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Strategy in Industrial Development: India and South Korea

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Source: *India International Centre Quarterly*, Vol. 20, No. 4 (WINTER 1993), pp. 1-18

Published by: [India International Centre](#)

Stable URL: <http://www.jstor.org/stable/23003687>

Accessed: 15/05/2013 18:05

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*Strategy in Industrial Development:  
India and South Korea\**

In 1986 when I first gave a talk comparing industrialisation in India and South Korea at a Delhi University seminar, the reaction was one of utter disbelief. "Why not compare Punjab and Korea?", said one participant. "Why not Ludhiana and Korea?", said another. These remarks were typical of our general intellectual milieu. Our intellectuals and bureaucrats have traditionally looked to the West for learning. In the East, only China has generally been viewed as a possible comparison. East Asia in general (including Japan) was for years an object of lofty disdain. We had, as it were, nothing to learn from East Asia. Only a few academics studied East Asia.

Over the last two years, the economic debate has changed dramatically. An economic crisis and a crusading Finance Minister have finally shaken us up from our intellectual slumber. The politicians of today, said John Maynard Keynes once, are only implementing what some academic scribblers wrote a few years ago. Having been an academic scribbler himself, India's Finance Minister may not be a routine politician. Still, it took political power to make an idea respectable for the bureaucrats and intelligentsia, the idea that India may have something to learn from East Asia. South Korea (Korea hereafter), which has achieved the most remarkable economic transformation in this century after Japan, has begun to receive attention.

Some misconceptions nonetheless remain. It is sometimes argued that Korea is a high growth achiever because it had American patronage. It is instructive to recall that many states have had American patronage in the post-1945 era. The Philippines and Chile under Pinochet's regime come naturally to mind. The former has not had an impressive economic record, and the latter fluc-

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\*The larger study on which this essay is based has benefitted from comments by Stephan Haggard, Garry Herrigel, Ronald Herring, Lucian Pye and Atul Kohli.

tuated between good economic performance and bad. Something more than American patronage is involved and must be accounted for.

It is also sometimes believed that Korean transformation was market-driven, the government playing a minimal role in the economy. Until recently, the economics profession, on the whole, subscribed to this view. Called the neo-classical orthodoxy, this market-based view was challenged by political economy research in the mid to late 1980s.

This essay will primarily deal with the neo-classical orthodoxy—due to its centrality in the current development debate. My argument will be two-fold. First, though India underused the market mechanism and overused the state in areas where reliance on the market would have been more beneficial for the country, the Korean contrast does not support a "free markets" case. Second, the forms of state intervention were intrinsically superior in Korea, whereas those in India led to a wasteful use of economic resources. Two differences in government intervention stand out. For shaping investment and production decisions of private entrepreneurs, Korea primarily relied on interventions through the credit system, whereas India chose physical controls such as licensing. Moreover, overestimating the constraints of the world market and underestimating the opportunities it provided, India's leadership relied on an import substitution regime. We wanted to produce everything that we used to import, for which, therefore, we provided protection to our manufacturers. Korea did not have a free trade regime but it combined import substitution with export promotion in a manner that exploited the world market to the fullest. As a result, in a matter of three decades, Korea has gone through an economic miracle comparable in this century only to Japan.

What follows is not an exhaustive discussion of the entire gamut of economic policies pursued in India and South Korea. Rather, the focus is on the state-market interaction. I suggest in the end that while we can learn from Korea's success, we can't expect the Indian state, our politicians and bureaucrats, to show the same degree of sustained commitment to economic growth. Hence, instead of relying on a Korean-style state intervention in the economy, we have to, willynilly, pay greater attention to the market forces than did Korea.

In order for a comparison of the development performance of two countries to make sense, comparisons (i) over time, (ii) along some measures must be made. Typically, these measures are: economic growth rates and their impact on per capita incomes and poverty; percentage of population dependent on agriculture; relative contributions of industry, agriculture and services to the national economy; and the commodity composition of industrial performance over time, i.e. whether the industrial sector has diversified from labour intensive "low value added" goods (textiles, footwear) to technologically sophisticated, "high value added" goods (machinery, chemicals, electronics).

Between 1965 and 1980, Korean economy grew at a rate of 9.5 per cent annually, as against India's growth rate of 3.7 per cent. Between 1980 and 1991, Korean and Indian growth rates were 9.6 and 5.4 per cent respectively. Such widely diverging growth rates have had a dramatic impact on the poverty and per capita incomes of these countries. The ratio of population below the poverty line continues to be high in India—between 30-35 per cent, by most estimates. In Korea such absolute poverty has disappeared. Moreover, it is not often realised that in 1961 the per capita incomes of Korea and India were roughly the same, \$73 and \$80 respectively (at 1961 prices). By 1991, Korea's per capita income was nearly \$6330, while India had crawled to a mere \$330 (both at 1991 prices).

A larger comparative profile is even more illuminating. In 1961, compared to Korea, the per capita income of Brazil was over twice as large at \$186, of Mexico over four times higher at \$313, of Argentina over five times at \$379, and Chile over six times at \$453. By now, Korea has left all of these Latin American countries behind. Other countries at the per capita level of Korea in 1961—Kenya (\$80), Afghanistan (\$70), Pakistan (\$79)—are, like India, still at the low income level.

In the early fifties agriculture contributed 47 per cent to Korean GDP and manufacturing 9 per cent. The Indian figures for the mid-fifties were 49 per cent and 12 per cent. By 1991, the share of agriculture in Korean GDP had come down to 9 per cent as opposed to India's 31 per cent. In Korea, manufacturing had climbed up to a share of 28 per cent in GDP, whereas in India it had slowly gone up from 12 per cent in the mid fifties to 18 per cent in 1987. Within the manufacturing sector, Korea, whose most sophisticated exports were textiles and apparel in the early sixties, has now one of the

most efficient steel plants in the world. It also exports ships, consumer electronics, cars and digital switching equipment. India does have these high-value added industries, but except software, most are internationally uncompetitive. In an interesting account, Vasant Sathe, a cabinet minister in the Rajiv Gandhi government of India, compared India's performance in the steel sector with Korea thus:

...while 14,500 workers at the Pohang steel plant in South Korea produce nine million tonnes of steel, a 125,000 workforce in India is not able to produce even six million tonnes of steel. Before the Pohang steel company was formed in 1968, South Korea's total steel production was only about 185,000 tonnes and that too from small open hearth furnaces. With a total investment of about \$3.6 billion, the plant which started production in only 1970 reached a peak level of 9.1 million tonnes by the end of 1984.....Compared to this our performance is dismal. And this despite the fact that we have employed similar technology and equipment at very heavy costs to the public exchequer...

Why did India grow so slowly—at a rate nearly one third that of Korea for almost three decades? It should be noted, first, that though further improvements can certainly be made, the performance of Indian agriculture has been quite satisfactory. Indian agriculture has maintained a trend growth rate of 2.7 per cent for nearly four decades (1950-90), considered reasonable, if not spectacular, by international standards of agricultural growth rates. Moreover, at 3 per cent per annum, Korean agriculture grew at a rate only marginally higher between 1954 and 1980, and since 1980, the agricultural growth rate has slowed down to 2.1 per cent per annum.

It is India's industrial performance which primarily accounts for our economic sluggishness. Between 1956 and 1965, industrial output grew at 7 per cent annually. Between the mid-sixties and 1980, it dropped to 4 per cent per annum. Korean industry, on the other hand, grew between 1953-62 at 10.8 per cent, and after Korea changed its strategy to export promotion during 1962-64, its industrial growth rate between 1965 and 1980 went up to a spectacular 16.5 per cent. In the 1980s India's industrial growth rate picked up to 6.3 per cent per annum; in the same period, however, Korean manufacturing grew at 12 per cent a year.

It is by now widely recognised that three factors accounted for the country's industrial sluggishness: excessive regulatory control on the private sector by the state, a general absence of competition in the economy, and an enormously inefficient public sector whose inefficiencies—due to the centrality of power, coal, telecommunications and transport reserved for the public sector—spilled over the entire industrial economy.

Two aspects of the regulatory regime were critical: investment and production controls, and the foreign trade regime. The industrial licensing system pre-empted domestic competition by restricting entry, thereby protecting early entrants. Until licensing was dismantled in 1991, it has been estimated that 80 different enactment and control agencies had jurisdiction over investment, production and distribution relating to a given plant. The intended goal of this control regime was to ensure that scarce resources were utilised according to a plan that was socially rational, and that investment went into "strategic" sectors beneficial for the entire society rather than for only some sections of it. The actual outcome however was very different. Given that there was only a limited number of licenses to be given, the early entrants typically reaped stable profits, not to be depressed by more new entrants. Moreover, the principle of cost plus pricing ensured profits. In a system like this, the energies of investors were not so much centred on capturing markets via cost-reduction or product differentiation, but on "license cornering" that would automatically guarantee profits. Since profits were guaranteed, the bureaucrats and politicians also derived enormous benefits from licensing: How was one to know whether a license was given on the basis of the technical superiority of a project proposal, or on the basis of a bribe? Even the economists who in many ways provided the intellectual rationale for the industrial control regime in the past realised the horrors of licensing over time. K.N. Raj, for example, wrote:

...the industrial licensing system as it grew over a period of nearly three decades had accumulated much filth and fat. It had ceased to perform effectively most of the functions it was designed for earlier, become a major source of political and bureaucratic corruption, and was being used by powerful interests ...to throttle competition from potential rivals...In my view it is wiser therefore to rather abandon the dishonesty and hypocrisy of it all than maintain pretences which...created needless delays and inefficiencies all around.

The Monopolies and Restrictive Trade Practices (MRTP) Act, added to the industrial control regime in 1969, introduced another wedge between intentions and outcome. The intended outcome of the Act was to prevent concentration of income and assets by prohibiting large firms to expand. In practice, however, this meant that in areas where costs could have come down from large scale production, firms continued to produce at high cost levels. Excess capacity was not allowed to be used even if demand for it existed; if a given plant could produce 100 units of output with its machinery, it was wasteful to have prohibited it from producing more than 60 units. Furthermore, prevention of expansion ruled out rational product diversification by a given firm: if the technology, skills and equipment needed for car production could be utilised with some modification to produce buses and trucks too, reducing costs of all three products in the bargain, it was irrational not to have allowed such broadbanding and to have given individual licenses for the separate production of each. Inefficient capital use was the outcome.

Secondly, the import substitution strategy ensured that there was no foreign competition. A host of tariff and quantitative controls provided a protected market to domestic producers. Few scholars would claim that the very initiation of this strategy was wrong. Any country wishing to develop must protect the domestic industry in the beginning. But the infant industry argument can not hold indefinitely. A child after all must grow into maturity: protective care stretched too far impedes the coming of age.

Finally, in addition to the regulatory regime, the performance of the public sector has also been a major source of waste in the economy. Consider some typical examples of inefficiency. In the power sector, India's capacity utilisation ratio was 45 per cent right through the 1970s: capital was invested to generate 100 units but was producing only 45 units of output. Management, a reasonably specialised matter in the late twentieth century, has generally been entrusted to the generalist officers of the Indian Administrative Service (IAS) who do anything from administration to development to electronics to fertilisers: by the time they understand something about fertilisers, they are moved to power, then to shipbuilding, still later to telecommunications and so on. In the 1970s, thirty public sector units of the central government recorded losses continuously for the entire decade, and the pattern con-



tinued in the 1980s. The story of the state electricity boards and state road transport corporations is of course worse. As initially envisaged, the public sector was to have generated resources for investment. Except in the oil and natural gas sector, this has not happened. Instead, losses have been made up by budgetary grants with a remarkable consistency. The presumed generator of resources became a net resource-consumer.

Why was such an industrial strategy continued well into the 1980s? After all, the results had started accumulating by the early 1970s. It is clear in retrospect that the continuance of industrial strategy was both in the interest of the state elite—political and bureaucratic—and the industrialists. The state elite sought rents and enrichment through its control over licenses and other regulatory instruments. Moreover, direct public investment was an enormous political and bureaucratic source for offering patronage. The industrialists, on the other hand, were protected from internal competition by the licensing system and from external competition by the tariff barriers and quantitative restrictions of an import substitution strategy.

In addition, there were powerful ideological barriers to changing policy. India's political leadership has, until recently, distrusted competition. Somehow the assumption has been that only the big industrialist would benefit from competition, and that too at the cost of the small man. Competition has been considered a zero sum game: that it could be a positive sum game has gone unrealised. Moreover, Indian politicians and intellectuals generally believed that competition would actually increase prices of industrial goods for the industrialist then would have no checks on his profit-seeking instincts. The typical image of a businessman is that of a *bania*—a trader-cum-moneylender—who has been traditionally disliked for his "unscrupulous" money-making instincts which are supposed to have been disciplined only by authoritative action in the past. A dominant, and largely correct, image of the feudal times and of a sector with highly undeveloped markets has been carried over to the modern sector where one would rationally expect the terms of argument to be different. Few policy-makers shared the belief that competition itself could be a check on the profit-making instinct of the industrialist for it would force him into cost reduction (via process innovation), or into quality improvement (via product innovation). Industrial goods would have been generally



cheaper as a result of such cost-reduction in India, not more expensive.

**I**n 1945 Korea was divided along the 38th parallel. The division was considered to be a disaster for South Korea. The South received about two-thirds of the population and about half the arable land. Most of the mines and half of the manufacturing went to the North, including electricity and heavy industry.

Syngman Rhee led the government in the South from 1948 to 1960. His industrial policy was much like the pattern followed elsewhere in the newly emerging world. An import substitution strategy of industrialisation was instituted with its standard elements: the exchange rate remained overvalued right through the 1950s, which made the initial imports required for the subsequent substitution cheaper; and to make sure that this did not lead to indiscriminate importing at the cost of domestic production, high tariffs and quantitative restrictions on imports were imposed to protect domestic industry. Import substitution was used, in particular, to create a base in basic goods such as chemicals, and capital goods such as machinery and transport equipment.

After a confused political interregnum, Park Chung Hee took over the government in 1961 and remained the head till 1979. It is this period which accounts for Korea's economic transformation. Unlike the meandering economic policy of its predecessor, the Park Government is generally considered to have been committed, most of all, to economic growth. Exactly how Park managed to bring this transformation about is a matter on which considerable controversy has emerged.

A number of economists, prominently Anne Krueger, Ian Little and Bela Balassa, argued that the miracle was market-driven and is a proof of what neo-classical economics can do if followed by the policy makers. The other group of economists, chiefly the participants of the Harvard Korea Project, Larry Westphal, Alice Amsden, and Robert Wade have argued that the miracle was state-driven and is a proof of what interventionist economic strategy can do if conceived and executed properly by the policy makers.

The neo-classical reading begins with the export promotion strategy of the Park regime and the reforms he undertook between

1964-67. In 1964, the exchange rate was devalued by 50 per cent to bring it in line with the market price of the Korean *won*; in 1965, instead of a multiple exchange rate, a unitary exchange rate system was adopted; and in 1967, tariffs were lowered for imports. (Alongside, interest rates were doubled on both bank deposits and loans to encourage savings and to discourage profligate use of bank credit.) Most of this was aimed at promoting exports, a task in which Korea succeeded to an almost incredible degree. Within a decade and a half, the share of exports in GNP rose from about 2 per cent in the early 1960s to as much as 30 per cent by the mid seventies, rising even further since then.

By the end of the 1970s, this reading of the Korean economic performance had produced a powerful neo-classical orthodoxy. Anne Krueger summarised the theoretical implications:

...gains from liberalisation occur both because of increased competition and traditional comparative advantage reasons, on the one hand, and because resources allocated to seeking rents and restrictions are reduced. As far as the underlying view of the government is concerned, there is increased recognition that bureaucrats and others develop a vested interest in controls, and that a 'dynamic' of control emerges.

The political economy research of the 1980s and 1990s challenges this view. Heavy state intervention is shown to have existed: not only internally but also with respect to trade. The intervention, however, has not been across the board. It has been—and this is critical—highly *selective* and according to a government strategy.

The essence of the strategy, dualistic rather than entirely market-driven, is best summarised by Pack and Westphal:

The strategy treats industries that are well established in the sense of being internationally competitive quite differently than it deals with the infant industries that are the particular targets of selective intervention. The objective of the strategy is to exploit the comparative advantage of the former industries while building a comparative advantage in the latter industries.

And further,

Export performance has been the practical yardstick for measuring progress towards international competitiveness. Infant industries

have been expected to begin exporting very soon if not immediately after they begin production. And established industries likewise have been monitored with respect to their export performance...

Export promotion and import substitution have thus gone together.

When we look at the means or instruments through which this strategy was implemented, the departures from the neo-classical understanding become all the more stark.

(i) Imports for domestic market were treated differently from those required by exporters. The former remained subject to tariffs and quantitative controls; the latter were tariff-exempted. Exporters thus faced a free trade regime: manufacturers for the domestic market did not. Korean automobiles, which have made their appearance in the western markets now, were protected for twenty years. Because of import controls, Korean streets for years had mostly indigenous cars.

(ii) Government monopoly over banks was used to encourage exports, influence investment decisions and force compliance. Both differential interest rates and quantitative credit rationing were resorted to. Exporters had automatic access to the working capital required for export activity, and subsidized investment capital was available for industries that the government selected for exports or for the strategic infant industries that were supposed to learn first by doing and then export. Cole and Park in their seminal study of the Korean financial system have documented in detail how interventions through the banking system were an *integral* part of the government's development strategy. Compliance enforcing measures included refusals to renew subsidised credit to companies that did not meet the yardstick of exports after an initial phase of protection. This was also supplemented with fiscal mechanisms: fiscal concessions, if any, could be withdrawn or tax returns of companies could be subjected to "careful examination". In general, "it does not take a Korean firm long to learn that it will get along best by going along."

(iii) Critical investment decisions were not taken by private firms in response to market signals. Rather, the government indicated its investment priorities to which the private investors responded. The government chose to foster a few infant industries

at a time and foster them well, instead of promoting all at the same time. Korea industrialized through conscious planning: from light manufactures and textiles, it moved to steel and ships in the second plan (1967-71); then came the "big push" towards heavy and chemical industries (HCI), including expansion of steel and shipbuilding, in the third plan (1972-76); next it moved towards consumer electronics and still later towards industrial electronics including attempts to develop indigenous digital public switching systems and acquiring know-how to manufacture fibre optic based communication systems. Alice Amsden shows in detail how government's investment priorities in fact were "market augmenting" rather than "market conforming" interventions.

(iv) Export targets have been an important instrument of promoting exports. Targets were not only set for industries and commodities, but also for firms and overseas markets. In the early sixties, these targets were allocated by the government but, over time, the government came to set them in consultation with firms, looking at their projections and utilising their knowledge of the foreign markets. Firms were closely monitored with respect to these targets. Monthly trade promotion meetings, held since 1965, chaired by the President and attended by concerned government officials, chief executives of export associations and heads of some key firms, were the main governmental channel for exchanging information with firms, assessing performance, revising targets if necessary, and indicating coming enforcement of compliance. The diplomatic missions or embassies abroad were also assigned quotas and some special institutions for this purpose were created, the best known being the Korean Trade Promotion Corporation (KOTRA).

To sum up, the Korean state intervened heavily in the economy; it was committed to economic growth; it had a strategy which was vigorously implemented; the instruments chosen for implementation ranged from using market-based methods (price and price-based policies such as taxes, exchange rates and interest rates) to quantity controls and quotas to direct public investment; the instruments were changed depending on the situation (government control over banks was handed over to private hands in 1982); export promotion went along with selective import substitution; there were incentives for performance and penalties for non-performance and performance was closely monitored.

Two analytical conclusions can be drawn. First, the invisible hands of the market were married to the visible hands of a policy or strategic design. Second, the *market was used as a subset of the strategy as well as its ultimate benchmark*. At any given point of time, there was enough protection from the market but only in the interim. The protected infants were expected—sooner than later—to stand up to international competition.

**A**gainst this background, it is easy to see why India has lagged behind—at least some of the important reasons, if not all, emerge clearly. Rather than state intervention per se, what has made a difference is the ends of intervention and its forms. The state intervention under Nehru, starting with the second plan was undoubtedly motivated by the goal of economic development. Under Mrs Gandhi for over a decade and a half, however, state intervention was less a vehicle of economic management and development, more a means for political patronage. It is noteworthy that after the late sixties till the mid-eighties, economic policy did not prominently figure in India's political debates.

One might argue that the primary aim of politicians is power maximisation, not economic development of the country, which can only be a fall-out or which matters only to the extent that it might decide issues of power. This approach misses a crucial point. Political leaders at least can exercise the option of *coupling power maximisation with policy* or strategy. Whatever opinion one might have of Nehru's economic worldview, he made a conscious attempt to join the two: notice the split in the Congress party over economic policy in the fifties, the breakaway of the Praja Socialist Party (PSP) and later of Swatantra Party. Mrs Gandhi decoupled policy from power maximisation; after 1969, the splits in the Congress Party were over everything except economic policy, indeed policy in general. When the leaders of Korea were vigorously pursuing the goal of economic development *and* staying in power (*and* perhaps enriching themselves) producing a miracle in the end, Indian leaders were only staying in power, using state intervention in the economy for political patronage and personal enrichment.

The fact that ends of intervention alone are not enough is perhaps self-evident. Forms of intervention must be such that the ends can be easily reached. Two crucial differences mark the forms

of intervention chosen by Korea and India. The first relates to the use of the financial sector. Private economic behaviour in Korea has been moulded by policy makers *primarily* via government control over bank credit. In India, the shaping of private decisions was attempted primarily via physical controls—investment licensing and capacity controls through the MRTP. Banks were nationalised in India in 1969 but credit from the banks was tried not as a substitute for licenses; the chief aim was to reserve resources for the small sector.

Physical controls are inferior to the credit mechanism as a way of directing investment and production for several reasons. In a credit based system, loans must be recovered and if credit is periodically desired for sustaining profitable production—which it will be if it is subsidized—then a mechanism for performance evaluation and enforcement is built into the system. In a license-based system, such periodic evaluation is not readily obtainable. Once granted, there is no easy way of checking performance since, unlike subsidised credit that a producer would like to have to keep costs of production down and maintain profits, a license holder does not depend as a matter of course on the government for maintaining profit levels. In fact, what happens is precisely the opposite. Licenses by blocking further entry of firms ensure that a search for profits does not translate into a pursuit of productivity. Licensing can help direct investment but is ill-suited to monitoring how efficient the production coming out of that investment is, whereas a virtually constant need for credit offers potential for both.

Investment and capacity licensing is irrational in another way. If new changes in technology require changes in the scale of production, bureaucratically mediated capacity licensing is typically slow to respond creating much delay and waste. In a credit based system, on the other hand, the effective limit on the scale-response to technological change is availability of credit, not *both* capacity licensing and credit. This makes the process easier and more flexible.

The second crucial difference in forms of intervention has been the way import substitution was used in Korea and India. Two main arguments constituted the rationale for the import substitution strategy: that exports could not be relied upon, for world trade would not increase; and that infant industry required protection. Of these, the former was, it is clear now, a case of "export pessimism" for, as it turned out, world trade during the fifties and the



sixties (until the oil shock of 1973) expanded at a historically high rate. The successful cases of development today made full use of this expansion through exports. The second, infant industry argument, is valid though the way it has been used in Korea and India shows that it makes sense only if used in a *selective and time bound* manner, not *across the board and indefinitely*. Korea used the strategy strictly as a means; it promoted a few infants at a time, with the condition that they be able to compete in the international market sooner than later. In the case of steel and ships, international competitiveness took only two to three years; in the case of computers, about five; and in the case of chemicals and machinery, the lag was ten years. In India, there has been an assumption that this would happen. The leadership did not devise a mechanism or make an attempt to ensure that this actually *did* happen. It was not realized that even though import substitution was an attempt to reduce the constraints of the market, its major ultimate test was the market itself. Unless the protected infant can compete later, protection can only generate incompetence, besides wasting resources that go into protective care.

**A**nother important question is worth asking. Did Korea's economic policies require its authoritarian political system? It is sometimes argued that unless economic management can be insulated from the clientelist pressures of interest groups — something that takes an acute form in a democracy since the political leadership is more dependent on group support than in an authoritarian system — rational economic policies can not be implemented and resources will have to be allocated to satisfying groups in a manner that is politically expedient but economically wasteful. India's democracy, according to this logic, is a problem for economic growth, a problem Korea did not have to face until the late 1980s.

It is tempting to argue this way but the argument can not be carried beyond a point. First of all, there are a 130-odd authoritarian countries in the third world but most have abysmal economic records. Moreover, those that have stayed largely democratic have not all done badly. Costa Rica, Colombia, Venezuela and Malaysia have, in fact, done quite well.



Could India, given its democracy, have *adopted* and *implemented* the policies that made the difference in Korea. Would these policies, given India's democracy, have led to similar results?

Take the forms of state intervention first. It will be hard to make the argument that physical controls can be run in a democracy but interventions through the credit system are impractical. Both aim at public direction of the investment and production activities of private agents. One mechanism, however, makes it easier to link investment with productivity by monitoring performance, the other, due to difficulties of monitoring, effectively breaks the link. The credit mechanism offers both carrots and sticks, not simply sticks — carrots in the form of subsidies and sticks in the form of possible subsidy withdrawal or even credit withdrawal. That in no way is antithetical to democracy. In India's case, the credit option was available. In 1969, banks were nationalized. But the government, instead of using its control over credit to increase productivity, in fact increased its reliance on physical controls by enacting the MRTP Act, which imposed strict capacity ceilings on the private sector.

Would Korean-style import substitution have been an insurmountable problem in a democracy? It should be clear that a drastic trade liberalisation is not the issue here; a carefully calibrated exposure to international competition is. A drastic trade liberalisation may be hard to push in a democracy, with domestic firms collapsing against the price and quality advantage of foreign goods. But it is unclear that a dualistic trade policy and internal deregulation would encounter the same difficulty. Once again, the basic principle is the same as in the case of credit. Carrots are coupled with sticks; protection today is traded against the promise of performance tomorrow.

The superiority of state intervention through the credit system and selective and time-bound import substitution (over physical controls, and indefinite and across-the-board protection) does not depend on democracy or authoritarianism. Given the goal of industrialisation in developing countries, this policy set is *intrinsically* superior, whatever the system. A more rational use of resources, easier monitoring of the performance of private economy and speedier industrialisation are built into the policy design. Even if one accepts that the pulls and pressures of a democratic system inevitably lead to compromises in the implementation of a

desirable policy set, and that resources in such a system always get diverted to clientelist purposes, the fact remains that, despite such slippages, the outcome would still be better.

The argument, therefore, can not be that South Korean economic policies require South Korea's political system. The argument can at best be that results of those policies in a democratic system will most probably be less miraculous — a growth rate of six to seven per cent instead of nine to ten per cent.

Let me summarise the conclusions that emerge from the analysis above. First of all, the difficulties of economic reform are often overstated in a democracy. The results of reform in a democratic system may not be as spectacular or quick as in a dictatorship, but a democracy does not preclude economic reform *per se*. Much depends on how coalitions of support are built by the reformers in the political system and in the larger society.

Second, whether or not the market forces are *consciously* allowed to rule the economy, an export-orientation introduces producers to the notion of competitiveness. Unless internationally competitive, goods cannot be exported on a continuous basis. Moreover, an outward looking strategy is also by now unambiguously associated with economic efficiency and welfare, and an inward looking strategy with a plethora of inefficiencies, corruption, and mass poverty. An inward return in India, if that were to happen at all, would amount to condemning ourselves to the mistakes of the past.

Thirdly, since, judging from their past performance, India's politicians and bureaucrats, despite the reform under way, cannot be expected to show a *sustained* commitment to economic growth, it follows that we should also not expect them to implement successfully a Korean-style policy design, based as it heavily was on credit market interventions. Korean economic performance does not support the case for an increasing withdrawal of the state from the economy; the behavior of India's politicians and bureaucrats does. Reliance on the market mechanism is a second-best solution, for the first-best does not exist.

The puzzle for the next round of research lies in figuring out how the Korean state, despite powers of intervention, did not fatten on corruption. There are stories of political corruption, but most

reports indicate that the day-to-day bureaucratic corruption was relatively small. Most other states in the third world, democratic or authoritarian, kept fumbling, but in spite of extensive discretionary powers, the bureaucracy in Korea did not end up vastly misusing the discretion. At this stage of our knowledge, we can provide explanations for why Korean business behaved the way it did — the state through credit subsidies, after all, developed a combination of incentives and penalties that was hard to escape and, if taken in the right spirit, was immensely profitable. We still do not know enough about why the Korean bureaucracy behaved the way it did. Only the next round of empirical research will enlighten us on that.

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