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THE ROLE OF INSTITUTIONS IN TRANSITION GROWTH:  
THE EAST ASIAN NIC'S

Gustav Ranis

Yale University

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## **Abstract**

### **The Role of Institutions in Transition Growth: The East Asian NIC's**

This paper examines the role of institutions in the transition process of the East Asian "Gang of Four." The stylized facts characterizing modern growth are discussed, along with the transition phases to modern growth. The importance of institutional structure to the sequencing of transitional subphases is explored. The institutional structure itself is seen to depend on the particular nature of secularism, egalitarianism and nationalism as defined by Kuznets in each country concerned. Contrasts in colonial history and initial endowments are also considered. The evolution of institutions accommodating successful transition in East Asia are explored.

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Gustav Ranis  
Frank Altschul Professor  
of International Economics  
Yale University

Section I     Introduction

By now there is near universal agreement with reference to the relative success of the so-called East Asian "Gang of Four" in the course of the post-war development effort. That success has not only permitted them by and large to grow rapidly but also to do so in the context of eliminating their initial state of underemployment and to maintain, and in some cases even to improve upon, a fairly egalitarian distribution of income; and, last but not least, to adjust relatively well to the buffeting administered by the international economy during the post-1980 period. Even the critics no longer write these cases off as instances of unusually heavy dosages of foreign aid or other "special case" manifestations, e.g. via favored treatment by the U.S. in the context of the new protectionism. On the other hand, there is much less agreement when one tries to proceed beyond a description of that well known success story in order to understand why it happened, which presumably is not irrelevant to the issue of what, if anything, in that experience is useful elsewhere in the third world. Here the debate is sharp between those who wax eloquent about this real world application of pure laissez faire in the developing economy context, on the one hand, and those who claim that these are cases of a fairly active and quite intrusive government, on the other. It is for this reason that an examination of the role of institutions in the

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transition process in this part of the world comes at a rather opportune moment.

Institutions can be viewed in many ways. I will simply adhere to the notion that institutions define how people inhabiting a certain land space and having command over given resources decide to organize themselves for economic activity. Such people are, of course, constrained by their initial conditions which include not only the size of country, natural resources, man-land ratios, etc., but also the quality of the human capital stock in its various dimensions. Given these constraints or, if you like, opportunities, how people organize themselves to navigate the shoals of successful transition growth is a key issue that needs to be addressed. In Section II we briefly outline the dimensions of the developmental task embodied in a successful transition to modern growth for the East Asian type of developing economy and describe the nature of the initial conditions underlying the system's institutional and economic capacity at the outset. In Section III, we provide some examples of the role of institutions and institutional change in easing the task of transition in East Asia. Some final thoughts are presented in Section IV.

## Section II The Transition to Modern Growth and the Initial Conditions

As is well known, modern growth is characterized by a number of stylized facts, including prominently the sustained routinized application of science and technology to the production process, accompanied by accelerated population growth, capital deepening, pronounced structural change and the geographic spread of the process within and across countries. To the extent we expect contemporary LDC's to effect the transition into this promised land we can expect such characteristics to appear in the long run.

Kuznets was less concerned with analyzing the transition towards that long-run as he was with describing the characteristics which increasingly had to be associated with its successful accomplishment. Historically, the geographic spread of modern growth from England to the Continent to the latecomer countries of the West was effected rather smoothly over long historical periods of time. In the post war third world, East Asia included, on the other hand, the effort was made to do this rather quickly under the telescoping pressures we are all familiar with. Moreover, there were additional handicaps in having to shake off colonial constraints plus a rather deeply rooted agrarian or primary product oriented economic structure which was partly a function of resource endowments and partly a function of these colonial strictures.

The transition growth process itself can be viewed as something of a metamorphic phenomenon characterized by sub-phases occurring in some more or less definite sequence. The nature of the transition sub-phases and of a system's success in navigating them en route to an eventual graduation into modern growth is constrained by a number of exogenous factors. Included are the national physical endowment, the world economic environment, as well as other aspects of initial conditions on the human side which make up facets of the institutional dimension which is the focus of this paper.

Given marked differences in the exogenous factors affecting the path of transition, the sub-phases, each characterized by a somewhat distinct set of structural characteristics and modes of operation of the economy, will differ, i.e. there is no inevitability about moving along a fixed historical path. But it is important to recognize that the sequencing of the subphases is related to differences in both the initial economic and organizational conditions as well as in the response mechanisms of the system over time. Institutions thus have

two characteristics: one, they are an essential component of the initial conditions; and, two, they can be classified as either accommodative or obstructive in terms of the ability of the system to navigate to modern growth over time.

The beginnings of a transition growth effort may thus be set rather arbitrarily at the point where the economic system begins to move out of its agrarian colonial resource allocation and trade pattern when it mainly exports primary products in return for the importation of manufactured consumer goods and in exchange for capital goods intended to expand the capacity of the same enclave sector. The next subphase almost invariably, including in East Asia, constitutes an effort at industrialization through early import substitution, with a new politically independent system capturing control of its foreign exchange earnings and allocating them to building up the capacity to produce at home the previously imported non-durables.

Import substitution may be viewed as a nationalistic act, a repudiation of dependency; thus ideology fits economic expediency. The new industries are seen as a way of creating jobs so that the population pressure on the land can be relieved. At the same time the pace of labor absorption during import substitution is actually limited by the availability of capital, the frequently inefficient selection of technology, as well as the initial shortage of mature entrepreneurs.

While this subphase is shared by virtually all developing countries, the choice made at the inevitable end of this subphase is a crucial one, i.e. given that the majority of LDC's continue with import substitution, but now shifting to the manufacture of capital, durable consumer goods and the processing of intermediate goods, the East Asian NIC's shifted toward something we have called primary or easy export substitution, which basically consists of

exporting into international markets the same non-durable consumer goods previously supplied only to the domestic market. Then, once labor surplus had been eliminated, they proceeded to the production and export of the higher technology, more capital and technology intensive goods exemplified by the so-called secondary import and export substitution output mix. The East Asian NIC's which selected this particular path of subphases en route to modern growth required not only a milder version of primary import substitution but also a substantial shift in the policy mix at its termination. It is in this context, i.e. of institutions which are built flexibly at the outset and accommodate rather than obstruct the achievement of transition growth over time, that the role of institutions will be examined. Our focus here will be more on Korea and Taiwan, the larger and somewhat less atypical representatives of the Gang of Four.

Turning to the initial exogenous conditions, we are all familiar with the fact that the East Asian countries inherited a relatively poor natural resources base and a heavily labor surplus condition, combined with a substantial amount of physical infrastructure, especially in the rural areas, inherited from the colonial period. What is less well understood are the initial conditions governing the actual or potential role of government in organizing the system for the transition process, i.e. what might be called the "political culture" pre-existing during the early 1950's.

In that context Kuznets has emphasized the importance of three ingredients as a system moves towards modern growth, i.e. secularism, egalitarianism and nationalism. It is in terms of these dimensions that I believe the basic success of an accommodating institutional structure as demonstrated by a capacity for accommodating policy changes can be found.

Secularism is defined by Professor Kuznets to mean a "concentration on life on earth with a scale of priorities that assigns a high rank to economic attainment... The increased power of man over resources provided by science that constitutes the basis of the view of man as captain of his destiny in this world". Such this-worldliness is certainly part of the initial conditions the East Asian NIC's could depend upon in the beginning of their transition growth process. The often referred to "pragmatism" of the Chinese culture which suggests that the individual work hard in the context of a stable political environment and not become politically, ideologically or religiously attached to vague spiritual values was undoubtedly an important ingredient, accommodating to innovations in the policy sphere as well as along production functions. Secularism in the East Asian NIC's is by no means confined to the elite; the attitude of "stomach first and spiritual values later" -- just the reverse as what is often referred to as the "spiritual East" -- is wide-spread. Salvation is much more likely to be found on this earth through hard work than by sloganeering or spiritual retreat.

Turning to egalitarianism, Kuznets saw this as a trait which emphasizes the need for equality of opportunity, not necessarily equality of income at the end of the day. This is consistent with some minimum necessary income inequality as a consequence of the normal minimal required hierarchy in all human affairs as well as with various strongly felt social obligations to help the poor. It does, however, connote an emphasis on equal access, e.g. through the competitive examinations system on the educational front, as well as by permitting the individual equal access to compete in the work-place, i.e. with a relatively less than typical dosage of elitism or non-competitive group manipulation.



Perhaps most important is the third element, a heritage of nationalism which Kuznets defines as "the claim of a community of feelings ground on a common historical past and its historical heritage -- in its extreme form an overriding claim of allegiance of the members to the larger community and sovereignty vis-a-vis all groups beyond that national unity". Thus, while it is easy to agree that all governments must provide public goods, even in the most laissez faire Friedmanesque camp, the importance of the pre-existence of such an organic nationalism as an initial condition governing the East Asian NIC's cannot easily be exaggerated. In contrast to many LDC's at a similar stage of early transition growth, the East Asian populations already possessed a most valuable asset in the form of such an organic nationalism. As a consequence they clearly felt a part of a larger community and without having to address marked heterogeneities in race, geography, background, etc. by appeals to what can only be called an artificial or synthetic nationalism.

While economists are understandably loathe to put too much weight on cultural factors, there can be little doubt that the felt need to create a synthetic type of nationalism when facing marked regional or ethnic or religious disparities among groups pulling in many different directions all too frequently leads new LDC governments to overpromise and overcommit and, as a consequence, to be both unable to carry out the major developmental functions and in danger of losing their credibility early in the game. The most obvious example is the much earlier capability of the East Asians to shift from "under the table" inflation taxes in paying for infrastructure and other government activities to "on the table" explicit tax systems. The early gift of a national identity coupled with substantial freedom of individual action can thus be contrasted with the search for that identity which is often coupled with much posturing and visible interventions by government on behalf of a skeptical public.

Perhaps another way of putting it is that the typical East Asian citizen thinks of himself as having certain obligations to the state, feels the need to reach a consensus and not to make too many unreasonable demands on the government. This stands in some contrast to other LDC's where the citizen thinks more of his rights in a struggle with other interest groups petitioning the government to provide this favor and that as quickly as possible. The basic confidence in government does not exist; as a consequence the government is tempted to do more than it is capable of, loses further credibility, and the downward cycle continues.

In short, the differences in organizational/institutional choices that one can discern in looking at the East Asians in contrast to other LDC's requires a much more basic definition of "initial conditions" than is usually entertained. Policy choices clearly do not take place in a vacuum but must be related to an institutional/organizational typology which is as much a part of initial conditions as the tried and true resource endowment, factor proportions, size of country ratios that we usually focus on exclusively. What political scientists like Hofheinz and Calder call the "insulated developmentalist state", i.e. relatively insulated from political pressure groups, does not just happen but is very much a function of the kind of pre-existing organic nationalism with respect to regional, political and ethnic integration of the population to support the government without expecting too much from it. Some economists like Lloyd Reynolds seem to come to somewhat similar conclusions. After surveying 100 years of development in 40 LDC's Reynolds states that "my hypothesis is that the single most important explanatory variable is political organization and the administrative competence of government". In other words, the co-existence of egalitarianism, secularism, and organic nationalism provides for a system of mutual obligations, with the government having a very

substantial role deriving from the fact that the various constituencies assume it will utilize it for the common good, based on technocratic and not political principles. As Chalmers Johnson puts it, it is a situation where technocrats can rule while the politicians and/or the military reign.

It is, in fact, easy to overstate the real content of pluralistic political openness or democracy in, let us say, Latin America, in contrast to the East Asian, one party martial law regimes. It is at least a very good question where political and economic participation or freedom of choice for the average citizen and where the chances of popular participation and an equitable distribution of income are more pronounced. The freedom of governments to construct institutions and change them as required to accommodate the changing economic environment is clearly much more pronounced in the East Asian cases. We are not at all suggesting here that man lives by bread alone; only that we are entirely too fixated, in my view, on archetypical cases of superficial political democracy and less willing to examine the possible extent of popular participation and decision making within a possibly highly decentralized public sector in a one-party state.

The initial position with respect to institutional choice on the mixed economy spectrum is thus usually heavily a function of initial conditions, including colonial history. In the majority of LDC cases, the overseas territories had generally witnessed a fairly strong administrative structure focussed on law and order where colonialism was associated with the rule of the market under agreed rules of the game not, of course, focussed on the system's development. The effort to change this configuration naturally yielded a certain inherent initial bias on behalf of government interventions, usually of the direct or horizontal kind, in most LDCs' early post independence period. Given the institutional preconditions, there was less need in East Asia to

select a particular class to receive particular favors through a direct allocation system, e.g. import licenses, overvalued exchange rates, cheap credit, tariff protection, etc. and all the other well known discretionary decisions which determine who shall live and who shall die. We have a similar problem when we identify market orientation with text book laissez faire and simple-mindedly relegate the ideal role of the state to one that Adam Smith would find unduly restrictive.

Synthetic nationalism, the effort of a community to ground itself in a common cause when the basic historical and cultural heritage is not as strong as it might be, arises in part as a natural consequence of another type of colonial era. Consequently the tools of colonialism are often rejected along with the objectives and much of the bias against the use of the market, and much of the faith in the power of direct government actions in the economic as well as the political sphere, stems from that experience. Similarly, with respect to egalitarianism, the denial of inherited differences among individuals, a legitimate desire to break down an earlier feudalism and thus move towards greater equality of opportunity is often interpreted as trying to achieve instead an equality of outcomes -- something that can only be achieved, with difficulty, by continuous government intervention after the fact. We are here talking about a "secondary" income redistribution rather than a "primary" income distribution through participation in the market-place. There is, of course, also a danger that a this-worldly approach may be translated into the new national states' ascendancy over religion and translate itself into an undue faith in the state's capacity to make a large number of directly allocative decisions across the board in various markets.

In other words, synthetic nationalism is often associated with inadequate dosages of egalitarianism and secularism as important ingredients in the

transition process. In most developing countries there exist considerable doubts in the early transition period with respect to the adequacy of the human resources, their ability to bear risk and to perform vital entrepreneurial functions. This, in turn, leads to the much observed tendency for governments to want to take over these functions or, more frequently, to attempt a careful administrative selection of people who ought to be more capable than others and to whom the various required pieces of paper commanding necessary inputs at subsidized prices ought to be disbursed.

Similarly, with respect to the relationship to the working class, there is a strong tendency for misplaced egalitarianism to reflect itself in an early emphasis on minimum wage legislation, undue generosity in government wages, in fact generally all practices which focus on wage rates rather than wage bills. An extreme extension of this, of course, is the early acceptance of so-called modern welfare legislation, shifting somewhat prematurely from the family to the state as a provider of social and old age insurance. All this is usually coupled with a strong tendency, again under the influence of colonialism and the needs of a synthetic nationalism, to try to exclude foreigners, seen as having participated in the colonial, market driven, past.

In this situation the intervention by a group of often Western educated civil servants, well intentioned, eager to cut the colonial tie and to create the preconditions for transition growth, generally focussed on the provision of public goods as a way of assisting indigenous elements, seems fully justified for both ideological and pragmatic reasons. It is indeed very understandable that such societies try to distance themselves from their heritage and initially accept the practical concern of implementing infant industry protectionist regimes during which entrepreneurs need temporary protection against the world of the most advanced countries, require at the outset

infrastructure and possibly a redistribution of assets -- all yielding a relatively strong bias in favor of direct government intervention.

The critical question, however, is whether this first subphase of transition, which seems to be generally accepted in virtually all developing countries, is a mild version and lasts for relatively short periods of time, or an extreme version which continues even when its economic rationale has long ago petered out. As already indicated, once this subphase runs out of steam the vast majority of LDC's choose to persevere with the same policy setting, now directed towards a new set of goods and fuelled by a combination of natural resource exports and foreign capital inflows.

The East Asian cases, starting off with a larger dosage of organic nationalism, egalitarianism and secularism, were able to maintain a relatively short, milder version of the import substitution syndrome and thereafter to move gradually towards the further liberalization of various markets. This required substantially different economic/organizational/ institutional choices in the course of the transition growth effort, but is a far cry from anything approaching a reduced role of government or an ideological commitment to laissez faire. In fact, I am prepared to argue (see below) that the role of government became more important in the course of the transition process in Korea and Taiwan and that the critical issue is the continuous flexibility of institutional and policy change in the effort to organize society's human and natural resources most effectively rather than any absolute preference for either a pure market solution or government intervention.

The overall consistency in the trend of institutional and policy choices is, moreover, much more important than the actual average level of interventionism. Korea and Taiwan during the 1960's, for example, were able to avoid the stop/go experience of so many developing countries which typically

experimented with periods of liberalization followed by renewed restrictionism and intervention, only to be followed by yet another cycle, further increasing the uncertainty on the part of all the participants. There probably exists a general consensus that a policy more or less consistently adhered to, even of a lower average quality, is much to be preferred to an oscillating policy defined to be superior "on the average".

Secularism embedded in the Confucian philosophy of egalitarianism as represented by the competitive examinations system and an organic nationalism providing strong historical glue to a relatively racially and geographically homogeneous society undoubtedly were important initial conditions to be mobilized effectively in the course of the transition growth effort in East Asia. These features cannot easily be created through protection and other direct interventions by the state, but they can be promoted in a society by introducing additional elements of economic and class mobility. In the case of the East Asians their initial advantage in institutional resources and their disadvantage in natural resources undoubtedly reinforced each other by enhancing the ability of the system to overcome the resistance of powerful vested interest groups to changes in institutions and policies required for the common good. In other words, if nationalism can be enlisted on behalf of the transition effort rather than constituting an obstruction to it this can be the single most important explanation of successful transition.

Economic pragmatism may thus be viewed as a mixture of the aforementioned three elements which has much to do with the unleashing of human energies and establishing a tighter relationship between effort and the reward system. Secularism really constitutes one pillar of this pragmatism via the dedication to the materialism of secure survival. The East Asians are well known for their secular culture, leaving the pursuit of godliness, e.g. Buddhism, to a small minority.

Egalitarianism suggests that social distinctions are to constitute a reward to those who perform economic tasks with distinction. The climb along the social ladder from landless peasantry to land owning status and from there to entry into the landlord class could be a realistic hope for most in the East Asian countries. Thus both the competitive empirical exam and the land tenure system undergirded egalitarianism as a basis for our observed pragmatism.

Organic nationalism, on the other hand, lends wisdom to this art of sharing, i.e., it puts limits on egalitarianism and is required for one's awareness of a common bond of history. The basic notion remains that individuals grouped into families, villages or other voluntary associations must indeed share, but not excessively and less over time. The extended family system, for example, which puts limits on egalitarianism in the colonial and early transition period gradually breaks down as one moves towards mature growth. In East Asia there is an increasing belief that, while community obligations do provide for the less fortunate members of society, the extension of such concern within the local community or village is to a larger national community, which requires a careful assessment of the costs and benefits if egalitarianism is not to be too severely limited. The trick here is to translate a common consciousness of cultural heritage into behavioral rules which are conducive to the institution of a sequence of reforms, including land reform, tax reform, etc. which, while expressing calculated sympathy with other members of the community, do not endanger the underlying principle of egalitarianism as defined by Kuznets.

It is this three tiered composite pragmatism which translates itself into family self reliance coupled with the intuition that governments' capacity to "take care of everything" is extremely limited. Thus pragmatism is conducive to the gradual depoliticization or market orientation of a system as we have



witnessed it in East Asia. Gradually more activity is defined as materialistically or secularly oriented while the community of sharing as expressed by direct across the board government intervention in the production process gradually diminishes in importance. Thus institutional and policy change must also be viewed in an evolutionary perspective.

The case of high expectations concerning the quick achievement of growth and income equality through direct government action is almost always bound to lead to frustration, as has been shown in many LDC's. What usually follows is a series of erratic policy fluctuations without a clear trend instead of some linearity in the direction of gradual liberalization. The problem is that once vocal demands are set in motion stop/go policy changes are likely to be adopted, with every change in the finance ministry leading to a new set of policies, sometimes liberalizing, more often reversing the trend. Let me now turn to some of the specifics concerning the role of institutions in permitting the required pragmatic flexibility in the East Asian case during its transition growth process.

### Section III Institutions and East Asian Transition Growth

We do not intend to once again describe the success story of the East Asian case. But it is necessary to recall that both Korea and Taiwan went through "easy" import substitution phases in the 50's, moved into easy export substitution during the 60's, and, once they reached the end of their unskilled labor surplus condition in the early 70's, moved on into secondary import and export substitution. The ability to navigate these subphases represents a manifestation of changes in institutions as they affect various markets within these economies, both in terms of the macro economic setting as well as the specific sectoral actions of the government in terms of its management of the economy.

We have already referred to the fact that the typical import substitution policy mix, including protectionism, import controls, multiple exchange rates and large government budget deficits, coupled with rigid inflation, a substantial emphasis on public enterprises and a pronounced dedication to the idea of government planning, were all present in the cases of Korea and Taiwan in the 50's but represented a somewhat milder version by LDC standards for reasons already referred to. For example, the fiscal system was, from the beginning, deployed in the sense of not permitting large scale deficits with the help of foreign aid but, even during the 50's, accommodated efforts to shift from inflation finance to tax finance. In other words, a nearly balanced budget was viewed early and consistently as having important private and public value. As long as LDC governments were still severely limited in their direct tax capacity, as is true in most cases, indirect taxes were resorted to, but not only of the import/export tax variety but also via the rice/fertilizer barter program. Consolidated income tax reforms were promulgated as early as 1955, for example, in Taiwan, and budgetary surpluses began to appear in the early 60's. While there have been more fluctuations in this policy in the case of Korea the emergence of budget deficits at any point in time consistently evoked a search for new taxes. Thus, from the beginning, the East Asians have tried to move away from "under the table" covert taxation and been able to increasingly implement rounds of tax reforms to generate adequate direct "on the table" government revenues.

The institutional framework undergirding the monetary or credit market supported such general fiscal restraint. Whenever inflation set in, as it did, especially in Korea, from time to time, governments usually did not try to suppress the interest rate by further monetary expansion but permitted that rate to move up towards its equilibrium value. It is quite interesting, for

example, to note that a high interest rate policy trying to remove some of the repression in money markets, now more typical in LDC's, was initiated in Taiwan as early as 1955 and reaffirmed in 1972 after some slippage just at the time when the rest of the world was about to enter an unprecedented period of inflation. This is not to say that there wasn't a good deal of direct credit allocation in Taiwan and Korea; in fact, the so-called "commercial" banking system in both is very much a part of the public sector and allocations are constantly made to particular firms, especially in the case of Korea. But it is also true that, viewed in long term perspective, the notion took hold early on that money creation is not to be used consistently to shift profits to favored private parties or to state enterprises.

At the same time the role of public enterprise varied substantially in the 1950's in both countries but has continued to be much more important than the usual liberalization rhetoric would indicate. By the time Taiwan, for example, entered into secondary import and export substitution the "ten big projects" became part of the government's program focussing not only on overheads but also on areas where the government might have a natural monopoly or where the still rather fledgling capital markets were not able to provide other alternatives. This is in no way intended to contradict the fact that the growth of directly productive activities in the fast growing East Asian economies has taken place primarily in the private sector, only to note one element of the advertised pragmatism in terms of the continued importance of directly productive public sector activities over most of the period.

The same point can be made with respect to policies towards the agricultural sector. As is well known, land reforms were instituted in both Korea and Taiwan in the early post-war period, actions which were politically eased by the fact that land owners could be compensated by the transfer of

title to industrial assets abandoned by the Japanese, as well as by the fact that land reform could be promulgated by Mainlanders or occupation authorities on a domestic landlord population. The full significance of this institutional change may be seen not only in the fact that spatially dispersed farmers were no longer neglected on the political stage, as they are in so many other developing countries, but also and more importantly, in that it paved the way for the deployment of a decentralized non-agricultural activity to follow, especially in the case of Taiwan and somewhat later in the case of Korea.

A very important additional component of this institutional success story is the conversion of Japanese-built farmers' associations into voluntary associations making local infrastructural decisions, creating a local cooperative banking network, and helping diffuse both agricultural and food processing related non-agricultural technology. The decentralized nature of the JCRR-farmers' association structure, as well as that of local government generally, has been frequently commented upon, but its participatory implications within a non-democratic one-party military government aren't always given full weight. This, plus the establishment of a unitary and relatively flexible exchange rate system after the early 1960's, plus an approximation to price stability, permitted Taiwan's farmers, even though they were being taxed, to be able to count on no further deterioration of their terms of trade, permitting them to export labor intensive non-traditional commodities such as mushrooms and asparagus to the rest of the world. It is often forgotten that the first explosion of labor intensive non-traditional exports from Taiwan was in these agricultural products.

The subsequent dramatic success of the East Asian NIC's in exporting labor intensive manufactured goods during the export substitution subphase of the 60's is well known. What is less well known is that even here there was only a

partial liberalization in effect in terms of the protection afforded to these industries. It is true that foreign exchange institutions had been gradually depoliticized, starting with the reduction of the import licensing and quota system in the late 50's and early 60's, as well as the shift from overvalued multiple to realistic unitary exchange rates approaching a managed floating peg system by the 1970's.

But it is also true that protection and directional controls remained fairly substantial throughout the period. The government, for example, continued to provide political favors to specific urban industries both overtly and covertly, e.g. through direct credit allocation, interest rate differentials and exempting certain "new and strategic" industries from corporate taxes, for example. This package of policies reflects an awareness that while increased competitiveness of domestic producers is crucial for the ultimate penetration of foreign markets in the labor surplus economy domestic consumers can and should be exploited as long as it is politically feasible, i.e. the sequential order of East Asian liberalization implies that, while the sovereign state clearly cannot exploit foreign consumers, it can, for a while at least, continue to squeeze its domestic consumers; it also means that domestic entrepreneurs once they had demonstrated their competitiveness in foreign markets were less fearful of going head to head with foreigners in the domestic market at a later point. It is also true that part of the pragmatism in evidence here is that as a system becomes more complicated in terms of both the numbers of domestic and imported goods in the total basket it becomes increasingly difficult for civil servants to make the necessary decisions on selective import controls, preferential target industries, credit allocations, etc. Thus in both Korea and Taiwan import controls were gradually liberalized and tariff rates reduced, even though the observed oscillations are more

sustained and wider in the case of Korea, given its more serious political instability as well as its perhaps less moderate reaction to external shocks.

It is well to remember, moreover, that, contrary to situations in most other LDC's, the overvalued exchange rate was no longer used to transfer incomes from primary product exporters to the new urban industrial class in the East Asian NIC's. This is true in part because institutional flexibility permitted a change in policies; it is also true in part because here natural resources, often used to fuel an increasingly inefficient development process, were basically scarce, and foreign aid, important in helping to bring inflation under control in the 50's, was terminated in the early 60's in the case of Taiwan and reduced substantially in Korea. In other words, rents to continue to fuel special favors for non competitive industries could no longer be counted on dependably, and a change in the policy mix emerged as in the national interest.

Our hypothesis about the continued flexibility of institutional change in the East Asian NIC's is even more in evidence in the period since about 1970 when primary export substitution yielded to secondary import and export substitution with the exhaustion of the labor surplus. The pragmatic orientation of a system relatively uninhibited by synthetic nationalism has led to a continued role for governments, pointed in the direction of flexibility in institutional construction as well as institutional reform.

This phenomenon could be observed in the fields of education, science and technology, agriculture, control of capital movements, etc. all areas sensitive to continuously new problems brought about by the requirements of transition growth. For example, once the labor surplus condition had basically been terminated in the early 70's, the East Asian NIC's entered a situation in which the need for further development of their human resources placed much greater

emphasis on the quality dimensions of growth, including skilled labor and high talent man-power generally as well as requiring more support from the system's science and technology infrastructure. In Taiwan, for example, compulsory education was extended to 9 years in 1968, vocational education and manpower training was promoted by 1970; the Korean Institute of Science and Technology was established in the late 60's; and in both economies the old science and technology institutes were revamped and new criteria established forcing activity to become more closely linked to the market instead of following internalized "big science" criteria. Given the importance appropriately attached to the routinized contribution of science and technology to modern growth this emphasis on education, training and the appropriateness of technology choice and the direction of technology change constituted an important ingredient in permitting the East Asian systems to navigate successfully in their transition efforts.

Establishing the infrastructure and providing the appropriate rules of the game for these institutional activities is clearly a public sector activity, i.e. appropriate initial institutional choices and institutional flexibility over time are essential to the success of directly productive private activities in both agriculture and non-agriculture. This same institutional flexibility was demonstrated in Taiwan whose government first promulgated a major three tier land reform in the early 50's but, once labor shortage conditions had come into play in the early 70's, shifted to a second land reform by the late 70's, a package which included the promotion of joint farm management, contract farming, the enlargement of farm size through land consolidation schemes, and other realistic responses to a changing factor endowment. The same institutional flexibility is in evidence in non-agriculture. Not only was decentralized industry encouraged by the rural

orientation of government infrastructural allocations (roads, electricity, etc.) but the establishment of export processing zones and the encouragement of bonded warehousing serving as an extension of that concept facilitated the foreign raw materials based export substitution drive. At the same time the credit and technological networking provided via the JCRR/farmers' association structure and the establishment of industrial estates assisted substantially in encouraging the growth of domestically oriented rural industries based on domestic raw materials. In both areas the nature of the East Asian patent system including the greater flexibility of patent offices and the greater unwillingness to let foreign multi-nationals use patents for blocking purposes were helpful. In this area there is perhaps more intervention in evidence in the case of the East Asian NIC's than in Latin America, but it is of the accommodating type. One may assume that the East Asians are looking to the Japanese case in which the legal structure, including that of a lower threshold/lower cost type of patent, the utility model, proved very effective in encouraging medium and small scale or blue collar type of innovational activity.

The East Asian NIC's have undertaken relatively few organizational reforms in the credit market area. Both systems are only now engaged in an effort to broaden these markets and provide for more specialized institutions, including the establishment of bond markets and organized money markets, with the help of appropriate institutional innovations. Private banks have become somewhat more competitive even though they are heavily protected and increasingly independent of the government controlled "commercial" banking system. The establishment of such additional financial institutions is undoubtedly a prerequisite for a substantially less repressed credit market. The important point to be made here is that the liberalization of the credit market had to be accomplished



very gradually, with the market initially stratified according to size and credit-worthiness, as the notion of an equilibrium prime rate has begun to emerge only in recent years. This is particularly interesting since it coincides with McKinnon's recent "second thoughts" about jumping to a fully equilibrium interest rate strategy too early in the development process because of the problems of adverse risk selection etc.

The same general observation can be made with respect to international capital markets. East Asian NIC's realized quite early that foreign investment had a positive role to play and should be encouraged by statute. Nevertheless, the kind of liberalization that one often reads about did not take place. Restrictions continued to be in vogue and substantial DFI flows began in earnest on Taiwan only after the termination of U.S. aid in the early 60's. Only gradually do we witness the institutionalization of direct investment via further reductions of government restrictions on foreign firm operations, including on export prohibitions, as well as the positive government encouragement of joint ventures as domestic capability increased. The domestic financial market today still provides inadequate scope for operations by foreign banks.

It is, moreover, interesting to briefly examine the organization for planning by the government in the East Asian NIC cases. In Taiwan, while the locus for government planning shifted from the Council of International Economic Cooperation and Development in 1963 to the Economic Planning Council in 1973, economic development plans continued to be compiled but were increasingly viewed as think pieces or general guidelines in the vein of the French indicative plans to convey a sense of national purpose, not in any sense mandatory or regulatory. In fact, when the planning machinery was once again reorganized in 1977, this time into the Council of Economic Planning and

Development, it became even less concerned with formal resource oriented planning and more with policy debates and the pragmatic formulation of future attitudes towards the private sector, comparable to the functions of the U.S. Council of Economic Advisors. This is somewhat different in the case of Korea where the Economic Planning Board has had more regulatory functions at any point in time but with the same trend being exhibited over time.

Finally, of course, there is the issue of the so-called "repressive" labor market situation in East Asia compared to that of other LDC's. It is quite clear that labor legislation, including dealing with employment, labor relations and working conditions, retirement benefits, minimum wage legislation, etc. has generally not been on the front burner in East Asia and thus has not raised the real cost of labor. The government clearly seems to have kept in mind the importance of participation by the working class, i.e. working class incomes rather than wage rates by individual elite working class members, all of which is much easier to accomplish when there is no strong union organization. It is my strongly held view that unions in any case derive their power from government in labor surplus situations and that the nexus of union wage legislation and government intervention on behalf of the worker is very often one of the major signs of synthetic nationalism and may be counter-productive with respect to the very people it is meant to help.

#### Section IV Some Final Thoughts

It should, of course, be remembered that all economies move along ambiguous, uncertain and non-monotonic paths, usually lurching forward in one direction, sometimes sideways, often partially retracing their steps. Moreover, they are much too complicated organisms in the institutional and narrowly economic sense to be neatly packaged either into well defined

transitional subphases or alternative institutional decision making paths. These are all matters of subtle differentiation among shades of grey, rather than black and white. But even given the recognition of all this subtlety of real world differences it is, nevertheless interesting to note the particularly flexible choices made by the East Asian NIC's which stood them in such good stead over time.

Initial conditions have to be examined relative to a certain point in time because we can't trace the problem back to Adam and Eve. Given those initial conditions we do not believe in inevitable sequences or unbreakable straight jackets; but we do adhere to the notion that organizational and policy choice over time is very much conditioned by where systems find themselves at the outset, both in terms of the more conventional indices of factor endowments, size of country, etc. as well as in the nature of the obstructing or accommodating institutional heritage which we have been emphasizing in this paper. Accommodating institutional changes, furthering the objective of the majority of the participants in the process of transition, represent perhaps the most important ingredient in developmental success. The East Asians may have had good luck in terms of their initial human conditions but they also built on that initial good luck with the proper institutional actions which gave them the necessary flexibility over time, i.e. once something did not work they were willing to change it. For example, when import substitution came to an end in the late 50's on Taiwan there was a great deal of filling and backing in an effort to cartelize, or regulate the market; ultimately, under the pressure of the scarcity of natural resources and the signal that foreign aid was about to be terminated, the institutional milieu was changed to accommodate the shift to a labor intensive export orientation. Once again later, after the labor surplus had been used up, these systems provided policy and institutional

change to permit the easing into a more technology, educated labor and capital intensive phase of production and exports.

Here as elsewhere import substitution constituted an early important element of post-independence nationalism. But, unlike elsewhere, that nationalism did not require intervention on a quasi-permanent basis but was consistent with an early effort to gradually liberalize by indicating an understanding that the identification between colonialism and the market mechanism is overdrawn, as is the identification between organic nationalism and direct controls. In fact, a willingness not to give up on political nationalism but to let it manifest itself in the non-economic arena was clearly in evidence in the East Asian NIC's.

In the absence of a dependable flow of natural resource intensive exports over time and/or generous foreigners willing to provide foreign capital for the asking, it became relatively easy for institutions to be established which would help convince industrialists; the effort had to be made sooner or later to shift towards large volumes of competitive exports and away from the small volume/large profit margin domestic market syndrome, useful for the reallocation of rents from the agricultural to the industrial sector. It was similarly easy to convince workers that they might be better off with larger wage incomes resulting from having more members of working families employed rather than the alternative high wage rates for only the employed heads of households. And it was easier yet to explain to other civil servants whose power and sometimes extra incomes were severely affected by any even gradual trend toward liberalization that the alternatives were not available in the long run. Thus, facing a decline in the rate of industrial growth and the threat of competitive price wars or cartelization at the end of the import substitution phase, policy makers in the East Asian NIC's made flexible

institutional choices accommodating changes in the economic environment. The so frequently encountered entrenched habits and strong vested interests of hot house industrialization never had a chance to flourish.

In the Toynbee sense of challenge/response the East Asian NIC's, in fact, had an easier problem. There was no real alternative for them but to build institutions that would tend to mobilize their human resources over time, first unskilled, then skilled, on behalf of the transition growth effort. This included not only the provision of infra-structure and, most importantly, its equitable allocation as between urban and rural claimants but also the creation of special facilities such as export processing zones, bonded warehousing, rural credit institutions, the support of farmers' associations and cooperative banks, increasing assistance for information diffusion on appropriate technologies, markets, etc. with respect to both process and attribute choices and, even on a time limited basis, help where economies of scale or externalities could be demonstrated to be important, e.g. in the case of financial markets.

It seems increasingly clear, and not just in East Asia, that the mobilization of large numbers of economic actors is difficult to undertake either in rich or poor countries, East or West, North or South. The East Asian NIC's recognized that a strong government was essential but that its willingness to exercise self restraint in selecting the areas in which it could effectively intervene and where it could not represented the key to building an accommodating institutional structure. In the absence of this institutional capacity the path to modern growth becomes much more difficult for developing countries and much more painful for the vast majority of their populations.