

# **THE EVOLUTION OF POLICY IN A COMPARATIVE PERSPECTIVE: AN INTRODUCTORY ESSAY**

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Future historians will probably agree that the major economic and political event of the second half of the twentieth century was the transition to modern growth effort by the contemporary less developed countries (LDCs) after World War II. Viewed in a long-run historical perspective, trying to move their systems from a prewar condition of “colonial agrarianism” toward what Simon Kuznets has referred to as the epoch of modern economic growth (MEG) has constituted a monumental societal undertaking. This modern epoch is basically the *scientific epoch* that started with the Industrial Revolution in England in the latter part of the eighteenth century, that is, the routinized and institutionalized exploration of science and technology and its applications as an essential part of the art of production providing the primary growth-promoting force.

The impact of this new phenomenon on the speed of gains in material well-being as well as on the marked nature of the structural change away from agriculture (implying the urbanization of the population) has amounted to a profound change in the way of life as well as in the institutional environment that regulates economic activity. This new way of life has seemed both attractive and irresistible. Once started, the modern epoch spread geographically from England, in chronological order, to the Continent, the United States, Germany, Canada, and Japan in the nineteenth century, and to Eastern Europe as well as parts of Latin America during the early twentieth century. The development effort in most of the contemporary LDCs after World War II represents a further dispersal of that same modern epoch to Asia, the rest of Latin

America, and parts of the Middle East, with much of Africa still substantially behind the others.

It has become increasingly apparent in recent years that of all the contemporary LDCs making the transition growth effort, the so-called East Asian NICs (Taiwan, South Korea, Hong Kong and Singapore) have been most successful. The purpose of this book is to analyze the experience of one of this “Gang of Four”, Taiwan, with the intention of determining whether an abstract set of ideas or conclusions can be generated from that experience that may prove useful to other situations similar in structure but not as far along in performance.

The authors are conscious of the fact that the Taiwan experience can, at best, be relevant only to a particular family of LDCs, though that family may be quite large—namely, the group of open dualistic economies characterized by the coexistence of a large agricultural and a smaller nonagricultural production sector internally and (given their size) by the relative importance of international trade and foreign capital externally. The conclusions of this book may, in other words, be less relevant for the oil-rich Middle Eastern countries or for many of the African countries (because of their educational and other infrastructural deficiencies) or to the very large countries of South Asia and China (because of the relatively smaller role of openness). It is therefore likely to be most relevant for the host of open dualistic economies of Latin America and of South and Southeast Asia, some of which seem to be continuously and often unsuccessfully struggling to effect their own transition while suffering from the maladies of the chronic import substitution policy syndrome—for example, excessive inflation, protection, overvalued domestic currencies, foreign exchange shortages, and slow growth.

As compared with the other LDCs, the common denominator of the East Asian NICs has been their relative shortage of natural resources, unless one considers the “location” of Singapore and Hong Kong as *entrepôts* as a natural resource. Since these four areas were not in a position to exploit something they did not possess, an inescapable conclusion must be that their overall success was due primarily to their ability to exploit something they did have: their human resources.

Inferentially, in other words, the secret of their success must be sought in the area of their policy experience through which each system's institutional environment was able to mobilize such significant creative energies of their populations as hard work, saving propensity, entrepreneurial strength, and the capacity to engage in risk-taking activities. The so-called Gang of Four apparently adopted policy measures outlining an environment or *institutional milieu* that turned out to be conducive to the effective mobilization of human resources in that broad sense. This is especially noteworthy because South Korea and Taiwan, at any rate, were viewed internationally as "hopeless basket cases" of development in the early 1950s. It must have been something largely within the system, then, that turned things around so dramatically.

Transition growth in all contemporary LDCs begins within the constraint of a certain set of initial conditions. For the East Asian NICs, these initial conditions are their relatively small size, their poor natural resources, and the high quality of their human resources as inherited from the historical past. Such cultural traits defined an initial social environment that undoubtedly proved especially conducive to modern growth. But it was policy changes over the past thirty years that built upon and modified that initially favorable environment. Thus, even though every other open dualistic system does not have the same initially favorable opportunities and cannot be expected to have the same type of performance, the policy experience of the East Asian cases can be instructive in substantially improving performance elsewhere and enhancing the chances for success in the transition growth effort.

A few additional words about the importance of the so-called special cultural traits are probably in order at the outset. It is quite clear that these human characteristics are part and parcel of a system's initial conditions. They were undoubtedly important and gave the East Asians an initial advantage but, unlike the case of initially favorable or unfavorable endowments of natural resources, such cultural conditions constitute advantages that are themselves subject to repair through human action over time.

## INITIAL CONDITIONS

All policies (including economic policies) are formed within the context of a society's cultural environment. The authors of this volume have labeled the Chinese cultural background as one that is essentially pragmatic as a guiding principle for economic organization. Simon Kuznets, for example, commented as follows on the traits "associated with" or conducive to modern growth:

The broad view associated with the modern economic epoch can be suggested by three terms: secularism, equalitarianism and nationalism. By secularism we mean concentration on life on earth, with a scale of priorities that assigns a high rank to economic attainment ... Equalitarianism means a denial of any inborn differences among human beings, unless and except as they are manifested in human economic activities... that makes man a full-fledged participant in the community of man... [bound together] by nationalism, the claim of the community of feeling grounded in a common historical past and its cultural heritage [on account of which] equalitarianism is limited.<sup>1</sup>

Economic pragmatism, Chinese style, represents a mixture of these three elements that has much to do with the unleashing of human energies due to the equity of the reward system that encourages such efforts. In Tibet, for example, as in other agrarian societies, the priests pray while the peasants toil, a societal standard that meets none of the three precepts. As long as such initial conditions obtain, Tibet is unlikely to enter the modern epoch since it is constrained by such an entirely different set of values and principles of income distribution. It is, in effect, a system under which the merits of economic performance by individuals are neither valued nor calculated.

More precisely, secularism suggests a certain dedication to the materialism of secure "survival" rather than to other worthwhile, and perhaps even nobler, social, political, or moral causes. As Kuznets

<sup>1</sup>*Modern Economic Growth Speed: Structure and Spread* (New Haven: Yale University Press, 1966), pp.12-14.

also points out, Protestantism, as interpreted by Tawney and Weber, implies that even though a “secular people” also prays and meditates, it indulges in these nonenergy-consuming religious activities infrequently, in sharp contrast to the basic nonsecularism of medieval Christianity. Although a secular people can take to the streets to engage in energy-consuming demonstrations against issues that affect its own life only very indirectly (for example, to protest against racial discrimination, abortion, colonialism, dictatorship, or pollution), it does so rarely and somewhat half-heartedly. Historically, the Chinese are well known for their secular culture, leaving the pursuit of Buddhism as a full-time occupation to the small minority of the priestly class. What has been more sacred in much of the West (for example, God) was a relatively minor preoccupation in the East. The commonly held image of Eastern otherworldliness and Western pragmatism may indeed be reversed.

Equalitarianism in fact is equivalent to the modern term of income *distribution equity*. It suggests that social privileges like wealth and social status are expected to be awarded to all who choose to perform economic tasks with distinction. This, in turn, implies that the cardinal principle of equity, the *equalization of opportunity*, is realistically applicable to all; that is, that every person is made a full-fledged participant in the community of man. The award of medals to those who work hard on the production line may seem to run counter to such equalitarianism because the honor diminishes as the ranks of heroes swell. To achieve family honor and prosperity in the long run through toil and frugality (to climb up the social ladder from landless peasantry to landowning status, and from there to entry into the distinguished gentry class), on the other hand, was a realistic hope for all in traditional China. With its peculiar, competitive imperial exam and its land-tenure systems, traditional China indeed exhibited strong cultural traits along the lines of equalitarianism as it has been defined here.

Nationalism, by contrast, lends wisdom to the art of sharing by putting limits on equalitarianism, and it is acquired from an awareness of one’s own history. The Chinese once again may be seen as unusually conscious of the continuity of their long, well-documented history of

over 3,000 years, far exceeding that of, say, the Philippines or Brazil. Their instinct is that to continue to exist as a group, individual families must indeed share, but only moderately.<sup>2</sup> The extended family system, which put severe limits on equalitarianism in China as elsewhere, broke down gradually during the eighteenth century. From that time on, the Chinese increasingly came to believe that those who do not achieve through economic endeavor deserve to be relatively poor, notwithstanding a residual community obligation to provide them with minimal survival support to guarantee the opportunity to compete for survival. “To help in an emergency rather than in perpetuity” is an age-honored Chinese proverb.

This residual community of feelings under nationalism, moreover, implies an extension of the concern within a local community or village to a larger community when incomes are transferred by political forces among provinces. The feeling of concern for this larger community requires a careful assessment of the costs and benefits if equalitarianism is not to be too severely limited by this manifestation of nationalism. The difficulty is that the formation of reasonable—not too costly to equalitarianism—behavior rules on a national scale is slow to form even as nationalism usually has taken the population by storm in the postcolonial era. The trick is to translate a common consciousness of cultural heritage into behavioral rules that are conducive to the institution of a sequence of orderly reforms (for example, land reform and tax reform) that express calculated sympathy with other members of the community without endangering the underlying principle of equalitarianism.

It was this tradition of pragmatism, as translated into habits of family self-reliance coupled with the intuition that government patronage is neither necessary nor likely to be forthcoming, that the East Asian NICs were able to draw on in the early postwar era. It is no accident that all “Gang” members are geographically adjacent to mainland China

<sup>2</sup>Kuznets clearly recognized that there should be a limit on the interference with egalitarianism imposed by the “community of feelings” of nationalism when he wrote that “large incomes were justified because they were received by the economically efficient” while “the general rise in per capita economic product made the remaining inequality tolerable on rational ground” (*ibid.*, p. 14).

and inhabited by a people well known for their pragmatic culture. Ironically, it is also in this region that we have witnessed, over the course of the past thirty years, the wastage of human energies during the most violent social upheaval—the Cultural Revolution on the mainland, which focused on socialist redistribution in utter disregard of the basic equalitarian principle. The fact that the Communist regime seems to have recognized this problem and is seeking to rectify it by means of a drastic liberalization program testifies to the underlying pragmatic tradition that is now resurfacing after years of political suppression.

It does not stretch our imagination too far to see the significance of a pragmatic culture in the context of the transition growth effort, for economic pragmatism is clearly conducive to an increasingly market-oriented economy. The very notion of a market system, as narrowly defined by pure economic theory, marks off an area of human activity that is basically materialistic or secular. Clearly, a system that provides economic incentives also rewards distinguished economic performance. It assigns a progressively smaller role to the community of feelings as expressed by direct government intervention in the production process. Although the mainland regime will no doubt continue to emphasize its socialist objectives for political reasons, a free market solution, once started, appears to be irrevocable.

Taiwan has the same pragmatic cultural background, but in the absence of the political constraints of the Communist system, it has moved consistently in the direction of a market economy. This is what we have referred to in this book as a liberalization process. Alternatively and synonymously, one can view this as a process of the gradual depoliticization of the economic system, as the gradual withdrawal of political forces from the system that regulates economic activities. When one adds a time dimension one arrives at the notion of policy changes within an evolutionary perspective.

A major advantage of the type of economic pragmatism under discussion is the possibility of depoliticizing the economic system gradually, with economic agents devoting their energies increasingly

to production, without the government, in spite of all rhetoric to the contrary,<sup>3</sup> really interfering too much in the name of income distribution equity. Given their cultural background, the populations of the East Asian NICs found it easier to accept the hierarchy of income and status related to economic achievement. This gave the policy liberalization process the rare dimension of linearity over time; that is, it was a process of change tending more or less consistently and irrevocably in the direction of a greater role for the market. Such linearity is observable in the series of small steps taken in that direction in all policy areas that affected the overall functioning of the system.

And such basic linearity, like good health, can really be appreciated only when it is missing. Secularism, equalitarianism, and restricted nationalism are not prominent features of the initial human resource conditions of most LDCs. For example, when LDC citizens have only a relatively short historical awareness of their own common cultural heritage, the feeling of community (nationalism) must often be hastily created. This usually involves rallying people through appeals to nobler, usually nonsecular causes (anticolonialism, welfare-statism, socialism, antimultinationalism, unionism) in which the visibility of government actions as a “partner” of the downtrodden is a key ingredient that fulfills an emotional need. Although people’s awakening to the existence of a larger national identity covering strangers in far away places is in this way often readily achieved, the formation of orderly behavioral rules to implement an economic program to help the downtrodden (“who pays how much taxes to benefit which other parties” or “how has the government intervened directly to help whom by hurting whom”) is an entirely different matter. In addition to the benefit side of the coin all government economic policies have a cost side that is usually underestimated, especially by politicians.

The high expectations that are aroused concerning the quick achievement of income equality through direct government action almost always lead to frustration. What usually follows in other LDCs is a series of erratic policy fluctuations without a clear trend, rather

<sup>3</sup>There are also posters on the walls in Taiwan swearing faithfulness to “income distribution equity”, the same Sun Yat-sen principle as on the mainland.

than policy linearity in the direction of liberalization. Ironically, the consequence of this demand for equity is that it becomes more and more difficult to supply. In other words, once vocal demands are set in motion the tendency for helter-skelter, stop/go policy changes to be adopted becomes irresistible. Every change in the finance ministry, every foreign aid fad can lead to a new set of policies, sometimes liberalizing, more often directly interventionist in character. This is in sharp contrast, as we demonstrate, to the more or less linear trend of policies that permitted Taiwan to achieve growth and, incidentally, real equity as a consequence of an increasing reliance on markets over time.<sup>4</sup>

It may be especially appropriate in this context to note that Confucius also believed that social conflicts are due more to inequity than to poverty. Equity and income-distribution-related issues impinge on all socioeconomic controversies as well as on the central arguments of this book that are concerned with policy change. The usual tripartite ranking according to the relative importance attached by professional economists, moving from efficiency (microeconomic) through instability (macroeconomic) to equity, should be exactly reversed before it is of any use as a guideline for understanding the political process of policy formation in the transition growth process. Although equity, as we have defined it, is paramount, microeconomic Pareto optimality is almost irrelevant. Citizens agree readily on efficiency but have difficulty on what is meant by equity. Depoliticization, on which liberalization is based, constitutes a process of the discovery and acceptance of equitable rules of sharing (of the equalitarian variety) in the course of the modernization process.

## **THE EVOLUTION OF POLICY**

In this book we have examined the dynamics of policy formation in Taiwan. This constitutes a new type of analysis that focuses on the

<sup>4</sup>See also Fei, Ranis, and Kuo, *Growth with Equity: The Taiwan Case* (Oxford: Oxford University Press, 1979).

importance of linearity in the evolution of economic policies by way of two unconventional analytical inputs: the notion of subphases in transition growth and the notion of a policy evolution matrix. The first emphasizes the linearity or consistency of changes in the evolution of the productive structure over time; that is, that it follows some sort of orderly metamorphosis as it moves from agrarianism toward the epoch of modern growth. The second deals with the question of an evolving policy matrix that accommodates rather than obstructs such a linear evolution in the organizational features of the system. The juxtaposition of these two evolutions within the same framework of reasoning constitutes, I believe, something of a useful methodological innovation.

A unique feature of the transition growth experience of Taiwan is that the thirty postwar years can be divided roughly into three main subphases of transition growth: the initial, internally oriented, import substitution subphase (1950–62), the externally oriented subphase (1962–80),<sup>5</sup> and a technology-oriented subphase (after 1980). The contrasting features of these subphases can be and have been well documented<sup>6</sup> in terms of a system of macroeconomic variables (time series for GNP, agricultural and nonagricultural output, total population, agricultural and nonagricultural labor force, imports and exports, savings, investment) that, when examined within an accounting framework, confirms the existence of such subphases. With the help of these demarcations in the life cycle of the system one can trace the decline of the relative importance of the agricultural sector and the growing importance of international trade, as well as the shift in the composition of exports. The emergence of a *technology sensitive* phase after 1980, during which much *R* and *D* related activity came to the fore for the first time, testifies to the near termination of the transition growth

<sup>5</sup>This subphase has, in fact, been further broken down into the 1962–70 period before the system's unskilled labor surplus came to an end, and the 1970–80 period characterized by the gradual shift to a more skill- and capital-intensive production and export mix after the advent of unskilled labor shortage and substantially higher real wages.

<sup>6</sup>See Fei, Ohkawa, and Ranis in Ohkawa and Ranis, eds., *Japan and the Developing Countries* (Oxford: Basil Blackwell, 1985). Here we note that a similar sequential order of subphases can be detected for post-1950 South Korea as well as for historical Japan.

effort as the economy moves into modern growth marked by the routinized reliance on science and technology.

The essentially academic contribution of this book is perhaps best illustrated by our effort to classify development policies and to indicate their emergence over time with the help of a time axis (see appendix). Ten categories of policies are, in fact, identified in terms of their sectoral or market relevance. Accordingly, we note a division into Fiscal and Taxation Related Policies (I, II), Monetary and Foreign Exchange (III, IV, V), Government Enterprises (VI), Agriculture Policy (VII), Manpower and Education (VIII), Science and Technology (IX) and Economic Development Planning (X). By enclosing the years 1962–80 between vertical lines, we indicate the three main subphases of transition growth (from import substitution through external orientation to technology orientation) in order to show not only the timing (or the timely appearance) of a particular policy measure but also the more complex notion of the conformable evolution of policy that accompanied or accommodated the evolution of the economic system through the various subphases.

## **POLICY EVOLUTION AND INSTITUTIONAL CHANGE**

Ever since the revival of interest in growth theory after the Second World War, economists have come to the conclusion that an understanding of the attempt at modernization in the less developed countries involves both economic analysis and institutional analysis. For example, more than twenty years ago Fei and Ranis stated the matter as follows:

It is the purpose of this book to present a theory of development relevant to the typical labor surplus type of underdeveloped economy and to extract some policy conclusions from it. Our approach has been to seek a reasonable compromise between narrowly defined “economic analysis” emphasizing the logical precision of the relationships between measurable economic phenomena and broadly defined “organizational considerations” emphasizing the

importance for these measurable phenomena of the non-measurable changes in the institutional milieu...<sup>7</sup>

Although much progress has, of course, been made since then, especially in the economic analysis involving the measurables, the nonmeasurable changes on the organizational, institutional, or political economy side have proven to be more difficult and elusive.

The appearance in 1966 of Simon Kuznets's previously cited work on "Modern Growth" provided the profession with a more historical view, to the effect that growth in contemporary LDCs can be viewed as passing through an organizational as well as an economic metamorphosis. The organizational metamorphosis, at least in the mixed economy case, can be seen as evolving in the direction of a more market-oriented economy. This organizational metamorphosis is, in turn, associated with a metamorphosis in the production structure that becomes increasingly complex, both internally and externally. These linked organizational and economic transitions can be viewed as comparable to the physiological metamorphosis of a biological entity (a butterfly) as it goes through various stages of life (silkworm, larva, butterfly). In the evolution of human organizations, however, there is a basic difference: the process is accompanied by an evolving system of ideas, or ideologies. In the analysis of policy formation, however, I believe an effort must be made to place such, often nebulous, expressions as "institutional inertia", "vested interests", "vested ideas", or "outmoded economic theories" into some sort of logical order. I take this to be the central argument and novelty of this book.

Commonly, the terms *social organization* and *institution* tend to be used interchangeably.<sup>8</sup> To an economist, a market with all its prices represents a *coordinating mechanism* in which all the participants that are being regulated may be assumed to be otherwise unrelated strangers. This is an organizational view of the market. However, an economic/

<sup>7</sup>*Development of the Labor Surplus Economy: Theory and Policy* (Chicago, Ill.: Irwin Press, 1964), preface.

<sup>8</sup>According to Webster's dictionary, an *institution* is defined as the totality of "practices, relationships and organizations in a society or culture." Notice that the term *system of ideas* does not appear.

institutional framework differs from this mechanical/organizational view because the institution is also concerned with ideas. In particular, it takes into consideration the fact that institutional participants may not entirely be strangers. They are to some extent concerned for each other when, guided by the idea of the community of feeling or broader social relations, they decide to support each other either directly or indirectly, through the government. An institution is thus seen as the sum of the behavioral practices of an organization supported by certain ideas governing human relations, by a feeling of community concerning what is "right" or "wrong" with respect to members of that community. In the course of the transition growth process it is to be expected that as the economic system becomes more complex the arena of human activities in which people behave as arm's length strangers becomes relatively larger over time.

In all societies, it is the set of laws and regulations and their implementation that make up policies. They obviously constitute the most important component of institutions. Thus a policy evolution, as traced in the policy matrix here, is really tantamount to an evolution of institutions or of ideas on human relationships at least as they affect the most essential socioeconomic groups. This suggests that the elusive and nebulous topic of economic/institutional change can be pinned down by focusing on the income distribution implications of economic policy change. After all, the area of human activity in which citizens need not entirely disregard community is composed mainly of ideas related to income distribution. This is quite clear from the prominence attached to the provision of "taxation with consent" in the constitutions of Western democracies. Policy instruments (taxes, interest rates, and foreign exchange rates), whether used wisely or foolishly, always carry important income distribution implications, often tantamount to "taxation without consent." This is decidedly more true in the political processes of a developing country than in developed societies.

The liberalization and depoliticization of a mixed LDC economy does not necessarily imply that the government does less. In fact, as compared with the LDCs, the governments of the industrially advanced countries as a group usually spend a much higher percentage of national

income, so in that sense the government does *more*. The crucial test for liberalization is the withdrawal of political forces from the market system—especially the domestic finance and international trade markets—where the *income transfer impact* of policies (for example, a manipulated foreign exchange rate or interest rate) on various social groups (labor, consumers, farmers, urban entrepreneurs) is not firmly backed up by the political consensus of a pluralistic society. Unfortunately, such a political consensus is hard to achieve because, on monetary matters, the income transfer impacts are not as well understood as outmoded macroeconomic theories, which usually emphasize Pareto optimality or problems of short-run instability in industrially advanced societies.

Even though all social institutions (including funeral procedures and fashions) are subject to change, the process must invariably overcome the resistance of vested interests (for example, that of the funeral profession or husbands) as well as of vested ideas (ancestor worship or notions of sex appeal). The fact that policy changes must go through a political process of enactment and implementation implies that such resistance is usually quite explicit and deliberate.

Although policy formation analysis cannot therefore avoid reference to systems of ideas and vested interests, taking a longer term perspective greatly simplifies matters. As Keynes admonished us,<sup>9</sup> the popular notion of the importance of vested interests (for example, the resistance of welfare recipients to government budget cuts in the United States, or the resistance to tariff reductions by domestic firms in Taiwan) is usually exaggerated. In the long run, what really counts in policy formation is the power of ideas. The United States Congress, for example, is currently keenly aware of the struggle of vested interests for entitlements under various welfare programs. Few, in a historical or reminiscent mood, would interpret the birth of the welfare state over the quarter century 1950–75 as the product of greed rather than “noble ideas.” Yet, for the analysis of short-run policy fluctuations in LDCs, the role of vested interests may well be crucial. It is, however,

9. John Maynard Keynes, *General Theory*, final page.

the linearity of policy changes in Taiwan, seen in a long-run historical perspective, that is the main subject of this book. Whatever “resistance” by vested interest groups is put up is soon enough rendered oblivious by the force of “history.” In this book, we have chosen not to put such vested interests at center stage in spite of their short-run journalistic appeal. Instead, we concentrate on institutional changes as an issue ideologically related to income distribution in the course of the transition growth process.

## **IDEAS AND POLICY INSTRUMENTS**

The importance of ideas in policy formation is well illustrated by the treatment of Taiwan’s import substitution subphase (1950–62) in this book. Two sets of issues are the focus. On the one hand, there is the issue of the preexisting economic structure and the underlying system of ideas culminating in the adoption of an import substitution strategy. On the other hand, there is the issue of the content of the various import substitution policies used to implement that strategy.

Most contemporary LDCs emerged after World War II sporting the economic structure of a primary export economy and the ideology of a postcolonial system. This ideology essentially has three ingredients that converge to form the so-called mixed economy, a politicized market system. The first relates to the adoption of an import substitution strategy in the effort to achieve a measure of autarky, or economic independence, to put alongside recently achieved political independence. The second relates to the deployment, to some degree, of centralized economic planning. The third is tied up with a strong sense of nationalism requiring the visible presence of the sovereign state in the economic arena.

In such a system there is unlikely to exist a clear delineation between those areas of human activity into which the government does or does not intrude. Almost every nontraditional activity involving social relations—from education to entertainment, from dress codes to hair codes—invites the possibility of government regulation. Such intrusions are not as much the fault of the vested interests of civil

servants, who consequently acquire power, as of citizen demand for emotional fulfillment. Taiwan initially was no exception to the generalized adoption of such a politicized system. The subsequent trend toward depoliticization of its economy must be seen in that broader historical perspective of the earlier, omnipresent intrusion of government power.

During the period of initial or primary import substitution (1950–62), Taiwan adopted the familiar package of policies (overvaluation of the domestic currency, government deficits, restriction of imports, “low” interest rates, price inflation) used by many contemporary LDCs of the open dualistic variety to implement the import substitution strategy. Various policy instruments were deployed to help overcome the initial difficulties of autarky and underline the “omnipotence” (or imagined omnipotence) of civil servants. The most pronounced of these difficulties was the initial inexperience of the new entrepreneurs together with the educational deficiencies of the civil servants who were in charge of implementing such policy intrusions.

In the context of a pure economic approach the quantity of money ( $M$ ), the interest rate ( $i$ ), the exchange rate ( $r$ ), the rate of import duties ( $t$ ), and prices ( $p$ ) are treated as instrumental variables in macro-model equations. Indeed they often represent policy instruments rather than market-determined equilibrium magnitudes in LDCs. In order to analyze policy formation in the political process, however, the variables ( $M, i, r, t, p$ ) must be more closely linked to the underlying system of political ideas. Within the import substitution package, for example, the set ( $M, i, r, t, p$ ) is deployed by the political powers who initiate and carry out an import substitution strategy in order to forcefully transfer income from one class of economic agents (for example, consumers or farmers producing an export crop) to another class (for example, industrialists or the treasury). Such *forced income transfers* are sanctioned by the current system of ideas (for example, anticolonial, socialist, or nationalist). Although we are certainly not unmindful of the impact of these variables on growth (within a more narrowly defined traditional economic analysis), we are even more interested in the

basic question of what caused certain policies to be adopted in the first place.

In the typical contemporary LDC, civil servants, operating a small-sized government budget, may realistically be able to produce much less than is expected of them. Since total outputs are produced mainly by private citizens, as a consequence of which purchasing power is generated and circulated, the economic power of the civil servants lies primarily in their ability to transfer income from those who earn it to those who do not. Although by these acts the fundamental principle of economic pragmatism—rewards for those who perform—is violated, whether these transfers are accomplished through the direct fiscal tools of taxation and expenditure or through the indirect tools of price controls and exchange rates may make a substantial difference for the performance of the system. In fact, there exists the even more powerful alternative of money creation ( $dM/dt$ ), which may prove most costly of all. What makes this a feasible tool in the developing countries is that the private sector cannot avoid the use of money ( $M$ ) as a medium of exchange that, while circulating, also serves as the *unit of account* for economic rewards within the market system. Unearned income or purchasing power manufactured by money creation thus becomes a perfect substitute for earned purchasing power in commanding goods and services in the marketplace. The power of money creation is indeed limited only by the growing realization within the realm of ideas that it is likely to be harmful.

The record of wartime public finance shows that by using money creation ( $dM/dt$ ) civil servants can acquire virtually unlimited amounts of goods and services, or wipe out any overhanging of government indebtedness, without resort to taxation. Civil servants can thus grant purchasing power to industrialists, at negative interest rates, without resort to voluntary savings. They can build up a stock of foreign exchange for their own use without resort to international borrowing. If resorted to by private citizens, this same set of actions would certainly be condemned as counterfeiting. In the hands of public-spirited civil servants, however, the creation of money ( $dM/dt$ ), when used in conjunction with policy variables such as taxation ( $t$ ), the foreign

exchange rate ( $r$ ), the interest rate ( $i$ ), international borrowing ( $b$ ), and government expenditures ( $e$ ), constitutes a legitimate (if silent) act of burglary. This is especially true where there exists neither the tradition of central bank autonomy nor near-autonomy, where, in effect, there is an inability to resist the political pressures for monetary expansion. There are few societies in which all transfers are “on the table” and openly debated within a pluralistic democratic system. It is always a matter of degree, but it is especially difficult to restore monetary and fiscal responsibility where these traditions did not exist even in colonial times.

Monetary and fiscal responsibility thus constitutes a crucial ingredient of economic pragmatism. A government loan enacted to save a troubled Chrysler Corporation in the United States was indeed preceded by prolonged legislative deliberations on the costs to the taxpayers versus the benefits to Chrysler stockholders and workers. In the typical developing country such an action can be mandated as an executive decision simply by means of monetary expansion implying a “benefit without cost”.<sup>10</sup> In other words, in most advanced industrial countries the cost-benefit calculation is more likely to be subject to a political process beforehand, whereas in most LDCs the cost or the benefit is implicitly apportioned to unidentified parties after the fact—usually with a considerable time lag between money creation and price inflation. Economic pragmatism implies moving toward the calculation of contributions and rewards for people as market participants. Monetary and fiscal restraint imply a similar meticulous calculation of the costs and benefits for citizens as participants in the political process. Taxation with representation becomes meaningless when money creation is used routinely to solve problems.

The popularity of an expansionary monetary policy and the permanence of price inflation (as in some Latin American countries) is partly due to political ideology—for example, where there is a short tradition of democracy or a long tradition of military dictatorship, all types of economic problems tend to be “solved” conveniently through

<sup>10</sup>In the case of Taiwan, it should be noted, the practice of lending to industries in distress or lending to strategic industries was discontinued at the end of the 1970s.

the avoidance of cost-benefit calculations embedded within the political process. A substantial part of the blame, of course, is the mysterious way in which monetary matters work themselves out under the table—"in a way not one in a million understands" (Keynes). When money is viewed as a liquid asset and when the linkage between money creation and desirable inflation is severed by a large time lag, people entertain the notion that money creation can, in the long run, also accomplish the "good things" that it appears to be able to do in the short run. Civil servants in developing societies are at times especially easy victims of this view. The reason we may "all be dead in the long run" can sometimes be traced to the illusory solutions we seek in the short run.

## **THE COMPLETION OF THE LIFE CYCLE**

As is well known, the success of transition growth in Taiwan has been due in large part to the gradual abandonment of the import substitution strategy in the early 1960s. The accumulation of policy-related data over more than twenty years (1962–84) provides convincing inductive evidence to support the central thesis of this book, namely that this is a case of policy evolution moving linearly in the liberalization direction. Depoliticization of the economic system occurred on all fronts but not simultaneously, as is shown along the horizontal axis of our policy matrix.

Although Taiwan's institutional transformation is, of course, not yet quite complete, at present the system is almost ready to behave like an industrially advanced country immersed in modern growth. Of all the contemporary open dualistic economies, Taiwan is undoubtedly the first to have "graduated," in effect almost to have completed its life cycle of transition growth. This central thesis could not have been supported by inductive evidence much earlier. The appearance of this book is thus extremely timely.

The linearity of the policy evolution in Taiwan can be seen from the fact that the liberalization movement gained momentum through time

in small cumulative steps rather than by the large leaps and bounds that often imply reversal and policy fluctuation. For a particular policy, such as devaluation, to take root, it must be a “step” in the “life” of the policy adjustment process. Usually an *ad hoc* first small step is followed by a bigger step a few years later, one that has more of an ideological appeal. Obviously the only way to portray institutional change is through the fact that thoughts and practices change concurrently. A good example is provided by the evolution of the fiscal policies indicated on the axis in the policy matrix, in which one can note the sequence of tax reform measures (income tax, 1955; tax reform, 1970; introduction of a value added tax, 1983) adopted in order to broaden the tax base in response to threats of a budget deficit. The pragmatic government never had the illusion that a fiscally responsible treasury could avoid the unpleasantness of having to confront the pain of political compromise. Moreover, as we point out, although the aversion to deficits represented the initial motive for tax reform, once carried out such reforms in turn led to new ideas.

To cite another example, the *ad hoc* liberalization of import controls via several small steps by 1971 subsequently gained momentum so that, by 1983, it could take on an entirely new and unprecedentedly ideological appeal by accepting the principle of the survival of the fittest and the discipline of international competition in the domestic market—a far cry from the xenophobia and autarkic appeal of the early import substitution era. Many previously sacred cows (public enterprises and/or the automobile industry) are now faced with scheduled tariff reductions and threatened with the prospect of virtual extinction through the competition of imports.

In short, the chorus for liberalization in the Taiwan newspapers of 1983–84 certainly would have shocked those awakened from their early 1950s sleep. This manifestation of a new self-confidence to meet and win in fair competition with foreigners in the domestic market is itself, of course, the culmination of success in competing in foreign markets during the earlier years. Policy formation at any moment in time clearly cannot be understood in a flashbulb vacuum, independently of what transpired in earlier phases of

transition growth, either in the realm of the evolution of ideology, consequent changes in policy, or related changes in performance.

The small-step approach to policy change advocated in this book is really quite natural because vested ideas are seldom abandoned overnight. As Keynes pointed out “those who are thirty-five or over do not give up their belief readily.” The introduction of a new tax system in Taiwan was, for example, heralded over a long period by the propagation of the “ideology” of the necessity of never-popular new taxes. The bill for a value added tax (1983) was prepared, studied, discussed, and propagated for at least ten years before it could be enacted. In fact, the enactment of a value added tax that is least distortionary in terms of relative prices was viewed as complementary to the scheduled substantial reduction of tariffs (1983). Thus, to keep the budget in balance and simultaneously to free up relative prices were the twin objectives consistent with the liberalization movement of the early 1980s.

Seen in this long-run, historical perspective, 1986 may well turn out to have been a significant landmark in the evolution of the institutions of Taiwan. Even though economic liberalization constitutes the central theme of the evolution of economic policy described here, the reader should also be aware of the fact that this process in the economic arena has, in fact, been accompanied by a gradual process of democratization in the political sphere. An acceleration of the pace of both the liberalization and democratization process in 1986 was then manifested in the formulation of new ideas that continue to be debated on the island. It is our unconditional prediction that the maturing of these new ideas will ultimately usher in another new subphase of policy once these tendencies are translated into new policy and/or legislative measures and that this will occur in the not too distant future.

In the economic arena, the implementation of a value-added tax (1986, category I of our matrix) as a government response to the emergence of a small prior budget deficit (1982), testifies to the persistent resistance to government deficits and inflation. The introduction of a new customs valuation system (1986, category II) constitutes a further liberalization measure in that the assessment of

import duties based on a tariff schedule calculated to discriminate against imports was replaced by import duties based on actual values. With respect to interest rate policies, the introduction of a prime rate system (1985, category III) moved the financial system one step closer to the free market end of the spectrum, with borrowers stratified by credit-worthiness rather than by political connections. Another event of major importance that occurred in 1986 was that the national currency was permitted to appreciate, persistently and significantly (1986, category IV), itself an indication that the system's political structure had entered a new phase of maturity in coming to terms with the persistent export surpluses that began to emerge after 1982. The resulting accumulation of very large foreign exchange reserves (more than US\$70 billion by the end of 1987) is increasingly seen as a problem, replacing the traditional mercantilist view of seeing it as an undisguised blessing, not only in terms of Taiwan's international economic relations (especially with the United States), but also in terms of Taiwan's domestic economy.

It is our firm prediction that further economic policy changes in at least four areas will find their way into the policy matrix in the near future. The proposed further tariff reductions (1983, category II) will be implemented, and the current effort at the liberalization of capital markets (1983, category V) will be accelerated to integrate the Taiwan economy more fully with that of the rest of the world and to make it compatible with the demands of global, market-oriented efficiency.

Such liberalization of trade and capital movements signifies a further reduction of the penetration of the market by political forces in terms of the selection of specific directions of investment and even specific projects. Another significant continuing change in the institutional framework governing Taiwan's international economic relations is the partial dismantling of its centralized foreign exchange reserve system under which the government has traditionally monopolized the holding of foreign exchange reserves as it first monopolized the power of monetary expansion in order to acquire its huge stockpile of reserves. The system will undoubtedly evolve in a direction that allows the nonbank public to hold a portion of Taiwan's foreign exchange reserves

so that, subject to private choice, some of the holdings can be converted into foreign assets including real estate or capital investments.

All liberalization movements are, of course, not necessarily the result of temporary foreign exchange affluence or temporary pressures from the United States that relate to its own trade deficit, pressures which might be viewed as short run and transitory. Far more important is the long-run process of liberalization I have been describing, of which the anticipated organizational changes in the years ahead simply represent logical extensions.

In the political arena, the democratization process brought with it during 1986 institutionalization of a polity characterized by competitive parties. This was followed not only by the elimination of martial law but also the permission for the publication of additional newspapers, the depoliticization of institutions of higher education, and greater tolerance generally, ranging from religious cults to teenage hair styles. In its broadest sense such parallel liberalization efforts imply the gradual atrophying of the government's authoritarian power in both the economic and political spheres. Government can be expected gradually to abandon its position as the one legitimate and uninhibited moralizing center. What is significant in the liberalization process in Taiwan is that this gradual transition is likely to be accomplished in the context of an atmosphere of accommodation and orderliness. The traditional Chinese cultural value of pragmatism may have much to do with this peaceful evolution that has brought Taiwan into an epoch of modern economic growth characterized by the coexistence of pluralistic interest groups that compete with each other in both the economic and political spheres, as is the case in the industrially advanced mixed economies.

## **TRANSFERABILITY OF POLICY EXPERIENCE**

There is little need for yet another volume to catalogue the set of "wise" policy measures that have been adopted in Taiwan over the past thirty years. These policies, moreover, have more recently become part of the *conditionality* discourse among the experts of the

International Monetary Fund, the World Bank, bilateral donors, and many contemporary LDCs: how to balance the budget, to devalue, to control inflation, to liberalize imports. Nevertheless, the fact that such “wise” advice is given repeatedly also implies that it is often ignored, or that it is tried and subsequently abandoned. What one often observes, consequently, are policy fluctuations with or without a steady trend. In recognition of this fact and as one by-product of our examination of policy evolution in Taiwan, we briefly consider the transferability of this experience. By recognizing that there may be some historical logic to the evolution of systems and the adoption of certain policies in transition growth, we have been able to distinguish between policies that, in the short run, accommodate from those that obstruct that evolution.

For LDC spokesmen and analysis who sometimes argue that the policies of Taiwan, as good as they may be, are irrelevant for them since they are “not yet ready”, or because Taiwan is a “special case”, we responded that thirty years ago Taiwan was not ready. It started its own transition growth process with initial per capita GNP levels not much higher (US\$159 in 1957) than those of India or those of Fukien Province on the mainland at the time. Today, Taiwan’s per capita income exceeds that of India by 800% and that of Fukien by something like 700%. In fact, the many mixed economies of the third world more favorably endowed with natural resources than the “Gang of Four” might well take heart from the fact that their initial conditions are more favorable rather than less.

The important lesson for other mixed, open, dualistic economies, in fact, is that there is always time to start the cumulative process of linear policy change. The experience of Taiwan indicates that the requirement of good policy is in large part to move through time unmistakably in the general direction of liberalization. As Kuznets suggested, by the time countries enter the modern growth epoch their production structure is likely to converge in a common pattern. It would not stretch imaginations too far to suggest that the organizational features of mixed LDCs will also tend to converge in the use of a market-oriented system typical of the industrially advanced countries.

It is this sequential, gradual approach toward a clear objective that is likely to be more successful than following the all-or-nothing propositions of purist advisers. This idea of a sequential order of policies of course also entails the notion of policy priority in the liberalization process: that certain policies should be liberalized first, depending on the seriousness of various bottlenecks at each point in time. A good example is the relative importance of the efficiency of horizontal allocation of resources domestically relative to the extent of overvaluation of the exchange rate.

Government discretionary controls clearly bias the direction of private investment. In Taiwan the tariff protection and import controls of 1952 and the Statute for the Encouragement of Investment in 1960, all part of the import substitution era, caused substantial *resources allocation inefficiencies* that violated the principle of Pareto optimality sacred to the microtheorist. Rare indeed is policy advice offered by international agencies that will not include as a top priority the dismantling of such discretionary controls. And yet the Taiwan historical experience has shown that a country can live with some of these controls for a long while and still be quite successful in its transition growth effort. The Statute for the Encouragement of Investment, for example, is not scheduled to terminate until the late 1980s, while only relatively small steps in the direction of tariff reduction and import liberalization were taken in the 1960s and 1970s (see the policy matrix) as a prelude to a major push in 1983. Although effective rates of protection were relatively low by LDC standards, there has been no radical reduction in tariffs, such as occurred in Chile, until this day.<sup>11</sup> The message from Taiwan thus is that monetary restraint and a realistic foreign exchange rate are more important than the elimination of discretionary controls that can be tackled at a later point in this evolutionary policy perspective. This may come as a surprise to the pure economist, given his strong vested ideas concerning the importance of Pareto optimality, but the message nevertheless is valid for most LDCs endeavoring to move from fourth to third best situations.

The successful policy experience of the East Asian NICs is, in fact,

<sup>11</sup>Even after the 1983 tariff reductions, the maximum tariff rate is still a whopping 73%.

transferable to other open, dualistic, developing economies if, and only if, economic pragmatism is transferred as well. If what the country aspires to are such cultural values as income sharing through welfare programs to direct market-generated income from one social class to another, policy fluctuations and upheavals are likely to continue to stand in the way of economic progress. Since good economists can usually predict policy impacts with relative ease, the suitability of the policy experience of Taiwan is dictated by the transferability of its political economy decisions, especially the ability to gradually depoliticize the economic system, so that families are increasingly rewarded by their economic performance rather than by entitlement through political patronage.

It is only natural that a book on the formation of economic policy on Taiwan be the joint product of academic development theorists who have observed rather closely the historical path of development of Taiwan and a high-level government practitioner who has been one of the principal architects of economic policies on the island over the past thirty years. The book is thus a joint effort at reasoning with respect to development policies as well as with respect to the political processes underlying policy formation. The principal author, Minister K. T. Li, is a firm believer in the doctrine of the “Three People’s Principles” of Dr. Sun Yat-sen (the principles of nationalism, democracy, and economic livelihood) . The fact is that these principles have consistently provided the guidelines for policy design through both the establishment and, later, the dismantling of the politicized system of import substitution. This strongly suggests that the success of these principles was largely due to the flexibility with which they were applied in the course of the transition growth process. The analysis of Taiwan’s policy evolution embodied in this book thus leads us to the insight of the need for a compromise between granting economic actors the freedom of self-reliant participation and the mutual concern for citizen welfare. In fact, Fei and Ranis’s earlier, related work on this issue indicated that an increasing emphasis on development through

<sup>12</sup>See *Growth with Equity: The Taiwan Case* (with Shirley Kuo).

market liberalization proves to be perfectly consistent with the equity of income distribution objective.<sup>12</sup>

A realistic, pragmatic liberalization effort, resolutely maintained, is thus much superior to the frequently encountered fluctuating policy patterns that alternate between periods of doctrinaire interventionism and periods of equally doctrinaire laissez-faire. This is the essential piece of transferable knowledge conveyed in this book's analysis of Taiwan's transition growth process. It is superior because it is likely to be more sensitive to both economic analysis, in terms of the sequence among sectors, and the recognition of economic actors' need for linearity in policy direction. It is superior also because it recognizes the realities of political economy in terms of who is helped and who is hurt by various policy changes and how, in recognition of all this, the required minimum consensus for action can be established and sustained.