

Recipe For Success

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Jeffrey Sachs & Nirupam Bajpai

Theory teaches that economic growth is based on three factors: accumulation of the factors of production, both human and physical capital; efficient allocation of resources in an economy; and improvements in technology over time. Debate centres around the choice of economic institutions (market versus state allocation, open trade versus protectionism, and so on) that most effectively delivers these three components of growth.

One implication of economic theory, confirmed by experience, is that with the right policies poor countries can expect to grow faster than rich countries. Poor countries can expect their per capita incomes to "converge" with rich countries'. Convergence occurs mainly because of the first and third factors. Poor countries tend to accumulate capital more rapidly than do rich countries, because the former have lower capital labour ratios and higher rates of return on new investments. And poor countries have the advantage of using the technological advances of the rich countries.

These tendencies have played an important role in the rapid growth of east Asia. But convergence is possible only when there are effective economic and governmental institutions supporting rapid capital accumulation, efficient allocation of resources, and rapid diffusion of technology.

Experience, interpreted by economic theory, suggests that certain institutional arrangements have been key to east Asia's rapid growth.

First is the openness of the economy. The quintessential feature of east Asian development has been rapid growth of manufacturing exports. This has been supported by policies which have allowed manufacturing exporters to operate at near world prices. East Asia avoided trade policies that undermine the capacity of manufacturing exporters to obtain necessary inputs at world prices or that penalize exporters through export taxes. The last can arise from tariffs and quotas on inputs, inconvertible currency, state monopolization of exports on unfavourable terms for exporters or explicit taxation of exports.

National trading regimes differ, but the following have been common features in east Asia. Currency convertibility on the current account; zero or low tariffs (and the absence of licensing) for capital goods and intermediate inputs, and modest tariffs on consumer goods; subsidizing of exports; and other institutions supportive of exports like state guarantees on export credits. In general, east Asia has been open to imports and exports.

Openness, and the orientation to manufacturing exports, contributed to growth. It helped to ensure the efficient allocation of resources. It promoted domestic competition by limiting the market power of domestic firms and by providing an international benchmark. It promoted rapid capital accumulation through foreign borrowing and foreign direct investment. Openness promoted rapid technological improvement through the import of foreign know-how.

India, however, has been a closed door.

Its average tariff rate of 27 per cent far exceeds that of the east Asian economies. This average excludes trade barriers like a ban on consumer goods. Not all of east Asia relied heavily on FDI to achieve rapid growth. Japan and South Korea are exceptions. But most of the region, especially southeast Asia, relied on FDI. In comparison to them, India is much more difficult a place for FDI approvals.

Second is the promotion of saving through fiscal policy. East Asian economies have high rates of national saving far in excess of India's. This contributes to rapid capital accumulation and thus rapid economic growth. This was not always the east Asian case. The general pattern is that saving rates rose with growth, from modest levels in the Sixties to over 30 per cent of the gross domestic product in the Nineties.

National saving is the sum of government saving and private saving. Government saving, in turn, is the excess of current government revenues over current government expenditure. The largest difference between India and east Asia lies in government savings rates. The east Asian economies all have sizeable government savings. India's government saving is close to zero. In many east Asian countries, private saving rates are also unusually high. This partly reflects the rise of financial institutions that effectively mobilize household savings.

Third is a high degree of internal competition. The east Asian economies promote efficient allocation of labour across sectors through a variety of pro-market policies. One, the engine of growth in east Asian industrialization has been the private sector. The rapid growth of manufacturing since the Sixties is almost entirely due to private enterprises.

Two, in one way or another these private firms are exposed to competition, either against imports or as exporters on world markets. Protectionism, when it exists, is almost always in the service of export promotion rather than for the protection of the domestic market *per se*.

Three, private firms operate in a regulatory environment which offers high flexibility for wage setting, hiring and dismissal of workers. In almost all of east Asia the terms of collective bargaining agreements are set according to market forces felt at the enterprise level. Unions tend to be weak. Workers have few guarantees of long term employment, with the partial exceptions of South Korea and Japan. East Asian firms can reduce their workforces with short notice and modest severance payments.

India stands as the extreme outlier in this case, since workers in large firms in the formal sector have a virtual guarantee of continued employment. For firms of 100 employees or more, reductions in the workforce depend on local government permission, which is almost never granted. Loss making firms are not even allowed to shut operations without government consent. Such labour regulation has been devastating. Formal sector employment in India is shockingly low, largely because so much urban employment is informal. Out of 506 million working people, formal sector employment was 27.4 million in 1994, or a meagre 5.4 per cent. Of this, 19.3 million worked in the public sector and just 8.1 million worked in formal private firms.

Fourth is social policies targetted to human capital accumulation. East Asia has not undertaken extensive social welfare spending. As a result it has been able to maintain relatively low rates of government expenditure and taxation. In particular, these governments have not pursued largescale redistributive transfers via welfare spending or budgetary subsidies. This restraint has helped preserve high rates of government savings while avoiding distorting rates of taxation. On the other hand, the east Asian governments have made major commitments to human capital accumulation in the form of spending on primary education and health. A notable success has been high rates of literacy an area where India lags far behind.

The east Asian economies have avoided the fiscal burdens of heavy government spending. Total government spending as a per cent of GDP tends to be low: between 15 and 30 per cent of GDP. India's overall government spending is around 35 per cent of GDP, on the very high end of the east Asian economies. But the counterpart of relatively low government spending is relatively low rates of taxation. Corporate tax rates in east Asia are in the range off 15 to 30 per cent compared with a rate of 55 per cent in India.

It is often claimed that in addition to these market forces, the key to rapid industrialization in east Asia rests on special industrial policies of the government. The role of government in industry differs markedly, ranging from an interventionist South Korea to a minimalist Singapore. The evidence suggests that it is the common features in east Asia currency convertibility, moderate tariffs, strong private sector orientation rather than specific industrial policies that are behind the region's successes.

The economist Paul Krugman has called into question the growth performance of east Asia. He argues this has resulted from capital accumulation rather than from improved productivity. He compared this with the Soviet economy, which also grew on rapid capital accumulation.

He concluded that east Asian growth is neither a model for others nor sustainable. This misses the point of east Asian growth. Unlike the Soviet Union, the accumulation of capital in east Asia has been carried out under international market forces, tested repeatedly by the market. There is no reason to suspect east Asia would be subject to a Soviet collapse since industrial production has been responsive to market demand on an ongoing and intensive basis.