of these reforms were much

[10]For more details, see Lee (1991) which discusses how these reforms have not successfully addressed the principal-agent problem Qian (1994) and World Bank (1995a) provide excellent overviews of the difficulties of Chinese SOE reform

less dramatic than the other decentralization efforts Productivity growth in the State sector remained fairly low, and State enterprises have continued to suffer large financial losses In reaction to this unsatisfactory state of affairs and to other developments, the Communist Party of China (CPC) declared in November 1993 that the property rights of SOEs would be clarified in order to improve their performance This is the first time that the ambiguity of property rights was officially recognized as a cause of poor SOE performance

The Political Necessity for a Gradual Reform Strategy

Gradualism in China is as much the result of political deadlock or compromises within the CPC between the hard-liners and the reformers, and the general lack of consensus in the society at large, as the result of a particular theory of reform [11] The hard-liners have enunciated the "bird-cage economy" doctrine In the conception of its originator, Chen Yun, the central plan is the cage and the bird is the economy The premise is that without central planning, production would be in chaos—i e, without the cage, the bird will fly away The amount of market activities that is to be tolerated to keep the economy working is analogous to the amount that the cage needs to be swung to create the illusion of

[11] An early recognition of this point is Hamrin (1984) who identified three camps in 1978 the neo-Maoist "conservatives" exemplified by Hua Guofeng, Li Xiannian and Ye Jianying, the orthodox reformers exemplified by Chen Yun and Peng Zhen, and the pragmatic reformers exemplified by Deng Xiaoping, Hu Yaobang and Zhao Ziyang Over time, the first two groups merged because their members were "unwilling to grant Deng and his successors an open mandate to depart further from China's Marxist-Leninist heritage" (p 488) The aim of this conservative-orthodox coalition was to establish a modified form of "the Leninist political and economic order that prevailed in China in the mid-1950s and early 1960s [with the watchword being] stability, order and control" (Harding 1986, pp 54–55)

greater space that is required to keep the bird happy [12] The reformers, on the other hand, believe that only a market economy will promote long-term economic development [13]

With these differences in view, it is not surprising that the CPC has continually altered its stated goals for economic management These changes partly reflect the results of experience under the reforms, and partly the shifting balance of power between competing factions, with competing conceptions of the economy Table 3 summarizes the evolution of CPC's desired economic mechanism, which went from "a planned economy with recognition of the law of market exchange value" in 1978, to a "planned economy that is supplemented by market regulations" in 1979–1984, a "planned commodity economy" in the 1985–1988 period, and (after two more changes) "a social market economy

[12]It is noteworthy that while Chen Yun believed strongly in central planning, he was not obsessed with heavy industry growth (at the expense of agriculture production) as Stalin and Mao were (Lardy and Lieberthal 1983) There was, as a result, more consensus between the planners and the pro-market reformers over agricultural reforms than many other aspects of reform

[13]This absence of consensus has persisted throughout the reform period On the eve of the Tiananmen incident, *The Economist* (1989) reported "At the heart of the rivalry between Mr Zhao [the party leader] and Mr Li [the premier] are very different ideas about where China should be going Mr Zhao would like to steer China out of the current mess by freeing more prices generating more competition between factories and between provinces [reducing] sharply the amount of industry directly owned by the state [and] finding ways to stop party people from interfering in the way factories are run Mr Li thinks China can modernize itself only if the center keeps a firmer hand on things "

In short, "muddling through" has not been a strategy, as claimed by McMillan and Naughton (1992), so much as a result of the lack of political consensus, see Woo (1994) for a discussion of the lessons for reform drawn by McMillan and Naughton Shirk (1993) and White (1993) provide analyses of the political economy of China's economic reform

Table 3 The Ever-Changing Desired Final State of the Economy

Period	Desired Endpoint Upon Completion of Reform
1978	A planned economy in line with the law of market exchange value
1979 to October 1984	A planned economy supplemented by market regulations
October 1984 to October 1987	A planned commodity economy
October 1987 to June 1989	An economy where the State regulates the market and the market regulates the enterprises
June 1989 to 1991	An economy with organic integration of planned economy and market regulations
1992 to present	A socialist market economy with Chinese characteristics

with Chinese characteristics" in 1992[14] The 1992 statement was very significant because the word "plan" was finally dropped from official rhetoric The phrase "socialism with Chinese characteristics" is an implicit denial of the universality of socialism, and hence a rejection of the planned economies of the Soviet bloc where State ownership of production units is the norm

The demise of the Communist Party of the Soviet Union in 1991 probably enabled the Chinese reformers to re-start the economic liberalization that had been suspended by the hard-liners

[14]The "law of exchange value" is from the Marxian (labor-based) theory of value, and the Chinese twist is to add the word market into it, "commodity economy" refers to an economy in the early stage of economic development where the emphasis should be on increasing production rather than on equality, so that concessions to market incentives may be necessary

which dominated policymaking after the unfortunate 1989 Tiananmen shooting The process of marketization and internationalization of the Chinese economy actually accelerated[15] because the Soviet experience convinced the leadership of the CPC that "centralized control, enforced egalitarianism, international isolation and ideological dogmatism" was suicidal (Garver 1993, p 26) CPC has even gone as far as allowing some degree of privatization of SOEs In November 1993, CPC required SOEs to adopt new operating mechanisms

> Large and medium-sized State-owned enterprises are the mainstay of the national economy [for them] it is useful to experiment with the corporate system As for the small State-owned enterprises, the management of some can be contracted out or leased, others can be shifted to the partnership system in the form of stock sharing, or sold to collectives and individuals [16]

Official thinking on the role of SOEs has continued to evolve By late 1995, the implicit official position appeared to be that State ownership of the 1,000 largest existing SOEs would satisfy the political definition of "socialism with Chinese characteristics" (*China Daily* 1995k, *Financial Times* 1995a, 1995b, *Wall Street Journal* 1995b)

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[15]For example, on January 1, 1994, the currency was made convertible for most current account transactions and a new market-compatible tax system was introduced

[16]Decision of the CPC Central Committee on issues concerning the establishment of a socialist market economic structure from a document produced as supplement to *China Daily*, November 17, 1992

THE NATURE OF CHINESE ECONOMIC GROWTH

Sources of Growth

Chinese economic growth after 1978 can be divided approximately into two phases, according to the sources of growth [17] The first phase is the 1978–1984 period where rapid growth in the agricultural sector was an important contributor to overall growth As noted earlier, comprehensive liberalization of the primary sector was initiated at the end of 1978 by the introduction of rural markets and the rapid spread of the household responsibility system on land tenure Some production incentives (notably profit-retention) were introduced for some classes of non-agricultural activities during the first phase of reform The average annual growth rate for this period was 8 8 percent Agriculture and industry made almost equal contribution to the output expansion, 32 and 34 percentage points, respectively, as seen in Section 1 of Table 4

The impressive growth of the first phase led to broader liberalization of the secondary and tertiary sectors in mid-1984 The most radical liberalization occurred in the rural areas with the lifting of restrictions on the formation of TVEs [18] The average annual growth rate in the 1984–1993 period was 9 4 percent, and the biggest contributor to GDP growth was the industrial COE sector,

[17]The official growth rates are calculated from different base years, e g , 1980 prices for the 1981–1990 period and 1990 prices for 1991 onward The output growth rates reported are based on 1990 prices The result of the conversion of the pre-1990 growth rates to the 1990 basis is that the growth rates in the earlier period will be lower because (1) the ratio of the agricultural price to the industrial price was higher in 1990 than in 1980, and (2) the industrial sector was the biggest contributor to economic growth in the 1984–1993 period This is why the average annual rate for 1984–1993 is 9 4 percent instead of the official rate of 9 7 percent

[18]It is hence not strictly correct to characterize the second phase of reform as "urban reform," since this stage of reform also involved further liberalization of the non-State rural industry

29 percentage points Industrial individual-owned enterprises accounted for 8 percentage points of the aggregate output growth

Table 4 Contribution to GDP Growth by Sector and by Ownership in the Industry Sector (percentage)

Using official data with series re-based on 1990 prices								
Growth in 1978–1993	16 5	13 8	25 0	5 9	6 9	5 7	26 1	9 2
Growth in 1978–1984	31 8	20 3	12 8	0 2	0 8	5 2	28 9	8 8
Growth in 1984–1993	11 6	11 7	28 9	7 7	8 9	5 9	25 2	9 4
After re-deflating industrial output by factory-gate price index								
Growth in 1978–1993	18 8	12 9	20 3	5 4	6 4	6 5	29 0	8 0
Growth in 1978–1984	29 3	21 8	16 2	0 2	1 0	4 8	26 6	8 9
Growth in 1984–1993	14 3	9 1	22 0	7 6	8 8	7 2	31 1	7 6

We must note immediately, however, that the real output of the COE sector seems to be grossly overstated in the official data, because the official price deflator for COE output almost surely understates the rise in COE output prices by a significant amount each year This understatement of inflation seems to be related to two main accounting phenomena First, some COEs report exactly the same levels of nominal and real output in their reports to the statistical agencies, as if there were no price changes at all This seems to be a simple, but pervasive, reporting error Second, the accounting of new product lines by the COEs is inadequate, as

it essentially assumes zero inflation for new products produced by the COE in a given year The real output reported by SOEs is also exaggerated by the appearance of new products

The combined result of these faulty accounting procedures is a large understatement of inflation For example, the implicit deflator for COE industrial output rose only 5 percent in the 1990–1993 period compared to the 35 percent increase in the implicit deflator for SOE industrial output and the 41 percentage increase according to the factory-gate survey of industrial goods prices When total (COE and SOE) nominal industrial output is deflated by a price index based on a survey of factory-gate prices, the annual 1984–1993 GDP growth rate is reduced from 9 4 to 7 6 percent

We must point out that inadequate deflation is not the only cause of the exaggeration of output growth Phantom output appeared to have also been a major problem The Director General of the State Statistics Bureau has conceded that

> some local government officials deliberately exaggerate local industrial production and other results in order to pave the way for their administrative careers The problems are particularly rampant among the country's rural enterprises (*China Daily* 1995h)

He cited the example of Anyang County in Henan Province, whose reported 4 88 billion yuan in rural enterprise output last year was 27 percent more than the true reported figure The country's reported output of 26 large enterprises was 47 6 percent in excess of the true amount (*China Daily* 1995f) In our opinion, the incentive for local officials to overlook deflation of output by the enterprises (an act which they can truthfully claim innocence of) has to be stronger the incentive to report phantom output [19]

[19]See World Bank (1992) for details of the inadequacies of the Chinese statistical system

Even after correcting (crudely) for these price distortions, the conventional view regarding the sources of growth during the 1984–1993 period seems to remain unchanged The industrial sector was the chief source of growth, and the non-State sector was the engine, as seen in the lower section of Table 4 The main qualification to the conventional view is that there might not have been an acceleration of growth in the second phase compared with the first

The Mechanics of Growth

Table 5 reports standard growth accounting for China during the reform period, relying upon Li et al's (1992) estimates of capital stock growth and using the assumption of a labor share of income equal to 0 5 [20] We find capital accumulation to be the biggest contributor to the 1978–1993 annual GDP growth rate, accounting for 4 9 percentage points On the aggregate measures, the annual total factor productivity (TFP) growth rate was higher in the 1978–1984 period than in the 1984–1993 period, 3 2 percent and 2 6 percent, respectively, when the official real industrial output data are used, and 3 3 percent and 0 8 percent, respectively, when industrial output is deflated by price survey data

The fact that a high proportion of growth is accounted for by capital accumulation is consistent with the findings of growth-accounting exercises for other Asian economies, which also attribute the preponderance of growth to factor accumulation (Young 1994) Even the modest level of annual TFP growth that we have calculated would probably be reduced by a more careful measurement of labor input, controlling for quality improvements Moreover, a portion of the TFP growth rate can probably be attributed to the reallocation of labor from surplus-labor

[20]A labor share of 0 5 is approximately the average labor share found by Li et al (1992)

Table 5 Growth Accounting (percent per annum)

Real GDP Growth	Using Official Data	Using Official Data After Re-deflation of Industry
Average 1978–1993	9 2	8 0
Average 1978–1984	8 8	8 9
Average 1984–1993	9 4	7 6
Capital Accumulation	**Growth Rate**	**Contribution to GDP Growth**
Average 1978–1993	9 8	4 9
Average 1978–1984	8 1	4 0
Average 1984–1993	11 0	5 5
Labor Force Growth	**Growth Rate**	**Contribution to GDP Growth**
Average 1978–1993	2 7	1 4
Average 1978–1984	3 1	1 6
Average 1984–1993	2 5	1 3
Contribution of Total Factor Productivity to GDP Growth	**Using Official Data**	**Using Official Data after Re-deflation of Industry**
Average 1978–1993	2 9	1 7
Average 1978–1984	3 2	3 3
Average 1984–1993	2 6	0 8

agricultural activities to higher-productivity industrial and service activities Remember that labor markets in China have certainly not equated the marginal productivities of labor in the countryside and the urban areas, because of strict restrictions on legal migration of families within China

To estimate the growth effects of labor migration, we must measure the size of labor migration from agriculture to industry, and make assumptions about the differences in marginal labor productivities in the two sectors The official estimate of labor in agriculture, based on registered residency status, is an overstatement of labor input in agriculture because of illegal rural migra-

tion, especially to coastal TVEs From the official estimate of the size of illegal migration to be 80 million and the World Bank's highest estimate of the "floating population" to be 150 million, we assume unmeasured rural migration to be 100 million with 60 percent ending up in industrial jobs Based on this estimate and assumptions about productivity differential between the two sectors, we can estimate the effects of labor reallocation from agriculture to industry

Under the Cobb-Douglas production function, the (unobserved) marginal productivity of labor is equal to the (observed) average productivity of labor multiplied by the share of labor in production If we make the crude assumption that both agriculture and industry are Cobb-Douglas production functions with the same share of labor (taken to be 0 5), the marginal productivities of labor in the two sectors are equal to the observed average productivities of labor in the two sectors, multiplied by 0 5 Under this assumption, the reallocation of labor from agriculture to industry is calculated to have added around 1 3 percentage points annually to GDP growth in 1978–1993 (Woo 1995b) More realistically, we should assume that the share of labor in industry is lower than the share of labor in agriculture, which would imply a smaller differential in marginal productivities than implied by the observed differences of average productivities In this case, the output effects of labor migration would be reduced A reasonable guess would be an effect between 0 5 and 1 0 percentage point per year

Acknowledging the huge uncertainties surrounding growth accounting, especially in the Chinese context, we would break down the 9 4 percent annual growth rate of 1984–1993 into the following components (a) 1 8 percentage points from improper deflation, (b) 5 5 percentage points from growth of capital stock, (c) 1 3 percentage points from growth of labor force, (d) 0 5 to 1 0 percentage points from the sectoral reallocation of labor, and (e) 0 2 to 0 3 percentage points from other factors These estimates

prompt us to examine the sources of China's high capital stock growth

China's High Rate of Capital Accumulation

China's high rate of capital accumulation probably has its roots in two phenomena a high marginal productivity of capital and conditions for high rates of household saving The high marginal productivity of capital is, in turn, a function of initial conditions of capital scarcity, abundant labor, and access to world technology and management Moreover, even as capital accumulates rapidly in labor-intensive manufactures, the rate of return on marginal investments remains very high since the elastic supply of surplus labor from the countryside keeps real wages low despite the rapid growth of the economy

These factors help to account for China's large inflows of foreign direct investment in the past decade and the continuing high domestic investment demand within China They do not adequately explain the high saving rates of China's households, which as in other East Asian economies, are far higher than in Europe, the United States, and most non-Asian developing countries Household saving is about 23 percent of disposable income in China versus 21 percent in Japan, 18 percent for Taiwan, 16 percent for Belgium, 13 percent for West Germany, and 8 percent for the United States (World Bank 1990b, Table 4 9) The annual flow of household saving into the formal financial system (the State banks and rural credit cooperatives) has risen steadily from 3 4 percent of GDP in 1980 to 11 7 percent in 1991 Of course, the high marginal productivity of capital also ensures a relatively high return to savings, which probably helps to account for part of the high savings rate

But a full explanation of China's saving rates would involve the following factors First, there is an almost complete lack of State-provided social security coverage for households outside of

the State-enterprise retirement Second, taxation of savings is very low Third, the Chinese government has taken special care to preserve positive real rates of return on household deposits in the State banking sector since the start of reforms Fourth, China's demographic characteristics of a young population with a rapidly growing labor force and a low dependency rate contribute to China's high saving rates Fifth, financial repression may also play a role [21] China's households are unable to obtain investment loans or consumer credit or housing mortgages, and thus must save for precautionary purposes and for large capital expenditures [22]

It should be noted that China's high household saving rate has helped to stabilize the economy beside contributing to its high growth rate Chinese households accumulated the money balances that the government created in order to finance the budget deficit and off-budget transfers to loss-making enterprises As credit was extended to the economy, it was transferred to households (e g , through wage payments), and then accumulated in

[21]"Financially repressed" refers to a financial system characterized by interest rate controls, restrictions on the development of new financial instruments, and disinterest in financial intermediation according to commercial principles (many times because of the dominance of State banks) In a situation where the rate of return to investment is very high and where there is no financial intermediation, the only way that a person can reap the high return is through self-financing of the lumpy investment This explains Liu and Woo's (1994) finding for a sample of OECD and East Asian countries of a negative correlation between the private savings rate and the degree of the sophistication of financial intermediation

[22]Following Liu and Woo (1994), one could see the high return to investment created by the economic liberalization as a major reason for the rise in the household saving rate since 1978 The self-financing of the now-legalized TVEs encouraged the rural households to save Qian (1988) reported that the rural household saving rate went from 4 9 percent in 1957 to 26 8 percent in 1982, and then to 32 percent in 1984

rising real money balances Remarkably, M^2/GDP rose from 38 percent in 1979 to 106 percent in 1992

Without the high saving rate, and in particular, the substantial increase in real money balances during the period, the credit expansion would have resulted in inflation Technically, seignorage can be written as the sum of the inflation tax plus the increase in real money balances held by the public In China, the high seignorage (credit expansion used to finance the loss-making enterprises) did not translate into a high inflation tax because of the increase in real money balances The rapid increase of money balances was abetted by the financial repression of the Chinese economy Until recently, money balances were virtually the only form of financial saving available to Chinese households Thus, part of the demand for money was a demand for financial wealth (rather than for transactions balances per se, as in an advanced economy)

The ratio of M^2/GDP appears to be leveling off as the agricultural economy becomes fully monetized and as new financial instruments appear, which are alternative savings instruments In the future, the Chinese government will either have to reduce the budget deficit (including the implicit deficit due to credits to loss-making SOEs) or change the form of financing to bond issues rather than credit expansion The greater problem would come if households were to begin to reduce their demand for monetary balances It might prove very difficult, or fiscally very expensive, to sterilize the inflationary impact of a sharp decline in demand for real money balances

Other Growth-Promoting Factors

Besides the "advantages of relative backwardness" — i e , low initial capital stock, abundant labor, and untapped technologies — which supported high saving and investment rates, there were additional aspects of the pre-reform period which supported

rapid growth after the onset of reforms One key factor was the relatively limited extent of China's central planning in the pre-reform era, in comparison with the pervasiveness and detail of planning in Eastern Europe and the Soviet Union Qian and Xu (1992) have noted that around 25 million commodities entered the Soviet economic plans, while in China, only around 1,200 commodities were included Another favorable initial condition was the relative financial stability in China at the start of market reforms Unlike most of Eastern Europe and the former Soviet Union, China did not begin the reforms with a large overhang of foreign debt or with extreme repressed inflation and large budget deficits

As we have stressed, much of China's impressive growth is the result of its rapid integration into the global economy Labor-intensive, export-oriented manufactures have been enormously profitable and the source of enormous job expansion China has been able to attract large inflows of foreign investment, technology, and management expertise In all of these aspects, China has been favored by the vast network of family ties between mainland and overseas Chinese The explosive growth of the Special Economic Zones in southern China was underpinned by the wholesale movement of labor-intensive industries from Hong Kong and Taiwan China was closer, wages were lower, and language difficulties were nonexistent compared to the alternative sites in Southeast Asia Managers could commute daily from Hong Kong to supervise their factories in Shenzhen Perhaps most importantly, family connections greatly reduced the transaction costs of the investment by providing reliable local supervisors, inside information on the enforcement of regulations, and contacts with the local authorities

Needless to say, the market reforms could not have taken place without political toleration from the CPC The history of the two disastrous leftist campaigns—the Great Leap Forward (1958–1962) and the Cultural Revolution (1966–1976)—opened the way

for economic reform by fundamentally discrediting the leftist alternative and the administrative capacity of the State The Great Leap Forward resulted in the starvation of some 30 million Chinese, and the Cultural Revolution produced a 60 percent "purge rate among the party officials" (Fairbank 1987, p 320) By the time that Deng Xiaoping transferred a significant amount of economic policymaking power to the provinces, the central ministerial and party apparatus were too politically exhausted to resist the decentralization By contrast, both Gorbachev and Yeltsin faced relatively intact central bureaucracies which succeeded in derailing or deforming many crucial aspects of the reforms

THE TVE PHENOMENON

We have seen that TVEs have played a central role in the growth of the non-State sector after 1978 In this section, we explore the TVE phenomenon in more detail, discussing whether the TVEs represent an efficient new ownership form, or whether they are likely to prove a way-station on the path to private ownership For reasons described below, we tend to support the latter view

The Range of TVEs

The foundation for TVEs was laid during the decade-long Cultural Revolution when the official emphasis on self-reliance and the breakdown of the national distribution system caused the rural communes to expand their non-agricultural activities These nonagricultural activities of the communes were grouped into production units called TVEs as the commune system began to dissolve in 1979 The simultaneous relaxation in 1979 of restrictions on the nonagricultural activities of the peasants also led to more TVEs being set up An enterprise could be classified as a

TVE only after approval by the local government and a TVE (until recently) paid lower taxes than a private enterprise

The concern for rural underemployment led to increasing liberalization of the regulations governing the formation of nonagricultural enterprises, particularly those that were registered as collective-owned The growth of TVEs was also greatly helped by the agricultural surplus that followed the reform of the agriculture sector Since 1984, the terms of approval and supervision of TVEs have varied greatly across regions There are three main types of TVEs

(1) In the first type of TVE, the local authorities exercise tight controls over TVEs This tight control over TVEs has come to be known as the Jiangsu Model because of its concentration in Wuxi, Suzhou and Changzhou, three cities in southern Jiangsu province In 1985, the Wuxi authorities would confer TVE status on a firm only if its "initial investment was from the savings of a community body," its site belonged to the community, its production equipment the property of the community, and its distribution of profits complied with the local regulations The Wuxi authorities protected its TVEs by imposing fines on skilled workers who left for better jobs elsewhere and by limiting the number of partnerships and individual firms that could be set up Finally, the "average wage rates were not allowed to diverge too much among firms" (Luo 1990, p 150)

(2) The second type of TVE form is known as the Zhejiang Model The local governments in Zhejiang province, although the majority shareholder in many TVEs, normally refrain from intervening in the investment, dividend and personnel decisions of the TVEs, provided that the enterprise makes an annual contribution to the village funds Since the Zhejiang TVEs have complete operational autonomy and their financial ties to their communities

are indistinguishable from the taxes that a private firm is required to pay, they are essentially "private" in their operations

(3) The third type is private enterprises masquerading as TVEs The entire capital of the enterprise is from one individual or a small group, and the individual or group pays a fee to the local authority in order to be allowed call itself a TVE, a charade that is popularly referred to as "wearing a red hat" The main reasons for the desire to disguise the true ownership are lower tax rates, easier approval procedures, less restrictions on the size and operations of the enterprise, and shelter against possible reversal in the political fortunes of the reformers As the official press has described it "hundreds of thousands of private companies have registered as branches of publicly-owned units on the condition that they pay money to their so-called owners [because private companies face] complicated registration procedures, heavy levies and less preferential treatment than State firms [in fund raising and fund use For example, one] private company had to write 46 receipts of 10,000 yuan each for goods worth 460,000 yuan because non-state firms were only allowed to issue bills under 10,000 yuan" (*China Daily* 1994d)

It is commonly believed that the number of red-capped private enterprises is greater than the number of registered private enterprises A 1993 survey found that in one county in Hebei province where there were "at least 1,000 private businesses, the official number was eight" (*China Daily* 1995b)

While the Jiangsu Model is "more highly regarded than [the Zhejiang Model because] the former adheres to traditional socialist concepts" (*China Daily* 1993b), it is experiencing financial difficulties in the 1990s The Jiangsu authorities have attributed the malaise to "the ambiguous property relationship [that damp-

ened] the villagers' enthusiasm for township firms" (*China Daily* 1993b) Moreover, "In the second half of [1992], Wuxi, Suzhou and Changzhou transferred the operation rights of some deficit ridden small-scale State or publicly-owned enterprises to private businessmen through rental or auction sales (*China Daily* 1993c)

The above taxonomic discussion makes it clear that it is hard to be precise about the nature of TVEs It is primarily because of the vagueness about the ownership and control of TVEs, the great variety of TVEs, and their evolving nature, that the official statistics on TVEs now cover all non-State enterprises in the rural sector

All three forms of TVEs are fundamentally different from SOEs in three important ways The first difference is that TVEs face less of a principal-agent problem than the SOEs because of the shorter supervision distance The direct linkage in TVEs between local people's working efforts and their economic benefits not only reduces the cost of supervision, but also improves the local owners' incentives to monitor the management, exert pressures on managers to improve the business, and complain about managerial appropriation of resources when it occurs excessively

The second difference is that TVEs face hard budget constraints Since the TVE is a non-State enterprise, the rescue of a bankrupt TVE is not the State's responsibility In the last economic downtown, the number of industrial TVEs fell from 7 7 million in 1988 to 7 2 million in 1990 while the number of industrial SOEs increased from 99,000 to 104,000

The third difference is that TVEs can implement institutional innovations without the approval of the central government Recent locally-initiated transformation of TVEs into "shareholding cooperatives" to enhance the supervision of TVEs shows this feature very well This freedom of TVEs has enabled them to move closer to best international practices in corporate governance

It has been suggested that the social service functions (especially housing, healthcare and pensions) of the SOE sector have been a significant positive impact on the growth of TVEs[23] The argument is that the SOEs subsidize the TVEs SOE workers who resigned or took early retirement to accept a job at a TVE have sometimes kept receiving at least part of the social services of the SOE The problem with this claim is that the areas of China that have the greatest concentration of SOEs—and hence, allegedly, the greatest amount of SOE subsidies to the TVEs—are the areas where TVE growth has been unimpressive, e g, the northeast provinces The coastal provinces in central and southern China, which have relatively few SOEs are the ones that have produced the explosive TVE growth This negative correlation between the dominance of SOEs and the growth of TVEs suggests that the social subsidies from the SOEs to their workers who join TVEs are, in general, not large enough to make the total TVE compensation package greater than the total SOE compensation package This is why the labor force of the TVEs is drawn overwhelmingly from the rural population, with few workers coming directly from the SOE workforce

Explaining the Collective Ownership Form of TVEs

The TVE ownership structure is highly unusual by international standards In most countries with rural industry, such as Indonesia, ownership of small enterprises is private This has given rise to many debates among academic scholars and policymakers

Some scholars have argued that collective ownership reflects deep Chinese cultural patterns The dominance of private enterprises in rural Taiwan appears to refute this "cooperative culture" hypothesis, however Other scholars have said that collective

[23]See, for example, the comments of Dr Dongtao Zou (1995)

ownership is necessary because China lacks a sufficient number of entrepreneurs to develop on the basis of private ownership Still other scholars have said that collective ownership is an effective way to raise capital funds for rural enterprise and to reduce the principal-agent problem by shortening the supervision distance (Chang and Wang 1994, Che and Qian 1994)

We are skeptical of these explanations, at least as a general theory of TVEs In our opinion, an adequate theory will have to be based on the following two considerations First and most obviously, private ownership was basically prohibited in many areas until recently Therefore, collective ownership of rural industry arose because other forms of ownership were discriminated against, if not, prohibited Zhang (1993) reported that

> In virtually all aspects relating to local governments, the non-collective TVEs tend to be unfavorably treated [compared to] their collective counterparts Areas in which local governments appear to have discriminated against non-collective TVEs include access to bank credits, to larger production premises, to government allocation of inputs and energy, to government assistance in solving technical problems and for initiating joint ventures and so forth In the field of taxation and profit distribution, there is evidence that non-collective TVEs run a greater risk of being excessively levied, and that local governments tend to treat the non-collective TVEs more arbitrarily than do the collective ones

Second, the collective ownership reflected the low labor mobility in the countryside, which resulted largely from the household registration system Community ownership was plausible because the community members expected to remain in the same place indefinitely, and there was also no complicating factor of inward migration

The Problems with the TVE Ownership Structure

Since the growth of the TVE sector has been so dynamic, does it really matter that its ownership structure is unusual? Can China simply continue along the same path, building on the successful accomplishments to this point? The problem is that the unclear and unusual ownership structure may prove to be a source of future difficulties in the rural areas While things have gone well up until now—mainly because China desperately needed small rural enterprises and there was low rural labor mobility—the future of the TVEs will likely be hindered in the absence of future ownership reforms

An analogy is helpful From the 1950s through the 1980s, Yugoslavia fostered a kind of collective ownership of its industrial enterprises under the rubric of "social capital" The workers in the enterprises were supposed to govern the social capital Up to the 1970s, Yugoslavia grew rapidly with this unusual system, and many studies proclaimed the advantages of Yugoslavia's worker-management system In the 1980s, however, the entire system came crashing down and in a way that underscored the problems arising from a lack of real owners When the economic crisis arrived in the early 1980s, there were no forces to represent the long-term interests of the enterprise The workers and management continued to pay themselves large incomes, and allowed the enterprise capital to be wasted or misused Few, if any, would now challenge the present dismantling of Yugoslavia's syndicalism

There are five major reasons why the rural Chinese economy should not rely mainly on collective ownership of industry for its long-term development The first reason is the most obvious Collective ownership invites political intervention by the local government in the workings of the enterprise Indeed, many economists praise this political intervention as essential to promoting enterprise formation, but the opposite is also likely and the local government can stifle the healthy development of the

enterprise There are innumerable stories of local officials demanding bribes or personal services from the rural enterprises

Also, good managers are sometimes forced out of rural enterprises by local officials who favor family members or other political favorites These kinds of intervention have a very long history in China dating back for centuries The great China historian, John Fairbank (1987), even claimed that local bureaucratic intervention in rural industries was a major reason why China did not develop a vigorous market economy in past centuries

> In feudal Europe the merchant class developed in the towns Since the landed ruling class were settled in their manors upon the land, the European towns could grow up outside the feudal system instead of being integrated in it Medieval burghers gained their independence by having a separate habitat in these new towns, and new political authority to protect them, in the persons of the kings of nation-states In China, these conditions were lacking The early abolition of feudalism and the dependence of the emperor and his officials upon the local gentry left no political power outside the established order to which the merchant could turn for special protection Between them, the gentry and officials saw to it that the merchants remained under control and contributed to their coffers instead of setting up a separate economy (pp 180–81)

In a sense, the TVEs reject a long-standing pattern in Chinese economic history rural enterprises under the control of local bureaucrats That the risks are the same now as in past centuries is evidenced by recent news reports, such as the following

> But ambiguous ownership or property rights in the collective economy coupled with the long standing integration of government administration and enterprises management [have] led to some problems Among these

> were incidences where some local officials embezzled or diverted collective enterprise funds or properties to other purposes, and the rights of enterprises or employees were repeatedly infringed upon (*China Daily* 1994a)

> Who really owns township enterprise is a burning question which must be answered In rural enterprises sponsored by local communities, such as township or villages, the property right belongs to the whole community, but to no individual in particular As a result, the community leadership randomly interferes with the enterprises, internal management, thus preventing the workers themselves from bringing their initiative into full play (*China Daily* 1994c)

> As China heads toward a market economy, an increasing number of private companies are no longer feeling the need as register as "red cap," or collectively-owned ventures [because the] difference in preferential treatment between private and public units has been narrowed But there is a problem The collective units are now arguing that private firms could not have developed without their help As the so-called "owners" of the companies, the State firms usually ask for high compensation for the "divorce" or ask the companies to merge with them (*China Daily* 1994d)

The second problem is that the risks of collective ownership become much greater when mobility in the society increases With more geographical mobility within China, it makes much less sense to link a household's financial investments within one's original geographical community Currently, when a worker leaves the community, he cannot take his "share" of the TVE with him, it remains within the village, as part of the community property The result is to limit mobility and to increase the risks facing a family if they are forced to move for one reason or another

The third problem with collective ownership involves the problem of risk diversification When a local community puts its wealth only into the narrow range of enterprises in the community, it can end up losing everything—jobs and savings The fact is that localized collective ownership is the opposite of risk diversification A better strategy of risk reduction is for households to diversify risks by investing in financial assets unrelated to the workplace and locality

The fourth problem with collective ownership is that it limits the scale of operations of the enterprise Currently, a TVE can grow as a result of new investments by the community (including reinvestment of profits) or through bank loans It is very difficult, however, to get outsiders to invest in the TVE, since the property rights of the outside investors would not be well-defined or well-protected The outside investors would also be afraid that the local government would manipulate the profits of the enterprise for the advantage of the local community, and against the outside investors The likely result is that many TVEs fail to grow to an efficient scale They lack the equity investment necessary for growth and either rely upon a dangerous level of bank debt or simply remain at a suboptimal scale

The fifth problem with collective ownership is that it limits the market for managerial control Suppose that a rural entrepreneur has a good idea for an new enterprise Perhaps he can convince township government to support him, but it is possible that he will be unable to do so In a normal market economy, he might be able to raise his own money to start the business or would be able to purchase an existing business Both of these options are currently difficult in China because of the heavy bias towards collective ownership

Moreover, because of the collective ownership of TVEs, entrepreneurs only receive a small proportion of the benefits of a successful business that they organize Conversely, suppose that an existing enterprise has a bad manager, but one that is favored

for political reasons by the local government This manager will be protected in his job In a normal market setting, an outside buyer might approach the owners of the business and make a takeover bid, replacing the manager after buying the enterprise This is nearly impossible with the collective ownership of the TVEs

The TVE as a Transitional Enterprise Form

In addition to these five problems, a recent development has increased the pressure on the TVEs to "clarify" their property rights The capacity expansion of many of the coastal TVEs in southern China has forced them to rely increasingly on migrant labor from the poorer provinces The original inhabitants in these richer provinces want to prevent new residents from having an automatic share in the dividends of the collective-owned enterprises, and some have converted the community-owned TVEs into "shareholding cooperatives" by corporatizing the TVEs and dividing the shares among themselves The fact that the government has not clamped down on what could be the first step in de-collectivizing the TVEs (effective de-collectivization occurs when the shares are legally transferable) has been viewed as implicit approval, and this has accelerated the conversion of TVEs to shareholding cooperatives

With the further relaxation of discrimination against private ownership since early 1992 to counter the rural unemployment caused by the post-Tiananmen austerity policies, many TVEs have been taking off their "red hats," albeit with difficulties in many cases because of demands for "alimony" payments from the local governments The spurt in investment in TVEs since early 1992 may well be caused by the clearer signal from the authorities that the hard-liners' abhorrence toward private ownership will decrease further in the near future The signal became stronger in November 1993 when, for the first time in the history of the Chi-

nese Communist Party, the Central Committee deemed the clarification of the property rights of SOEs to be desirable

It is very likely that the ownership structure of TVEs will change markedly in the next few years, either spontaneously or according to law More enterprises are discovering the need or desirability of clear, private property rights,[24] starting a grassroots process of spontaneous privatization (Chen 1994) It was reported that at the end of 1993, 10 percent of rural enterprises has adopted some form of the "share-holding cooperative system," whose commonly-articulated ideal form is as follows

> A portion of the shares must be held by the collective The rest will be held by work unit employees, who can apply only for a fixed number of shares These shares cannot be listed on the market and can only change hands among employees And if the worker leaves the plant, his or her shares must be transferred back to the unit or to other employees Regardless of the number of shares, workers have an equal say in the unit's decision-making process (*China Daily* 1994c)[25]

In a field trip through Zhejiang province in summer 1994, Woo found substantial deviations from the above norm, for example, he found villagers who were not employees of a TVE holding its shares, and voting power was according to the number of shares In some cases, managers were simply trying to take complete ownership of the enterprises that they manage It is

[24]An internal study of the Ministry of Agriculture concluded that township "enterprises which have adopted cooperative shareholding generally [performed] better than those which have no shareholding system," (*China Daily* 1994c) The phenomenon of asset-stripping is also on the rise (*China Daily* 1995g)

[25]These details are confirmed in *China Daily* (1992, 1994a) The first article noted that "usually 30–60 percent of the shares is reserved for collective ownership "

likely that a legislated process, with better-defined legal standards, community choice, and a voting mechanism among the stakeholders will be preferable to a spontaneous process dictated by the power or tactical prowess of competing groups

THE SHORTCOMINGS OF SOE REFORM

The obverse side of the rapid growth of TVEs has been the lackluster performance of the State-owned enterprises Nonetheless, a lively debate continues about the efficacy of SOE reforms undertaken since the mid-1980s Almost all analysts agree that non-State firms have outperformed State enterprises The debate over SOEs, therefore, has centered on a different question whether SOE performance itself has improved markedly as a result of reform efforts This question is related to another heatedly debated topic whether SOE privatization will take on increased urgency in the future We therefore turn now to a review of SOE performance

A number of studies have concluded that total factor productivity (TFP) growth of the Chinese SOE sector has been positive in the reform period, and some also indicate that this TFP growth is higher than in the pre-1978 period [26] But we can regard Chinese SOEs as having been successfully reformed only if we keep our expectations of SOE performance low Most studies estimate that annual TFP growth in Chinese SOEs is only about half that in collectively-owned enterprises [27] This relative inefficiency of the SOE sector is supported by Xiao (1991) who found a positive statistical relationship between the TFP growth of a province

[26]See, for example, Chen, Wang, Zheng, Jefferson and Rawski (1988), Granick (1990) and Lau and Brada (1990)

[27]For example, the annual TFP growth rates for SOEs and TVEs were 2 4 percent and 4 6 percent, respectively, in Jefferson, Rawski and Zheng (1992), 0 1 percent and 5 5 percent in Wu (1992), and 4 7 percent and 2 8 percent in Huang and Meng (1995)

and its share of industrial output produced by non-State enterprises

Woo, Hai, Jin, and Fan (1994) have pointed out that the studies of Jefferson, Rawski and Zheng (1992) and Groves, Hong, McMillan, and Naughton (forthcoming), which found positive TFP growth in industrial SOEs by estimating production functions for the SOE sector, seem to be based on flawed price data, characterized by an excessive growth of intermediate input prices (thereby understating the growth of real intermediate inputs, which are measured as nominal intermediate inputs divided by the intermediate goods price deflator) and insufficient inflation of final output prices, thereby exaggerating the rate of growth of real final output (which is measured as nominal final output divided by the final output price deflator) Two of the key building blocks of the data therefore appear to be dubious in a way that overstates the growth of total factor productivity of the SOE sector [28]

One key reason why technical improvements have been lackluster despite the positive incentives of the decentralization reforms may lie in the fact that it continues to be financially more rewarding for an SOE manager to spend time developing good relations with the State bureaucracy than to increase productive efficiency Until the 1990s, large and medium-sized SOEs had to fulfill production quota at below-market prices, and they received subsidized inputs in turn If the amount of subsidized inputs was high, the quota system would generate a positive rent to the enterprise Li (1994) estimated that an SOE which made positive market profits in the 1986–1988 period received a rent that was 2 7 times that of its market profit, i e , total profits equaled market profits plus rent Bureaucratic haggling was vastly more profitable than competing in the market Li's estimate did not include the rent that an SOE received from tax bargaining, a practice so

[28]See the exchange on this point between Woo, Fan, Hai and Jin (1994) and Jefferson Rawski and Zheng (1994)

pervasive that an SOE paid an effective income tax rate of 33 percent instead of the legal rate of 55 percent

SOEs and Macroeconomic Instability

Technical efficiency should not be the sole criteria of successful enterprise reform, as we also care about the financial results of the SOE sector, since State-enterprise losses contribute to macroeconomic instability By this standard, the SOE reforms also look relatively unsuccessful Overall profitability of the SOE sector has been declining, and a large proportion of SOEs are still making losses a decade after the start of enterprise reform This poor financial performance was most vividly seen in 1992 when output grew 13 percent, and yet roughly two-thirds of Chinese SOEs were running losses in a boom year[29] These enterprise losses cannot be blamed on price controls because the price controls covered only a small proportion of SOEs in 1992 Even if the SOEs had become technically more efficient, a large proportion had also become financially less viable Naughton (1992) has suggested that the primary reason for the decline in the rate of profitability of the SOEs is the expansion of competition from the COEs encouraged by the economic reforms The problem with this explanation is that the fall in SOE profits has occurred across

[29] *China Daily* (1993a) reports "At present, about one-third of State firms are definitely operating at a loss and another one-third suffer hidden losses, according to the State Statistics Bureau" Hidden losses refer to various methods that allow a firm to prevent from showing an accounting loss—e g, the firm is exempt from forwarding sales tax revenue to the State, and a firm's unsold output is valued as income As long as there is no accounting loss, an SOE can borrow working capital from the banks to pay its employees and suppliers

This two-third figure was confirmed by Gao Shangquan, Deputy Director of the State System Reform Committee of the State Council (the Cabinet) in a speech delivered at the 1992 annual conference of the Chinese Economic Association of the United Kingdom

the board, even in heavy industrial sectors with negligible new entry by non-State firms [30]

Fan and Woo (1996) have suggested that excessive wage increases throughout the SOE sector may have been the more important reason for the decline in profitability They found that the ratio of direct cash income (wages plus bonuses) to net output value rose from 11 6 percent in 1980 to 15 9 percent in 1988, and that indirect income (e g , housing and in-kind distributions) as proxied by net nonproduction expenditure increased more than twice s much as net output value There is, in general, little incentive for State-enterprise managers to resist wage demand because their future promotion to larger SOEs is determined in part by the increases in workers' welfare during their tenure The easy availability of loans from the local banks made it possible to increase labor compensation and capital investment at the same time [31]

Official data on industrial SOEs show that the average annual rate of labor productivity growth and direct real wage growth over the 1978–1990 period were 4 4 percent and 4 1 percent, respectively [32] In a recent study, Zhao (1992) estimated that the indirect real wage costs grew an annual average of 12 5 percent in the 1978–1990 period, raising the share of indirect wages in total

[30]The financial performance of the SOEs continued to worsen after 1992, even though annual real growth rate in the 1993–1995 period was always above 10 percent In the first ten months of 1995, the profits of the SOEs within the government budgetary plan dropped 23 percent Vice-Premier Wu Bangguo reported that "more and more enterprises have run into the red, and the amount of losses is increasing" (*China Daily* 1995j)

[31]Minami and Hondai (1995) found that wage compensation has been increasingly excessive in the machinery industry

[32]Direct wage is the sum of the basic wage and some kinds of bonuses and cash subsidies State Statistical Bureau 1992, Tables 4 37, 7 1 and 10 16)

compensation from 15 percent in 1978 to 31 percent in 1990[33] Incorporating Zhao's finding into the official data, the average annual increase in the real wage was 5 4 percent This finding supports Fan and Woo's (1996) contention that the higher wage growth caused profitability to fall even though technical efficiency might have increased Notably, productivity growth in the collective sector is much greater than the direct real wage growth in that sector—8 3 percent and 3 6 percent, respectively—whereas productivity growth and direct wage growth are roughly equal in the SOEs

The financial weakness of SOEs has threatened to destabilize the macroeconomy through two channels The first is through the State budget The financial contribution of the SOE sector (as a percentage of GDP) has declined steadily in the reform period SOEs paid income taxes that amounted to 19 1 percent of GDP in 1978, 7 0 percent in 1985, and 1 7 percent in 1993, and they remitted gross profits of 0 0 percent, 0 5 percent, and 0 1 percent, respectively The consequent widening of the budget deficit contributed to faster monetary growth The second channel is through the banking system This is because the bulk of SOE losses are not covered by budget subsidies but by bank loans Moreover, since the promotion of an SOE manager depended on the expansion of the enterprise under his stewardship, State enterprise managers put continuous pressure on local banks for investment loans When the firm is not doing well financially, the justification for the investment loan application is to increase the firm's competitiveness by technical upgrading

The result of the central bank's accommodation of the requests for loans to cover losses and to finance investments is that the amount of reserve money growth directed toward SOEs seems

[33]From Table 9 in Zhao (1992) Indirect wage rate growth was computed by assuming that direct wage rate grew 4 1 percent annually The 12 4 percent figure is the lower-bound estimate because in-kind consumption hidden as production cost is not included in the indirect wage data

to be substantially greater than the budget deficit itself, causing the "consolidated government budget deficit," including subsidized loans to the SOEs, to be over 10 percent of GDP in 1990 and 1991 (Wong, Heady, and Woo 1995) Broadman (1995) reported that

> While explicit and implicit fiscal (i e , on-budget) subsidies [to SOEs] as a percent of GDP have been declining in recent years (from about 5 9 percent in 1990 to about 3 5 percent in 1993), quasi-fiscal (i e , financial system) subsidies have been increasing (from about 3 8 percent in 1990 to about 6 0 percent in 1993) The net result is that total subsidies to SOEs are large and remain virtually unchanged (p xii)

The Generation of Social Tensions by Embezzlement

In December 1995, the State Administration of State Property (SASP) reported that asset-stripping in the SOE sector "has been about 50 billion yuan [annually] since the early 1980s State asset drain must end" (*China Daily* 1995k) [34] This would mean that the cumulative loss of SOE assets in the 1983–1992 was equivalent to some 24 percent of the original value of fixed assets in the SOE sector in 1992, or some 34 percent of the net value of fixed assets in the SOE sector Hong Kong banking sources have estimated that about US$10 billion of Chinese capital flee abroad annually, i e , capital flight in 1993 was one-third of the gross capital inflow in that year (Fan 1994)

These two trends are not surprising They are indeed likely by-products of ceding decisionmaking power to the SOEs, despite the absence of real owners, while also legalizing non-State enterprises, thereby making it easier to launder the assets stripped from the State sector China's gradual "spontaneous privatiza-

[34]See also *China Daily* (1995d, 1995e) and Wang and Li (1993)

tion" process is likely to result in a more unequal distribution of property ownership than a Czech-style mass privatization program, though admittedly Russia's mass privatization process did not prevent massive corruption (particularly of valuable assets in the natural resource sectors) Perhaps even more importantly, the steady stripping of State assets tends to subvert political legitimacy much more than a transparent method of privatization It is notable that the original demands of the 1989 Tiananmen demonstrators were the reduction of inflation and corruption It is somewhat ironic, therefore, to justify slow reforms of the SOE sector on the basis of preserving social stability, when the unreformed ownership structure contributes to asset stripping, corruption, and macroeconomic instability

THE SITUATION IN THE RURAL SECTOR

Economic welfare in the countryside fell sharply relative to urban levels in the 1949-1978 period The ratio of per capita urban consumption to per capita rural consumption increased from 2 1 in 1952 to 2 9 in 1978 The major reason for the widening of the urban-rural consumption gap in this period was the stagnation of rural consumption levels throughout the period of the Cultural Revolution period, while urban consumption averaged annual growth of 3 percent

The main mechanism sustaining the widening of the urban-rural gap before 1978 was the household registration system The household registration system (which still exists today) assigned residency rights according to the individual's place of birth Before free markets became widespread after 1980, getting food outside of one's hometown was a major problem because ration coupons were dispensed through work units (*danwei*) at the permitted place of residence As most urban jobs were with State-owned and State-operated factories, a peasant could not proffer his services at the factory gate at a lower wage Furthermore,

during most of the 1960–1980 period, the purchase of train tickets required permission from the work unit![35]

Economic growth came to the countryside with the dismantling of the commune system in late 1978, the raising of purchase prices for grain, and the legalization of free markets for many agriculture products Rural consumption soared so that its real level in 1983 was twice that in 1977 Per capita rural income increased an average of 14 6 percent every year from 1978 to 1984, which rapidly reduced the urban-rural consumption gap, until the 1985 value of the gap was slightly below the 1952 value of 2 1 After 1985, the dynamic growth of rural income stopped, and growth in rural income slowed to 2 8 percent in 1985 and stayed below that rate in 1986–1989 A spurt of 12 percent growth in 1990 was followed by zero growth in 1991 By 1991, the urban-rural gap had climbed back to 2 6

The initial decrease and subsequent widening of the urban-rural consumption gap mirrors well the jump in agriculture productivity growth after 1978, followed by relative stagnation after 1985 (see Table 6) The annual growth in rice yields went from 1 4 percent in 1966–1977 to 5 1 percent in 1978–1984 and back to 1 3 percent in 1985–1994 It certainly appears that the impressive agricultural growth in the early years of the reform was a one-shot improvement in productivity that followed the liberalization of the agricultural sector and the introduction of the household responsibility system for land tenure

There are of course other factors that contributed to the poor agricultural performance after 1985 The first factor is the large reductions in State investment in agricultural infrastructure (e g , irrigation works) after 1979 The level of real investment in agricultural infrastructure in 1994, for example, was only 58 percent the 1979 level The second factor is that State procurement prices

[35]For details of the household registration system and on rural-urban migration, see Cheng and Selden (1994), Sabin (1994) and Wu (1994)

Table 6 Growth in Grain Yield (percentage)

Period	Grain	Rice	Wheat
1966–1977	3 1	1 4	4 4
1978–1984	5 7	5 1	8 0
1985–1994	2 0	1 3	1 9

Source China Statistical Yearbook

after 1978 have not been raised in line with the increases in input prices The government is reluctant to increase procurement prices because urban retail grain prices have lagged behind procurement prices, creating large budgetary subsidies for food (Johnson 1994) In fact, when the State decided to clamp down on inflation in late 1993, grain procurement quotas were reintroduced and price controls were put on 27 agricultural commodities Worse yet, whenever credit was tightened to fight inflation (1985, 1989 and 1992), the government would pay for part of its grain procurement with coupons (IOUs) instead of cash With such adverse relative price trends after 1984 (when prices of industrial products accelerated), the flagging of growth in grain production is understandable

A third factor causing the slowdown in yields in the 1990s may have resulted from the government's policy response to the post-1985 slowdown The government's strategy announced in late 1990 was to re-collectivize part of farm operations "to establish a two-tier operational system (*shuangceng jingying tizhi*), which [sought] to integrate decentralized household-based farming with collectively-organized socialized service system [plowing, planting, fertilizing, harvesting]" (Ash 1992) It seems that the peasants interpreted this partial re-collectivization as the first step toward the abolition of the household system (land, after all,

still could not be owned privately), and they reduced their work efforts and their investments in the land [36]

Another striking aspect of the reform period is that delivery of social services to the poor rural areas has not improved Just as with State investment in agricultural infrastructure, State spending on several key rural social services has actually declined The World Bank (1992) reported that

> In urban areas, schools benefit from a much greater local revenue base and from categorical grants from the provincial or national government Rural primary schools, however must rely almost entirely on local community support Health services are the weakest component of the rural safety net Available evidence does document a significant erosion of township and village level health infrastructure and personnel after 1975

It seems, therefore, that the widened urban-rural inequalities are likely to persist in future years and could even be exacerbated by trends in productivity and social policy The stagnation of the rural sector can be a source of political instability, as evidenced by the rural unrest in 1992 and 1993 (*Far Eastern Economic Review* 1993, *Japan Economic Newswire* 1993) Unless agriculture growth can be greatly increased, it is important that rural-urban migration be facilitated so that the surplus labor in agriculture can shift to higher-productivity industry and services

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[36]In the opinion of Zhang Yunqian of the Central Policy Research Office The peasants' misgiving that the contract responsibility system based on households would be abolished has never been dispelled Because of such misunderstandings, when they heard about developing the collective economy and improving dual operations, they took it as abolishing the household contract system" (Johnson 1994, p 11)

As Johnson (1994) judged there to be no significant economies of scale in Chinese agriculture, he saw the aim of the 1990 policy to be strengthening of "the power and influence of the local cadres'

FUTURE CHALLENGES

Two points about China's gradual reform program deserves re-emphasis The first is that the dual-track approach worked in China, but not in Jaruzelski's Poland and Gorbachev's Russia because of China's vast rural hinterland The TVEs and other non-State enterprises were able to grow without sharp rises in marginal costs and without the need to force reductions of employment in the SOEs because of the existence of surplus agricultural workers The second is that China's gradualism is an "easy-to-hard" reform sequence, that is, it began with the relatively easier problems and has left the hard problems until later In contrast, the more radical approach in parts of Eastern Europe and the former Soviet Union have tackled the hardest problems—including ownership transformation, structural reforms, and political democratization at the beginning

China's rapid growth can continue as long as the non-State sector remains dynamic and essentially unhindered by financial losses or problems thrown up by the SOE sector Dynamism of the non-State sector, however, is likely to require continuing reforms in that sector, such as the extension of truly private ownership instead of collective ownership Moreover, State enterprise reforms will have to be deepened in the future to include privatization and structural adjustment, if losses in that sector are to be kept limited

We would enumerate the main economic reform challenges as follows (1) restructuring of TVE ownership to encourage private, transferable ownership rights, (2) the restructuring of the SOE sector, especially to encourage private, corporate forms of ownership, (3) the modernization of the fiscal system and of federal-local fiscal relationships, (4) the development of a non-State financial sector, (5) the elimination of policies that aggravate regional inequality, and (6) the establishment of market-supporting institutions and commercial law

Ownership Transformation of the TVEs

For reasons discussed earlier, China would be ill-advised to continue to base its rural industrialization on collective ownership This is especially true as geographical mobility within China rises, so that the village no longer represents a long-term stable base for collective ownership The problems for the future can be divided, in the broadest sense, into two parts First, what kinds of ownership should be encouraged for new rural enterprises? Second, what should be done about the ownership structure of existing TVEs?

The main task for future enterprises is to ensure that normal forms of private ownership—including self-proprietorship, partnerships, privately held corporations, and publicly held corporations—are all possible in the rural economy without incurring excessive transactions costs Even if collective ownership by the community remains an important option for the future, it is also necessary that truly private ownership should also be allowed and fostered by the legal system An important task, therefore, is to clarify the legal guidelines for private ownership and encourage a wide variety of forms of ownership The new company law that went into effect on July 1, 1994 is an important step forward in this task

The second problem concerning existing TVEs is more complicated Throughout China, existing TVEs are suffering from the lack of clarity of property rights, and there are many spontaneous attempts throughout the country to clarify the ownership of the TVEs In almost all cases, there are at least three claimants or stakeholders that are insisting on ownership rights local governments, enterprise managers and workers The situation is further complicated by the vast variety of ways that individual TVEs were started

As a general point, China might benefit from one important aspect of the Eastern European and Russian privatization experi-

ence when it considers the ownership question of existing TVEs In the most successful privatization programs—such as in the Czech Republic—one of the key strategies was to give each enterprise a range of choices with respect to future ownership change In any successful ownership transformation of existing TVEs, it will be important, and probably inevitable, to give choices to the community The community, and perhaps workers, could vote among a menu of possible legal options, including preservation of the collective structure or privatization among the main stakeholders

Restructuring the SOE Sector

Without deeper reforms of the SOE sector, the financial demands of loss-making State enterprises will continue to threaten macroeconomic stability In our view, it will be highly desirable for China to push forward to privatization of the SOE sector and liquidation of the unredeemable loss-making enterprises Widespread privatization, perhaps under a different rubric, is not as far-fetched as it might seem There are currently some 25 property rights exchanges in China where State assets are sold to the public (*China Daily* 1994b)

Reports indicate that there are around 150 unofficial property rights exchanges in smaller cities, and the operations of these unofficial exchanges are dependent on the ideological climate (Fan 1995b)

Modernization of the Fiscal System

The 1994 tax reform has not reversed the decline in revenue as hoped Tax collection in 1994 was 9 1 percent of GDP (*Wall Street Journal* 1995a) down from 13 1 percent in 1993 While the continued financial weakening of the SOE sector was an important reason for the decline, it appears that many branches of the new National Tax Service had not really divorced themselves

from the influence of the local governments, which desire to retain the funds for local development

The tax system has continued to be badly administered, allowing tax fraud and tax evasion Under the new VAT system, producers receive VAT refunds on their exports However, the large amount of false export claims has resulted in overpayment of VAT refunds The government has suspended the VAT refunds for exports Local governments are continuing to give illegal tax exemptions, so that the actual customs revenue (which goes to the central government) is only 6 percent of total import value, despite an average tariff rate of over 30 percent [37]

It is imperative that tax administration be improved and central-local fiscal relations be better institutionalized to yield independent tax authority to the central and local governments Otherwise, the State will not be able to finance the infrastructure investments required to prevent bottlenecks that would slow economic growth

Development of the Non-State Financial Sector

Presently, State banks dwarf all other financial institutions as sources of funds and SOEs receive about 70 percent of total domestic credit Recognizing the gross inefficiencies of State banks, the Chinese government has ordered them to commercialize their operations To the extent that State banks would respond to these new exhortations, more capital would be channeled to the more efficient non-State enterprises—a desirable outcome

Both the transformation of State banks and the greater access to investment funds by the non-State sector would be achieved faster if the government would unleash competition by legalizing

[37]This low realized tariff rate also reflects the immense amount of export-processing activities where the import of the raw inputs for the assembly operations entered tariff-free

non-State financial institutions Private banks would compete directly against State banks, and the private nonbank financial institutions, by deepening the equity and bond markets, would create alternative sources of investment funds Another desirable by-product of the competition from the non-State financial institutions is that it would be more difficult (i e , costly) for the government to impose many non-economic objectives on State banks

Given the grave financial crisis that State-managed pension schemes have caused in many developed countries, China should avoid this future financial trap by allowing the establishment of private pension funds Concretely, the government should not expand existing State-managed pension schemes to cover non-State employees The present virtual monopoly status of the People's Insurance Company of China in providing social insurance to non-State employees is hard to justify

Elimination of Policies that Aggravate Regional Inequalities

Recently announced plans include giving the backward interior provinces the same preferential trade and investment enjoyed by the coastal provinces, and eliminating some of the special tax benefits enjoyed by the coastal areas These measures should help ameliorate the growing regional inequalities of the past decade, though the coastal regions will continue to benefit from an inherent geographical advantage in participating in world trade It is also important to end price controls on grain prices for farmers and to provide more support for social infrastructure in the rural areas

Deepening of Market-supporting Institutions

The rule of law is an absolute necessity for the establishment of a system of property rights and an independent judiciary body is required for objective adjudication of disputes Furthermore,

regulatory institutions to supervise the financial markets are important in maintaining the integrity of these markets and the public confidence in them The State should focus on delivering social services that markets usually provide inadequately, if at all—e g , welfare, education (especially in rural areas), and healthcare to the indigent The correction of market failures will improve the working of a market economy and strengthen its political foundations

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India's Unfinished Reform Agenda

Jeffrey Sachs

INTRODUCTION

India is poised to become one of the world's most dynamic economies in the second half of the 1990s as a result of the economic reforms started in 1991 These reforms, led by Prime Minister Narasimha Rao and Finance Minister Manmohan Singh, have begun to unshackle the Indian economy following decades of excessive state regulation Nonetheless, the reform program remains incomplete While the reforms have probably raised India's growth potential from 3-4 percent per year to around 5-6 percent per year, reforms are still needed to raise India's economic growth still further to 8 percent per year or more in the second half of the 1990s Fortunately, the remaining reforms are within reach, economically, politically, and administratively

More than by any specific policy failing, India's reforms are hampered by an unwarranted lack of confidence among many Indian politicians and businessmen One oft-stated fear is that India would be unable to stand up to global competition if the economy is fully opened Partly as a result of such fears, India remains one of the most protected market economies in the world today, with tariff levels that are still high by international standards and with quantitative restrictions that still cover a wide range of consumer goods Fortunately, the fears over international competition are misplaced Indeed, with a more open and deregulated economy, India stands poised to repeat China's export boom of the past decade based on low labor costs, the availability of managerial and engineering skills within India, and the inflow of international capital and technology If there is any con-

solation to India, it is America's labor-intensive manufactures (in textiles, apparel, footwear, electronics assembly, automobile components, and the like) that have much more to fear from India's low-wage competition than vice versa [1]

Another widespread fear is that India could be "overwhelmed" by foreign multinational corporations, such fears have deep "East India Company Syndrome" Yet experience again shows how anachronistic these fears are given modern geopolitical and economic realities Foreign multinationals offer the capital, international market access, and technology that India lacks, and are, therefore, vital to remolding India as a strong and rapidly growing economy India's neighbors that are relying heavily on foreign direct investment (DFI)—such as China, Indonesia, Malaysia, and Thailand—have been pulling far ahead of India in terms of economic growth, income levels, and productivity, while also increasing their security and geopolitical influence in the world community India's continuing ambivalence to DFI, as a result, exacts a heavy toll on the Indian economy India is ceding billions of dollars of DFI to its neighbors each year, flows that otherwise would have come to India While China achieved actual DFI inflows of around $15 billion in 1993 and commitments exceeding $150 billion, India settled for a mere $0 5 billion in actual inflows and commitments of around $3 billion

A third misplaced fear is that economic reforms would be socially iniquitous In the name of social justice, India spends tremendous amounts of resources and political energy to protect the few percent of workers in the organized sectors of the economy, but as an indirect result, it hinders the chances for the other 90+ percent of the population to find gainful employment outside of the subsistence agriculture or low-productivity informal employ-

[1] I have recently argued, with co-author Howard Sha of Harvard University, that low-wage competition with developing countries reduced U S manufacturing employment by roughly 6 percent during the period 1978–1990, mainly in the low-skill sectors See Sachs and Sha (1994)

ment Most of the reforms that are now feared or stalled—including privatization, greater foreign investment, and labor law reform—could be implemented in a way to enhance social conditions as well as to spur economic growth

In the most general terms, if the government leaves the productive sphere to the private sector (including foreign enterprises), it will be able to devote more resources and attention to real social needs, such as increased literacy and access to primary health care With the increasing availability of international capital for industry and for many kinds of infrastructure (e g, roads, telecoms, and ports), the government can redirect its own very scarce resources to those areas which are distinctly within the purview of the government, especially primary education and health This kind of policy shift is underway throughout the developing world Economy Minister of Chile, Eduardo Aninat, for example, announced a major increase in government spending on education, this was made possible by Chile's extensive privatization program in recent years Similarly, Argentina's Economy Minister, Domingo Cavallo, recently announced a new and extensive wave of privatization, again with the stated purpose of allowing the government to refocus its efforts where they are most needed, in education and skill upgrading

It is hard to imagine a more propitious time for India to make a full-fledged opening to the world, combined with additional steps in internal reform Unlike in the colonial era, the world economy is now governed by international law rather than sheer rapacity and opportunism The Uruguay Round of the GATT represents a remarkable commitment of some 120 nations in the world to abide by principles of open trade, nondiscrimination, and harmonization of law in crucial areas of commerce, services sector regulation, and intellectual property rights The weaker countries, if anything, are favored by the codes themselves, since the developing countries are given extra years in which to comply with several of the new international standards But most im-

portantly, the agreements give the developing countries a realistic chance to develop on the basis of nearly complete market access in industrial products (including textiles and apparel after a ten-year phase-in), as well as increased opportunities in agriculture, services, and the attraction of foreign investment

In addition to benefiting from a law-based international environment, India also enjoys the benefits of a world economy that is becoming "deeply integrated", that is, integrated not just in trade, but also in finance, production, and economic institutions Ten or twenty years ago, open world markets meant mainly free trade With new technologies and worldwide economic liberalization, open world markets now mean extensive and remarkable linkages in finance and production as well The "emerging markets" in the developing world, including India's, are attracting tens of billions of dollars of portfolio investments from the developed countries, as a part of a profound process of global diversification of institutional equity portfolios (pension funds, insurance companies, and mutual funds) This process is not a fad, but represents a fundamental and economically justified search for risk diversification in long-term equity investment

The increased flows of DFI from developed to developing countries are as remarkable as the portfolio flows The increase in DFI in the past decade has substantially outpaced the increase of global trade, which, in turn, has consistently outpaced the increase in global GNP China, of course, has so far been the world's leading beneficiary of large-scale foreign direct investment flows Actual flows into China in 1993 totaled some $15 billion, while new commitments during the year exceeded $150 billion Even if this number is discounted, China is surely attracting DFI at an historically unprecedented rate[2] With proper reform

[2]The commitment figure is inflated for at least three reasons First, only around one-half of commitments actually materialize into projects in future years Second, a sizable proportion of DFI into China perhaps, as much as 30 percent, is in fact not foreign investment at all, but rather

steps, India could match or even outpace China in attracting DFI, given India's superior conditions regarding the rule of law and political democracy and stability

This paper outlines several areas for continued reform action further opening of the economy to trade and financial flows, further unshackling of the private sector from State regulation, socially-responsible privatization of the State-owned enterprise sector, and a fundamental redirection of government efforts away from economic management toward a focus on primary health and education, so that all Indians will be positioned to take advantage of the new economic opportunities The next section takes up some general observations about the reform agenda, and the section after that goes point-by-point on specific measures for spurring India's growth and equitable development

GENERAL OBSERVATIONS ON INDIA'S GROWTH STRATEGY

In current world conditions, it is possible for India to achieve very dynamic growth based upon labor-intensive manufacturing that combines the vast supply of Indian labor (including skilled, managerial, and engineering labor) with foreign capital, technology, and markets On this basis, the East Asian economies have achieved growth rates consistently above 6 percent per year, and China has managed growth in excess of 10 percent each year in the 1990s Malaysia, to cite another example, has shifted from being a raw-material exporter in the 1970s (with commodities accounting for 80 percent of exports) to a manufacturing exporter

Chinese State enterprise funds that have been "laundered" in Hong Kong for reinvestment in China as "private" funds Third, the DFI numbers are also inflated by overestimates of the capital contributions of foreign partners in joint venture projects in cases where the foreign contribution comes in the form of physical capital investment rather than an injection of cash

today (with manufactures, mainly electronics, accounting for 70 percent of exports), and with GDP growth of 8 percent per annum

To achieve similar growth rates in India, the first and foremost task is to unshackle private enterprises (both domestic and foreign-owned) from the heavy hand of State regulation, in order to tap India's supply of labor and to attract large flows of foreign investment Deregulation of the private sector is even more important than privatization of the state sector, with the proviso that government monopolies in key sectors—finance and infrastructure—must be abolished (de facto as well as de jure) if India is to achieve maximum private sector growth

A competitive environment for private business requires (1) flexibility in the hiring and dismissals of workers, (2) the freedom of entry of capital, including foreign capital, (3) the ready availability of land for new business activities, and (4) adequate infrastructure, including power, ports, roads, and telecommunications Moreover, local and State governments must have the freedom to facilitate infrastructure to meet local needs in a rapid and flexible manner

Despite the great advances in India's reform, the necessary flexibility of the private sector is certainly not yet achieved Labor laws protect the rights of a small proportion of work force while raising the costs of hiring the vast majority of workers outside of the organized sector Archaic land regulations hamper industrial development in major cities, such as Bombay Foreign capital is still viewed with suspicion and is generally subject to government approvals for equity ownership above a 51 percent threshold And, of course, basic infrastructure remains inadequate

Moreover, State governments generally lack the authority to make needed breakthroughs in infrastructure on the local level Road building is hampered by many kinds of Union-level restrictions (e g , forestry rights) and by the union's control over "na-

tional highways" Telecommunications continue to be the nearly exclusive domain of the union government As a result, major cities still lack cellular phone systems and adequate data transmission networks, even as China's coastal cities are all building or improving their cellular and data networks

In addition to unshackling the private sector, the State sector also requires four types of reform (1) the ending of State monopolies (in banking, insurance, telecoms, and other infrastructure), (2) the transfer of ownership of State-owned enterprises to private owners, (3) the closure of loss-making State firms, and (4) the redirection of government resources and political attention to meeting basic human needs, including primary education and health In order of priority, (1) and (4) certainly outrank (2) and (3), though all are important and should be carried out The first key is to unleash private activity (by ending State monopolies) and to upgrade labor force skills Privatization per se is important to improve enterprise performance, but it is even more important to protect the Treasury from heavy financial losses in the State-owned sector Such losses are partly observed in the budget (in the form of enterprise subsidies) and are partly hidden in the form of bad loans in the State-owned banking system

China illustrates the preeminent importance of (1) and (4)[3] China's growth has come despite the continuing failure of its attempts to reform the State-owned enterprise sector, which continues to lose money at an alarming rate even during boom years The key to China's growth, therefore, has been in the dynamic non-State sector, which operates freely of almost all regulatory impediments, as well as in the growth-oriented policies of local governments, which compete to provide infrastructure to support the non-State enterprises The good news for China is that State-owned industry covers only about 8 percent of the work force, so

[3]For a recent study of the factors behind China's rapid growth and a comparison with the reform problems in Eastern Europe and the former Soviet Union, see Sachs and Woo (1993)

that there is plenty of scope for the rapid growth of the non-State sector and the overall economy, even if the State sector lags behind One can say that China needs privatization of the State-owned enterprises mainly for the sake of macroeconomic stability, which is being undermined by the huge losses (and resulting huge subsidies) of the State-owned sector

The situation is similar in India The State sector is highly inefficient and loss-making These losses pose heavy scale costs on the State, and by themselves justify the need for a widespread privatization program But at the same time, the State sector is relatively small, employing just a small percent of the total labor force Therefore, the real key for India will be rapid growth in the non-State sector This, in turn, requires a more liberal policy environment, supported by improved infrastructure, and the end of State monopolization of key service sectors (such as finance and telecommunications) which provide crucial inputs to manufacturing

Liberalization, even with privatization, is not enough however Only a literate and numerate labor force will be able to take full advantage of the new world market conditions Chinese literacy far outstrips Indian literacy, and this has greatly bolstered the growth rates in China [4] Even in basic export assembly operations in the Chinese coastal enterprises, literacy is a pre-requisite for an effective labor force One of the major reasons for a free market-policy based heavily on foreign investment is to free the government's energies and finances to make a wholehearted attack on illiteracy and inadequacy of primary health care in India's vast rural heartland

The general guidelines—private sector deregulation, production based on labor-intensive manufactures supported by foreign

[4]According to the *1994 World Development Report* of the World Bank, overall Chinese literacy stood at 73 per cent in 1990, compared with 48 percent in India

capital inflows, and a major assault on illiteracy—must be turned into specific policy actions in the near future Of course, the government has already made remarkable and successful headway in this direction The following list of ten items suggests areas where the reforms remain incomplete, and, therefore, where specific and practicable steps could help push the reform process forward Most of these steps are already contemplated or are under continuing debate within the government

SOME SPECIFIC AREAS FOR FURTHER REFORM ACTION

Trade Liberalization

India has gone from being a closed economy to an open economy, but it is still a highly protected economy by current international standards Tariff rates remain high, consumer goods imports are still subject to a strict licensing regime, and DFI is still highly regulated in many areas, especially foreign ownership of more than 51 percent of production, as well as in key sectors such as telecommunication These remaining barriers are unjustified and costly to India

The current surfeit of foreign portfolio capital inflows, which are swelling India's foreign exchange reserves, makes this an opportune time to accelerate the opening of the economy Unlike the IMF and World Bank, I do not believe that the capital inflows by themselves pose a significant inflationary risk, even though they increase the money supply (and could therefore, accommodate inflationary pressures arising from other sources) As long as India keeps a strong grip on domestic credit expansion to the government and the banking system, and keeps the exchange rate roughly stable, inflationary pressures are likely to remain under control Therefore, I would not recommend actions to stifle the foreign inflows Rather, I would view these inflows as an opportunity to accelerate trade liberalization and financial market liberalization

Specific Recommendations

(1) Lower the maximum tariffs to around 30 percent, and the average tariffs to around 20 percent, ahead of the previously announced schedule In addition, convert the remaining quantitative restrictions (mainly on consumer goods) into tariffs, initially around 20-30 percent

(2) Further liberalize capital flows including longer lags in repatriation of export earnings, greater access of foreign institutional investors to Indian financial assets, and easier approvals for foreign direct investment outflows by Indian enterprises seeking to invest in foreign operations All of these as partial steps toward full convertibility of the rupee

(3) Maintain the intervention of the Reserve Bank of India in the foreign exchange market to prevent the appreciation of the rupee Indeed, the government should consider a very slow, gradual depreciation of the rupee to compensate partly for price inflation Perhaps a target of around 4 percent per year rupee depreciation would make sense under current conditions Exporters should know that the government will stand behind them by providing a profitable environment for export expansion This policy will mean the continued accumulation of foreign exchange reserves and continued money growth backed by foreign reserves, but the consequences should not be particularly inflationary if the budget deficit and domestic credit are kept under control and if the trade and capital account are liberalized as recommended

(4) Move to a basket of currencies as the basis of exchange rate pegging and foreign exchange market intervention, in response to the rapid growth and diversification of India's foreign trade

Comment

Trade liberalization ahead of schedule may be opposed by some business interests, but the package would be broadly popular and can be justified in view of prevailing trade and balance-of-payments conditions Consumer goods liberalization has the double advantage of lowering consumer goods prices, and thereby restraining inflation in the short term and increasing government revenues by converting quantitative restrictions into tariffs

Foreign Direct Investment

The government has been working hard to change India's long-standing attitude to foreign direct investment and has made important steps in liberalization Nonetheless, the DFI regime remains considerably more restrictive than in most other countries with which India must compete for DFI flows There is, in my view, no justification whatsoever for the continuing 51 percent rule, requiring government approval for foreign ownership of between 51 and 100 percent of equity This rule should be scrapped in favor of automatic approval for 100-percent foreign ownership except on a small list of sectors which will continue to require government authorization (e g , banking and some other sectors where India will want to negotiate reciprocal investment rights) As mentioned above, the government should also ease the restrictions on DFI outflows by nonfinancial Indian enterprises, to allow these enterprises to enter into joint ventures and DFI arrangements in other countries

Private Financing of Infrastructure

The government has made important conceptual steps in opening infrastructure investment to private investment, but it has not yet achieved many concrete results in this area One of

the key problems is that State governments are still very much hampered in their ability to settle infrastructure projects with foreign investors, since union approval is needed in many cases This is particularly true in telecommunications, where key regions could easily attract DFI for new local systems (e g , cellular phone systems in Bombay, Madras, etc), but are effectively blocked from doing so by union laws and regulations

Recommendations

(1) Establish new legal regimes at the union level for roads, power, ports, and telecommunications (for local services) that give State governments much greater autonomy in attracting DFI

(2) Push ahead on a general liberalization, demonopolization, and privatization of telecommunications

Comment

So far, telecoms has been held back from the opening of infrastructure, to some extent on the grounds of "national security " The truth is that India stands to risk its national security by falling far behind the rest of world in telecommunications technology and services as a result of the continuing union level monopoly There is simply no way that India will be able to maintain global competitiveness in data transmission, size of networks, and range of services, without a huge infusion of foreign capital and technology Fortunately, telecom privatization has proved to be the most lucrative form of privatization throughout the world The government stands to reap billions, if not tens of billions of dollars, through the step-by-step privatization of the telecommunications systems

Tax Reform

India has had several excellent tax reform studies and commissions that have set forward sound proposals for a revamped tax system The key, therefore, is not new ideas, but effective and timely implementation The main guidelines are clear tax simplification, broad-based taxes with low marginal tax rates, and generous provisions for investment in new enterprises

Recommendations

(1) As the Finance Minister has rightly and repeatedly urged, rapidly introduce the VAT as the sine qua non of effective tax reform in India Almost all countries in the world now rely on the VAT as the backbone of the tax system

(2) Eliminate all taxes on interstate trade, including the Octroi The Octroi could be replaced, in the short term, by newly shared federal taxes (e g , a surcharge on gasoline), as compensation to State and local governments that now rely on the Octroi Such compensation should be temporary, however, and should be phased out over a five-year period The main metropolitan governments that now rely on the Octroi (e g , Bombay) should be pressed to introduce a complete overhaul of land taxation during the next five years, so that local governments can be run on the basis of property taxes (as in most local governments in the world) rather than trade taxes

(c) Restrict State-level sales taxes to final goods purchases, excluding sales taxation on intermediate inputs Of course, most sales taxes should simply be eliminated and replaced by tax sharing of the proceeds of the union level VAT

(d) Simply eliminate most other small taxes (stamp taxes, transactions taxes, other document taxes) in the interest of

tax simplification and administrative honesty and efficiency

Financial Market Reform

India's banking and insurance companies were nationalized more than 20 years ago Many other countries had also taken such misguided actions in the 1970s and early 1980s (e g , Mexico, France, and Chile), but these countries have almost completely reversed this policy since then India is, therefore, one of the last countries in the world to rely on a State-owned, State-run banking system The results are predictable and highly adverse a strong politicization of the lending of the banks, bad debts throughout the banking system that will have to be picked up by the government, widespread corruption, and huge inefficiency in loan allocations

The government has announced some partial steps to improve the situation including corporatization of the banks, partial sales of shares up to 49 percent, recapitalization of the banks, and adaptation of international guidelines on capital adequacy I would like to state, in emphatic terms, my view that none of this will be enough to prevent further strongly adverse consequences from the continued state dominance of the banking system State banks will simply continue to go broke and be the source of political headaches, scandals, and inefficiency, until these banks are returned to the private sector

Recommendations

(1) Proceed with the divestiture of shares above the 49 percent limit now envisaged by the government, through public offerings of shares or sales to domestic and foreign investment groups

(b) Move simultaneously to enhance the powers of the bank regulatory authorities for oversight, monitoring, and intervention when necessary, and extend more licenses to foreign banks, with a view to creating domestic competition, and establishing Bombay as a key regional banking center for all of Asia Of course, foreign banking licenses should be negotiated on the basis of reciprocal rights for Indian private-sector banks to enter foreign markets as well

Privatization of Nonfinancial Enterprises

The government of India has so far resisted the worldwide trend towards privatization of nonfinancial enterprises, relying instead on partial ideas of corporatization, divestiture of shares of up to 49 percent, Memoranda of Understanding (MOUs) on the management of State enterprises, new managerial incentive schemes, and so forth These partial ideas are almost sure to fail No country in the world has figured out how to manage a large State sector China has tried to reform its State enterprises for the past 10 years (with every partial measure now under discussion in India) and has failed miserably Even in the boom year of 1993, more than half of China's State enterprises continued to lose money Vice Minister Zhu Rongji announced a suspension of key reform measures during the rest of 1993, as the Chinese government tried to cope with the financial fallout of heavy losses and subsidization of State enterprises

The problems are endemic to State ownership and cannot be resolved by tinkering at the margins State managers have little incentive to run the enterprises profitably Why return profits to the State, when it is possible to increase the compensation of the managers and workers? Nor do the political overlords really care about profitability of the enterprises, rather, they care about employment, patronage, and kickbacks This is why State enter-

prises have lost money in all countries, not just in the developing world France's flagship State enterprises have almost all required bailouts in recent years Italy, France, Spain, the U K, as well as dozens of developing countries have embarked on privatization programs in the past decade, mainly to save the State from the extraordinary costs of losses and loan bailouts of the State-owned sector

Privatization can be politically popular, if it is well designed The Indian government's apparent view that privatization will come at a high political cost is simply unjustified to judge by international experience The key is to make sure that the main stakeholders in the process—the workers, the management, and the public at large—all see themselves as beneficiaries of the privatization process

Recommendations

(1) Privatization should be designed to achieve solid public understanding, as well as support by the State workers

In particular

- workers in the enterprises should receive shares of the privatized enterprise to compensate them for their implicit stake in the enterprises This could come, for example, in the form of 15 percent of the shares being given free to the workers (based on seniority, wages), or 30 percent at half price Workers should receive their shares not as a group (e g, held by the union, or in trust for the workers), but as individuals The shares should be freely tradable, and management teams should also receive a small proportion of shares, perhaps 1-2 percent, depending on the size of the enterprise

- the privatization process for the general public should be highly transparent and competitive Private sales to single bidders should be prevented An international review board (e g , headed by the IFC) could be contemplated as a way to give additional public confidence to the process
- the government should earmark a portion of privatization revenues for social spending (e g , for the National Renewal Fund or some comparable scheme), so that the general public can see itself to be beneficiary of the privatization process This kind of direct earmarking was successfully implemented in Mexico
- the government should aim, where practicable, to sell some of the enterprise shares in public offerings to small investors to foster a sense of direct public participation in the process, as proved to be attractive in the U K in the 1980s

(2) The privatization process should aim to cover all of the manufacturing enterprises now in government hands, during an established timetable of 2–3 years

Labor Law Reform

India's labor laws give extreme protection to the small proportion of workers in the organized sector by making dismissals a highly costly politicized process Every dismissal is subject to governmental review and judicial challenge This policy virtually prevents dismissals and restructuring except at inordinate and highly uncertain costs to the enterprises Restructurings are long delayed or blocked altogether There are, of course, two obvious implications First, loss-making firms are unable to pull out of trouble While private firms in distress are often pushed to failure, State-owned enterprises live on a soft-budget constraint

The second and far more important effect is that new firms are discouraged by the fears of ultimate high costs of restructuring sometime in the future The high implicit tax on dismissing workers is also a high tax on hiring workers, as potential employers look ahead to the future operations of the firm Remarkably, in a country with a vast supply of untapped labor, India has hit upon a way to keep the vast proportion of its labor underutilized, and has done so in the name of "social justice "

India needs a revamped labor relations system that recognizes the urgent national objective of drawing tens of millions of workers into new jobs in the organized sector This can be accomplished only by raising the flexibility on hirings and dismissals The new regime should continue to protect the legal interests of workers, but in a much more realistic way that is in tune with market realities

Recommendations

(1) A new labor relations law should outline the conditions for dismissals and severance payments, and the terms for collective bargaining over such issues In general, enterprises should have the flexibility to hire and dismiss, subject to minimal standards and collective bargaining agreements

(b) The law should specify minimal acceptable terms for dismissals of permanent employees, such as advance notification of layoffs, and severance payments in the case of economic dismissals (e g , three-month wages for workers with employment over one year) The law would also make clear that terms and procedures for dismissals beyond the minimum standards may be the subject of collective bargaining agreements between unions and management Of course, the law would also differentiate between temporary workers and permanent workers,

small and large enterprises (which have much greater flexibility for small enterprises), and various sectors of the economy (e g , with special rules for construction, where the need for flexibility in the size of the work force is paramount)

(c) The role of the judiciary or governmental review would arise only when the terms of the contracts or the minimum standards of the law have been breached, and there is no automatic right of review for all workers The existing presumption against dismissals would be eliminated

(d) The government might usefully search for a way to draw a line between existing employment (e g , up through a cut-off date) and future employment Existing workers would continue to receive the protections of the current regime, but new enterprises would be governed by the new law Even under the current regime, however, new opportunities would be sought for collective agreements between the unions and the enterprises to best serve the long-term health of the existing enterprises

Land Law Reform

India's major cities are held hostage by antiquated land laws that block urban renewal, profitable commercial real estate development, and adequate metropolitan tax system based on property taxes Extensive rent control leads to remarkable patterns of land misallocation, such as vacant factories and undeveloped land in the heart of Bombay, and leads to the dilapidation of the inner cities, where building owners and real estate developers lack incentives to upgrade and renovate properties Moreover, the urban land system is subject to notorious corruption in addition to inefficiency At the same time, ceilings on land holdings in the countryside can be a significant obstacle to the development of agro industry

Recommendations

(1) Most importantly, urban land laws should be decided at the level of the municipality, rather than the union government The existence of union-level restrictions on urban land development should simply be scrapped

(2) The major urban areas should embark urgently on rental decontrol, over a very short period of time for commercial tenants, and in a phased manner for residential tenants There is enormous international experience in rent decontrol (e g, New York, Paris, Singapore) and these cases should be examined for important lessons

(c) A revamped urban tax system, based on new property valuations, should be introduced as soon as possible, as a substitute for the Octroi and other highly inefficient taxes as already suggested in item 4 (b)

(d) Ceilings on landholdings in the countryside should be redesigned to support the efficient consolidation of land for agro industry, where profitable (This topic is beyond the scope of this survey, however, as I must perforce exclude agricultural reforms from the discussion)

A Reorientation of Government Social Policy

The first eight items all call for a withdrawal of the government from operational management of the productive sectors of the economy The government should allow the private sector (both domestic and foreign) to provide the capital, management, and entrepreneurial decisions needed to fuel India's coming boom in labor-intensive manufacturing production and services

But this reduction in the role of the State should be balanced by a strongly increased role in one area human resource development The government has a particularly urgent role in spreading literacy and access to primary health care to all of In-

dia's citizens, so that they can all participate actively and benefit fully from India's economic transformation

India's continuing high rates of illiteracy (around 52 percent of the total population, 66 percent of the female population, and perhaps 80 percent of the female population in rural areas) constitute a human and economic tragedy for the country Virtually every international study in the past has shown that female literacy, in particular, is crucial for higher women's status in the society, lower rates of absolute poverty, improved family planning, reduced fertility rates, higher female labor force participation, and, of course, much higher rates of productivity and market earnings

The illiteracy rates are a reflection, in part, of inadequate resources devoted to primary education, and the poor design of incentive schemes to promote literacy The government's intention to restrict its involvement in productive spheres should be balanced by a new and credible commitment in the area of primary education This is not only good politics to show that the economic reforms are not a boondoggle of the rich, but is absolutely sound development economics, from a hard-headed public investment point of view

Specific Recommendations

(1) Existing subsidy programs on food should be re-targeted to support enhanced primary education Rather than providing across-the-board subsidies on food prices—which tend to get dissipated in corruption, administrative costs, and lower food prices for the wealthy—subsidy programs should be targeted (in part) at school children by guaranteeing one nutritious meal a day for every school child in every school in India (especially rural India) Not only would this very much help to target the aid to needy households (households with many children tend to be

poorer households), but it would also provide a vital economic incentive for poor parents to send their children to school Subsidy programs should also be better targeted towards mothers with young children to promote adequate nutrition in preschool years

(b) Privatization revenues should be earmarked for increased expenditures on primary health and education

(c) The union government should provide greatly enhanced transfer payments to the states to help support primary health and education It might do this on a matching-grant basis, so that State governments are given an incentive to increase their own effort in expenditures in these areas

SOME CONCLUDING OBSERVATIONS ON THE DYNAMICS OF ECONOMIC REFORM

The most unfortunate mistake of governments engaged in economic reform is the belief that economic reforms are a painful necessity that are likely to be costly at the polls This is a simplistic view of a more complicated reality As a general principle, the electorate can sense the difference between a dynamic, honest government attempting reforms, and time servers Since the public so rarely is treated to the first variety of government, they really appreciate it when the occasion arises

To be sure, it is generally politically tricky to clean up an inherited financial crisis (such as India's in 1991), since budgetary austerity is rarely simple to manage At the same time, however, the public is usually grateful for an end to high inflation and financial uncertainty Most other areas of reform—trade liberalization, stimulation of new labor-intensive manufacturing, improved infrastructure, and even privatization—can be hugely popular, except with narrow groups of vested interests Many dynamic re-

formers, even those carrying out tough stabilization programs, have gone on to achieve great electoral vindication Recent examples include President Menem in Argentina, President Sanchez de Losada in Bolivia, and Prime Minister Vaclav Klaus in the Czech Republic

Of course, it is still necessary to think carefully about the political design of reform packages For example, the government should repeatedly emphasize that by getting the government out of the "wrong" areas of economic life, the government will be able to direct more effort to the "right" areas, such as health and education And of course it should deliver on such a promise through concrete, visible programs Similarly, privatization programs should be designed in a way to involve all the key stakeholders, as argued earlier, including the workers and the public at large

In the end, the test will be whether the reforms deliver growth, jobs, and rising economic security In this regard, India's reformers stand in good stead With a labor-abundant country opening up to world capital, the chances for dynamic growth are very good, particularly if the remaining shackles on the economy are stripped away India's task of making growth, after all, is much simpler, say than Russia's, where large portions of the existing manufacturing base must be closed down to make room for new economic activities

The first stage of reforms will have come to several electoral tests in State elections and a national election The record of achievement is already solid, and politically acceptable reforms (such as further trade liberalization, especially on consumer goods) should continue But assuming the reformers renewed electoral mandate, the opportunity for decisive breakthroughs in many areas of economic management will be at hand

In addition to continued reform impetus from the union government, the State governments in India should be viewed as potential agents of rapid and salutary change In most vast conti-

nental countries such as Brazil, China, and now Russia, regional governments have taken the lead in pushing reforms and prompting further actions by the central government In Brazil, it is Sao Paulo State and Minais Gerais that are the reform leaders at the regional level, in China, it is the coastal provinces and the provinces farthest from Beijing in the lead, in Russia, reform leaders in Nizhny Novgorod and in the Russian Far East have been major spurs to reforms at the central level

India has not yet freed up its State government sufficiently so that they can add great dynamism to the reforms In most key infrastructure areas, the central government remains in control, or at least with veto over State actions Coastal states like Maharashtra, Gujarat, and the Southern states are very likely to pull ahead Their progress will help raise all areas of the country, though interior provinces will likely not gain as fast The fast-runners should be allowed to pull ahead The union government should focus its compensatory actions mainly in the areas of health and education Expensive industrial targeting policies to promote industry in the "hinterland" has generally proven to be a costly and corrupt fiasco in other countries that have tried it [5] It is hard enough to get rapid industrialization where it really belongs, India does not have the resources to squander on promoting industrialization where it is not otherwise viable

Finally, while India has much to gain by these reforms, it should also keep in mind the intense competition that it now faces in the international markets Other Asian economies such as Indonesia, Malaysia, and even China are far ahead in terms of market opening, export promotion, and improved skills of the labor

[5]Italy poured trillions of lira into the Mezzegiorno in past decades, leading to a large number of white elephant investment projects that could not gain competitiveness Argentina failed in its costly subsidy schemes for Tierra del Fuego and other high-cost regions, while Brazil failed in its quest to use state subsidies to create industrialization in the poor Northeast

force India competes with these countries, as well as the reforming countries of Latin America, Eastern Europe, and the former Soviet Union for world capital and foreign direct investment India stands to do very well in this competition, but only if it decides to fully join in the global economy

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India's Economic Reforms: The Tasks Ahead

T N Srinivasan

INTRODUCTION

Since the assumption of office by Prime Minister Mr P V Narasimha Rao and Finance Minister Dr Manmohan Singh in July 1991, there have been a number of far-reaching economic reforms in India A lot has already been written about the reforms, and recently Jagdish Bhagwati and I had the privilege to share our thoughts on the reforms and the tasks ahead with the Finance Minister Our report has already been published by the Finance Ministry (Bhagwati and Srinivasan 1993) I am sure some, if not most, of you have read it as well I would like to take this opportunity to talk about the developments since our report last August and the tasks ahead I have not had the opportunity to read the most recent (March 1994) announcement on foreign trade policies But I am informed that in spite of all the liberalization and simplification, it still is over 1,000 pages! It is perhaps an indication that, to use Robert Frost's words, there are many miles to go and more promises to keep before we go to sleep on economic reforms

THE FOUNDATIONS OF THE POST-INDEPENDENCE DEVELOPMENT STRATEGY

Before I get to the tasks ahead, let me briefly set the stage by recapitulating the foundations and objectives of Indian economic development, the development strategy and the system of economic management that was in place until the Rao-Manmohan Singh reforms, and the program of reforms thus far It is impor-

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tant to remind ourselves of the foundations laid more than half a century ago, not only for tracing the origins of post-independence economic policies, but also because some of the opposition to the recent reforms stem from the perception that they go against these foundations Such a review also highlights a not-so-well-known fact that most postwar debates and almost all ideas on development objectives, strategy and policy in the academic literature and in international organizations were clearly anticipated and addressed in pre-independence Indian discussion These include poverty alleviation as the overarching objective, articulation of a basic needs strategy, income growth and redistribution, development of agriculture versus industry, emphasis on heavy industries and import substitution, relative roles of large and small-scale industries, respective roles of the State and the market and many others

The foundations of post-independence planning for economic development were laid in the late 1930s and early 1940s, predominantly by the National Planning Committee of the Indian National Congress and also by other individuals and groups who offered their own plans for national development The National Planning Committee was constituted in 1938 under the chairmanship of Jawaharlal Nehru, and did most of its work prior to the arrest in October 1940 of Nehru and several other members of the committee It declared the following

1 The overarching objective of planning was[1] to insure an adequate standard of living for the masses

In other words, to get rid of the appalling poverty of the people The irreducible minimum, in terms of money, had been estimated by economists at figures varying from Rs 15 to Rs 25 per

[1]This and the subsequent excerpts relating to the National Planning Committee are taken from Jawaharlal Nehru (1946)

capita per month (at pre-war prices)[2] There was lack of food, clothing, housing, and every other essential requirement of human existence To remove this lack and ensure an irreducible minimum standard for everybody, the national income had to be greatly increased, and in addition to this increased production, there had to be a more equitable distribution of wealth

We fixed a ten-year period for the plan, with control figures for different periods and different sectors of economic life Certain objective tests were also suggested (a) the improvement of nutrition so as to have a balanced diet with a calorific value of 2,400 to 2,800 units for an adult worker, (b) improvement in clothing from the then consumption of about 15 yards to at least 30 yards per capita per annum, (c) housing standards to reach at least 100 square feet per capita Further, certain indices of progress had to be kept in mind (a) increase in agricultural production, (b) increase in industrial production, (c) diminution of unemployment, (d) increase in per capita income, (e) liquidation of illiteracy, (f) increase in public utility services, (g) provision of medical aid on the basis of one unit for 100 population, and (h) increase in the average expectation of life

2 Industrialization was deemed to be the primary instrument for achieving the overarching objective

Indeed the problems of poverty and unemployment, national defense, and economic regeneration in general cannot be solved without industrialization As a step towards such industrialization, a comprehensive scheme of national planning should be formulated This scheme should provide for the development of

[2]It is interesting to note that a poverty line was defined are early as 1938, long before the expert committee of the Planning Commission defined one in 1960, but the figure of Rs 15 was the same in both, except its real value at 1960 prices was much lower than its real value at pre-war prices

heavy key industries, medium-scale industries and cottage industries

3 Promotion of heavy industries and industries providing capital goods and universal intermediates was deemed vital

The three fundamental requirements of India, if she is to develop industrially and otherwise, are (a) a heavy engineering and machine-making industry, (b) scientific research institutes, and (c) electric power These must be the foundations of all planning, and the National Planning Committee laid the greatest emphasis on them

4 On large-scale versus small-scale industries, the Committee was clear in its emphasis on large-scale industry

As noted in the Committee's report, "an attempt to build up a country's economy largely on the basis of cottage and small-scale industries is doomed to failure It will not solve the basic problems of the country or maintain freedom, nor will it fit in with the world framework, except as a colonial appendage" (p 413)

5 The dominant role of the State and the public sector in industrial development was also spelt out in clear terms

The very essence of this planning was a large measure of regulation and coordination Thus while free enterprise was not ruled out as such, its scope was severely restricted In regard to defense industries, it was decided that they must be owned and controlled by the State Regarding other key industries, the majority were of the opinion that they should be State-owned, but a substantial majority of the committee considered that State control would be sufficient Such control of these industries, however, had to be rigid

6 The committee also laid down the principles governing land and credit

Agricultural land, mines, quarries, rivers and forests are forms of national wealth, ownership of which must rest absolutely in the people of India collectively The cooperative principle should be applied to the exploitation of land by developing collective and cooperative farms

We, or some of us at any rate, hoped to evolve a socialized system of credit If banks, insurance firms, etc were not to be nationalized, they should at least be under the control of the State, thus leading to State regulation of capital and credit It was also desirable to control the export and import trade By these various means, a considerable measure of State control would be established in regard to land as well as in industry as a whole, though varying in particular instances, and allowing private initiative to continue in a restricted sphere

7 National self-sufficiency was declared to be a very important objective

The objective for the country as a whole was the attainment, as far as possible, of national self-sufficiency International trade was certainly not excluded, but we were anxious to avoid being drawn into the whirlpool of economic imperialism We wanted neither to be victims of an imperialist power nor to develop such tendencies ourselves

It should be emphasized that prior to independence there was widespread agreement across the political spectrum, not only on the overarching objective of poverty alleviation, but also on the dominant role the State had to play in achieving the objective Indeed, that the strategy for economic development should be articulated through a national development plan and implemented through State-directed planning was also widely accepted In

fact, a group of businessmen put forth their own development plan (the so-called Bombay Plan), and the labor unions came up with their own People's Plan (not to mention the followers of the Mahatma who put out their Gandhian Plan)

The objectives of planning for national development as enunciated by the National Planning Committee and by the authors of the other plans, as well as the central role that the State was meant to play in achieving them, were reflected in the sections dealing with the Directive Principles for State Policy in the Constitution of India adopted in 1950 The Planning Commission was also established in 1950 to formulate plans for national development

The very first Five-Year Plan (1951-56) reiterated many of these objectives and policies For instance,[3] the central objective of planning in India at the present stage is to initiate a process of development which will raise living standards and open out to the people new opportunities for a richer and more varied life Adoption of modern technology and rapid capital accumulation were deemed the key factors in promoting development

It is clear that in the transformation of the economy that is called for, the State will have to play a crucial role Whether one thinks of the problem of capital formation, the introduction of new techniques, the extension of social services or of the overall re-alignment of the productive forces and class relationships within society, one comes inevitably to the conclusion that a rapid expansion of the economic and social responsibilities of the State will alone be capable of satisfying the legitimate expectations of the people

Control and regulation of exports and imports, and in the case of certain select commodities, State trading is necessary not only from the point of view of utilizing to the best advan-

[3]This and the following excerpt from the First Five Year Plan are from Planning Commission (1951)

tage the limited foreign exchange resources available, but also for securing an allocation of the productive resources of the country in line with the targets defined in the Plan To some extent, overall controls through fiscal, monetary and commercial policy can influence the allocation of resources, but physical controls are also necessary For one to ask for fuller employment and more rapid development and at the same time to object to control is obviously to support two contradictory objectives

An elaborate regulatory system was instituted to implement the objectives of the policy framework First of all, there was the industrial licensing system under which investment in capacity creation in any industry by a firm in the private or public sectors needed an industrial license unless the cost of investment was below a certain level While this bound has been increased over time, it was not high enough to exclude many investment proposals from the purview of licensing The second was the exchange control system under which imports were licensed under various categories at different points of time actual user licenses (for raw material imports), capital goods licenses, import replenishment licenses (for exporters), etc The third was licensing of technology imports and of foreign direct investment as well as foreign collaboration proposals The fourth was the control on investment financing—primarily on the sale of equities and debentures on the domestic capital market by firms and on foreign equity participation in joint ventures The fifth was a set of price and distribution controls on some commodities including items of mass consumption as well as intermediate goods The sixth was the control on concentration under the Monopolies and Restrictive Trade Practices (MRTP) Act In summary, the regulations covered the whole spectrum the scale, technology, the location of any investment project other than relatively small ones were regulated, permission was needed to expand, relocate, change the output or input mixes of operating plants, critical inputs, particularly imported ones, were allocated, access to domestic equity markets and debt

finance was controlled, some vital consumption goods (for example, food grains, sugar, and vegetable oils) and critical inputs (for example, fertilizer, irrigation water, fuel and water, etc) were subject to complete or partial (for example, through the operation of dual markets) price controls, almost automatic and made-to-measure protection from import competition was granted to domestic producers in many "priority" industries, including in particular the equipment producers

The crucial aspect of all these regulations is that they were essentially discretionary rather than rule-based and automatic Although some principles and priorities were to govern the exercise of these regulatory powers, these were largely non-operational for two reasons First it was impossible even in theory, to devise a set of principles or rules for all the myriad categories of regulations that were mutually consistent and in consonance with the multiple goals of the industrial policy framework, which in themselves were not entirely consistent Second, the problem of translating whatever rules there were into operational decisions was a problem of Orwellian dimensions The allocative mechanism was largely in the form of quantitative restrictions that were unrelated to market realities A chaotic incentive structure and the unleashing of rapacious rent-seeking and political corruption were the inevitable outcomes Those with the appropriate connections could get almost any regulation waived or favorably interpreted, and those without could be faced with an adverse interpretation of one regulatory barrier after another I would go so far as to argue that the discretionary regulatory system instituted in the name of planning for national development instead became a cancer in the body politic

ACHIEVEMENTS AND FAILURES SINCE INDEPENDENCE

It is sobering to compare the achievements (Table 1) under four decades of planning and extensive controls on economic ac-

tivity with the objectives as enunciated by the National Planning Committee

First, the extent of poverty indeed has gone down the proportion of the population with monthly per capita consumption below a very modest poverty line at 1960-61 prices of Rs 15 per capita per month for rural India and Rs 20 for urban India, fell from over half the population in the mid-1950s to about a third in the late 1980s, according to official estimates Although other analyses disagree with the extent of reduction in poverty incidence, almost all agree that there was reduction, mainly in the 1980s It so happens that the 1980s was a period when the growth rate of GDP averaged over 5 percent per year as compared to around 3 5 percent per year in the previous three decades Unfortunately, this spurt in growth seems to have been achieved through fiscal expansion, financed by domestic and external borrowing As such, to the extent the modest achievement in poverty alleviation is a consequence of more rapid but debt-led growth, without structural reforms its further sustainability was doubtful

Second, in contrast to the National Planning Committee's objective of raising real national income by somewhere between 200 to 300 percent in 10 years, and to the targets ranging from an annual average rate of growth of 5 5 to 7 5 percent in the various five-year plans since the second, national income grew only by about 515 percent in the 42-year pe-riod (1950-51 to 1992-93), that is, at an average annual rate of little less that 4 percent Except for the sixth and seventh plans (1980-1990) when national income grew by 5 5 percent each year, in all previous plans the rate of growth did not exceed 5 percent

Third, self-sufficiency has been achieved in a number of commodities, especially food grains But it has been achieved at a very modest level of consumption For example, per capita consumption of food grains rose from 420 grams per day during 1951-55 to 480 grams during 1990-93, a rise of 14 percent over a

Table 1 Selected Economic and Social Indicators, 1950–1951 to 1992–1993

	1950-1951	1960-1961	1970-1971	1980-1981	1986-1987	1987-1988	1988-1989	1989-1990	1990-1991	1991-1992	1992-1993
Economic Indicators											
GDP at Factor Cost											
At Current Prices (Rs Crore)	8979	15254	39708	122427	260030	294851	352703	408661	475604	551552	627913[a]
At 1980–81 Prices (Rs Crore)	42871	62904	90426	122427	163271	170322	188462	201453	211260	213590	222089[a]
Per Capita Net Nat I Prod (1980-81 Rupees)	1127	1350	1520	1630	1871	1901	2059	2160	2213	2167	2216[a]
Index of Industrial Prod (1980-81=100)	18 3[b]	36 2	65 3	100 0	155 1	166 4	180 9	196 4	212 6	212 4	
Index of Agr Prod (1969-70=100)	58 5	86 7	111 5	135 3	152 5	151 3	183 2[c]	187 0[c]	192 0[c]	186 6[c]	
Gross Dom Cap Form (as % of GDP)	10 2	15 7	16 6	22 7	21 7	23 6	25 1	26 7	27 4	24 2	24 5[a]
Gross Domestic Savings (as % of GDP)	10 4	12 7	15 7	21 2	19 5	21 5	22	24	24	23 1	22 3[a]
Output											
Foodgrains (million tons)	50 8	82 0	100 4	129 6	143 4	140 4	169 9	171 0	176 4	168 4	180 0
Finished Steel (million tons)	1 04	2 39	4 64	6 82	9 55	11 68	12 84	13 00	13 53	14 33	na
Cement (million tons)	2 7	8 0	14 3	18 7	36 6	39 6	44 8	45 8	48 8	51 7	54 3
Coal (million tons)	32 3	55 2	76 3	119 0	175 2	190 9	207 0	213 7	225 5	243 8	255 0

Table 1 Selected Economic and Social Indicators, 1950–1951 to 1992–1993 (continued)

	1950-1951	1960-1961	1970-1971	1980-1981	1986-1987	1987-1988	1988-1989	1989-1990	1990-1991	1991-1992	1992-1993
Crude Oil (million tons)	0 3	0 5	6 8	10 5	30 5	30 4	32 0	34 1	33 0	30 4	27 0
Electricity Gen (utility only IWH)	5 1	16 9	55 8	110 8	187 7	202 1	221 4	245 4	264 3	287 0	301 4
Wholesale Price Index[d] (1981-82=100)	16 9	19 6	35 5	91 1	132 7	143 5	154 2	165 7	182 7	207 8	228 7
Consumer Price Index[e] (1982=100)	260[f]	1117	2524	15023	39705	44034	48645	55630	58369	64751	77127[a]
Central gov t budget deficit (Rs crore)	-33[f]	-117	285	2576	8261	5816	5642	10592	11347	6855	7202[a]
Foreign Trade											
Exports (Rs crore)	606	642	1535	6711	12452	15674	20232	27658	32553	44041	53688
Exports (US$ million)	1269	1346	2031	8486	9745	12089	13970	16612	18143	17865	18532
Imports (Rs crore)	608	1122	1634	12549	20096	22244	28235	35328	43198	47851	63375
Imports (US$ million)	1273	2353	2162	15869	15727	17156	19497	21219	24075	19411	21882
For Exch Res (Excl gold and SDRs)											
Rs Crore	911	186	438	4822	7645	7287	6605	5787	4388	14578	20140
US$ million	1908	390	584	5850	5924	5618	4226	3368	2236	5631	6434
Social Indicators											
Populations[g] (millions)	439 2	548 2	683 3	779 0	795 1	811 3	827 4	846 3	862 5	878 6	
Birth Rate[h] (per 100)	39 9	41 7	36 9	33 9	32 6	31 5	30 6	30 2	29 5		
Death Rate[h] (per 1000)	27 4	22 8	14 9	12 5	10 9	11 0	10 3	9 7	9 8		

Table 1 Selected Economic and Social Indicators, 1950–1951 to 1992–1993 (continued)

	1950-1951	1960-1961	1970-1971	1980-1981	1986-1987	1987-1988	1988-1989	1989-1990	1990-1991	1991-1992	1992-1993
Life Expectancy at Birth[i] (years)	-	-	-	-	-	-	-	-	-	-	-
Male	32 4	41 9	46 4	54 1	-	-	-	-	55 9	59 9[j]	60 4[j]
Female	31 7	40 6	44 7	54 7	-	-	-	-	55 9	60 7[j]	61 2[j]
Total	32 1	41 3	45 6	54 4	-	-	-	-	55 9	60 3[j]	50 8[j]
Education											
Literacy Rate[k] (%)											
Male	27 16	40 40	45 95	56 37	-	-	-	-	64 1	-	-
Female	8 86	15 34	21 97	29 75	-	-	-	-	39 3	-	-
Total	18 33	28 31	34 45	43 56	-	-	-	-	52 2	-	-
Health and Family Welfare[k]											
Reg Med Practitioner (Thousands)	61 8	83 7	151 1	268 7	331 18	335 6	368 6	381 9	405 2	-	
RMP per 10,000 Population	1 7	1 9	2 8	3 9	4 2	4 4	4 5	4 6	4 7	4 8	-
Hundreds of Beds[l] (all types) per 10,000	3 2	5 2	6 4	8 3	9 2	9 2	9 5	9 4	9 6	-	-

Notes na = Not available

a Estimate

b Data refer to calendar year 1950

c Provisional estimate

d Figures for the period up to 1980–81 derived by converting the indices on earlier bases into base 1980–81=100

e Figures for the period up to 1988–89 derived by converting indices on earlier bases into base 1982=100

f Refers to 1951-52

g As of March 1, 1951 and so on up to 1980-81 and 1990-91 as per Census of India Figures for the period 1986 to 1990 are based on adjusted projections of the Standing Committee of Experts on Population Projection Figures for 1991-92 and 1992-93 relate to 1st of March 1992 and 1993 based on annual series of the Standing Committee of Experts on Population Projection and adjusted to confirm to 1991 census data

h Data of 1950-51 and 1960-61 relate to 1941-51 and 1951-61 census estimates, respectively Data for 1970-71 onwards are Sample Registration System (SRS) estimates for calendar year 1971 and so on

i Data for 1950-51, 1960-61, 1970-71 and 1980-81 relate to the decades 1941-50, 1951-60, 1961-70 and 1971-80 respectively, centered at the mid-point of the decade, i e , 1946, 1956 1966 and 1976 Data for 1990-91 relate to the Age Specific Death rates averaged over 1981-88 as estimated by SRS and related to the mid point of 1981-88, i e , 1985

j Based on the extrapolated values of Standing Committee of Experts on Population Projections centered at mid-point of the period The extrapolation has been done by using the norms standardized by the United Nations

k Data for 1950-51, 1960-61, 1970-71 and 1990-91 relate to the years 1951, 1961, 1971, 1981 and 1994, respectively The figures for 1951, 1961 and 1971 relate to population aged 5 years and above and those for 1981 and 1991 relate to population aged 7 years and above All India literacy rates exclude Assam for 1981 and J&K for 1991

l Includes beds in hospitals, dispensaries, DILCs, clinics, sanatoriums, etc

Source Government of India (1994), pp S-1 and S-2

period of about 38 years The situation with respect to other items of mass consumption is not much better

Fourth, life expectancy at birth increased from about 32 years around 1951 to about 60 8 years around 1992, and the rate of infant mortality fell from nearly 150 per 1,000 live births in 1951 to 79 in 1992 The literacy rate rose from 18 percent in 1950–51 to 52 percent in 1990-91 While these achievements are substantial, they are modest in comparison to the achievements of other developing countries in South Asia (e g , Sri Lanka) and elsewhere

Fifth, industrial production, as measured by the general index (base=1980–1981), rose from 18 3 in 1950-51 to 219 9 in November 1993, a twelve-fold increase Output of finished steel rose fourteen-fold from about 1 to 1 4 million tonnes and of coal seven-fold from 32 to 223 million tones during the same period Although the share of manufacturing industry in GDP rose modestly from about a sixth to a fifth between 1950-51 and 1992-93, its share in gainful employment changed much more slowly, with agriculture continuing to be dominant, accounting for over two-thirds of the labor force in the late 1980s as compared to about three-fourths in the early 1950s Large-scale manufacturing industry (i e , registered factory establishments) doubled its share in GDP from about 6 percent in 1950-51 to 11 percent in 1992-93, but without a commensurate increase in its share of gainful employment Thus rapid industrialization in the sense of a significant change in the employment structure did not take place

Sixth, the share of gross domestic capital formation in GDP at current market prices more than doubled from 10 2 percent in 1950–51 to 24 5 percent in 1992–93 However, the fact that there was no com-mensurate increase in the rate of growth of GDP reflected the capital-intensive character of the modest growth that was achieved External savings accounted for less than a tenth of total investment in 1992–93 Even at its peak in 1965–66, it accounted for only a sixth of investment

Seventh, the public sector became dominant in several industries The share of the public sector (administration and enterprises) in GDP was over 25 percent, and in the economy's capital stock about 45 percent at the end of the 1980s All the major banks and insurance companies were nationalized in 1969 and these accounted for over 90 percent of the financial sector's assets in the early 1990s While the public sector banks had succeeded in mobilizing savings, extending banking to rural areas and directing credit to "priority" sectors, the subsidies and defaults had become so large that the policy of subsidized and directed credit had become unsustainable and the net worth of the banking sector had been severely eroded

Eighth, as noted earlier, until the 1991 reform measures, government control over production, investment, technology and vocational choices, prices and foreign trade had become so extensive that there was no possibility of exercising the discretion vested in the layers of bureaucracy by the system of controls in a rational manner A chaotic system of incentives and opportunities of rent seeking were created

Ninth, the development strategy that emphasized import-substituting industrialization, and the foreign trade and exchange control regime that sustained it, reduced the role of the external sector in development India's share of world exports fell from its level above 2 percent at the time of independence to about 0 6 percent in 1993 The share of foreign trade (i e , exports plus imports) in GDP at market prices was virtually unchanged over four decades hovering in the range 12–15 percent

In sum, achievements since independence, with respect to economic growth, poverty alleviation and industrialization have been modest, not only in comparison to the targets of the National Planning Committee, but also to the achievements of a number of other developing countries, particularly in East Asia Ironically, the target with respect to the extent of State involvement in the

economy has been achieved, although the objectives sought to be promoted through such involvement have not

Then again, while self-sufficiency at low levels of domestic use was achieved with respect to a number of commodities, self-reliance in the sense of being able to augment domestic resources through borrowing from abroad on one's own terms in order to sustain one's chosen path of development was not In fact, in spite of the pursuit of import substitution across the board, the economy continued to be buffeted by periodic balance-of-payments crises, the latest one at the end of 1990 pushing the country to the verge of default on its external debt

THE ORIGINS OF THE MACROECONOMIC CRISIS OF 1990-1991

Ever since the Second Five-year Plan (1956-61), the economy had experienced balance-of-payments problems which took on crisis proportions on more than one occasion While the overall macroeconomic and fiscal policy framework was conservative and stable until the mid-1970s, given the massive microeconomic distortions, the economy was inefficient and grew at a slow, but sustainable rate of 3 5 percent per year The late 1970s saw the abandonment of fiscal prudence—revenue surpluses (i e , excess of current revenues over current expenditures) yielded to sustained and increasing revenue deficits Overall fiscal deficits soared and the government resorted to extensive borrowing at home and abroad Of course, such fiscal profligacy resulted in an improvement in the growth rate from the 3 5 percent or so per year This increase in growth was not sustainable because there was no change in the basic policy fundamentals—apart from removal of minor irritants here and there, under the liberalization of Prime Ministers Indira and Rajiv Gandhi, the system of economic management and the broad development strategy remained intact Thus, the binge of borrowed growth led to its inevitable de-

nouement once the Gulf War broke out I need not go into the details of the reaction of the government then in power (i e , of Prime Minister Chandrasekhar) to the crisis and the Draconian measures it had to take The Rao government, when it came to power in July 1991, had to take similar short-term measures, including borrowing from the IMF, pledging of India's official gold stock, import restrictions, etc However, to its credit, it realized that the problem was not a short-run one, but is the culmination of the pursuit of a development strategy and a policy framework that had long outlived its usefulness Instead of tinkering with the framework at the edges here and there, it undertook a comprehensive set of reforms

The chief elements of Rao-Manmohan Singh reforms of 1991-94 are devaluation of the rupee, abolition of import licensing with the important exceptions that the restrictions on imports of manufactured consumer goods and on foreign trade in agriculture remained in place, replacement of cash compensatory scheme for exports, initially by freely salable eximscript under which an exporter can sell 60 percent of their foreign exchange receipts at a market determined exchange rate, and later by fully convertibility of the rupee on the current account, reduction in the number of tariff lines as well as tariff rates, reduction in excise duties on a number of commodities, some limited reforms of direct taxes, abolition of industrial licensing except for investment in 18 industries and for locational reasons in cases of "polluting" industries, relaxation of restrictions on large industrial houses under the Monopolies and Restrictive Trade Practices Act, easing of entry requirements (including equity participation) for direct foreign investment, and allowing private investment in some industries hitherto reserved for public sector investment A National Renewal Fund for assisting workers currently employed in enterprises that would have to be scaled down or closed altogether has been established, although without the support of the political barons of the labor aristocracy in the organized sector, such scaling down is unlikely

It is obvious that these reforms are systemic and go beyond liberalizing the more irksome controls at the margin that earlier economic liberalization under the Indira and Rajiv Gandhi regimes had attempted Besides, there is an apparent realization that the benefits from reforming one sector could be limited, if other related sectors are not also reformed As such, the needed reforms are conceived as a package of coordinated action in several areas

ACHIEVEMENTS SINCE JULY 1991

The results of the first three years of reforms have been very encouraging (Table 2) As the government's Economic Survey (Government of India 1994) puts it

> The economy has emerged decisively from the crisis of 1990-91 The crisis reached its peak in the summer of 1991 when foreign currency reserves had plummeted to almost $1 billion, inflation had soared to an annual rate of 17 percent, industrial production was falling and overall economic growth had declined to 1 1 percent (in 1991-92) The program of stabilization and the economic reform measures put in place in 1991-92 helped restore economic growth to 4 percent in 1992-93 brought down the rate of inflation to 7 percent, restored the level of foreign currency reserves to $6 4 billion and stimulated a strong recovery in export towards the end of the financial year The measures taken during the past two years also averted a deepening crisis in the banking sector, ensured a systematic overhaul of foreign trade and exchange rate policies, largely dismantled the cumbersome and abuse-prone system of industrial licensing, launched a more liberal policy towards foreign investment and ushered in far-reaching changes in the governance of the capital market (p 1)

THE TASKS AHEAD

Fiscal Deficit

Let me begin with the fiscal situation It will be recalled that in 1990-91 the fiscal year ending March 31, 1991, the central government's fiscal deficit was 8 4 percent of GDP A few years earlier, it was even higher at 9 percent In fact, since the mid-1970s, the central government's revenue account had been consistently in the red With the stabilization program initiated in July 1991, a target of 4 7 percent for the fiscal deficit was set for the recently concluded fiscal year 1993-94 Against this target, the revised estimates for 1993-94 suggest that, in fact, the actual deficit is likely to be closer to 7 percent of GDP and the revenue deficit likely to exceed 4 percent of GDP The budget estimates for 1994-95 do not envisage a major reduction in the deficit

It is true that except for ideologues, there is nothing sacrosanct about revenue or fiscal balance as such Indeed, as the finance minister, Dr Manmohan Singh, argued in his budget speech, in the present state of the economy, including the sizable holdings of foreign exchange revenues, food grain stocks and modest inflation, too sharp a fiscal contraction might prove counterproductive from the perspective of reviving industrial growth and may not even be necessary from the perspective of inflation control On the other hand, such fundamentals are not the only forces that drive behavior Expectations do matter and the credibility of the government's commitment to long-term fiscal discipline is thrown into doubt when even for sound fundamental considerations the government decides not to push the fiscal brakes too hard, having committed to doing so earlier In any case, some analysts—such as my colleagues Willem Buiter and our former student Urjit Patel—have concluded that in spite of the actions taken since July 1991, Indian fiscal solvency is not assured and that further fiscal correction (Buiter and Patel 1992, 1993) on the order of about 4 5 of GDP is needed to stabilize the debt-GDP ratio They find only a limited scope for using an in-

Table 2 Key Indicators

	Absolute Value				Percent Change over Previous Year			
	1990-91	1991-92	1992-93	1993-94[a]	1990-91[a]	1991-92[a]	1992-93[a]	1993-94[a]
Gross National Product[b] (Rs thousand crore)								
Current Prices	468 1	540 1	616 5[c]	–	16 2	15 4	14 1[c]	–
1980-81 Prices	207 5	208 7	217 6[c]	225 9[c]	4 7	0 6	4 3[c]	3 8[c]
Gross Domestic Product[b] (Rs thousand crore)								
Current Prices	475 6	551 6	627 9[c]	–	16 4	16 0	13 8[c]	–
1980-81 Prices	211 3	213 6	222 1[c]	230 4[c]	4 9	0 6	4 3[c]	3 8[c]
Agr Production[d]	192 2	188 5	195 8	194 0[d]	3 0	-1 9	3 9	-0 9[d]
Foodgrain Prod (million tons)	176 4	168 4	180 0	179 1[d]	3 2	-4 5	6 9	-0 5[d]
Industrial Production (1980-81=100)	212 6	212 5	216 3	209 8[e]	8 3	0 0	1 8	1 6[e]
Elec Generated (TWH)	264 6	287 0	301 4	237 8[f]	7 8	8 5	5 0	7 4[f]

Table 2 Key Indicators (continued)

	Absolute Value				Percent Change over Previous Year			
	1990-91	1991-92	1992-93	1993-94[a]	1990-91[a]	1991-92[a]	1992-93[a]	1993-94[a]
Wholesale Price Index (1981-82=100)	191 8	217 8	233 1	251 1[g]	12 1	13 6	7 0	8 2[g]
Consumer Price Index for Ind Workers (1982=100)	201 0	229 0	243 0	264 0[h]	13 6	13 9	6 1	8 6[h]
Money Supply (M3 Rs thousand crore)	265 8	317 5	362 7	413 9[i]	15 1	19 4	14 2	14 1[i]
Imports at Current Prices								
Rs crore	43198	47851	63375	51477[f]	22 3	10 8	32 4	8 4[f]
US$ million	24075	19411	21882	16414[f]	13 5	-19 4	12 7	-1 3[f]
Exports at Current Prices								
Rs crore	32553	44041	53688	49182[f]	17 7	35 3	21 9	31 8[f]
US$ million	18143	17865	18537	15682[f]	9 2	-1 5	3 8	19 9[f]

Table 2 Key Indicators (continued)

	Absolute Value				Percent Change over Previous Year			
	1990–91	1991–92	1992–93	1993–94[a]	1990–91[a]	1991–92[a]	1992–93[a]	1993–94[a]
Foreign Currency Assets								
Rs crore	4388	14578	20140	34225[i]	-24 2	232 2	38 2	69 9[j]
(US $ million)	2236	5631	6434	10904[j]	-33 6	151 8	14 3	69 5[j]
Exchange Rate[b k] (Rs /US$)	17 94	24 65	28 96	31 36[f]	7 2	27 2	14 9	9 0[f]

Notes

a GDP and GNP figures are at factor cost
b Estimate
c Index of agricultural production (principal crops) with base triennium ending 1969–70=100
d Anticipated
e Average index for April–October, 1993
f April–December, 1993
g On January 29 1994
h On December 1993
i As on January 7, 1994
j April 1, 1993 - January 7 1994
k Composite rate from March 1992 to February 1993

Source Government of India (1994), p 2

flation tax to close the fiscal gap Since their analysis was completed before the budget, I presume that their pessimistic conclusions would only be further strengthened by the recent budget

Many analysts, including Jagdish Bhagwati and myself, have noted that the unfortunate tendency of most governments in such fiscal situations is to cut developmental expenditures, including expenditures on public infrastructure and social sectors to a greater extent than expenditures on exclusively nondevelopmental activities Clearly, any gains in fiscal health achieved by such cuts can only be temporary, since the cuts in developmental expenditures, particularly those relating to social and economic infrastructure, will adversely affect the future growth and hence future revenues This is neither to say, of course, that conventional classification of expenditures into developmental and nondevelopmental is correct, nor to assert that there is no room for more efficient utilization of expenditure of either category From a longer-run perspective, one has to examine the entire structure of the expenditure side of the budgets of governments at all levels in order to prune those unrelated to the proper role of the government and augment those that are all but currently underfunded Such a review has to encompass the size of government as well as pay, perquisite and job security of government employees

The Finance Minister has already implemented several of the suggestions in the report of the Chelliah Committee of tax reforms It is agreed that lowering the rates and widening the base are both important Regarding the latter, increasing the exemption limit beyond what is necessary to keep up with inflation is not particularly desirable Robin Burgess and Nicholas Stern (1993) have drawn attention to several central issues regarding tax reform in India Their remark that if tax reform is to be successful, it is necessary to be aware of who the gainers and losers are and where the vested interests lie, might seem banal, but that does not diminish its relevance from the perspective of any reform pro-

gram They add that if support for the reforms is to be mobilized, the gainers must understand and be activated in favor of realizing their rewards As they say, the potential losers usually recognize their position fairly rapidly and vociferously This is happening already—a large segment, the potential gainers from the Rao Manmohan Singh reforms, namely, the unorganized workers, and the rural poor are too diffused and have not been mobilized, while the labor aristocracy in the organized sector and the public employees and their spokesman have vociferously expressed their opposition Be that as it may, Burgess and Stern argue rightly in my view, in favor of moving away from dependence on taxes on foreign trade to domestic taxation Burgess and Stern's argument that tax and expenditure system should be made consistent with perception about the appropriate role of the state in economic development brings me to my next theme, namely, public enterprise

Privatization and Reform of Public Enterprises

Reform of public enterprises, including privatization and phasing out of unviable enterprises, has not gathered as much momentum as one would have hoped for Once again, it is true that public ownership per se need not necessarily lead to inefficient operation and that privatization need not necessarily lead to efficiency It is also true that privatization of enterprises that are significant actors in the markets for particular goods and services without ensuring adequate competition exists, or setting up a regulatory framework could be counterproductive If the alternative to public ownership of a natural monopoly or of enterprises in which for whatever reason there cannot be adequate competition is regulation of private enterprise, then the authorities have to set up efficient regulations and ensure that regulators are not captured by the interest they regulate The need for a proper set of prudential regulations of private and public sector banks and other financial institutions can hardly be overemphasized

It is not clear, at least a priori, why a government which cannot refrain itself from meddling in the management of enterprises it owns or otherwise tolerates their inefficient function and baits out the failing ones would not only devise efficient regulations but also enforce them transparently and fairly Thus, as Robert Willig (1994) pointed out recently, the presumed efficiency gains from privatization turns on the resumed inefficiency of political meddling in State-owned enterprises and the possibility of insulating regulators from political interference and private capture But all this arises only if adequate competition cannot be assumed

I would argue that in India, public ownership extends way beyond those products or services in which scale economy or network externality considerations would sustain only a few large firms Barring perhaps power, telecommunications and railways, these considerations do not weigh in heavily Even in some of these sectors, some countries have moved away from public ownership to regulation and privatization In other sectors, even in the unlikely event public sector firms operate efficiently, since the government has other more important functions, it might as well privatize such firms Thus, the fact a public enterprise could be made to operate efficiently does not imply that it should continue to be owned by the State Issues relating to the mode of privatization, whether or not to restructure an enterprise before privatization, etc are important, but should not be made out to be insurmountable problems

There is some international experience on privatization which might well be relevant for India For example, Mexico privatized over 1,000 State-owned firms between 1983 and 1991 (Edwards 1993) These included the telephone company (with revenues of over $18 billion), two airlines, 18 banks, and gigantic steel complexes Apparently the privatization enjoyed substantial political support, in large part it was done in close consultation with labor unions and the private sector, with the unions having

the right of first refusal Valuation of any firm to be privatized was done by an independent investment bank, though this value was not rigidly used as the minimum reserve price If the firm was too large, only a controlling percentage of equity was sold and sold only for cash There are other countries which also have privatized a significant number of government-owned firms The Indian case is thus not sui generis, there is much to learn from others But consideration of protecting incumbent employees at their current employment should not be allowed to slow down the pace of privatization unduly, as seems to have happened

I cannot resist referring here to Professor Mahalanobis who more than thirty years ago (Mahalanobis 1961) drew attention to the lack of any relationship between productivity, wage and salary payments in organized industry (private and public) as well as in general government He rightly pointed out that employees in organized sector and government and their dependents formed a very small proportion of the Indian population He advocated the establishment of a labor reserve service to absorb laid-off employees from unviable firms and to retrain for employment elsewhere Thus, the idea behind the recently established National Renewal Fund was already anticipated by the Professor Mahalanobis who was no right-wing reactionary

Infrastructure

Let me now turn to infrastructure As I already mentioned, as long as major infrastructural activities continue to be in the public sector, the reliability, availability and cost of their services would affect the response of other sectors to the incentives provided by the reforms Removing disincentives and providing positive incentives for production and exports will yield limited results if the poor performance of the public infrastructure severely constrains the output response

A number of desirable steps have already been taken to open power generation, operation of airlines, telecommunications and so on to private investment However the debate over the rate-of-return guarantee to the foreign investor Enron on its proposed investment in power generation in the state of Maharashtra highlights some of the difficult issues that I raised in my remarks on regulation A guarantee on payments from State Electricity Boards (SEBs) to whom a private generator has to sell his output could be rationalized even though there could be serious moral hazard problems in the willingness to pay by the SEBs But removing all normal business risks with investment and guaranteeing a fairly high rate of return are not easy to rationalize I would hope that we move away from such guarantees in the future Besides opening up power generations, we should open up power distribution for private entry as well Put another way, major externalities and scale economies arise largely in high voltage transmission and less in generation (with recent technologies), and not at all in distribution I would advocate placing the transmission network under an autonomous public agency to which private and public generators sell their output and from which all distributors buy their supplies

While control over the price of electricity in order to cross-subsidize preferred users through higher tariff on other users might avoid drawing attention to the redistribution implied by the tariff structure, it acts as a disincentive for potential investors into power generation An independent regulatory agency which sets the structure of power tariffs through a process of open public hearings, as in the United States, could be considered For want of time, I will not touch on issues relating to transportation and telecommunication except to point out that the chaotic situation in our major ports is a serious bottleneck

Foreign Trade and Investment

Let me now turn to foreign trade I am somewhat disappointed that the government has not thought fit to liberalize consumer goods imports or to prune further the negative list Also, vestiges of the discredited system of export incentives through right to import items of high domestic market value are still there In our report, Jagdish Bhagwati and I gave several reasons as to why liberalizing consumer goods imports is appropriate, I need not go into them again But I must admit to being puzzled by the opposition to consumer goods imports or multinational investment in the production of such goods by the guardians of socialism, if such imports are undesirable because they are luxuries catering to the demands of the ultra rich, their domestic substitutes should be deemed luxuries as well One cannot call a can of Pepsi a luxury while not calling its home grown rival Gold Spot one In stead of peddling such muddle-headed notions, they should argue for consistent taxation of luxuries, foreign and domestic

The recent spurt in agricultural exports is encouraging, but agricultural trade is yet to be liberalized Minimum export prices continue to exist for some commodities and export bans, such as the one recently imposed on raw cotton exports, ostensibly for reducing the cost of cotton for domestic mills, are imposed This is no way to build a long-term export base, if exports are likely to be banned whenever domestic interests are threatened, we become unreliable suppliers in the eyes of the rest of the world More importantly, while some insurance of farmers and vulnerable consumers from uncertainties and volatility of world prices of agricultural commodities would be appropriate, complete insulation of domestic and international markets is not in the long-term interest of either Apart form interventions in agricultural trade, there are several other aspects of government involvement in agriculture that are yet to be addressed, many of which lie in the domain of State governments such as investment, maintenance and operation of public irrigation systems, remaining restrictions

on internal movement of agricultural commodities on private account, subsidies on electricity, fertilizers and so on The large issue of agricultural and rural credit is already on the agenda of reform of the financial sector In most of these cases, the problems and needed reforms are well known What is needed is action

The opening up of the economy to foreign investment has had significant results in the form of large inflows of portfolio investment and restoration of confidence of nonresident Indian (NRI) deposit holders However, I would like to note some problems First, direct foreign investment flows, though encouragingly larger than earlier, still are below what smaller economies in Asia, such as Malaysia and Thailand, are attracting This suggests that the wait-and-see attitude of external investors is continuing Second, portfolio flows are by their very nature more volatile and short-term in nature than long-term direct foreign investment I do not know to what extent the recent spurt in such flows represents return flows of flight capital, but I suspect the share is significant This again is another volatile element Besides, the common mechanism of taking out such capital (or alternatively, bringing in such capital) illegally, viz overinvoicing (underinvoicing) of import or underinvoicing (overinvoicing) of exports, distorts recorded trade flows In the former case, recorded exports will be understated and imports overstated As such, I wonder whether there is an element of overinvoicing of exports and underinvoicing of imports in recent trade data Last, but not the least, rapid accumulation of external reserves following such increases in capital flows creates serious problems for monetary and exchange rate management Of course, to the extent the surge in inflows represent a permanent shift arising form external perceptions about beneficial structural changes in the economy expected from reforms, there is less to worry about But if they are not, and are temporary, and if such surges in capital flows lead to a temporary and unwarranted appreciation of the rupee, then our external competitiveness that is the objective of foreign trade reforms will be undermined The real appreciation can

come about if there is a strong growth in domestic demand, whether arising from increases in consumption or investment Since neither is sustainable and will have to be reversed when the inflows reverse, the problem is evident Sterilizing such inflows raises another set of problems in that it involves tightening monetary policy beyond what might be otherwise appropriate While trade and monetary sector reforms will enhance the efficiency with which flows are absorbed, they could also increase the flows The phenomenon of a surge in capital flows is not peculiar to India or something new A recent paper (Schadler et al (1993) goes into these issues in greater depth

Public Distribution System (PDS)

The PDS supplies specified quantities of rice, wheat, coarse cereals, edible oils and sugar at prices below ruling retail market prices to holder of ration cards through the fair price shops Although PDS initially covered (except in Kerala) only urban areas, at present rural areas are also covered In all there were 400,000 fair price shops as of March 31, 1993 of which about 75 percent were in rural areas Besides procurement of foodstuff for the PDS, government buys raw cotton and natural rubber as well under its price support program The direct budgetary costs of PDS (i e, the difference between the revenues from sales and the cost of purchase, transport, storage, distribution) have been growing In 1993-94, the central government alone budgeted Rs 30 billion for food subsidies, but the *actual* expenditure is expected to reach Rs 60 billion Ostensibly the PDS is meant to be part of a "safety net" for the poor Yet Minhas (1990) finds that in 1986-87, over 60 percent of the population (rural and urban) did not avail themselves of the PDS in rice and wheat Over 80 percent of the urban (70 percent of the rural) population did not buy edible oils from the PDS Only with respect to sugar and kerosene did a large majority of the population use the PDS However, a majority of those purchasing any of the five commodities exclusively from

the PDS in urban areas were from the bottom 40 percent of the distribution of per capita consumption expenditure In rural areas, the proportion of exclusive users of PDS with per capita consumption expenditure in the bottom 40 percent range from 46 percent in the case of wheat and 52 percent in the case of edible oils The analysis of Parikh (1993) of the same data analyzed by Minhas (for India as a whole) suggests that in the major states of North India, more than 90 percent of the population do not purchase any cereals from the PDS Further, the PDS was not particularly well-targeted in the sense that the bottom 70 percent of the population got more or less the same amount The subsidy from PDS purchases was a very small proportion of their expenditure on cereals, except in Andhra Pradesh and Kerala The PDS was not cost effective in reaching the poorest 20 percent of the households Out of every rupee spent, less than 20 percent reached the poor in all states except Kerala where 26 percent did

It would seem that the PDS did reach the poorest, though not necessarily in all parts of the country nor was it cost-effective in doing so At the same time, it supplied the non-poor the same commodities at prices below those ruling in the market Apart from poor targeting, the PDS also suffers form leakage of supplies to the open market Some estimates put such leakages to a third of rice, wheat and sugar off-take from the PDS and over a half of edible oil

In our report, Bhagwati and I suggested several ways in which the PDS could be made cost-effective and well-targeted However, not much has yet been done The most recent economic survey (Government of India 1994) merely restates the issues and suggestions for reforms without proposing any actions

> In a poor country some subsidy on basic food grain is justified But our present large and burgeoning food subsidy is poorly targeted and wasteful In the short run, containment of the food subsidy requires moderation in procurement price increases, prompt adjustment

> of issue prices and cost reductions in Food Corporation of India operation In the medium term, it is essential to move to a system where the subsidy is confined to the deserving poorest sections of society and delivery costs are reduced One possibility is to shift to program of food stamps for the poor Another is to decentralize much of the procurement-distribution function of the Food Corporation of India and the Center to the States and these organizations, with the objectives of achieving greater efficiency, accountability, improved targeting and subsidy reduction (p 10)

Financial Sector Reforms

Until the recent reforms, investible funds of the nationalized commercial banks and insurance companies were largely appropriated by the government for its own use or for directed allocation of "priority" sectors A significant portion of the directed credit was nonperforming (i e, the principal and interest were long overdue) and that invested in government papers yielded much less than good commercial loans Compounding all this on the expenditure side was the overmanned, overpaid and insufficient staff A hard-headed analysis would have shown much of the banking system to be insolvent on the eve of the reforms The central bank, viz the Reserve Bank of India, was virtually a captive of the government with little independence in formulating monetary policies

A number of steps have already been taken to reform the system Legislation as been passed to enable the establishment of special tribunals to recover debt due to banks and other financial institutions The capital base of public sector banks is being enhanced to meet the Basle norms of capital adequacy The twin instruments of statutory liquidity ratio and incremental cash reserve ratio through which the government has access to the resources of

commercial banks have been set at much lower levels than earlier A measure of independence to the Reserve Bank also has been provided Private banks are again allowed to be established with equity participation by foreign banks and nonresident Indians With the establishment of the Security and Exchanges Board, National Stock Exchange, Over the Counter Exchange, etc and the institutions of screen-based stripeless trading system in securities etc, the nonbank financial sector is also being reformed Government has received the report of a committee it has appointed on reforming the insurance sector, although actions are yet to be taken on its recommendations

While the above reforms are in the right direction, unless the government is able to face up to the entrenched unions of employees and officers of the banking sector on matters relating to computerization, staff size, structure and emoluments, the efficiency and cost-effectiveness of the public sector banks will remain in doubt Already the unions have organized a token strike against privatization Whether the government will have the gumption either to overcome the opposition of the unions and privatize or to let the inefficient "dinosaurs" among public sector banks become extinct through attrition but without privatization, while more and more newly established and efficient banks take their place, remains to be seen

Reforms in the States

Let me conclude with a couple of remarks on reforms in the States By and large the reforms since July 1991 have been at the level of the central government But many of the critical sectors (agriculture, irrigation, electricity, land) are under the control of State governments There are substantial differences in the administrative efficiency and resources of different states Without major reforms at the state level, the payoff from reforms announced by the center may be very limited Encouragingly some

states have already announced several reforms of their industrial policies, but much remains to be done While competition among states to attract private investment (domestic and foreign) will be a powerful force in pushing states to reform, there is also the danger that such competition might go too far in transferring public resources to the private sector without significantly increasing the quantum of investment

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