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# **Pakistan and Lessons from East Asia: Growth, Equity, and Governance**

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## Preface

The Centre for Research in Economics and Business (CREB) was established in 2007 to conduct policy-oriented research with a rigorous academic perspective on key development issues facing Pakistan. In addition, CREB (i) facilitates and coordinates research by faculty at the Lahore School of Economics, (ii) hosts visiting international scholars undertaking research on Pakistan, and (iii) administers the Lahore School's postgraduate program leading to the MPhil and PhD.

An important goal of CREB is to promote public debate on policy issues through conferences, seminars, and publications. In this connection, CREB organizes the Lahore School's Annual Conference on the Management of the Pakistan Economy, the proceedings of which are published in a special issue of the *Lahore Journal of Economics*.

The CREB Working Paper Series was initiated in 2008 to bring to a wider audience the research being carried out at the Centre. The CREB Policy Paper Series was started in 2010 with a view to separating empirical and policy research work. Rigorous, analytical, and empirical research is published as part of the Working Paper Series, while broader policy-oriented research is published as part of the Policy Paper Series.

It is hoped that these papers will promote discussion on the subject and contribute to a better understanding of economic and business processes and development issues in Pakistan. Comments and feedback on these papers are welcome.



## **Acknowledgments**

This paper is dedicated to the memory of the late Dr Moinuddin Baqai—mentor, colleague, friend, and one of the finest applied economists produced by Pakistan. After visiting the Republic of Korea, he was deeply impressed by the country's development, particularly as it had resulted from policy actions and not from the accidental possession of some valuable resource, such as oil. Could Pakistan do something similar? I was at the time responsible for the World Bank's economic program in Korea, and Dr Baqai urged me to write a paper that would examine the policies that sparked and sustained Korea's growth, and that would suggest lessons for Pakistan's policymakers. In keeping with the spirit of Dr Baqai's suggestion, I have limited the bulk of the discussion to the period from roughly about 1960 to the early 1990s; during these three decades, the Korean economy took off and made rapid growth almost a routine matter. Thereafter, the Korean economy had advanced so far ahead of Pakistan's that it would be difficult to draw meaningful lessons.

I should like to thank Danny M. Leipziger and David Dollar for discussions and advice on an earlier draft. The interpretations and errors are, of course, my responsibility.





## **Abbreviations**

GDP	gross domestic product
GNP	gross national product
HCI	heavy and chemical industry
IMF	International Monetary Fund
PRC	People's Republic of China
TFP	total factor productivity



## Abstract

The sustained and spectacular success of a number of East Asian economies compared with Pakistan's patchy performance has raised the questions of whether and how Pakistan could emulate the East Asian achievements. The East Asian performance is all the more remarkable because it did not arise from the fortuitous possession of some valuable resource, but was based on a clear strategy supported by effective policies.

In essence, the strategy followed by the East Asian economies was to import raw materials and semifinished goods, add value by an efficient labor force, and export the finished goods at a competitive exchange rate. This paper describes the major policies through which the strategy was implemented from the early 1960s to the mid-1990s (i.e., before the structures of the East Asian and Pakistani economies diverged too much to make comparisons meaningful) and contrasts them with Pakistan's actions in critical areas. It finds that the main reasons for the East Asians' success were:

- prioritizing economic development over virtually all other goals;
- enforcing economic competitiveness by adopting an export-driven growth strategy;
- adjusting policies quickly to maintain a competitive exchange rate;
- emphasizing education and training in order to create an efficient labor force;
- formulating realistic development plans and ensuring their timely implementation;
- preserving a substantial degree of equity in the distribution of income and wealth.

The paper finds that Pakistan did not give sufficient priority to development, did not possess a coherent growth strategy, and that its policy formulation and implementation were deficient in almost all key areas.

**JEL classifications:** E61, O11, O24, F14, N15.

**Keywords:** Macroeconomic policy, determinants of development, economic planning, economic growth, export drivers, exchange rate.

# 1 Introduction

Pakistan's patchy economic performance—compared with the spectacular success of a number of East Asian economies, such as Hong Kong, Malaysia, the People's Republic of China (PRC), the Republic of Korea,<sup>1</sup> Singapore, and Taiwan—during the last four decades has raised many crucial questions. How and why did the growth experience of Pakistan diverge from that of the East Asian "tigers"? What were the essentials of the East Asian model? How did policies and performance in the key areas of investment, savings, exports, industry, education, and so forth differ between Pakistan and these East Asian economies? What was their approach to industrial policy, productivity, and competitiveness? What policies propelled the unremitting surge in their exports? How did these countries view the role of external assistance? Did they sacrifice equity in the pursuit of rapid gross domestic product (GDP) growth? How important was economic planning? What was the contribution of governance? What lessons could Pakistan learn from their experience (and what perhaps would be better left unlearned)?

This paper attempts to address these questions by examining the policies of several East Asian "tigers" (particularly Korea) in key sectors of the economy. The analysis draws both on the extensive literature and on discussions with key stakeholders—including policymakers, academics, business leaders, members of think-tanks, journalists, and civil society members—over the decade-long period during which I was responsible for the World Bank's economic program in some of these countries.

Although Pakistan can learn from the experience of all the high-performing East Asian economies—and this paper also examines the Taiwanese experience in a number of areas—Korea offers the most lessons. This is so on three grounds: (i) Korea has a significant population (about 50 million in 2007) and thus falls

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<sup>1</sup> Subsequently referred to as "Korea" to distinguish it from the Democratic People's Republic of Korea (North Korea).

between the extremes of, say, the PRC (1.3 billion, and with a very different political structure from that of Pakistan) and Singapore (5 million); (ii) Korea, like Pakistan, has had to devote a considerable portion of its gross national product (GNP) (between 7 and 8 percent on average during 1953–70) to defense; and (iii) Korea, like Pakistan, has been ruled by military autocrats for substantial periods.

### **1.1 The East Asian Model**

Although the fast-growing East Asian economies had differences of history, geography, culture, and natural resources, they had some key factors in common that contributed heavily to their economic success.

What are the essentials of the East Asian development model? Johnson (1987) has characterized it as having four elements: “(i) stable rule by a political-bureaucratic elite not acceding to political demands that would undermine economic growth; (ii) cooperation between public and private sectors under the overall guidance of a pilot planning agency; (iii) heavy and continuing investment in education for everyone combined with policies to ensure the equitable distribution of the wealth . . . ; and (iv) a government that understands the need to use . . . methods of economic intervention based on the price mechanism” (p. 145).

Virtually all the fast-growing East Asian economies shared these characteristics to a greater or lesser degree. Perhaps what needs to be emphasized is the extent to which they all gave economic growth the highest priority. This provided a way of legitimizing regimes that had not come to power through a democratic process. Thus, successive Korean regimes could argue that, even if they had not been democratically elected, they were still the best option for the country because only a military regime could counter the threat from North Korea and also make the tough decisions necessary to ensure that inclusive economic growth took place. The argument was made more convincing by the widespread perception that the benefits of economic development under civilian regimes had accrued disproportionately to rulers’ cronies. Taiwanese leaders could also argue along similar lines, substituting the PRC for North Korea. Thus, faster economic growth

and a wider dissemination of its benefits were important elements in the legitimization of the Korean and Taiwanese regimes.

A complete discussion of the experience of the East Asian “tigers” and a comparison with that of Pakistan would require a substantial book. This paper concentrates on key areas and discusses these under three rubrics: (i) the spectacular GDP growth rates and the forces behind them; (ii) the measures that reduced poverty and improved the distribution of income and wealth; and (iii) the elements of economic governance that gave credibility to government policies and glued together plans, policies, and implementation.

Of course, while these matters are discussed separately, they are in reality quite intimately connected. Thus, for example, questions of governance underlie the increases in investment and the measures to reduce poverty, improve the distribution of income and wealth, and make an export-oriented strategy work successfully. Similarly, while one might discuss export promotion and industrial strategy separately, the success of the export strategy hinged on the success of industrial policies since the spectacular growth of exports was almost entirely of manufactured items.

## **1.2 The East Asian Achievement**

In 1950, Korea had a per capita income of USD146; compare this with USD203 for Egypt, USD150 for Nigeria, and USD562 for Mexico. By 1980, Korea’s per capita income had shot up to USD1,553 (an annual growth rate of 8.2 percent), Egypt’s to USD480 (2.9 percent), Nigeria’s to USD670 (5.1 percent), and Mexico’s to USD1,640 (3.6 percent).<sup>2</sup> Note that the last three are important oil producers. During 1962–80, Korea’s GNP grew at an annual rate of 8.5 percent in real terms (Johnson, 1987, p. 136). In particular sectors, the growth was even more impressive: between 1962 and 1980, value-added in manufacturing increased at an average annual rate of 18 percent. The value of Korea’s exports grew from USD55 million to USD22 billion, giving an annual growth rate of nearly 40 percent; in 2007, exports reached USD372 billion (compared with USD16 billion for Pakistan). The composition of exports changed:

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<sup>2</sup> All figures are expressed in 1974 US dollars.

manufactures accounted for less than 10 percent in 1962 but 90 percent in 1980 (Johnson, 1981; World Bank, n.d.). This growth performance has been achieved with an income distribution that is considered one of the most equitable in the developing world.

Taiwan's performance has been no less impressive. In common with other developing countries, it concentrated first on a policy of import substitution; this was initially successful, and the annual growth rate of real per capita GNP reached 6.0 percent between 1951 and 1955. However, as the domestic market became increasingly saturated, this rate dropped to 3.7 percent during 1956–60 (Wang, 1990, p. 25).

The government responded with a major change in direction in February 1960, which was reinforced in 1966. The new policies greatly strengthened export incentives by providing tax rebates and low-cost loans to exporters, and by setting up export processing zones. In July 1960, the exchange rate was devalued to the black market level. The result was that “these reforms simply had made it enormously profitable for suppliers of manufactured goods to sell abroad rather than at home” (Myers, 1986, p. 28). Exports grew rapidly in response to the incentives, shooting up from USD525 million in 1965 to over USD70 billion in 1989. In 2007, this country of 23 million (about one eighth the population of Pakistan) had exports worth USD247 billion – about 15 times as much as Pakistan. Propelled by the surging exports, Taiwan's average annual growth of real GNP per capita rose to 7.7 percent in 1960–73, dropped sharply during the first oil price crisis (1973–75), and then recovered to an annual level of 7.2 percent in 1975–87 (Wang, 1990, pp. 24–26).

International comparisons of income can be beset with uncertainties, but the contrasts between the performances of the East Asian economies and Pakistan are so staggering that the story remains unambiguous. It would help to put the Korean and Taiwanese record in perspective for Pakistan by considering the following. In 1960, Pakistan's per capita income was about USD85, while that of Korea was roughly USD130. In 1988, Pakistan's per capita income was estimated at USD340, compared with over USD4,000 for Korea. In 2007, per capita incomes in Pakistan and



Korea were USD790 and USD18,500, respectively (Government of Pakistan, 1975; International Monetary Fund [IMF], 2011).

Pakistan's exports in 1960 were valued at about USD220 million, compared with USD50 million for Korea. In 1988, Pakistan's exports were worth about USD3.5 billion, Korea's USD60 billion. In other words, starting 30 years ago from a per capita income that was about two thirds that of Korea, and exports that were worth more than four times than Korea's, Pakistan in 1988 had a per capita income less than one tenth that of Korea and exports that were worth a little more than one twentieth of Korean (and Taiwanese) exports. To make the picture even starker, consider that the value of Korea's (and Taiwan's) exports was, even in 1988, about double Pakistan's entire GDP. By 2007, Pakistan's exports were equivalent to about 4 percent of Korea's and 6.5 percent of Taiwan's (Government of Pakistan, 1975; IMF, 2011).

## 2 GDP Growth and its Drivers

Comparisons of different countries' national accounts over long periods inevitably involve some degree of approximation. Subject to this caveat, the broad story of GDP growth in Korea, Taiwan, and Pakistan would be along the following lines.

Over the period 1960–2007, Taiwan's GDP increased at an annual average rate of about 8.5 percent in real terms; during the same period, the real GDP growth rate in Korea was roughly 8.3 percent a year. Both these rates were substantially higher than that achieved by Pakistan, where GDP growth from the 1960s to 2007 is estimated at about 5.5 percent a year (Government of Pakistan, n.d.; IMF, 2011). Moreover, since the population in these East Asian countries increased at a significantly slower rate than in Pakistan, the disparity in the growth of per capita incomes was far greater.<sup>3</sup>

What were the drivers of this spectacular growth? Broadly speaking, the growth impulses came from five main areas:

- (i) high rates of investment,
- (ii) substantial increases in factor productivity,
- (iii) surging exports,
- (iv) a favorable monetary system, and
- (v) the judicious use of external assistance.

This section reviews the performance and policies of Korea and Taiwan under each of these rubrics, contrasting them with Pakistan's experience.

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<sup>3</sup> The difference can be illustrated in the following way. During this 45-year period, per capita income in Pakistan grew at a rate of about 2.5 percent a year, while in Korea and Taiwan, it increased at a rate of nearly 6.5 percent a year. USD1 increasing at a rate of 2.5 percent a year over 45 years would become USD3; USD1 growing at a rate of 6.5 percent a year over the same period would become USD17.

## 2.1 Investment Rates

The dramatic growth of GDP in Korea and Taiwan was driven by very high rates of investment and savings, and by steady increases in productivity. During the period 1970–2007, Korea invested about 32 percent of its GDP on average, and Taiwan about 30 percent, while Pakistan invested only about 18 percent.<sup>4</sup>

Both Korea and Taiwan provided substantial incentives for investment, including (i) generous provisions for depreciation, (ii) low-interest loans from the banking system, (iii) privileged access to foreign exchange, and (iv) government assistance (especially in Korea's case) to acquire technology and expertise from abroad. Pakistan also provided incentives—for some years in the 1960s, the combined depreciation allowances added up to more than 100 percent of the cost of industrial machinery—but the private sector rarely responded on the scale it did in East Asia. The country always lacked a coherent industrial and investment policy, and paid virtually no attention to the development or acquisition of appropriate technology.

## 2.2 Factor Productivity

In the standard growth accounting model, the sources of GDP growth are apportioned between the contribution of capital, labor, and that of a residual factor that is frequently associated with “technical progress” but is more neutrally referred to as total factor productivity (TFP) (Solow, 1956). How much of the growth in Korea, Taiwan, and Pakistan derived from factor inputs, and how much resulted from increases in factor productivity?

Estimates of the contribution of these inputs differ among various studies, but the broad conclusions appears to be that, for Korea in the period 1960–2005, increases in physical capital accounted for about 40 percent of GDP growth, increases in labor for about 30 percent, and increases in TFP for about 30 percent. Over roughly the same period, the contribution of capital to the growth of output in

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<sup>4</sup> I have given the figures for investment for the period 1970–2007 rather than from 1960, because the investment data for Pakistan before 1970 is particularly shaky.

Taiwan was about 46 percent; that of labor, about 18 percent; and that of TFP, nearly 36 percent. For the high-performing East Asian economies (Hong Kong, Indonesia, Malaysia, Singapore, and Thailand, in addition to Korea and Taiwan) as a group, the average growth rate of GDP between 1960 and 2003 was 6.5 percent a year. Of this, capital contributed nearly 49 percent, labor 25 percent, and TFP growth 26 percent. By way of comparison, Pakistan's GDP is estimated to have increased at an annual average rate of 5.3 percent between 1960 and 2005; the growth of capital contributed 44 percent, that of labor 36 percent, while TFP growth provided about 20 percent (see K. S. Kim & Hong, 1997, p. 183, Table 8.5; Stiglitz & Yusuf, 2001, p. 16, Tables 1.3 and 1.4; Thorbecke & Wan, 1999, pp. 3–20; World Bank, 1993, pp. 60–70, 2006, p. 13, Tables 2.2 and 2.3).

In short, GDP growth in Pakistan was driven primarily by increases in inputs, with a relatively small contribution from productivity improvements. GDP growth in Korea and Taiwan, on the other hand, owed substantially more to productivity increases. An important lesson for Pakistan therefore is that, if it is to be competitive in the world economy, its growth will have to depend much more on increases in productivity than has been the case in the past. This means that the investment rate will have to be increased from the average 19 percent of GDP to around 30 percent, and much more emphasis placed on education and training.

### **2.3 Industrial Policy**

Leipziger (1988) has argued that, "if IPs [industrial policies] are defined as interventions which alter the way resources are allocated in the industrial sector, then Korea surely has had an active industrial policy" (p. 121). Moreover, Korea's industrial policy has remained intimately linked with its trade policies. This strategy arose from the requirement of a resource-poor country that had to export in order to buy capital goods and intermediate products, as well as defense matériel, from abroad. Since only about 20 percent of the country's land is suitable for cultivation, Korean policymakers had little choice but to turn to manufacturing to provide goods for export. As a result of intensive intervention—including tax concessions, export subsidies, a favorable exchange rate, wage restraint imposed on trade unions, outlawing of strikes, and, most importantly, preferential access to

credit—the manufacturing sector increased its share from 12 percent of GDP in 1960 to nearly 32 percent (of a far larger GDP) in 1987.

### **2.3.1 Korea's Experience**

The evolution of Korea's industrial policies between the early 1950s and the mid-1990s can be divided into four broad phases: (i) import substitution from the 1950s to the early 1960s, (ii) liberalization from the early 1960s to 1973, (iii) an emphasis on heavy and chemical industries (HCIs) from 1973 to 1979, and (iv) renewed liberalization 1980 onward.

#### *Phase I: Import Substitution*

Between the 1950s and early 1960s, industrial incentives focused typically on import substitution. High tariffs were imposed on imports with close domestically produced substitutes; and low or zero tariffs on unfinished goods, machinery for import-substituting industries, intermediates, and food grains (much of the latter was provided under the US's Public Law 480, according to which repayment—if made at all—was to be in local currency). The exchange rate system was complex, leading to multiple rates, all of which were overvalued. Quantitative restrictions, especially quotas, were the principal mechanism used to control imports (Westphal & Kim, 1982, p. 214; see also Frank, Kim, & Westphal, 1975, pp. 25–41). The chief incentive given to exports was a provision for converting export earnings into foreign exchange certificates, which entitled the holder to import certain high-value items that were not otherwise available (this was similar to Pakistan's Export Bonus Scheme, which ran from 1959 to 1972).

#### *Phase II: Liberalization*

The second, more liberal, phase started in 1961 when President Chung Hee Park assumed office,<sup>5</sup> but really took stride from 1964 until about 1973. This period was characterized by an

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<sup>5</sup> Korean names have been written out in Western style, i.e., the family name appears last, not first, as is the Korean practice.

outward-looking strategy, principally an aggressive drive to boost exports. The most important weapon in turning the economy toward an export path was an active exchange rate policy. The exchange rate was significantly devalued in 1961 and 1964; the latter devaluation also introduced a sliding-peg system of continued adjustment so that exchange rate competitiveness eroded by inflation (or for other reasons) could quickly be compensated for.

Several other incentives were provided to exporters (Westphal & Kim, 1982, p. 215):

- (i) Income taxes on earnings from exports were reduced by 50 percent.
- (ii) Exporters were exempted from indirect taxes on exports and on inputs.
- (iii) The preferential interest rate on export credits was lowered.
- (iv) Tariff exemptions were provided on capital equipment used not only in producing exports, but also "indirect exports" (that is, intermediates used in the production of exports).
- (v) Favored access was given to foreign exchange loans.
- (vi) Depreciation allowances were made more generous.
- (vii) The preferential rate on working capital loans to exporters was reduced in steps from 14 percent a year in 1960 to 6 percent in 1967 (these rates were negative in real terms).
- (viii) The amounts that exporters could borrow were increased.

During this period, Korea continued to protect its domestic market from imports, but managed this with far greater sophistication and attention to market considerations. For example, examining the difference between incentives for export and domestic sales in the exportables industries, the World Bank (1987a) showed that

protection of the domestic market was high in industries in which Korea did not face strong export prospects, and it was low in industries in which Korean products were internationally competitive. Thus while Korean policy did offer protection to the domestic

markets of industries producing importables, it offered little incentive for industries producing exportables to keep their output at home (Volume 1, p. 35).

### *Phase III: Emphasis on HCIs*

The third major stage (1973–79) of industrial policy involved an important change in philosophy: instead of providing generalized export incentives that were, by and large, open to all potential exporters, the government consciously adopted a policy of favoring a particular sector, i.e., the HCIs. Industries singled out for preferential treatment were steel, nonferrous metals, chemicals (especially naphtha cracking and ancillary activities), general machinery, shipbuilding, electronics, and automobiles. In other words, the government's attitude changed from that of creating a favorable environment for export and then letting the market bring out the actual exporting industries. Instead, the government adopted a policy of "picking winners" and then encouraging them to grow rapidly by supporting them with special incentives. This obviously involved a cost to many other sectors, in that resources devoted to the HCIs were not available for deployment elsewhere. But, in fixing its attention on the HCIs, did the government in fact consistently pick winners?

### *Instruments Used to Push the HCI Sector*

The HCI drive was pushed forward by a wide range of policy instruments, especially fiscal preferences, import protection, and (most importantly) access to large amounts of subsidized credit. In the 1960s, Korean interest rates had been high; in 1972, the government lowered the ceilings. Because of the continuing inflation (around 15 percent a year), bank interest rates were negative in real terms, creating an excess demand for bank credit. The difference between bank rates and those charged by other sources of similar credit (such as the informal market, discussed above) represented a subsidy to those industries that were fortunate enough to get credit from the government-controlled banks — those industries that had joined the HCI drive. The share of credit allocated to the HCI group almost doubled from approximately one third of total bank loans in 1973/74 to about 60 percent in 1975–77 (J. H. Kim, 1990, p. 20). This increase came at the expense of the light

industry sector, whose share of bank credit fell from about 65 percent in 1973 to 40 percent in 1980. Moreover, this credit was provided at even lower cost than normal commercial bank rates. At the height of the HCI boom, the cost of borrowing for heavy industry averaged approximately 25 percent lower than that for light industry (World Bank, 1987a, Volume 2, Table 5.13).

The authorities also substantially widened fiscal incentives between the targeted industries and others. Dollar (1990) has cited a study by the Korean Development Institute that showed that, in the late 1970s, the marginal tax rate was around 50 percent for industries in the non-HCI group, but less than 20 percent for the HCI group (p. 23). This was brought about by a combination of tax exemptions, reductions, investment tax credits, and provision for accelerated depreciation to the designated "strategic" industries. The system of trade protection was also adjusted to afford further protection to the HCI group. Through changes in nominal tariff rates, import controls, import duty drawbacks, and other measures, the effective rates of protection were made to differ substantially between industries, with high rates of protection for the HCI sectors (over 70 percent in 1978, with particular subsectors, such as transportation, receiving as much as 112 percent) (Kwack, 1986, pp. 116–118, Table 10) and, in some cases, negative rates facing traditional light manufacturing sectors. It is little wonder, as J. H. Kim (1990) concluded, that "it became more important for private sectors to participate in the HCI program than to be profitability efficient or to build export markets" (p. 2). As a result of these incentives, investment in the HCI sector grew rapidly and accounted for nearly 80 percent of all manufacturing investment between 1977 and 1979. This massive redirection of resources meant that, while nearly all the investment programmed by the Fourth Five-Year Plan (1977–81) for heavy industry had been completed by 1979, the investment projected for light industries fell short of the target.

### *Results of the HCI Push*

Despite the number of analyses of industrial policy, there is no single universally accepted criterion for judging its success or failure. However, using different measuring rods, most analysts have concluded that Korea's HCI policy hurt the country considerably more than it helped. Even at the start of the new strategy, some commentators



expressed cautiously worded reservations about the feasibility and desirability of the ambitious targets for heavy industry (P. Hasan, 1976, pp. 91, 120–122). Several studies of the completed episode are now available and, while there are one or two dissenters (see, for example, Amsden, 1989, pp. 94, 99, 118), the overwhelming view is negative.

Balassa (1987) has argued that the HCI drive distorted profitability signals and channeled resources away from activities in which Korea had a comparative advantage, and that this was at least partly responsible for slowing down export performance (pp. 8–10). He has also shown that the incentive structure led to overinvestment and excess capacity in the HCI sector. Norton (1987) has made similar criticisms (pp. 29–54). Kwack (1986) has commented that the rapid increase in investment in the HCI segment meant that firms did not have sufficient time to absorb the new technology and that “excess capacity, high production cost, and low product quality characterized these firms” (p. 126). Leipziger (1987, 1988, pp. 124–126) has documented the misallocation of resources, and several more examples are given in the World Bank (1987a) study on restructuring Korean industry. Dollar (1990) has concluded that performance in several areas of HCI investment—such as machinery and many chemicals—was “disastrous,” adding that the steel industry became efficient and began to export, but that even in this activity the financial returns to investment remained very poor (p. 23). Song (2003) has maintained that the rapid increase of external debt in the 1970s, which became a major policy issue, was caused by insufficient domestic resources to fund the HCI drive at the pace required by the government (p. 137). Y.-C. Park (1986) has argued that the concentration of investment in the HCI sector and its associated infrastructure—which the government had to provide—drove away labor and capital from the light manufacturing and nontradable sectors. The gap between rapidly increasing domestic demand and the limited and more slowly growing capacity of light industry was the main cause of inflation in the 1970s.

Suh (1987) has derided the “surface” improvements of the 1970s, pointing out that inflation, the rapid rise in real wages in the expanding heavy industries, and the overextension of government investment and low-interest loans to the HCI group led to a loss of

international competitiveness and unbalanced regional growth, consequently worsening income distribution (pp. 22–23). Rhee, Ross-Larson, and Pursell (1984) have criticized the government's policy of promoting several heavy industries at the same time without considering the resource requirements and the costs this would impose on the economy. They have referred to the seriousness of "duplicated investments, of excess capacity, and of the bankruptcies [presumably of enterprises in light industry] induced by resource constraints that prevented the completion of new plants" (pp. 68–69). J. H. Kim (1990) has commented on the moral hazard aspect of the government's unremitting support of these industries, saying that it "put the government in the position of an implicit risk partner and created the expectation that the government would be responsible for its promotion policies and would provide a soft-landing to individual firms should the situation deteriorate" (p. 2).

#### *Phase IV: Renewed Liberalization*

The fourth phase in Korea's industrial restructuring policy dates from about 1980 and represents a cautious move toward liberalization (until about the mid-1990s). The need to rethink policy became urgent given mounting evidence of the financial losses and distortions caused by the HCI drive. The growth of GDP had slowed down and exports had begun to fall (in 1979, even the volume of exports had dropped below that of the previous year). Additionally, in 1979, Korea was hit by three exogenous shocks that quickly focused the government's attention on developing a policy response: (i) the second oil price rise; (ii) the worst agricultural weather in the country's recent history, which led to a fall of nearly 20 percent in agricultural production; and (iii) on 26 November, the assassination of President Park. In 1980, Korea's real GDP fell (by 5 percent) for the first time in the country's contemporary experience.

In response to the worsening situation, the authorities implemented a major devaluation in 1980 and shifted credit allocation policies; more importantly, they moved industrial policy toward greater neutrality between sectors. A World Bank (1987a) study of this subject listed the following major changes in policy (pp. 49–50):

- (i) Preferences were reversed toward large heavy industry by reserving credit for small and medium firms.
- (ii) The government's role in specific credit allocation decisions was reduced, and policies that awarded the HCI sector large-scale preferences were abruptly terminated.
- (iii) Interest rate subsidies for particular borrowers were eliminated and the role of policy targeting in lending decisions was scaled back.
- (iv) Variations in effective protection were reduced.
- (v) Real interest rates were increased, which reduced the gap between rates in the formal market and the "curb" market.

Although the government continued to play an active role in policy, there was a distinct move toward liberalization and many of the interventions can be justified on grounds of market imperfections (such as spreading knowledge about new technology and facilitating its introduction).

The authorities also realized that the financial system needed to be freed up to provide financing to those industries in which market signals would direct investment. The government therefore began a long-term program of financial liberalization. During 1983 and 1984, the government

- (i) gradually relaxed interest rate ceilings;
- (ii) divested itself of all nationwide commercial banks (although it continued to exercise considerable influence in the "privatized" institutions);
- (iii) authorized banks to undertake new activities, such as the sale of commercial paper and government securities;
- (iv) permitted the establishment of two new nationwide banks as joint ventures with foreign banks;
- (v) encouraged the introduction of new financial instruments, such as negotiable certificates of deposit;
- (vi) eased restrictions on foreign banks; and

- (vii) took measures to improve the allocation of credit (for example, the share of loans directed by the government was reduced from 16 percent of the total to 14 percent) (Aghevli, Bijan, & Marquez-Ruarte, 1985, pp. 17–18).

### **2.3.2 Taiwan's Experience**

Several commentators have pointed out that Taiwan and Korea adopted very different policies toward their manufacturing sectors, yet the overall development of manufacturing—in terms of productivity growth, structural change, and export success—was remarkably similar in the two economies. The specific industries that developed differed, largely as a result of the Korean HCI policy. However, the similarity in productivity growth, structural change, and export success in the aggregate suggests that industrial policy was not the most important cause of industrialization in either of these economies (see, for example, Dollar & Sokoloff, 1994, pp. 23–24).

Briefly stated, the clearest difference between the industrial structures of Korea and Taiwan was that the former was dominated by large enterprises grouped into conglomerates (the *chaebol*), while the latter consisted overwhelmingly of far smaller enterprises. In 1980, the average Taiwanese firm had only about 35 employees compared with about 70 in Korea. The very small firms, with less than five employees, constituted 43 percent of all manufacturing firms in Taiwan. A telling indication of the difference in the size of firms is that, in 1981, Korea's largest conglomerate (Hyundai) had gross receipts that were three times as large as the gross receipts of Taiwan's 10 largest private firms combined (Scitovsky, 1986, p. 137). Another measure of the size of Korean firms is that, in the 1980s, the 20 largest Korean *chaebol* were responsible for producing half the value-added in manufacturing.

Apart from supporting and, indeed, encouraging the difference in the size of the average firm in the two countries, there was also a major difference in the two governments' general approach to industrial policy. At the risk of oversimplifying matters, one can point to two broad approaches toward industrial policy. One type aims to provide a level playing field for all industries through the use

of general incentives, such as tax concessions or public investment in education and training. Such measures are often referred to in the literature as “functional” incentives. The second type of industrial policy targets the growth of particular industries and is often referred to as “picking winners.” For the most part, Taiwan’s strategy was to provide functional incentives while Korea followed the approach of picking winners, not only in terms of which industries to support but also which firms to back.

This does not mean that Taiwan did not specifically target some areas. It did, particularly in the 1970s, when it launched an ambitious program of heavy industry called the Ten Major Development Projects. These largely comprised petrochemicals, steel, and shipbuilding, and were followed by a nuclear power plant and automobile production. However, another major difference between the two countries’ approaches became apparent—Korea created incentives for the private sector to move into the targeted areas, while Taiwan acted through public enterprises.

This difference was most marked in the development of heavy industries, which are extremely capital-intensive; enterprises generally need to be very large because they draw much of their efficiency from economies of scale. The development of heavy industry in Korea was carried out almost entirely by large private firms that were parts of the *chaebol*. Since there were only a few very large private enterprises in Taiwan, almost all the large-scale production units required by heavy industry were located in the public sector.

Why did Korea have these large conglomerates that could implement large-scale heavy industry projects while Taiwan did not? The basic reason appears to be political. A joint study by the Chung-hua Institution for Economic Research and the Harvard Institute for International Development has expressed the issue very clearly:

The Korean *chaebol* were led by Koreans who had close ties to government and over time came to be the major supporters and financiers of the governing party and its president. Private businessmen in Taiwan, in contrast, were mainly Taiwanese, most of whom had only weak

ties to the mainlander-dominated Kuomintang government. . . . Although there were mainlanders in the private sector, the principal business of the mainlanders was government. The expansion of the public enterprise sector, in that context, was thus also an extension of mainlander power over the economy and polity (Hsueh, Hsu, & Perkins, 2001, p. 39).

For the most part, the Taiwanese authorities acted realistically in pushing the heavy industry program. They had their share of failures but showed a reasonable degree of flexibility in working out where their competitive advantage lay.

This is evident perhaps most clearly in the development of the automobile industry. The minimum scale of production required for the different components of vehicle production varies considerably, but large economies of scale are important for all major mechanical components, especially engines and transmissions and all major phases of production, including final assembly. The minimum efficient scale for annual output has been estimated to range from 100,000 to 250,000 units in assembly, rising to 500,000 in engines, and to 1,000,000 in stamping (Chu, 1994, p. 137). This scale of production could not be met by the relatively small enterprises in Taiwan, particularly as the domestic market remained small—annual domestic sales averaged only 106,185 units during 1977–80. Chu (1994) has pointed out that these figures are only about half the production capacity of a typical General Motors assembly plant (p. 137). It is not surprising, therefore, that many of the joint ventures between Taiwanese corporations (including public sector corporations) and foreign companies were either abandoned or failed, and the industry remained uncompetitive for long periods. Indeed, Hsueh et al. (2001) have commented that “well into the 1980s there wasn’t much to show for those [the government’s] efforts” (p. 44).

After 1985, government policies regarding automobile imports and production became more liberal, and the industry began to become competitive. The most competitive part of the industry, however, was not the production of automobiles but the production of automobile parts, which became a major export. There is a clear lesson here for

Pakistan, which has fragmented its small domestic automobile market between several assembly plants of which very few, if any, would be able to survive without very extensive protection. The lesson is that Pakistan should aim to find a niche market, such as in the production and export of (to begin with) a limited range of automobile parts and components rather than in the assembly of complete vehicles at plants of an uneconomic size. Another solution would be to cut down on the number of assembly plants so that the remaining ones have a better chance of expanding to an economic size.

### **2.3.3 Pakistan's Experience**

Pakistan's experience with industrial development could not have been more different from that of Korea. In 1959/60, manufacturing (both large- and small-scale) accounted for roughly 10 percent of Pakistan's GDP; in Korea it accounted for about 14 percent. In 2006/07, the share had risen to about 18 percent in Pakistan; in Korea and Taiwan, it was about 35 percent. Manufacturing value-added as a share of GDP had risen between these years by 80 percent; in Korea it had increased by 150 percent, and that from a much higher base. In value terms, manufacturing value-added (measured in terms of 1995 US dollars) in Pakistan increased by a factor of seven between 1968 and 2003; that in Korea increased by a factor of 40. Not surprisingly, a detailed study of industrial growth in Pakistan concluded that "[Pakistan's] industry is not the growth engine it is in economies that have developed rapidly such as those in East Asia" (Government of Pakistan, 2005, p. i).

The absence of an effective industrial policy, or even a coherent attitude toward the development of industry in Pakistan, has had some very unfortunate consequences. First, the industrial sector's contribution to the GDP has stagnated, and even, according to some estimates, declined. This has led some economists to talk about the "deindustrialization of Pakistan's economy," and to describe the decline in the large-scale manufacturing sector as "not a cyclical phenomena [*sic*] but a secular trend" (Wizarat, 2002, pp. 1, 82). Second, productivity in industry (whether measured by the rate of growth of TFP or labor productivity) steadily declined between 1955/56 and 1990/91 (pp. 76–82, Tables 4.1–4.4). Third, the absence of

a coherent policy also meant that incentives for investment in industry and the export of industrial products were given in an ad hoc manner. The accumulation of these uncoordinated incentives created significant distortions and enabled businesspersons to set up industries that were profitable only because of the existence of subsidies and monopoly rents. Indeed, a detailed study of some 750 firms found that export industries were the most inefficient in the sample (Naqvi & Kemal, 1991, p. 3).<sup>6</sup> This is completely contrary to the experience of Korea or Taiwan, where exporting firms consistently ranked high in productivity.

## **2.4 Export Policies**

The word “miracle” has become something of a cliché when describing the growth of and structural changes in Korea’s exports. As recently as 1962, the value of Korea’s exports was only USD55 million. With the export drive that followed, exports passed the USD100 million-mark in 1964, USD500 million in 1968, USD1 billion in 1970, USD10 billion in 1977, USD20 billion in 1981, USD30 billion in 1985, and USD60 billion in 1988. In 1960, Korea ranked 101<sup>st</sup> among the world’s exporters; today, it is the 12<sup>th</sup> largest. The structural change is no less impressive: in 1960, primary products accounted for 86 percent of Korea’s merchandise exports and manufactures for 14 percent. By 1980, the shares had been completely reversed – primary products accounted for 10 percent and manufactured goods for 90 percent of exports (Balassa, 1984, pp. 145–146, Table 3.2). The export surge enabled Korea to run large surpluses on its current account from 1986 and to retire much of its substantial external debt. In 1985, Korea was the fourth most highly indebted developing country (after Mexico, Brazil, and Argentina) with an external debt amounting to USD47 billion; by 1988, that figure had dropped to USD31 billion (as surpluses on the current account were used to retire debt).

The remarkable story of Korea’s export growth has been told by numerous writers, and need not be repeated here (see, for

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<sup>6</sup> The distortions created by uncoordinated export incentives and the resulting divergence between social and private profitability of a number of export items have also been highlighted in Ikram (1973).



example, the references cited in Frank et al., 1975; Westphal & Kim, 1982). In any case, for our present purpose, what is important is not a rehearsal of the chronological ups and downs of the incentive structure, but rather a broad view of the factors that propelled and sustained Korea's exports on this trajectory.

Three factors largely explain Korea's export performance:

- (i) the government's decision-making and implementation processes,
- (ii) the set of export incentives, and
- (iii) the international environment.

#### **2.4.1 The Korean Government's Commitment to Boosting Exports**

The effectiveness of the government's decision-making and implementation procedures must begin with the government's commitment to the export drive. A thoroughgoing commitment to boosting exports began with President Park, whose strategy called for priority in economic development but with less economic reliance on the US. The paucity of Korea's own resource base meant that this development had to be based on industrialization (which, in turn, would have to be import-intensive), and the aim of reduced dependence on the US meant that this import-intensive industrialization would have to be financed through a higher volume of exports. It is not surprising, therefore, that President Park's favorite maxims were "nation building through exports" and "exports first" (Song, 1990, p. 90).

In the year following President Park's seizure of power, the Ministry of Commerce and Industry began setting export targets classified by commodity and destination. Exporters who reached their stipulated targets would receive favorable access to credit and other inducements; exporters who failed could swiftly suffer from economic and other sanctions. The president himself also chaired a monthly meeting of exporters during which export targets were discussed "and bureaucratic impediments to achieving those targets summarily removed" (Steinberg, 1989, p. 134). This also explains the relatively small amount of corruption and interference shown by the Korean bureaucracy: exporting was identified as the criterion of

resource allocation, and the performance of all actors—firms as well as bureaucrats—was monitored against this target (World Bank, 1987a, Volume 1, pp. 36–37). Thus, “although it is too much to say that government officials are not amenable to corruption, their intervention rarely leads to a slowing down of production or a failure to meet prescribed targets” (Mason, Kim, Perkins, Kim, & Cole, 1980, p. 265).

The government’s measures of compulsion could be quite draconian and continued to be enforced by the regimes that succeeded President Park. In the 1990s, I was told by the president of Kukje (a large conglomerate) that he had been forced to sell the shoemaking component of his group because he had fallen foul of government policies. He was particularly upset because this enterprise was so profitable that it could comfortably cross-subsidize the rest of his conglomerate.

The important point that emerges is the close relationship between government and business. Jones and SaKong (1980) described the resulting “Korea, Inc.” in some detail, making clear that the government was the senior partner (pp. 66–69). However, the communication went both ways: over 80 percent of the 113 firms surveyed by Rhee et al. (1984) said that their annual export target was their own estimate, which was sometimes adjusted by the government (pp. 22–24).<sup>7</sup> The trade associations were regularly and seriously consulted to ascertain what incentives were needed to attain targets. In these discussions, much information was exchanged, and “if sales in a region were not up to target, the Korean ambassadors there were recalled to find out what the problems were and what could be done to spur Korean sales” (p. 22). One could hardly ask for a stronger government commitment to exporting.<sup>8</sup>

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<sup>7</sup> They also point out that it is difficult for firms to set their targets too low or too high because the trade association or Ministry of Commerce would reject a target that was too low compared with past trends or the industry-wide figure, while ministers would not accept too high a target for fear of not being able to meet it.

<sup>8</sup> The government continued to use the carrot-and-stick approach toward recalcitrant exporters until very recently. In the mid-1990s I was told by the president of Kukje (a large

It could probably be said without too much exaggeration that Korea has used one or other variant of almost any incentive scheme available to promote exports—Johnson (1987, p. 147) has quoted Youngil Lim as listing 38 different “export policy tools” used until 1976 (see also Frank et al., 1975, Chapters 3–6, 9–10; Westphal & Kim, 1982, pp. 214–220). The most important and most consistently used, however, were the exchange rate, the tariff-free access to imported inputs, and the provision of bank loans (often at subsidized interest rates) for working capital.

Since the 1960s (except during the HCI drive), the Korean government has generally maintained the real value of the won near the level needed for current account balance (Petri, 1990, p. 56). This has meant sharp devaluations from time to time, interspersed with fine-tuning adjustments. The realistic exchange rate evidently provided exporters with a substantial incentive. A World Bank (1987a) study showed that export performance between 1960 and 1975 was keenly responsive to changes in the exchange rate: in a seven-year period when the real exchange rate was high (in 1965 purchasing power parity terms), the average annual growth rate of exports was 43.5 percent; in the seven-year period when it was low, the average growth rate was 16.0 percent (Volume 1, pp. 32–33, Table 2.1).

As some observers have noted, the effect of unrestricted, duty-free access to imported inputs was to create a free-trade regime for export activities (Rhee et al., 1984, p. 11; Petri, 1990, pp. 61–62). Producers of exports could thus purchase their inputs at world prices, and were not disadvantaged vis-à-vis their foreign competitors. This was very important in the case of both Korea and Taiwan because, in view of the countries’ limited resource base, exports had to have a large import component (estimated at around 40 percent for much of the last three decades for Korea and over 50 percent for Taiwan) (see Frank et al., 1975, p. 82; Scitovsky, 1986, p. 150; Steinberg, 1989, p. 135). The preferential access to credit not only facilitated the purchase of working inventories, but the subsidy also made exports more profitable relative to domestic sales.

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conglomerate) that he had been compelled by the government to sell the very profitable shoemaking company from his group for having fallen foul of the government’s policies.

Finally, Korea astutely exploited some special factors in the international environment (Petri, 1990, pp. 62–63, 74). Because of its historical links with Japan, Korea maintained a strong trading relationship with the country, which also served as the source of much of Korea's technology. In addition, Korea benefited from its relationship with the US in terms of American business practices, market requirements, and contracts for construction and transportation during the Viet Nam war. By 1987, the US was Korea's largest market, accounting for about one third of its exports, and providing a bilateral surplus of nearly USD10 billion. In a situation of generally increasing world trade, Korea also began its export drive before other rapidly growing countries in East and Southeast Asia had started to do so. Even though Korean exports to developed country markets now appear to be more "protection-prone" than those of other countries, contemporary newcomers to the export drive are likely to hit protectionist barriers sooner than did Korea (Petri, 1990, pp. 72–73, Table 4.4).

#### **2.4.2 Lessons for Pakistan in Trade and Industrial Policies**

Pakistan can learn much from Korea's successes and failures with trade and industrial policies. In analyzing these policies, one can distinguish broadly between the impact that government interventions have on three types of incentives: (i) the overall incentive regime created by fiscal, financial, exchange rate, and trade policies; (ii) functional incentives, that is, interventions to offset some systematic pattern of market failure or distortion (such as imperfections in the markets for technology and human capital, or deficiencies in physical infrastructure); and (iii) selective incentives, which seek to identify and support "sunrise" industries, and manage the orderly elimination of "sunset" activities (World Bank, 1987a, Volume 1, pp. 100–101).

However, the most important lesson is the acceptance of a different philosophy concerning the external sector. The export performance of Korea and Taiwan—and indeed of the other Asian "tigers" such as Hong Kong, Singapore, and even Japan—can be reduced to a few simple truths. All these countries are deficient in natural resources and, hence, could not depend on exporting items that were based on indigenous materials. Instead, their strategy

consisted of importing raw materials and semifinished goods, adding value efficiently through an educated labor force, and exporting the final product at a competitive exchange rate. This process is the essence of the East Asian export miracle. Exports, therefore, were based mostly on imports.

The most important factor that translated these countries' strategy into reality was the level at which the authorities provided support to the export drive and the consistency with which they pushed it. Song (2003) has given a flavor of how important the authorities considered exports:

The basic philosophy of President Park Chung Hee was "exports first" or "mission building through export promotion." In President Park's eyes, setting highly ambitious export targets and then exceeding those targets was regarded as the height of achievement for businessmen and public officials in charge of export promotion. Under President Park's government, larger Korean firms were assigned annual "Export Targets" by officials in the Ministry of Trade and Industry which maintained an "export situation room" to supervise export behavior of various firms. The export targets were seen by firms as virtual "orders" or signed "missions." If they succeeded in fulfilling their export goals, there [were] ordained numerous benefits reserved for exporters, including preferential credit and loans, administrative support, and tax and other benefits. Thus, Korean exporters saw the over-fulfillment of their "export targets" – usually determined jointly with the government – as the keystone of their business strategy (p. 97).

Starting in December 1962, the president instituted a monthly export-promotion conference that he attended along with his chief economic secretary, the minister of planning, the minister of trade and industry, the director of the Korea Trade Promotion Corporation, and the chairman of the Korea Traders Association. The president himself checked the progress of exports and the performance of

exporting firms. The meetings served as a forum for revising and extending administrative support to exporters and also as a medium for exchanging information among policymakers, businesspersons, and economic experts.

The Korean government also used the stick in addition to the carrot. The former included withdrawal of financial support and legal punishment to enforce policies. Firms that consistently failed to meet their export targets would be threatened with tax investigations, restricted access to bank credit, and other punitive sanctions—measures that could lead to bankruptcy. Firms that met their export targets, however, were favored with even further support. Some writers on the Korean economy go so far as to say that, under the Chung Hee Park government, the primacy of expanding exports was so great that Korean businesspersons were expected to maximize exports rather than profits (Song, 2003, p. 129).

An important technical factor in Korea's export drive was the establishment of an overall incentive regime that did not penalize exports and, for manufactures, was modestly pro-export. As discussed earlier, this largely involved maintaining a competitive exchange rate, together with the ability of exporters to obtain their necessary imports essentially tariff-free. The latter is extremely important if a country's exports are based largely on imports.

The East Asian countries used the following methods to ensure that their businesses were not disadvantaged because of the high import component in their exports.

One method, used especially by Korea, was to create an institutional structure that swiftly rebated taxes paid on the imported component of exports—this involved regularly monitoring the performance of the administration of these rebates, and frequently revising the tables of coefficients of the import component of exports. Taiwan followed a more mixed route—it set up a number of export processing zones in which imports were allowed duty-free, thereby avoiding the administrative delays in first collecting and then returning the duties. It also provided a wide range of fiscal incentives such as (i) a five-year income tax holiday; (ii) tax deductions for exports (within

certain limits, businesses could deduct 2 percent of annual export proceeds from taxable income); and (iii) tax exemptions for undistributed profit (under this provision, the amount reinvested for productive purposes was deductible from taxable income, the idea being to maintain a high rate of investment and thereby keep upgrading technology in the exporting industries). The total cost of the tax reductions and rebates was significant—for example, from 1965 to 1980, rebates of these taxes and customs duties on exports amounted to 15–30 percent of total tax revenues (Kuo, 1999, pp. 60–61, Table 3.7.1).

Other subsidies were also significant in making exporting relatively more attractive for Korean firms than producing for the domestic market. The most important of these was that exporters were provided access to bank credit and did not have to borrow at the usurious curb market rates; we have already seen that the latter were generally three times the rate charged by banks. Moreover, as Rhee et al. (1984) have stressed, the authorities took pains to create an institutional structure that would ensure that the incentives legislated were, as far as possible, automatically and immediately made available to the exporter—an important lesson is that, in a private sector economy, “an incentive delayed is an incentive denied” (pp. 11–14).

The role of functional incentives has been less intensively documented, but in order to facilitate the export drive, the effects of overcoming market imperfections and infrastructure deficiencies could only have been helpful. The verdict on selective interventions is largely negative, especially in the period of the HCI drive (1973–79). The reason appears to be that, while governments might have an advantage in gathering information needed for long-term decisions in the earlier phases of industrialization, at later stages, entrepreneurs and markets become keenly concerned with dynamic factors and are more likely to show flexibility in moving into profitable markets and out of losing ventures than do governments (World Bank, 1987a, Volume 1, p. 102, Volume 2, pp. 85–92; see also the case studies on pp. 131–214). During the HCI drive, the Korean government continued to support its chosen industries even when the costs—both the direct financial costs and the opportunity costs in terms of what the country was losing by depriving the more efficient smaller industries of bank credit and other resources—had become clear.

However, for most of the period since the early 1960s, the Korean government used international prices and export sales (i.e., competitiveness in the international market) as a set of performance indicators. In Korea's experience, the most efficient results with industrial and trade policy were obtained when the authorities provided, on average, almost equal incentives for domestic sale and for export, and within manufacturing did not markedly discriminate between different items of export. This "level playing field" left it to the market to channel factors of production into areas of Korea's greatest comparative advantage. The market responded to the outward-looking strategy by channeling resources into labor-intensive activities which, as we have seen, rapidly increased exports and employment, and improved the income distribution.<sup>9</sup> This factor, namely, that government interventions generally worked to strengthen the allocative actions of the market—and thus remained pro-efficiency—distinguishes East Asian policy actions from those of eastern Europe, and is perhaps one of the most useful lessons for Pakistan.

### **2.4.3 *Pakistan's Experience with Export Policies***

Pakistan's experience with export incentives has been very mixed. For long periods, the country maintained an overvalued exchange rate, which of course encouraged imports rather than exports. In 1959, Pakistan introduced its first major measure explicitly designed to boost exports—the Export Bonus Scheme. This scheme provided exporters with a voucher that allowed them to purchase foreign exchange equivalent to a percentage of their export earnings; the percentage varied with the commodity exported. These vouchers could be sold on the stock exchange to importers and, in view of the extreme foreign exchange shortage, they commanded a premium. The importers could use the foreign exchange bought with these vouchers

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<sup>9</sup> A detailed study by Westphal and Kim (1982) concluded that, over the 1960s, "manufactured exports were more labor-intensive than manufactured imports, and they became increasingly more labor-intensive over time even as shifts in the composition of output caused manufacturing production for the domestic market to become somewhat more capital-intensive. The aggregate labor-capital ratio in the manufacturing sector actually increased between 1960 and 1973; at the same time, total factor productivity about doubled" (p. 271).



to purchase imports from a list of eligible items; many of these were high-value consumption articles. The effect of this scheme was to create a system of multiple effective exchange rates that depended on the percentage of exports allowed as the bonus and the premium that the voucher commanded on the stock exchange. The philosophy behind the Export Bonus Scheme was that consumers of luxury imports should effectively subsidize the country's exports.

However, the effects of the actual workings of the scheme diverged from this aim, and it failed to boost exports across the board. For most of its life, the scheme did not cover exports of primary commodities (thereby denying the incentive of a more realistic effective exchange rate); there were frequent changes in the eligibility of other items for export bonus (for example, cotton yarn was originally included in the scheme, later excluded, subsequently again included, and then excluded again from September 1965 onward); and there were also changes to the percentage of exports permitted as a bonus. The frequent changes in coverage and bonus rate increased uncertainty among exporters as to the effective exchange rate that would apply to them—in three shipping periods, i.e., July–December 1964, July–December 1966, and January–June 1968, eight bonus rates were applicable at the same time, giving eight different effective export exchange rates, while six or seven rates were common in other shipping periods (Ikram, 1971, p. 68; Islam, 1981, pp. 76–111). The possibility of frequent changes also led exporters to lobby for higher bonus rates for their own export items. The files of the Ministry of Commerce of that period are replete with telegrams and letters from numerous exporters' associations urging that their particular product be shifted to a higher bonus bracket (see, for example, annexes to Government of Pakistan, 1970).

As mentioned earlier, the Export Bonus Scheme served as an incentive to the export of manufactured items alone. A number of other concessions and incentives (such as the Export Performance Licensing Scheme) were also provided to manufactured exports, but without taking into account the effect of the totality of these measures. The result was that, in a number of cases, the social and private profitabilities of exported items diverged. The plethora of incentive schemes made it financially profitable for an exporter to

export a good even if, measured at international prices, the country suffered an economic loss; of Pakistan's major exports at the time, sacking, hessian, cotton yarn and (marginally) cloth all showed higher private profitabilities than social (Ikram, 1973).

## **2.5 Financial System and Monetary Policy**

In the period under study (the early 1960s to mid-1990s), the East Asian economies were more successful than Pakistan in harnessing their financial systems to support GDP and export growth.

### **2.5.1 Pakistan's Experience**

Direct public involvement in productive activities in Pakistan went well beyond that in the fast-growing Asian economies, and the borrowing required to finance this public sector activity crowded out the private sector. Through most of the period 1960–90, the share of public investment in total domestic fixed capital formation in Korea did not exceed 25 percent, while in Hong Kong it did not exceed 20 percent; in Pakistan it generally remained between 60 and 70 percent (Mukerjee, 1986, p. 14, Table 2).

Much of the public sector activity in Pakistan was financed by borrowing—budget deficits generally ran at between 4 and 8 percent of GDP for much of the period. As a result, government debt, particularly domestic debt, rose sharply. Total debt rose from 55 percent of GDP in 1980/81 to 78 percent in 1986/87, while domestic debt climbed from 20 percent of GDP in 1980/81 to about 37 percent in 1986/87. A concomitant of this increasing public indebtedness was the continuing rise in interest payments, which jumped from 15 percent of the budget's recurrent expenditures in 1980/81 to 21 percent in 1986/87 (World Bank, 1987b, Volume 1, pp. 2–3). Thus, the excessive expansion of the public sector without a commensurate increase in resource mobilization led the government into a situation in which it lacked any significant room for budgetary maneuver: the relatively fixed big-ticket items of expenditure (defense and civil administration) were joined by a large and increasing contractual item (interest payments), and the three virtually preempted the available resource, leaving only a pittance to finance the development program.

The public sector's increased credit requirements also "crowded out" the private sector. The government can invariably outbid the private sector in vying for credit because it is always able to pay a higher interest rate—it can always print the money. This can lead to a less-than-optimal use of resources, because the government is not necessarily the most efficient agent. This phenomenon of crowding out seems to have increased in the 1980s. A World Bank (1987b) study of Pakistan's financial sector found that private borrowers with collateral of 150–200 percent of their loans and sound guarantees (e.g., real estate) were able to borrow, but the more dynamic small and medium-size new entrepreneurs were being crowded out because of the risk-averse behavior of banks and preemption of credit by government and public enterprises (Volume 1, p. 4). The flows of credit to the larger enterprises also meant that more capital-intensive methods of production were being encouraged—between 1969 and 1981, the large-/medium-scale manufacturing sector—the main beneficiary of the credit allocations—had an incremental capital output ratio of 4.3, compared with 1.3 for the small industries sector (Volume 1, p. 4).

During the 1970s, construction and manufacturing in Korea received a larger-than-proportionate share of loans (than if the criterion had been fixed capital to output ratio); mining, electricity, and water and sanitation were moderately favored; transport, storage, and communication were least favored. Ranked in terms of capital/output ratios, construction was the lowest, followed by manufacturing (Cole & Park, 1983, pp. 182–184, Table 38). Moreover, both construction and manufacturing were privately owned and enormous earners of foreign exchange. Thus, credit allocation in Korea did not preempt the private sector, and was more in line with the country's comparative advantage.

In Pakistan, during the decades under study, the financial sector presented a major weakness: it could neither effectively mobilize savings nor efficiently allocate resources. Indeed, a very comprehensive World Bank (1987b) report on Pakistan's financial sector concluded bluntly that "it does not seem very likely that the present financial system can adequately support the formidable challenges needed of it" (Volume 1, p. 6).

The sector's chief structural weaknesses were identified as follows (World Bank, 1987b, Volume 1, pp. 3–6):

- (i) Segmented financial markets, with credit going chiefly to large-scale enterprises (with high incremental capital output ratios, as noted above).
- (ii) A lack of transparency regarding who pays and who benefits from the regulated flows of credit.
- (iii) The “crowding out” of the private sector (discussed above).
- (iv) Uncompetitive credit markets dominated by government-owned institutions without managerial autonomy, and with a declining quality of lending (25–30 percent of loans considered nonperforming).
- (v) A very high concentration of lending in very few accounts—in 1987, a mere 0.2 percent of the number of loans accounted for 50 percent of loan amounts. Government reports on the credit situation show that this depressing picture had not changed materially over the last three decades: in 1959, the Credit Enquiry Commission reported that, on 31 March, only 0.5 percent of the number of accounts had been given 62.7 percent of commercial banks' advances (Government of Pakistan, 1959a, p. 96, Table 14). Three years later, the Credit Committee lamented that, on 31 March 1962, only 0.41 percent of the number of accounts had taken up 56.6 percent of the amounts advanced by commercial banks (Government of Pakistan, 1962, p. 12, Table 3). Moreover, the number of persons receiving these advances could very well have been smaller than the number of accounts, because of the possibility of a single individual holding multiple accounts. Thus, *plus ça change, plus c'est la même chose* (the more things change, the more they remain the same).

For most of the period from the 1960s to the 1990s, Pakistan's financial intermediaries appeared unable to effectively perform their role of equalizing the marginal costs of and returns to capital employed in different activities with similar risks. However, in the next decade, the banking sector underwent a considerable measure of reform along the lines recommended earlier, and its contribution to GDP growth markedly improved.

### **2.5.2 Taiwan's Experience**

Insofar as reform of the financial sector was concerned up to the 1990s, Pakistan had perhaps more to learn from the experience of Taiwan than from that of Korea. These two countries followed completely different monetary policies because of radically different industrial and financial structures. The industrial structure in Taiwan was dominated by small firms: in the mid-1970s, the average Taiwanese firm in manufacturing was less than half the size (in terms of employees) of the average Korean enterprise (Scitovsky, 1986, p. 146); even by 1981, about four fifths were estimated to have fewer than 20 employees ("Taiwan and Korea," 1990, p. 20). Moreover, these firms were far less leveraged than their Korean counterparts. Korea, on the other hand, was dominated by the huge conglomerates known as *chaebols*. In 1984, the sales of the top ten *chaebols* equaled two thirds of the country's GNP (Amsden, 1989, p. 116, Table 5.1), and the sales of the top four alone equaled nearly half the GNP in 1989 ("Taiwan and Korea," 1990, p. 20). Moreover, as pointed out above, these firms were highly leveraged. Hence, increases in interest rates would have a much greater impact on Korean firms than on the Taiwanese.

Taiwan's policy was to let interest rates rise to market levels. As early as 1950, the Bank of Taiwan introduced a special system of savings deposits (the Preferential Interest Rate Deposits), which offered the depositor a nominal rate of 7 percent a month, i.e., 125 percent a year (Tsiang, 1986, p. 11). While interest rates did, of course, move up and down during 1960-90, they generally remained positive in real terms by a substantial margin. This policy had three main effects: (i) it led to a rapid increase in household and aggregate savings (the ratio of savings to GDP increased from 5.2 percent in 1952 to 13.2 percent in 1963, and from the 1980s remained in the range of 33-35 percent); (ii) it contributed significantly to slowing down inflation; and (iii) it encouraged labor-intensive production by making capital expensive (the unemployment rate in Taiwan for most of the period since about 1965 was less than 2 percent of the labor force).

### **2.5.3 Korea's Experience**

Except during 1965-72, Korea kept interest rates low through government fiat. The demand for credit at the officially mandated

interest rates therefore exceeded the supply by a considerable margin, the available bank credit had to be rationed, and a substantial “curb market” for credit developed. The artificial suppression of interest rates gave rise to unregulated financial markets, colloquially known as the “curb market,” which provided credit (according to some estimates) of perhaps 40 percent of the banking sector’s outstanding domestic credit. Interest rates in the curb market were generally two to three times those charged by the commercial banks. During the 1960s and 1970s, interest rates in the informal market were estimated to hover between 35 to over 60 percent per annum (compared with a rate on bank loans of 15–25 percent). For the period 1950–94 as a whole, the rate in the curb market averaged 40.8 percent per annum, compared with 13.7 percent on government-sanctioned loans from banks (see Chung, 2007, pp. 166–167, Table 5.12; Cole & Park, 1983, pp. 110–133, Table 30). Access to commercial bank loans (which, for much of the period, were government-owned) thus provided a substantial subsidy.

The government used the allocation of credit as a tool to encourage compliance with the regime’s objectives. This not only gave the authorities more scope for “arm twisting,” but also increased the possibilities of misdirecting credit flows. This in fact occurred during the “heavy and chemical industry” period (1973–79), when the government encouraged the setting up of these industries, regardless of efficiency considerations, and the banking system was compelled to provide the financing. This policy was responsible for the proliferation of nonperforming loans in the portfolios of the commercial banks, requiring special government concessions to deal with the problem.

## **2.6 External Assistance**

An allied lesson that Pakistan could learn from the East Asian experience of mobilizing domestic savings and boosting exports relates to a country’s dependence on foreign aid. Korea and Taiwan were major recipients of external assistance (especially from the US) at the start of their development drive. However, from an early period, these countries planned to reduce their dependence on concessionary foreign savings and succeeded in doing so.

### **2.6.1 Korea's Experience**

As bilateral aid from the US to Korea was phased down (and virtually eliminated by 1974), the World Bank set up a consultative group to mobilize and coordinate assistance from other donors; the group's first meeting was held in 1966. Korea received its first credit from the International Development Association (IDA)—the World Bank's concessional lending affiliate—in 1962. By 1973 (i.e., after only 11 years), the country had graduated from the IDA.

After only 13 meetings, the consultative group for Korea was terminated in 1984 because, as the official communiqué put it, "its role as a forum for aid coordination and enhanced mobilization of external capital for (South) Korea's development is now being fulfilled by the (South) Korean Government" (quoted in Ensor, 1984, p. 99).

### **2.6.2 Taiwan's Experience**

Foreign aid in Taiwan followed a largely similar pattern: it received substantial US assistance in the early 1950s, which was consciously phased out in the 1960s and ended in 1965. A Taiwanese policymaker and analyst commented:

The lesson that can be learned from Taiwan is that—with the exception of an emergency, such as a destructive earthquake, flood, or drought—foreign aid in the sense of an open-ended, long-range commitment of resource transfer is not needed after a time. Such commitments violate the sound principle of self-help, which is, after all, a cardinal moral principle of the market-oriented economy. Moreover, the habit of dependence on hand-outs from foreigners violates the principle of self-respect just as much as the habitual dependence of manufacturers on protected markets and government subsidies (Li, 1995, p. 231).

### **2.6.3 Pakistan's Experience**

Pakistan has not learnt the foregoing lesson. The first meeting of the Pakistan Consortium, as the aid donors group was termed, was

held in Washington as long ago as 1960. The group has continued to meet on average yearly since then, recently rebranding itself as the “Pakistan Development Forum.” Indeed, far from phasing out the Consortium, a further donors’ group—labeled the “Friends of Pakistan”—was set up in 2008. As far as the terms of aid are concerned, Pakistan continues to receive IDA funds, nearly 50 years after it first became eligible for them. It is clear that Pakistan’s policymakers have not taken the idea of self-reliance seriously, even though it was identified as one of the country’s main aims as far back as the Fourth Five-Year Plan (1970–75).

Perhaps this should not surprise anyone. There has frequently been a disjunction between the professed aims of the government’s strategy and its actual intent.<sup>10</sup> Thus, while the East Asian economies viewed foreign aid as a necessary but temporary prop, the authorities in Pakistan did not necessarily see it in the same light. To dispense with foreign assistance, a country has to do something to replace those resources—it must mobilize additional domestic savings, generally by raising revenues, and it must acquire more foreign exchange by increasing its exports. Pakistan has been loath to do the former, in large part because this would require taxing the income from sectors such as agriculture from which most of its ruling class has sprung. Similarly, sustaining an export drive would require a substantial change in the incentive system, which would change the distribution of rewards away from the existing “winners” (the importers). For most of Pakistan’s history, foreign exchange for imports had been tightly licensed—the winners, almost by definition, were those who had the political connections to obtain these licenses, and would thus not easily be displaced. Under such a system of economic governance, foreign aid became a necessity if the country were to attain a level of investment and imports that would sustain a respectable GDP growth rate.

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<sup>10</sup> The difference between the stated aims of the governments of united (pre-1971) Pakistan—to eliminate disparities in per capita incomes between East and West Pakistan—and their actions, as measured by resource allocations, offers another key example of this gap.



In fact, a prominent deputy chairman of the Planning Commission (i.e., the minister of planning) wrote that “the original ‘strategy’ was to use plans to obtain aid. The plans were the instrument by which persuasion was applied; they showed preparedness and resolve [to donors]. . . . Through all the years of planning the measure of the success of a plan has been the amount of aid which it drew” (S. Hasan, 1971, p. 37). In later periods, the rhetoric of self-reliance became more strident and a 20-year Perspective Plan was even prepared (as part of the Third Five-Year Plan, 1965–70) that projected phasing out foreign aid by 1985. However, since this Plan and its subsequent incarnations did not detail policies to mobilize additional domestic savings or raise exports to the required levels, one is entitled to a certain skepticism regarding the authorities’ commitment to the purported aim. Governments in Pakistan have never seriously contemplated reducing the country’s dependence on foreign aid.

### **3 Poverty and Income Distribution**

It is impossible to uniquely define what constitutes poverty because this condition has many facets. Poverty can be related to income level, with the poor being defined as those who live below a designated threshold of income—generally called a “poverty line.” Poverty lines can be absolute, relative, or subjective. For this paper, I have concentrated on the absolute poverty line because it is the most widely used and because data for this measure is available for Pakistan.

Absolute poverty lines are anchored in a cost-of-basic-needs concept. The usual approach is to define an absolute food poverty line in terms of the estimated cost of a food bundle that (i) provides a stipulated energy intake deemed essential or minimum by the standards of a given society, and (ii) is based on the consumption patterns of lower expenditure groups in that society. The food poverty line is then augmented by an allowance for nonfood consumption (see Fields, 2003, pp. 73–94).

Both the Korean and Taiwanese governments intervened to eliminate poverty and influence the distribution of income and wealth. They succeeded dramatically on both counts—absolute poverty was reduced to less than 10 percent of the population by 1980, while in terms of distributive equity (measured by Gini coefficients) both Korea and Taiwan rank at the very top of developing countries. Both were remarkable in successfully pursuing rapid GDP growth while improving the distribution of income and wealth.

#### **3.1 Poverty Reduction and Income Distribution in Korea and Taiwan**

The Korean government had always to be sensitive to distributional questions. The existence of a communist state in the northern part of the peninsula meant that South Korea’s citizens could always compare the degree of equity in their country with that in North Korea. A too-wide discrepancy in favor of the north might tempt some in the south to believe that communism was a superior system. Hence, it would have been politically imprudent to let the distribution

of income and wealth in the south become too unequal. Similarly, the Taiwanese authorities had to ensure that income distribution in their country remained more equitable than that in mainland China lest the lure of the communist system prove too strong.

Four factors explain the impressive results in Korea's and Taiwan's income distribution: (i) the redistribution of assets after the Japanese withdrawal (see, for example, the earlier discussion of the Korean land reforms); (ii) an outward oriented development strategy that, for the most part, emphasized the countries' comparative advantage in labor-intensive activities (and thus contributed to employment); (iii) a very strong emphasis on education, so that higher productivity (and higher paying) jobs became available to an increasing number of people; and (iv) an industrial strategy that provided incentives to invest in manufacturing and accelerated the sector's growth, so that jobs were rapidly created for the labor drawn away from agriculture.

Korean analysts generally agree on the following: (i) there were striking reductions in absolute poverty after 1965;<sup>11</sup> (ii) relative poverty declined until about 1970, then increased slightly, and then improved after 1979;<sup>12</sup> (iii) income inequalities were greater among nonfarm households than among farm households, i.e., by 1990, equity in Korea was essentially an urban problem (see especially Yoo, 1990, pp. 376–381).

Between 1965 and 1980, the number of households living in absolute poverty dropped from 41 percent of the population to 10 percent. All parts of the population gained—absolutely poor rural households fell from 36 to 9 percent, urban households from 55 to 10 percent. More aggregative measures, such as the Gini coefficient, show an improvement until about 1970 and a slight deterioration (still excellent results compared to other countries) thereafter; for most of the period the coefficient remained around 0.35 (Suh, 1985, pp. 8–14; see also Choo, 1980, pp. 277–335; Suh, 1980, pp. 336–372). The

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<sup>11</sup> The absolute poverty line was defined as KRW121,000 in 1981 prices per month for a five-member household.

<sup>12</sup> The relative poverty line is defined as one third of the average household income in a given year.

movements in the Gini coefficient for Taiwan are broadly similar, with the coefficient varying between 0.28 and 0.32 for most of the period from 1965 to 2000 (Yu, 1999, p. 145, Table 6.2).

The poverty ratio (the proportion of the population living below the poverty line) in Korea fell from 21.5 percent in 1975 to 9.4 percent in 2000, and to an estimated 8.8 percent in 2004. The course of poverty in Pakistan has been more variable. It was estimated that 17.3 percent of the population fell below the poverty line in 1988; this almost doubled in 2002 to 34.5 percent before falling sharply to 22.3 percent in 2006 (Government of Pakistan, 2009; World Bank, 2002).

A major achievement of Korea and Taiwan – and one that has especial relevance for Pakistan – was the reduction in poverty and improvement in equity in rural areas. It is worth looking at the most important weapon they used – land reform (see Section 3.2).

### **3.2 Land Reforms and Distributive Equity**

This section looks at how successfully Korea, Taiwan, and Pakistan were able to implement land reforms in the attempt to improve income distribution, especially in rural areas.

#### **3.2.1 Land Reforms in Korea**

Studies in several countries have shown that a major cause of income inequalities in rural areas is the distribution of ownership of rural assets, principally agricultural land. Korea was able to undertake thoroughgoing land redistribution between 1945 and 1950 for rather special reasons. During their occupation of Korea (1910–45), the Japanese authorities confiscated much of the country's arable land; by the end of this period, they held about 40 percent of Korea's agricultural land. With the defeat of Japan in World War II and the end of the occupation, this land became available for redistribution. Moreover, "Korean landlords ... also carried the taint of collaboration with the Japanese, at least in the eyes of most of their countrymen, and these landlords, as a result, were not in a politically strong position" (Mason, 1980, p. 237). Thus, there was little need to redistribute the formerly Japanese-held land among existing Korean landowners.

As importantly, the government was able to put through land reforms in 1949 that limited holdings to approximately 3 ha, with minimal compensation (effectively equal to only 1.5 times the average annual product of the land) being paid to the original owners. While these limits were probably evaded to some extent by illegally registering land under the names of different family members, the reforms were an overwhelming success. Tenancy, which had been 48.9 percent in 1945, fell to 5.2 percent in 1964, while ownership jumped from 13.8 percent to 71.6 percent between the two years (Ban, Moon, & Perkins, 1980, pp. 283–287, Table 120). Steinberg (1982) has noted that, “if income is more equally distributed today in Korea than in many developing societies, the primary reason is to be found in these land reforms” (p. 15).

### **3.2.2 Land Reforms in Taiwan**

Land reforms in Taiwan had a similar effect. Prior to the land reforms, tenant farmers comprised about 70 percent of the total farming population, and their rent payments varied between 50 and 70 percent of the annual crop. No allowance was made for crop failures and the rent was usually collected before the harvest, thereby increasing its real burden. If one considers that about 60 percent of the total labor force was employed in agriculture, it is clear that the distribution of income and wealth was very unequal.

The first agrarian reforms were introduced in 1949 and set a ceiling on land rent of no more than 37.5 percent of the annual crop. The reforms also provided more security for tenants—tenancy could no longer be terminated at the landlord’s will, tenants were granted written leases for a minimum of six years, and a lease had to be renewed if the tenant had not violated it (Li, 1995, pp. 67–70).

A second set of agrarian reforms was introduced in 1951. Under these measures, land confiscated from the Japanese was sold to tenant farmers. A third wave of agrarian reforms followed in 1953, in which holdings in excess of 7.5 acres were confiscated from landlords and sold to tenant farmers. The sale price was fixed at 250 percent of the value of the annual main crop, amortized over 10 years, with payment in either rice or cash (depending on the crop produced). Landowners received compensation in the form of land bonds (70

percent) and shares in public enterprises (30 percent). By the time the three waves of agrarian reforms had been completed, farm tenancy had halved. Li (1990, p. 70) estimated that the wealth transferred by land reform was the equivalent of 13 percent of Taiwan's 1952 GNP.

The successive waves of Taiwan's agrarian reforms followed each other quickly. A major reason for the speedy decisions was that the central government and most key positions in the provincial governments were held by officials from mainland China, who did not have a stake in land ownership in Taiwan.

### **3.2.3 Land Reforms in Pakistan**

To lay out the foregoing stories is to underscore the difficulty of replicating them in Pakistan, where agricultural land was not owned by a departing colonial ruler, and where the power structure is heavily dominated by the landowning class. Consequently, successive governments in Pakistan have not felt an irresistible compulsion to translate their egalitarian pronouncements into practice. Apart from the derisory effect of the land reforms that were undertaken, the government has consistently tiptoed around other methods of securing equity, for example, such as implementing a fair tax on agricultural incomes (see, for example, Government of Pakistan, 1964, 1967). Thus, while greater equity in rural income distribution might remain a professed goal, the government will have to look for a different set of tools with which to accomplish its aims.

Pakistan has enacted land reforms on three occasions: in 1959, 1972, and 1977. Each set of reforms was intended to lower the ceiling on ownership. The 1959 reforms imposed a ceiling of 500 acres of irrigated or 1,000 acres of unirrigated land, or 36,000 product index units, whichever was more. In addition, it permitted the landowner to retain up to 150 acres of orchards, made further allowances for stud and livestock farms, and also permitted, under some conditions, the transfer of certain amounts of land to the owner's heirs. The reforms of 1972 reduced the ceiling to 150 acres of irrigated or 12,000 product index units, and abrogated virtually all the exemptions granted under the 1959 reforms. The 1977 reforms continued to lower the ceiling to 100 irrigated or 200 unirrigated acres, or 8,000 product index units.

Although a detailed study of the economic effects of land reforms is not possible here (for a useful interim evaluation, see Ahmed & Amjad, 1984, pp. 124-129), certain aspects of the impact are striking. For example, the total amount of land reformed in Korea by 1952 (the land reform law was passed in 1949) amounted to about 3.6 million acres (Ban et al., 1980, p. 286, Table 119) out of about 5.7 million acres of cultivable land. The three sets of Pakistani reforms, on the other hand, had accounted for a total of 4 million acres out of 49 million cultivated acres by 1980 (Ahmed & Amjad, 1984, pp. 124-125, Tables 9.1-9.2). The Korean reforms also touched a much larger segment of the agricultural population—by 1964, the number of tenants had fallen to 5 percent of total farm households, from 49 percent in 1945 (Ban et al., 1980, Table 120). The Taiwanese reforms had a similar significant effect, reducing the tenancy rate from about 65 percent of farm households in 1945 to 18 percent in 1953. In Pakistan, the number of tenant farms declined only from 42 to 34 percent between 1960 and 1972 (Ahmed & Amjad, 1984, p. 127).

The Pakistani reforms were, moreover, riddled with exemptions and loopholes, so that only about 10 percent of landlords with holdings over 150 acres were actually affected, and the area resumed was only about 30 percent of the reported area (the real area was likely to be very different) owned by persons with holdings of over 150 acres. This was less than 1 percent of the total area in the Punjab and less than 3 percent of that in Sindh (Nabi, Hamid, & Zahid, 1986, p. 59). The concentration of ownership was barely affected. Additionally, the reforms were implemented very slowly—compare the results after three years (1949-1952) in Korea or four years in Taiwan (1949-1953) with those after 20 years (1959-1980) in Pakistan (see Ahmed & Amjad, 1984; M. H. Khan, 1981, pp. 71-72). On several counts, therefore, one may conclude that the East Asian reforms were much more serious than the three combined reforms in Pakistan, both in terms of transferring land ownership to the cultivator and in diluting the power of established landowners.

### **3.3 A Cautionary Note on the Concentration of Economic Power**

#### **3.3.1 Korea's Experience**

Despite the success of the Korean measures discussed so far, one must also be alive to the dangers of copying everything it did. An important Korean practice of which to be wary is the government's encouragement to concentrate economic power. Korea now has one of the most concentrated economies in the world. The share of the top 10 *chaebols* in GDP increased from 5 percent in 1973 to 11 percent in 1978; in the latter year, the share of the largest 46 groups was over 17 percent of GDP. The share of the top 30 groups in shipments, which Amsden (1989) has defined as a "close approximation of value-added," was nearly 41 percent in 1982 (p. 122). The concentration in particular sectors could, of course, be much larger: for example, the *chaebol* share in manufacturing value-added in 1978 was 43 percent (Jones, 1987, pp. 98-101). A study of 2,260 commodities showed that, in 1982, only 18 percent of them were produced under competitive conditions (where the combined share of the top three producers was less than 60 percent of the market). Moreover, in 1981, the average share of the top three producers in Korean manufacturing industries was 62 percent (higher than in Japan) (Amsden, 1989, pp. 120-121). Through its ownership of banks and consequent ability to ration credit, the government was able to control the actions of the *chaebols*. However, with the political freeing up of Korea, the growth of the financial sector, and the increasing availability of alternative financing sources, this degree of economic power is increasingly being translated into political muscle.

#### **3.3.2 Pakistan's Experience**

It is, unfortunately, not possible to provide a direct comparison with the situation in Pakistan, because the studies that I am aware of are either not directly comparable in terms of concepts (they are concerned with the share of business groups in manufacturing assets rather than in manufacturing value-added, and the data refers to enterprises of different sizes than in Korea) or coverage (they refer to the pre-1971 Pakistan) (see Ahmed & Amjad, 1984, pp. 216-218; Papanek, 1967, p. 68; White, 1974, p. 64). They all,



however, point to a very high degree of concentration. Jones (1987), after making some rough and ready adjustments, concludes (very gingerly) that “the top 43 groups in Korea would have sixty-three percent of the assets of manufacturing firms employing more than twenty workers, versus only forty-two percent in Pakistan” (p. 100). Further concentrating economic power in the manufacturing sector might simply mean that Pakistan had traded the influence of agricultural barons for that of industrial barons.

## 4 Economic Governance

The findings on economic growth, investment, savings, poverty reduction, and so forth represent only the end results of deliberate policy actions. A common factor in the experience of the fast-growing East Asian economies—and one that makes their achievements even more impressive—is their dearth of natural resources. Only 16 percent of Korea’s total land area is arable, compared with 28 percent in Pakistan. The East Asian economies also suffer from very high population densities: in 2007, the population density in Taiwan was 1,840 per square mile, that in Korea 1,276, while that in Pakistan was 575; Pakistan, therefore, has to contend with far less pressure on the land. Moreover, the East Asian economies possess very little in the way of minerals that might compensate for the scarcity of arable land.<sup>13</sup> Under these constraints, sustained economic growth must be largely policy-based. The crucial questions for policy, in this context, relate to the roles of the government and the market in the economic development of the East Asian economies compared with Pakistan.

### 4.1 The Role of the State

The state’s role in economic development has never been far from discussions of economic strategy. How far, and in what areas, should the state intervene directly, and to what extent should the questions of what to produce and how to allocate the items produced be left to private markets? For many economists, the fall of communism in eastern Europe appeared to provide a clear-cut answer—economies developed most quickly when their functioning was left to market forces. However, these questions have resurfaced with a vengeance, triggered by the financial crisis of 2008 in which several of the biggest financial houses and major industries of the US and Europe ran to their governments, pleading to be rescued from the consequences of their own improvidence.

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<sup>13</sup> Contrast this with the abundant deposits of coal, natural gas, marble, and gemstones in Pakistan.

Keynes (1972) would assign the state a nuanced role:

The most important Agenda of the State relate not to those activities which private individuals are already fulfilling, but to those functions which fall outside the sphere of the individual, to those decisions which are made by no one if the State does not make them. The important thing for Government is not to do things which individuals are already doing, and to do it a little better or a little worse, but to do those things which at present are not being done at all (p. 291).

Economic theory provides some guidance, but rather more on the nature of activities that the state could concentrate on than to what extent it should pursue these activities (the classic statement is that of Baumol, 1965). According to economic theory, there are two closely connected justifications for state intervention in the production and distribution of goods and services: (i) the existence of "pure" public goods, and (ii) the existence of externalities in the production/consumption of certain items. A public good is one whose consumption is nonexclusive: when A has it, so does B. National defense, the police force, and the judicial system are classic examples of public goods, in that, if these items exist, they protect not only individual A but also every other resident of the country. The point is that the benefits from public goods are indivisibly spread among the entire community; therefore, these goods and services cannot be commercially marketed.

An externality arises if there are substantial benefits (or detriments) to society other than those received directly by the consumer, and are not reflected by market prices. Thus, the market will not give out the proper signals, and the production/consumption of the item in question will not proceed to the optimal point. A frequently quoted example of a beneficial externality is primary education. There is substantial evidence that universal primary education provides general benefits to society, such as a reduction in population or in the crime rate (see Cohn, 1979, p. 53, for a summary of the findings of some of these studies), but if this education were to be provided exclusively through the private sector (and hence only to

those who could afford to pay for it), it would stop short of the socially optimal level.

Government actions in the real world do not, of course, conform to this pristine view of things. All governments intervene in numerous economic decisions and they intervene for myriad reasons, many of which—such as to protect the interests of a particular group or region—have nothing to do with economic efficiency. However, even disregarding such intentions, most governments intervene in economic decisions because they are suspicious of the efficacy or timeliness of the “invisible hand.” As Jones and SaKong (1980) have commented, “market failures being ubiquitous in the real world, a rigorous presentation of the beauties of the invisible hand ultimately provides a brief for the visible” (p. 8).

The questions for a policymaker in the real world therefore become: what does “good” (i.e., successful) practice tell us about the nature of government intervention, and to what extent can Pakistan adopt these modalities and policies?

The East Asian economies’ dramatic success has, for many observers in Pakistan, pointed to a possible third route. The lesson that seems to emerge is that the command economy, with its micro-management of all production and allocation decisions, has failed disastrously and been abandoned even by most countries that profess a communist ideology. In view of all the institutional constraints and market imperfections that exist in any economy, and particularly in a developing economy, reliance on untrammled market forces is hardly a realistic option for Pakistan. This lesson is further underscored by the recent collapse of the developed world’s financial and housing markets, and even its industrial structures. Given the striking success of the East Asian economies, whose experience combined a strong dose of state direction with an unremitting pressure for market efficiency, the question raised is to what extent their modalities and behavior could serve as a paradigm for Pakistan.

This study concludes that state intervention in the East Asian economies succeeded because, for the most part, it concentrated on creating positive externalities (such as expanding primary education) or encouraging an environment in which market signals could play the

chief role in allocating resources (primarily by adopting an outward-looking development strategy, in which export sales and the ability to produce at international prices became the main performance indicators). At the same time, the state strictly held the private sector accountable for living up to the targets that were considered socially crucial. These targets were few and carefully selected, generally relating to export performance and the modernization of technology, but were rigorously enforced through a combination of incentives and punishments.

This paper also argues that, while Pakistan can learn many practical lessons from the East Asian experience, it cannot and should not blindly follow everything these economies did (see, for example, Section 3.3). There are important differences between the institutional and political setups in Pakistan and those in the East Asian economies, as well as in the international environment. It will, therefore, be necessary for Pakistan to develop or strengthen the required attributes before it can successfully emulate the East Asian strategies.

## **4.2 Government Intervention in East Asia and Lessons for Pakistan**

The East Asian “tiger” economies, particularly during the period in which they commenced their rapid growth, were characterized by a political structure in which discretion and command by the ruling authority played a strategic role—what Myrdal termed a “hard” state (1968, p. 66; for the Korean case, see Cole & Lyman, 1971, Chapters 3 and 5; Johnson, 1987, pp. 143–144; Jones & SaKong, 1981, pp. 241–242; for the Taiwanese case, see Johnson, 1981, pp. 9–18). The essence of this form of intervention is the use of compulsion, subtle or overt, at the ruling authority’s discretion, and the discriminatory targeting of this compulsion (positive and negative) toward particular sectors, enterprises, associations (such as trade unions), or even individuals (see, for example, Amsden, 1989, p. 15; Jones & SaKong, 1980, pp. 127–135, Appendix B).

The Korean government’s ability to employ these tools gave it formidable power. Especially potent was its ability to instruct commercial banks on whether and how much they could lend to

specific borrowers, particularly in the large-scale sector, where enterprises had high ratios of debt to equity<sup>14</sup> and thus depended on bank credit for their very survival (see Steinberg, 1989, p. 135).<sup>15</sup> One assessment of this aspect of the government's actions concluded:

Because the government had a complete monopoly on all institutional credit, firms that failed to fulfill government-set objectives could lose access to bank credit, forcing them to seek credit on the curb, or informal, market at double or more the interest rates and, thus, making them uncompetitive. ... It could force firms to fire or hire key executives, require companies to merge or to move from family to public ownership, and stress critical industries (Steinberg, 1989, pp. 134–135).

Mason et al. (1980) have commented:

If incentive procedures do not work, government agencies show no hesitation in resorting to command backed by compulsion. In general, it does not take a Korean firm long to learn that it will “get along” best by “going along” (p. 265).

Elsewhere, they have reiterated:

All Korean businessmen, including the most powerful, have been aware of the need to stay on good terms with

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<sup>14</sup> For example, (a) Mason et al. (1980) put debt-equity ratios in manufacturing in the range of three or four to one in the first half of the 1970s (pp. 267–268); (b) Scitovsky (1986) notes that, from 1972 to 1981, the current plus fixed liabilities of Korean manufacturing enterprises were 364 percent of their net worth—more than four times as high as in the US. Moreover, almost two thirds of that debt was short-term (current liabilities), making firms even more vulnerable to movements in interest rates and to the continued availability of bank credit (p. 153); (c) E. H. Kim (1990) estimates that, during 1977–86, the ratio of equity to total value (equity plus debt) for all nonfinancial firms listed on the Korean stock exchange was about 16 percent, compared with around 45 percent for Japan and the US (p. 344).

<sup>15</sup> The *chaebol* (large conglomerates) were in debt to government-sponsored or approved institutions for more than four times the value of their equity assets.

the government to assure continuing access to credit and to avoid harassment from the tax officials (p. 337).

#### **4.2.1 Institutional Considerations**

Institutional, political, and international factors make it impractical for Pakistan to follow the East Asian route in an undiluted form

There are three reasons why Pakistan is likely to find it impractical to follow the East Asian command route in its undiluted form. First, the successful application of a policy in which the government intervenes directly to identify “winners” and works closely with such industries and enterprises to support them through their presumed periods of “infancy,” requires strong government institutions, considerable bureaucratic skills, and a firm commitment to economic growth as a national objective. If some or all of these conditions are absent, there is a serious danger that selective interventions will be captured by the intended beneficiaries simply to generate economic rents (i.e., unearned profits) for as long as possible.

It is thus essential that the government (including both politicians and bureaucrats) make decisions that are based on an assessment of the country’s long-term economic interests. This refers back to the first of the characteristics of the East Asian model described earlier (see Section 1.1). By and large, the Korean government was able to make such decisions. I was told in 1989 by the president of Kia Motors (the first Korean company licensed to manufacture passenger cars) that, when the company wanted to start producing light vans, it had to surrender its license to manufacture passenger cars. The reasons given were that (i) the government did not want any single firm to dominate the vehicle manufacturing sector; and (ii) it did not want to split the passenger car sector among too many firms, because the participants would not be able to reap economies of scale and would lose in competitiveness. Permission for the manufacture of passenger cars was then given to Hyundai and Daewoo. It was only when the market for passenger cars was judged to have expanded sufficiently that Kia was permitted to once again manufacture these vehicles. Contrast this with the situation in

Pakistan, where a much smaller market has been fragmented between at least half-a-dozen assembly plants, none of which could survive without massive protection against imports.

Unfortunately, Pakistan's experience suggests that most of the necessary conditions are indeed absent—a national consensus on the country's economic goals does not exist; the civil bureaucracy has been gravely weakened; and other key government institutions, such as the justice system, are in disarray. The inability of successive governments to impose economic discipline is evidenced by the number of industries that, because of import controls and other protective measures, have continued to amass economic rents, and there is virtually no example of an infant industry growing up and divesting itself of barriers against imports.

#### **4.2.2 Political Considerations**

The second reason is political. This has two major facets: (i) the government's commitment to development, and (ii) the methods by which the government pursues this aim. Can Pakistan, as Korea did, elevate economic development to the top of its agenda?

The pursuit of economic development requires critical tradeoffs between the requirements of development and of other policies. A key element is a resolution to refrain from wars and strife. It is quite striking that there has been no "hot" war on the Korean peninsula since the first Korean war which ended in 1955, nor has there been a war between Taiwan and the PRC. Pakistan, on the other hand, has been involved in outright wars with India in 1948, 1965, and 1971, and in major skirmishes in the Rann of Kutch in 1965 and Kargil in 1999, not to mention the recent attacks on the Indian Parliament and in Mumbai by groups based in Pakistan, which nearly brought the two countries to war. Such incidents, needless to say, create uncertainty, disrupt economic policies, unsettle trade arrangements, and divert resources away from development, and have done nothing to resolve the underlying causes of tension between the two nations.

The second important political element relates to how economic development is pursued. The most dubious aspect of the



East Asian, and particularly Korean, experience is the tradeoff between political liberties and economic gain. In both Korea and Taiwan, unrepresentative and authoritarian regimes were the rule during the period of their most rapid economic growth. In both countries, the regimes sought to legitimize their rule through the provision of economic gains for their subjects. But surrendering political rights for the possibility of economic benefits is a very chancy proposition. The rulers might not put economic development at the top of their agendas (witness any number of authoritarian regimes in Africa), or even if they do, they might not succeed in achieving it. Pakistan has had ample experience of periods in which the loss of representative government did not bring any significant economic gain for the population at large.

Moreover, Pakistan has only recently emerged from long periods of authoritarianism into one of representative government. After this long struggle, the electorate is unlikely to view with much favor the widespread employment of tax inspectors for the purpose of harassment, discriminatory directions to commercial banks, discretionary interest rates, concessional effective foreign exchange rates targeted toward particular enterprises, legal injunctions against trade unions, the outlawing of strikes, or a generalized use of “command backed by compulsion.” Nor would an attitude such as that embodied President Park’s statements sit well with the contemporary Pakistani voter:

In order to ensure efforts to improve the living conditions of the people in Asia, even undemocratic emergency measures may be necessary ... The gem without luster called democracy is a meaningless route for people suffering from starvation and despair (Hee, 1970, pp. 39–40, quoted in Mason et al., 1980, p. 251).

Ultimately, it is a question of choice—how much democratic freedom is one prepared to give up to (possibly) gain some economic growth? The Koreans were not given the choice. The average Pakistani, who has seen that “undemocratic emergency measures” do not necessarily bring economic affluence in their wake, might well look askance at an invitation to accept such tradeoffs. This does not

mean that Pakistan is inevitably doomed to remain a “soft” state in which “policies decided are often not enforced, if they are enacted at all” (Myrdal, 1968, p. 66). But it does mean that the state will have to exercise discipline by other means, and that perhaps some of the key weapons utilized by Korea are unlikely to be available to the Government of Pakistan.

### **4.2.3 International Considerations**

The third reason is the change in the international environment since the time the East Asian “tigers” began their charge. It was more permissive in the 1960s than today, allowing the East Asian economies to pursue an export-oriented strategy that could draw, initially at least, on subsidies and special concessions for the exporting industries. The founder of Hyundai, Ju-Yung Chung, once described to me how his shipbuilding business had started. During the HCI period, the government had given him access to subsidized bank loans, foreign exchange on preferential terms, permission to hire engineers from abroad, fiscal concessions, and so on, but what apparently made the decisive difference to the Greek ship-owner who placed the first contract with Hyundai was the Korean government’s guarantee to indemnify him should the vessel not meet specifications. This induced the ship-owner to award the contract to Hyundai, even though the company did not have a shipyard at the time!

At present, however, the manifold requirements of the World Trade Organization make it difficult to brazenly follow such a strategy without attracting retaliation or various penalties.

## **4.3 A Broad Strategy for Pakistan in the Present International Environment**

Having established some of the constraints that inhibit Pakistan from adopting the Korean (or indeed the East Asian model generally) in its undiluted form, one must now ask: given the actual economic and political situation in Pakistan, what should be the broad lines of government intervention in the coming decade? Achieving the results on which there would probably be a large degree of consensus—namely, rapid economic growth and better

income distribution, while preserving a liberal polity – would require the government to concentrate its options for intervention selectively in a few areas. Reasons of space compel me to limit the discussion to a few broad points.

The first requirement is to obtain some sort of national consensus on the country's economic goals. The debate on this should be widespread and candid about tradeoffs – not everything desirable can be accomplished at the same time, and the authorities should be clear about which desirable ends may have to be postponed or perhaps even given up altogether in order to attain others that are considered of greater primacy.

The second area to which attention should be directed is the strengthening of institutions, particularly the working of the civil administration and commercial judicial system. If the government is even thinking of intervening selectively in some economic areas, it will have to assemble a corpus of economic expertise in some ministry or agency (for example, the Planning Commission). Such an institution could analyze the likely effects of government intervention in some activity, draw on the experience of “best practice” in other countries dealing with the same or similar problem, and offer the government a range of options from which to select those that would be politically most feasible (see Ikram, 2009a, for detailed proposals for strengthening the Planning Commission to function effectively in an economy that is more privatized and globalized than in the 1960s and 1970s).

Third, it is most unlikely that the desirable GDP growth rate can be attained and sustained without a major increase in the ratio of investment to GDP. Pakistan's historical investment rate of about 18 percent or so is simply not enough to generate a sustained rate of growth of GDP of 7–8 percent a year – the rate required to absorb new additions to the labor force and to cut into the backlog of unemployment from previous years.<sup>16</sup> A further reason for raising the

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<sup>16</sup> This figure is based on studies for each of the provinces conducted jointly by the World Bank, Asian Development Bank, UK Department for International Development, and the provincial governments. A summary of the findings appears in Ikram (2009b).

rate of investment is the acquisition of new technology, because this generally comes embodied in machinery and equipment. The investment rate will have to be raised to 30 percent or more. This, in turn, raises questions about mobilizing a higher rate of savings—the historical rate of around 16 percent will be insufficient to finance the much higher rate of investment.

In order to provide the private sector with incentives to invest much larger amounts, a major effort must be undertaken to reduce the cost of doing business in Pakistan. In the present circumstances, this means streamlining the functioning of the bureaucracy, improving the working of the commercial judicial system, considerably upgrading the infrastructure (especially electricity), and expanding the system of education and aligning its output much more closely to market requirements (see Section 5.4).

Stronger institutions, a higher rate of capital formation, the greater access to technology that this brings, and improvements in the system of education and training should all work to significantly increase the productivity of Pakistan's economy. Taken together, these factors would make it possible to attain the economic goals that have been settled on by national consensus.

## 5 Some Further Comments

The preceding sections have elaborated on many lessons that Pakistan could have learnt from the East Asian experience. This section briefly highlights some further messages on which Pakistan could profitably reflect, and elaborates some points that were made earlier.

### 5.1 Government Credibility

An implemented second-best plan is better than a best that sits on the shelf, that is, a development strategy delivers benefits only to the extent that it is actually put into effect. A vital lesson that Pakistan could learn from Korea's experience is the importance of establishing the government's credibility in implementing its announced policies. That Korea's success owed more to its capacity to implement policies than to formulate plans has been reduced to a truism. Korea has never lacked for plans. In fact, the Office of Planning was established under President Syngman Rhee's government as far back as 1948; this office duly prepared a five-year plan (never implemented), and revised it later (also not implemented). There were also numerous missions by foreign experts to advise on policies and to prepare plans (for example, the "Nathan Plan" submitted in 1953, but never adopted). A three-year plan was prepared in 1960, but was first postponed for a year and then came into effect only for a few months before the Rhee regime fell. Chang Myon's succeeding government also directed the preparation of a five-year plan in 1960, but this was made irrelevant by the military coup of 16 May 1961 by which President Chung Hee Park came to power (see Mason et al., 1980, pp. 250–252).

The Park regime unambiguously gave economic development top priority, with the president proclaiming that, "in human life, economics precedes politics or culture" (Hee, 1963, p. 26). In addition to strengthening the planning process, he laid great emphasis on carrying out announced policies. Policies were implemented through a rigorous structure of rewards and punishments, including compulsion and administrative discretion. The result was a sharp increase in the public's perception that the government meant what it said. According to a major study of businesspersons' perceptions of government

resolve, only 3.2 percent of the respondents indicated that, under Rhee, decisions were “always implemented,” and 17.2 percent believed that they were “almost always implemented.” Contrast this with the Park period: 78.2 percent of businesspersons responded that decisions were “always implemented and that it was impossible to avoid complying,” and 16.6 percent said that they were “almost always implemented” (Jones & SaKong, 1980, pp. 136–137, Table 22). This shift in perception made it easier for the government to implement its policies without actually having to resort to extreme measures.

There does not appear to be a similar survey for Pakistan. However, given the ordinary citizen’s experience of taxes being evaded with impunity, of bribes being paid to successfully circumvent regulations, of the manner in which land reforms were carried out, of government budgets being presented and then withdrawn, of laws being announced and then hastily modified out of shape, it would not be surprising if the public was extremely skeptical about the government’s ability, and indeed willingness, to enforce measures that it had itself promulgated. An assessment of the Pakistan government’s “performance profile” during the Ayub period on the basis of six essential capabilities that a government must possess—extractive (i.e., taxation), distributive, regulative, responsive, symbolic, and international—came to a decidedly unfavorable conclusion (Sayeed, 1973, pp. 115–135). Another study concluded that “the overall evaluation of the [Zulfiqar] Bhutto period on the factors of government commitment to development, quality of economic management, and participation in decision-making is not high” (Burki & Laporte, 1984, p. 367). It is clear that one of the first requirements of imposing economic discipline is a change in the public’s perception of the government’s commitment to equity and economic development, and its resolve to carry out the policies it has announced. It is also evident that this change in perception will occur only if announced plans and policies are regularly implemented.

## **5.2 Economic Growth and Income Distribution**

Pakistan could learn that rapid economic development is compatible with a high degree of equity in income distribution. Korean policymakers saw to it that the acceleration of GDP growth

and improvements in distributional equity were not parts of a “zero-sum” game—in which a gain in one element could only come at the expense of the other. That Korea has been described as a “stunning example of growth with equity” (United Nations Development Programme, 1990, p. 42) is a measure of their success.

### 5.3 Trade and Industrial Policies

Trade and industrial policies have been discussed in some detail earlier, but a few supplementary comments would not be out of place here. Pakistan can learn much from Korea’s successes and failures with trade and industrial policies, and how these were carried out. In analyzing these policies, one can distinguish broadly between the impact that government interventions have on three types of incentives (World Bank, 1987a, Volume 1, pp. 100–101): (i) the overall incentive regime, created by fiscal, financial, exchange rate, and trade policies; (ii) functional incentives, i.e., interventions to offset some systematic pattern of market failure or distortion (such as imperfections in the markets for technology and human capital, or deficiencies in physical infrastructure); and (iii) selective incentives, which seek to identify and support “sunrise” industries, and manage the orderly elimination of “sunset” activities.

Since the last of these incentives appears to have acquired an inordinate importance in the minds of some Pakistani policymakers, it might be useful to put it in perspective. The implementation of selective incentives is only one of many strategic measures, and was used within a framework of policies that emphasized economic efficiency. A respected authority on the economic development of East Asian countries has written:

Given that selective promotion [in East Asian countries] has been successful, overall, it does not follow that it has been the major element in superior economic performance. One of the dangers of focusing on a narrowly defined industrial strategy is that the wider policy context gets left out of the calculation. The experience of East Asia confirms that successful industrialization is critically dependent on effective

macroeconomic management. . . . Low inflation rates and the maintenance of a stable and realistic exchange rate are essential in providing domestic industry with competitive access to international markets as well as ensuring an appropriate balance of incentives between tradable goods and nontradables (Wade, 1987).

As mentioned earlier, the most important factor in Korea's export drive was the establishment of an overall incentive regime that did not penalize exports and, for manufactures, was modestly pro-export. This involved maintaining a competitive exchange rate, together with the ability of exporters to obtain their necessary imports basically tariff-free. Certain other subsidies (such as on bank credit) were also significant in making exporting relatively more attractive than producing for the domestic market. As Rhee et al. (1984) have stressed, the authorities took pains to create an institutional structure that would ensure that the incentives legislated were, as far as possible, automatically and immediately made available to the exporter—an important lesson is that, in a private sector economy, “an incentive delayed is an incentive denied” (pp. 11–14). The role of functional incentives, meanwhile, has been less intensively documented, but to move the export drive forward, the effects of overcoming market imperfections and infrastructure deficiencies could only have been helpful.

The verdict on selective interventions is largely negative, especially on those introduced during the HCI drive (1973–79). The reason appears to be that, while governments might have an advantage in gathering the information needed to make long-term decisions in the earlier phases of industrialization, at later stages, entrepreneurs and markets become keenly concerned with dynamic factors and are more likely to show flexibility in moving into profitable markets and out of losing ventures than do governments (World Bank, 1987a, Volume 1, p. 102, Volume 2, pp. 85–92; see also the case studies in Volume 2, pp. 131–214). During the HCI drive, the Korean government continued to support its chosen industries even when the costs—both the direct financial costs and opportunity costs (in terms of what the country was losing by depriving the more efficient smaller industries of bank credit and other resources)—had become clear.



However, since the early 1960s, the Korean government has largely used international prices and export sales (i.e., competitiveness in the international market) as performance indicators. Korea's experience was that the most efficient results in industrial and trade policy were obtained when (i) the authorities provided, on average, almost equal incentives for domestic sale and for export, and (ii) within manufacturing, did not markedly discriminate between different items of export. This "level playing field" left it to the market to channel factors of production into areas of Korea's greatest comparative advantage. The market responded to the outward-looking strategy by channeling resources into labor-intensive activities, which, as we have seen, rapidly increased exports and employment, and improved income distribution.<sup>17</sup> This factor, namely, that government interventions generally worked to strengthen the market's allocative actions—and thus remained pro-efficiency—distinguishes East Asian policy actions from those of eastern Europe, and is perhaps the most useful lesson for Pakistan.

#### 5.4 State Intervention in Education

Pakistan can learn much from Korea's experience with human development, particularly where education is concerned. In 1945, the adult literacy rate in Korea was estimated at 22 percent; by 1970, this had risen to 88 percent (McGinn, Snodgrass, Kim, Kim, & Kim, 1980, p. 47; see also Y. B. Kim, 1980, pp. 234–275). Currently, it is nearly 100 percent. The earlier imbalance between male and female literacy has also been eliminated: in 1970, male literacy was 95 percent compared with 82 percent for females; by 1988, both sexes had essentially attained the same (95+ percent) rate. School enrollments increased at all levels: in 1953, less than 60 percent of the corresponding age group was enrolled in primary schools, but by 1970 the figure had reached

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<sup>17</sup> A detailed study by Westphal and Kim (1982) concluded that, over the 1960s, "manufactured exports were more labor-intensive than manufactured imports, and they became increasingly more labor intensive over time even as shifts in the composition of output caused manufacturing production for the domestic market to become somewhat more capital intensive. The aggregate labor-capital ratio in the manufacturing sector actually increased between 1960 and 1973; at the same time, total factor productivity about doubled" (p. 271).

100 percent. The enrollment rate for middle schools rose from 21 percent in 1953 to over 90 percent (of the appropriate age group) in 1980, while that in high schools went up from 12 percent to around 50 percent. Literacy in Taiwan also followed a steep trajectory—rising from about 55 percent of the population over six years of age in 1952, to 95 percent in 1993.<sup>18</sup>

The structure of the school system and how education in Korea is financed show that government intervention has followed an interesting direction. The government has concentrated on providing basic and compulsory (i.e., primary) education, leaving a large proportion of the higher levels to be supplied privately. Thus, by the mid-1980s, practically all primary schools were public, but over 40 percent of middle and nearly 60 percent of high schools were private. Families' financial contributions mirrored this division: at the primary level, the government provided almost 97 percent of schooling expenses (all fees for tuition and textbooks were abolished in 1978); at both the middle and high school levels, families provided over 75 percent of expenses. Overall, private households have paid about two thirds of the direct costs of education (Bunge, 1982, p. 96; see also Mason et al., 1980, p. 355). Government budgets reflect this: on one hand, the share of education has generally been 16–20 percent of the budget since 1964; on the other, about 70 percent of this spending has been on primary education (McGinn et al., 1980, pp. 45–47). These figures underline the importance of the private contribution to spending on education: although the country devotes about 6–7 percent of its GNP to education, the government's share is only about 2.5–3.0 percent, and targets chiefly primary education.

Several educationists have long advocated a similar strategy for Pakistan. Indeed, 50 years ago the National Education Commission eloquently made the point that “to argue that we are too

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<sup>18</sup> It should be borne in mind that attaining literacy in Taiwan and Korea takes much more work than in other countries because of the large number of characters in their scripts. The Korean language, Hangul, has a phonetic script, but about 2,000 Chinese characters are still widely used and taught in schools. They must be learned in order to be sufficiently literate to read newspapers, books, etc. Taiwan, of course, uses only the Chinese script.

poor to support education is to argue that we must always be poor" (Government of Pakistan, 1959b, p. 332). Stating forthrightly that "the concept of 'free' education is, in fact, a delusion," it went on to propose a structure of financing that would approximate the Korean model. The Commission recommended that local communities provide school buildings at the primary level, and that the recurring costs be shared equally between the provincial governments and local community; the sacrifice would therefore take the form of new taxes. At the secondary level, the Commission recommended that 60 percent of the cost be borne by fees and 20 percent each by the contributions of management and government. At higher levels of education, the Commission expected that higher fees and a corresponding sacrifice on the part of parents would be required (p. 333). The Commission concluded that "education is an . . . indispensable component of permanent economic improvement and greater financial sacrifice on the part of everyone is the only means through which our educational requirements can be met" (p. 334). What happened, or rather did not happen, to the Commission's recommendations is another example of the gulf between Pakistan's ability to articulate policies and its resolve to implement them.<sup>19</sup>

## 5.5 Domestic Resource Mobilization

There is much to learn from Korea's efforts to mobilize domestic resources. Unfortunately, lack of space forbids an attempt at anything resembling a reasonable examination of the government's fiscal policies or the measures devised to encourage private savings. However, even the bare bones of its performance are impressive. In 1960–62, gross domestic savings averaged only 3.0 percent of GDP; by 1967–69, they had risen to 15.7 percent; by 1974–76, they were 18.7 percent (Mason et al., 1980, p. 107); and by 1988, they had reached 35 percent. The composition has also undergone changes: after 1963, the government changed from being a net dissaver to a net saver, and by 1975 was providing about a third of gross national savings. Business

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<sup>19</sup> Very little public sector educational investment is recovered, so that in effect nearly all of it represents a subsidy. S. R. Khan, Mahmood, and Siddiqui (1986) recommend "a restructuring of the educational subsidy towards an increased emphasis on school education, particularly primary education" (p. 191).

firms were the most important savers, accounting for about 60 percent of gross national savings (particularly in the shape of depreciation funds and retained profits), while households contributed the remaining 5–10 percent (K. S. Kim & Roemer, 1979, pp. 51–55). The government's budget was brought into surplus through a combination of increasing revenues—there were four “comprehensive” tax reforms between 1961 and 1975 (Bahl, Kim, & Park, 1986, p. 15)—and reductions in current expenditures. The government viewed budgetary policy as a supporting rather than initiating tool (these were industrial and trade policies, and incentives for investment) in the development process, and kept the share of public expenditures low to avoid crowding out the private sector (p. 217). Between 1953 and 1986, government spending never exceeded 23 percent of the GNP and generally remained below 20 percent (J. Lee, 1990, pp. 265–268, Table 15.1). This again underlines the argument that, while the government remained the senior partner in “Korea, Inc.,” it retained this primacy through policy interventions rather than a direct fiscal contribution.

## 6 Conclusion

Perhaps the chief lesson that one should take away from an examination of the East Asian experience is one of hope. If one is critical of Pakistan's performance, the regret is for opportunities missed, not for a uniformly disastrous achievement. The population of Pakistan in 2007 is more than five times that at the time of independence. These 165 million persons are, on average, better fed, clothed, housed, educated, and connected to the outside world than their compatriots in 1947. The reproach is that the country could do much better. If Korea and Taiwan, perched on the edge of Asia, destitute of natural resources, and rent for long periods by war, (and, in Korea's case, with its capital city occupied twice by enemy forces) could achieve so much so quickly, then it should not be impossible for Pakistan, with its greater abundance of natural resources and a strategic geographical location, to achieve something comparable. However, this will not happen by itself; it will require a drastic change in attitude and strategy. The first requirement for such a change is to recognize that a change is necessary – as the Holy Qur'an (viii, 53) says: "Allah never changes the favor He has bestowed on any people until they first change that which is in their hearts."

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