The Role of Government in East Asian Development

Lessons for Ethiopia

Bachelor thesis within Economics

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Abstract

This paper examines the lessons Ethiopia can learn from East Asia’s growth to sustain its recent economic growth. By an in-depth analysis of the role of government in East Asian’s development it provides recommendations for Ethiopia. The study is based on the experiences of South Korea, Taiwan and Japan in the context of three issues: selective intervention policies, coordination problem and export orientation. Results of the study show that governments in East Asia have used phased selective intervention mechanism to nurture their industries and coordinated private investment to ensure national development. They have also targeted export markets to make their firms competitive and upgrade exports from primary products to higher value goods. The selective intervention suggests a greater role for government, however targeting of exports and the efficiency from international competition indicates the virtue of market mechanisms as well. Government intervention however must be phased, moving from targeting primary products to higher value goods. This paper suggests that government intervention has to be supplemented by a government-firm relationship that avoids too much government autonomy, which is meant to solve rent-seeking problem. Rent-seeking problem can instead be solved through performance requirement and time limits on protection.
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# Table of Contents

Abstract .................................................................................................................. i

Acknowledgment ................................................................................................... ii

1. INTRODUCTION ......................................................................................... 1

2. GOVERNMENT AND THE MARKET ................................................. 4
   2.1 Keynes and the Role of Government ......................................................... 4
   2.2 Developmental State .................................................................................. 5
   2.3 Neoliberalism ............................................................................................ 5
   2.4 Market Failure and Government as a Correcting Mechanism ..................... 6
   2.5 Government Failure as a Rent-Seeking, Coordination Problem .................. 8
   2.6 Some Previous Research .......................................................................... 9

3. ROLE OF GOVERNMENT IN EAST ASIA’S DEVELOPMENT .......... 10
   3.1 Selective Industrial Policy ......................................................................... 10
   3.2 Coordination Problem .............................................................................. 12
   3.3 Export Orientation ..................................................................................... 15

4. LESSONS FROM EAST ASIA’S EXPERIENCE .................................... 18
   4.1 Selective Industrial policy .......................................................................... 18
   4.2 Coordination Problem .............................................................................. 19
   4.3 Export Orientation ..................................................................................... 21

5. CONCLUSION ............................................................................................... 24

6. FURTHER RESEARCH ............................................................................... 25

References ............................................................................................................. 26
1. **INTRODUCTION**

Economists have long argued about what kinds of policies are effective in bringing about economic development. Consensus on policy has not been achieved. Two views can be identified for this divergence. One argues there has to be a greater role for government: The other endorses a minimum role for government and allowing the market mechanism to reign. At the center of this debate is the presence of market failures. The argument for government intervention is a reaction to market failures and in the positive role for government in addressing them. The argument for minimum role for government on the other hand points to the problem of government failure.

Two policies can be identified that reflect the above arguments. One is the neoliberal policies, which prescribes a minimum role for government and stresses privatization and liberalization (Stiglitz, 2008). The other is the developmental state concept, which argues that the state should have a greater role in directing a country’s development. Bagachi (2000, P. 398) defines the developmental state as “a state that puts economic development as the top priority of government policy and is able to design effective instruments to promote such a goal”. It draws from the practical experience of the East Asian countries, which UNCTAD (2007) describes as a mix of different government interventions that effectively move around resources from one industry to the other.

Developing countries, such as Ethiopia, are looking out towards the development experience of the East Asian countries in a bid to sustain economic development. Ethiopia is a developing country with a population of 79.4 million people (UN, 2011). Before 1991 most of the economic activities were controlled by the state when the country was ruled by a military government which took over private investment through a nationalization policy. The military government was overthrown in 1991 and the country progressively moved towards a market economy. Public enterprises have been privatized through the country’s privatization agency. However foreign entry in the banking sector is not allowed and the government controls the telecom sector, showing the strong influence of the government in the economy. Ethiopia is an interesting case to draw lessons from East Asia since the country is engaging in a policy of state intervention. The country’s industrial policy, Industrial Development Strategy prescribes a development strategy that is guided by a strong and autonomous government (FDRE, 2002). The private sector is also identified as the engine of growth in the country’s bid for rapid industrialization. Ethiopia follows Agricultural Development Led Industrialization (ADLI)
and believes, as documented in its industrial policy that accelerated and sustainable
development will be achieved by a transition from agriculture to an industry led economy.
According to Ohno (2009) the core of the ADLI is boosting productivity in both sectors while
at the same time creating an input-output linkage between them.

According to the UN (United Nations) (2011) there has been an 11 percent economic growth,
as measured by GDP (Gross Domestic Product), over the past several years in Ethiopia. The
report also states that the country has embarked on national programs to accelerate economic
growth with a bid to become a middle income country by 2025. This however requires
sustaining growth and moving away from a dependence on a handful of industrial outputs.
The East Asian experience is rich with such a transition and policies were aimed at changing
the industrial structure targeting diversification and international competitiveness. It is
therefore interesting to draw lessons for Ethiopia from their experience. The Ethiopian
economy, according to the UN (2011) report, depends on rain-fed agriculture, which exposes
the country to climate related shocks. It has also been affected by inflationary pressures and
problem of food security. Agriculture constitutes 46 percent of GDP and industry accounts for
13 percent only. According to Gebreeyesus and Iizuka (2010), for example, the country’s
export structure has not changed for many years, with food items making up 61 percent. The
country’s plan according to the UN report is to transform the economic structure with a
significant increase in the share of industry. According to Aryeetey and Moyo (2012) such
change in economic structure involves resource transfers from low-productivity to high-
productivity activities. What did the East Asians do to achieve a rapid industrialization?

The purpose of this study is, to explore lessons for Ethiopia by drawing from the experiences
of the East Asian countries with emphasis on the role of the government. What lessons can be
drawn from the East Asian experience, in terms of the role of government? The paper
addresses this research question. What roles did government play in the East Asian countries?
What major policies and strategies can be identified? What kind of intervention did the East
Asian governments pursue? How did they solve coordination failures? These will largely be
answered by a critical review of literature, and presenting the policies they pursued.

The focus in this study is on the experiences of the East Asian countries of Japan, South
Korea and Taiwan. These countries largely depended for their growth on polices targeted at
upgrading a domestic industrial structure faced with similar structural problems Ethiopia
faces. The growth in the Southeast Asian countries has largely been the product of foreign
direct investment by multinationals, which is lacking in countries such as Ethiopia and fails to be a viable option. China is not included as well since the Chinese economic success has been largely helped by its diplomatic and political standing in the world, which has enabled it to carry out authoritarian polices without repercussions on a push for democracy. Ethiopia’s government policy is however to build a democratic developmental state, which makes a powerful authoritarian state option not a viable one.

The role of government is a wide topic and there are two ways to address it. One is a study of all the functions that a government is supposed to do to bring economic development which Luo (2005) calls a functional approach and includes the study of factors such as economic environment, regulation of the economy, the enforcement of laws and contracts. This paper uses the positive approach which studies what the governments have actually done since the interest is not a total emulation of the East Asian model, in which case the functional approach would have been most appropriate. The paper will not dwell much on the conceptual differences between the market and the state or which is better. It will rather focus on identifying the development policies of state intervention in the East Asian countries and draw lessons for Ethiopia. The concepts will be discussed in the theoretical review part only to give a conceptual base to the discussion, they are not meant to provide a full-fledged comparison or endorsement of one over the other.

The paper progresses by a review in chapter two of the concepts and theoretical underpinnings of markets, market failures, and the positive role of the state as well as the negative implications of government intervention. The next chapter presents the role of government in development in the East Asian countries of Japan, Taiwan and South Korea, to be followed by the chapter discussing the lessons to Ethiopia. The final chapter will be a presentation of the conclusion and recommendations for further research.
2. GOVERNMENT AND THE MARKET

This chapter discusses the issue of markets and governments. It starts with Keynes’ theory on the role of government. It follows by distinguishing between neoliberalism and the developmental state concepts. This is followed by a discussion of market failures and the role of government in correcting such failure. The last section will be a discussion of two forms of government failure, rent-seeking problem and government coordination problem.

2.1 Keynes and the Role of Government

Keynes argues that the enlargement of the functions of government is a condition for individual initiative to function successfully. Such enlargement involves “the task of adjusting to one another the propensity to consume and the inducement to invest” (Keynes, 1936: p. 380). Keynes argues that an optimum rate of investment cannot be determined sufficiently by the rate of interest. This is due to “fluctuations in the market estimation of the marginal efficiency of different kinds of capital” (Keynes, 1936: p. 164). Keynes argues that such fluctuations will be too great to be offset by any practical changes in the rate of interest.

An approximation to full employment, for Keynes, is achieved by comprehensive socialization of investment. Keynes argues such socialization is possible, since the state is in a position “to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an even greater responsibility for directly organizing investment” (Keynes, 1936: p.164). But Keynes also argues that it is important to ensure a mechanism whereby public authority cooperates with private initiative (Keynes, 1936).

The appropriate role for the state, according to Keynes (1936), is not the ownership of means of production. All that is necessary for the state is “to determine the aggregate amount of resource devoted to augmenting the instruments and basic rate of rewards to those who own them” (Keynes, 1936: p. 378). Keynes pushed, in the 1930s and 1940s, for the establishment of a National Investment Board (NIB). The purpose of such a board is achieving full employment “through a strategic regulation of aggregate flow of investment expenditures through public long-term financing” (Seccareccia, 2012: p. 75). With regard to classical theory of economics, Keynes states his criticism is not largely on the logical problems of its analysis but that the assumptions underlying the theory are never satisfied. Due to such unsatisfied assumptions, Keynes argues that it cannot solve the economic problems of the actual world (Keynes, 1936). Instead Keynes argues if central government intervention “succeeds in establishing an aggregate volume of output corresponding to full employment as
nearly as is practicable, the classical theory comes into its own again from this point onwards” (Keynes, 1936: p. 378).

2.2 Developmental State
The developmental state is generally linked to the practical experiences of East Asian countries such as Japan, Taiwan and South Korea where development was led by activist states (Wade 2010, Woo-Cummings 1999). Chalmers Johnson first used the term to characterize the role the Japanese state played in Japan’s postwar economic development (Johnson, 1999). The rationale for the idea of more intervention by the developmental state in a developing country context is seen in two aspects. The first is the argument that the status of developing countries in the world economy is far behind the developed ones. Indicating, therefore, the problem faced by late industrializes cannot be adequately addressed by market forces alone. The second one is a belief in the power of governments to correct such disadvantage through industrial policy. The combination of these two is “respectively termed the demand for and supply of state economic leadership in the political economies of developing nations” (Clark, and Jung, 2002: p.18).

The nature of the developmental state is seen in two components: ideological and structural. The ideological component is about the mission of accelerated development which is argued to give the state its legitimacy. The structural component gives the state the capacity to effectively implement policy. Such capacity is a result of political, institutional, and technical factors resulting from the autonomy of the state. Such factors enable the state to execute national development, through steady high rates of economic growth and structural change (Mkandawire, 2001; Zenawi, 2012; UNCTAD 2007). Developmental state theory is also linked to early development economics theory. Such view is evident in the works of Rosenstein-Rodan (1943) and Scitovsky (1954) through their big push theory that marked the decisive role the state plays in the coordination of complementary investment. The works of Gerschenkron (1962) also stresses the important role of the state in industrial financing in relation to modern technical progress. Common to all these views is the stress on the government’s role for economic development (Chang, 1999).

2.3 Neoliberalism
The belief in markets dates back to Adam Smith’s (1776) invisible hand theory. The theory states markets lead to efficient outcomes, thus government should not intervene with the market mechanism. Neoliberalism is based on the idea that the market mechanism lead to
efficient outcomes. It came as a reaction against state intervention by advocating liberalization and a minimal role for the state (Chang, 1994). There is also an argument that the state is a non-market organization and should be limited to activities that are large-scale and which private agents cannot supply (Krueger, 1990). Some of the activities are maintenance of law and order and provision of public services. Neoliberal policies are also referred to as ‘Washington Consensus’ policies, a term coined by Williamson (Williamson, 2004). The ‘Washington Consensus’ is a list of prescriptions which originally had ten items that included fiscal discipline, trade liberalization, privatization, deregulation, property rights and other recommendations put forth by Williamson (2004). Later, the ‘Washington Consensus’ policies were largely used as a basis by multilateral financial institutions, such as the IMF (International Monetary Fund) and WB (World Bank), in pushing development agenda targeted at mostly liberalization aimed at minimizing the role of government (Stiglitz, 2004).

Wade (2010) attacks the push on developing countries to open up their markets arguing that a position that free and open markets work best for all amounts to ‘kicking away the ladder’ since developed countries also used protectionist policies in their early development. Chang (2003) also examines the early industrialized European countries such as Britain and France as well as East Asian countries such as Japan, South Korea and Taiwan. He argues that much of these successful countries used intervention policies through infant industry protection as well as other activist policies. Mkandawire (2001) argues that the failure of Structural Adjustments Program (SAP) pushed by the Bretton Woods institutions (IMF and World Bank) has led the institutions to recognize the role of the state in economic development. The SAP, in Africa, had focused on policies of securing macroeconomic stabilization, trade liberalization and economic deregulation as a major policy push. However, these policies did not “generate adequate investment to expand output, exports and employment” (ECA, 2011: p. 1). Rather it is argued by ECA (2011) that SAP weakened the state’s capacity, which was constrained from pursuing appropriate policies to accelerate growth. The assumption that market forces would generate overall economic growth had not considered market failures, weakness of economic and social institutions as well as inadequate infrastructure and human capital (ECA, 2011).

2.4 Market Failure and Government as a Correcting Mechanism

An appropriate study of the role of government must address the underlying reasons for justifying government intervention. The pervasive market failure argument presents the fundamental justification for government intervention. The major market failures can be

Countries in the early stage of development lack well-functioning markets or when the markets exist they tend to be incomplete or highly imperfect and impeded by risk of entry. Such market failures signify resource allocation based on price signals alone will not be good (Stiglitz 1996, Zenawi 2012). In the absence of well-established market institutions, Stiglitz (1996) notes governments have to decide how to channel long term capital, which could have been done through the market institutions if it existed in countries in an early stage of development. On the contrary neoliberals believe in efficient markets and prescribe to deregulation (Chang, 1999), arguing that the institutions that markets require exist. Even when there is any departure from optimality they believe they cannot be effectively solved by governments. Proponents of active government challenge the latter view by pointing to the presence of market imperfection and the weakness of institutions that are required to make them work efficiently, thus stating that government interventions are needed to improve on market outcomes (Lall, 2004).

The market failure with regard to technological spillover is a result of inadequate incentive for a private business to acquire new technology since the social benefits exceed private benefits (Kim and Ma, 2005; Stiglitz, 1996). Besides if firms, having incurred a lot of expenses were to fully capture the benefits that flow from the new technology to themselves, it will hinder national development by disabling the diffusion of technology. This added with the pervasiveness of the market under which such technological change takes place gives technology a public good characteristic, requiring government intervention to capture the externalities from technological development (Zenawi, 2012). Given the imperfections with market information, the social gains from the action of the state to bear some of the cost of acquiring the information will be high due to the economies of scale from getting such information (Jomo, 2001). Patent protection ensures payment for new technology only and does not cover the transfer and adaptation by other firms. Since firms in developing countries largely depend on adaption of existing technology, such market failure will not be addressed with a market mechanism alone (Stiglitz, 1996). Beyond the lack of incentive, private businesses are also constrained by lack of complete information on technical alternatives and the development of knowhow. Such knowhow comes from experience, and knowledge that is ‘tacit’, costly to acquire and needs a lot of time. Thus, technological capabilities fail to be generated automatically by the market mechanism (UNCTAD and UNIDO, 2011).
The market failure related with coordination failure comes when the success of a given activity is dependent on simultaneous investment to be made by economic agents who have to invest independently (UNCTAD and UNIDO, 2011). It is especially pronounced in developing countries which suffer from lack of a network of businesses, which means the government would have to be more active to make coordination of economic activities possible (Stiglitz, 1996). Another coordination problem arises with regard to human resource training. Since labor would easily flow from one firm to another, training is most likely to be underfunded unless coordination by government corrects such labor market externality (Jomo, 2001). The other form of coordination failure results from mismatch of skill and production since production cannot happen without appropriate skills, and vice versa (Zenawi, 2012).

One of the arguments against government intervention is also based on government coordination failure, which is discussed in the next section. The criticism on government intervention to correct market failure is that government action will lead to socially wasteful results. This is challenged by making a distinction between two types of states. One is an activist state capable of correcting the market failures while the other one is a state inhibiting socially wasteful activities. The neoliberal view on government intervention as a socially wasteful activity is therefore criticized for failing to make this distinction, rendering all state activity socially wasteful (Zenawi, 2012).

2.5 Government Failure as a Rent-Seeking, Coordination Problem

Kim and Ma, (2005) classify the problems with government intervention in two ways. Firstly they see it in terms of the behavior of rent-seeking and secondly they see it with regards to government coordination failure. The first is when government intervention creates economic rent that is captured by some groups, which in turn triggers rent-seeking activities that are deemed socially wasteful. While rent creation is understood to be part of the intention behind government intervention, the case that it results in socially wasteful activities is challenged. Chang (1994: p.119) argues that the mere existence of rents created by the state does not imply that “resources will actually be spent on rent-seeking”. The magnitude of rent-seeking cost rather depends on the process of how state created rent is obtained. Zenawi (2012) also argues that such rent creation by government does not have to be socially wasteful. He argues that such view of a state created socially wasteful rent-seeking arises by considering rent-seeking to be exogenous to the firm, defining exogenous as resource transfer that is unrelated to what the firm does internally. State-created rent does not necessarily have to be external to the firm. It could rather be tied with the activities within the firm and its performance. This
can be achieved by rewarding firms that perform in a certain manner with access to rents and denying others who do not perform as such. He calls this process ‘endogenizing’ rent in firm performance (Zenawi, 2012). Government coordination failure on the other hand is an argument that the failure of coordination by the market does not justify an intervention policy by governments to correct that (Kim and Ma, 2005). The problem lies in the wide range of information required for making coordination effective and the skepticism with regard to the ability of governments to get all the information required.

2.6 Some Previous Research

Evans (1998) assesses the institutional requirements of the East Asian success and points that developing countries can benefit from the experiences of the East Asian success as long as they build a capable state apparatus. The World Bank (1993) studies the economies of East Asian countries and concludes that export push holds an important lesson for developing countries. Careful government intervention is also identified as key. However, with regard to impact of selective intervention on East Asia’s growth it holds a middle position stating that it is neither as important as “advocates suggest nor as irrelevant as their critics contend” (World Bank, 1993: p.325). It also affirms that good macroeconomic management and limited price distortions to be important lessons. Stiglitz (1996) argues the experience of East Asian countries in the role of government should be viewed as an adaptable set of policies rather than a fixed role for governments. He however argues industrial policies to be successful in East Asia and recommendable along with measures to promote accumulation of physical and human capital. Based on a case study of Taiwan, and referring to the cases of Japan and South Korea Wade, (2004) finds that activist government policy was behind the East Asian success and holds much lesson for late industrializers. Amsden (1989) finds by a study of the South Korean economy that government activism was behind the country’s success based on deliberate government move of ‘getting prices wrong’, which explains much of the subsidies and protection used to nurture South Korean industries. She recommends a greater role for government in developing countries based on these experiences.
3. ROLE OF GOVERNMENT IN EAST ASIA’S DEVELOPMENT

In this chapter the paper discusses the role of government in East Asian development. Three aspects of the role of government are discussed. The first is coordination problem, the second selective intervention policy and the last is export orientation. I will specifically deal with the role government played in the countries of South Korea, Taiwan and Japan.

3.1 Selective Industrial Policy

One of the central elements of the government intervention in the East Asian countries of Taiwan, South Korea and Japan was the use of selective intervention through industrial targeting. Such selective intervention has been a shift from the general incentives provided in the early 1960s (Lim, 1998). The general incentives were the promotion of saving and public investment in education. Research was also subsidized as long as they are available to all industries, while industrial targeting involved differentiated export targets, credits and subsidies to selected industries (Lall, 2004). Public investment in selected industries was also part of the industrial targeting in Taiwan (Lim, 1998).

The integration of the East Asian countries in the global economy and their successful post war experiences are credited to their “well-targeted” trade and sectoral policies (Vos and Ocampo, 2008). The constant and consistent targeting of sectors through their industrial policies is also credited for their impressive technological capabilities that have left competitive industries and brand names in various sectors in the world. One of the widely accounted for successful intervention is Japan’s heavy industry sector, which Page (1994) argues were also imitated by the South Korean government in the 1960s. The selective intervention for this sector included measures such as import protection, subsidies and capital for other imported inputs. The South Korean government also applied selective intervention through priority for access such as for foreign exchange, state investment funds and preferential tax treatments (Chang, 1994).

The policy justification in the South Korean policy behind the need for selective intervention is the argument that market mechanism alone cannot be completely relied on to make South Korean firms competitive in the international market (Chang, 1994). Such departure from market led resource allocation led to the identification of sectors that have potential for high productivity and given access to various supports. Although Chang (1994) believes that the East Asian structural transformation has been market conforming in the sense that it progressively moved from a labor intensive technology to capital intensive industries the
process was less ‘market conforming’ since particular industries were often selected and nurtured by the state.

Sector specific policy is much higher in South Korea as compared to Taiwan, but Lim (1998) finds that even in Taiwan sectors such as textile which were selectively provided better facilities such as export loans excelled in export performance. He argues government roles through industrial targeting were important tools in both South Korea and Taiwan and secured the countries dynamic comparative advantages. Dynamic comparative advantage is one that takes the concept of time into consideration as opposed to static comparative advantage. Wade (2010) argues that active industrial policies in these countries focused mainly on production diversification and upgrading. In the case of Taiwan the government had employed incentive mechanisms that were ‘price-distorting’, such as managed trade, managed FDI (Foreign Direct Investment) and sector specific incentives for exports as well as using large public enterprise sector (Wade 2010).

Another important feature of industrial policy in these countries is the phased nature of selective interventions. Dickens (2004) notes that the nature of selected industries changed over time, with the emphasis in South Korea for example changing from a focus on consumer products during the primary import-substituting industrialization phase to chemicals, petroleum and steel. The latter would give way to automobiles, ship building and electronics. In the case of Taiwan, Dickens (2004) notes that there was a shift from primary import substituting industrialization to primary export oriented industrialization and then to secondary import-substituting and secondary export oriented industrialization. The first category targeted items such as food, beverages, and light manufacturing, while the second one targeted products such as textile, plastics and intermediate goods. The latter would give way to steel, petrochemical and computers. The last items are currently the country’s major industrial items. The government decided not only which sectors should be protected and when but also addressed how they should be organized, with some subsectors reserved for local firms while others were identified to be slated for joint venture arrangement with foreign companies and public enterprises (Dickens, 2004).

Most of South Korea’s major industries have been selected as priority sectors through the stages indicated above and supported immensely. But they have also been subjected to heavy control as well (Chang, 1994). The trend is similar in the other East Asian countries. Page (1994) indicates that the government support for selective sectors comes with strict rules in
Japan where firms in selected sectors pass through rigorous credit evaluation. Bardhan (1999) goes even further to show that protection conferred on some industries by the East Asian governments also comes with a preannounced duration and indicates instances of the government withdrawing protection from an industry after the lapse of a pre-announced duration (Bardhan, 1999).

High investment level was seen as important by the South Korean government, but it was dubbed insufficient to upgrade the country’s industrial structure in a short period of time. Policy makers believed macroeconomic policy was ineffective due to its uncertain effect on the targeted sectors. Macroeconomic policy took second place to industrial policy and where the two conflicted; the latter was given priority (Chang, 1994). The justification has been a precedence of long term faster growth to be gained by fast growth in the priority sectors up against short term gains. Even during recession times the fast increase of subsidized loans given to priority sectors as compared to unsubsidized general loans shows the commitment to selective intervention. However, it should be noted that this does not imply that macroeconomic policy was not stable. The World Bank (1993) states that it has been stable, providing a good environment for private investment. The report also acknowledges that government intervened to foster development.

3.2 Coordination Problem
Governments in East Asia have intervened in the market to solve the problems of coordination failures, whose theoretical foundations have been discussed in the previous chapter. South Korea, Taiwan and Japan have all coordinated private investment through a host of measures. Rodrik (1994) explains that governments in South Korea and Taiwan coordinated private investment beginning from the 1950s by providing subsidies and tax incentives as well as through public investment. Such measures helped resolve coordination failures that had blocked their industrial growth.

The use of coordination forums that combined public-private interaction was one important aspect of their industrial policies (Okazaki 2005, Wade 2010). Japan used its MITI (Ministry and Trade and Industry) for this purpose. South Korea had the Economic Planning Board and Taiwan used its Economic Planning Council and Industrial Development Bureau. Such forums helped set out convergent interests and facilitate coordination. Some of the issues resolved were avoiding oligopolistic struggles in order to serve wider interests than specific interests of firms in an industry. Wider interest here implies the national development in terms
of the firm’s competitiveness in international markets. Such struggles could come in the form of price wars induced by slow demand growth unanticipated by firms during investment (Chang, 1994).

Viewed from the whole economy perspective such coordination would be to the country’s advantage since, as Wade (2010) observes, firm behavior is disciplined by a continuous interaction in the coordinating forums for a common interest. The coordination also helped identify particular industry level problems and opportunities. Much of the East Asian policies have been tried elsewhere, but the focus on specific firm level interests and the consistency with which they are addressed in the forums distinguishes the East Asian success (Wade, 2004). Policy measures that improved government-business relations also helped direct resources to activities with high social returns since it created a favorable business climate through better programs. This way governments supplemented markets while businesses were encouraged to target resources to sectors of high social returns (Stiglitz, 1996).

One of the measures that the South Korean government directed against the coordination failure was in properly defining terms of entry and collaboration with the private sector in devising of plans (Kim and Ma, 2005). It also used specific industrial policy measures such as limiting excessive competition which it believed results in social waste (Chang, 1994). This has to be understood in the context of how the East Asian governments understood the role of the government. The neoliberal view placed the source of national economic development to come from the “relatively unfettered interaction of freely competing businesses and consumers” (Pempel, 1999: p.139). The East Asians emphasized the importance of long term national economic development. Such development is targeted to come by focusing on competitive advantage in international markets. The South Korean government used various ex ante coordination measures, meaning by considering anticipated changes, such as restriction of entry to avoid too much competition. Firms were at the same time disciplined through control over finance, to avoid inefficiency that results from lack of competitive pressure due to protection from competition used to solve the coordination failure of the market (Chang, 1994). Such inefficiency entails cost, whose implication is captured by World Bank (1993) noting that all interventions come with costs, either directly through the cost of subsidies, or through the loss of revenue, while the implicit one is through taxation of businesses and households. Such cost is manifested in tariffs and control over interest rates. The South Korean government expected firms to make extensive reports on export
performance as well as other sectors in the protected industry, which gave the government the information it needed to make decisions in the selected sectors (Chang, 1994).

Incentives that are provided with control coupled with a network of collaborative forums described above mark the success of the East Asian countries of Japan, South Korea and Taiwan. In the case of Taiwan for example, according to Wade (2004) policy issue is not entirely left in the hands of government. Policy makers closely consult with the country’s research institutions and universities, while private companies and foreign missions were also consulted. The Stanford Research Institute, paid by a U.S mission in the country was commissioned to provide advice on the country’s steps in industrialization, another company was consulted to make specific recommendation about which products to encourage. A characteristic feature of industrial policy in developmental states like East Asia is selective interventions through industrial policy.

Japan, according to Okazaki (2005) had established by 1948 The Business Research Society, composed of corporate managers, administrators, and researchers vested with the task of studying the development of important industries in Japan. From the various studies a clear consensus on the direction of the country’s future industrial structure and the problems to achieve it were identified. Exchange of information on problems faced by individual industries was also achieved through interaction with sectorial associations and a coordination failure was identified in term lack of complementarity among industries. Problems of economies of scale and incomplete information were also identified, which coupled with the coordination problem created “vicious cycle that could not be escaped by the self-motivated conduct of the private enterprises alone” (Okazaki, 2005: p. 95).

Simultaneous investment in related industries was formulated in Japan through government private sector collaboration. While the government engaged in fundraising, market creation and used the financial institutions through loan mediation, private financial institutions were induced as well to collaborate in the industrial policy. A successful result in the country’s steel and coal industry to make it competitive in the international market also created the prospect for the country’s success in the ship building industry (Okazaki, 2005). Explaining how central coordination mechanism of the state has been in the East Asian countries, Wade (2004) states that government resources and influence have promoted investments that would otherwise not be made possible through market mechanism alone.
3.3 Export Orientation

The impact of selective intervention in the East Asian countries is challenged by critics of government intervention, but there seems to emerge a consensus on the success of their export promotion. The divergence on why the success in export however is less settled. Proponents of free markets as the causes of East Asian growth indicate the mechanisms of the free markets derived from the competition in the international market influencing resource allocation (World Bank for example, 1993). Proponents of government intervention point to government policy instruments applied to stir export growth (for example Amsden 1989, 2008, Chang 1994, Lall 1997, Pempel 1999, Stiglitz 1996, and Wade 2004). There is an argument that even if the success in export is in line with the neoclassical view of export markets being a “good proxy for efficiency in resource use provided there is zero bias in incentives to sell abroad or at home” (Wade, 1992: p. 285). However the success of export in countries like South Korea and Taiwan has been a result of subsidies and incentive as well as controls on performance by the government that have made these firms succeed (Wade, 1992). The World Bank (1993: p. 24) also credits government intervention to the rapid growth in East Asia noting that it “has benefited from careful policy intervention” where the government has been involved through subsidies and other measures discussed so far. However costs to interventions were kept within limits (World Bank, 1993). The report states that the information related externality that comes from export sector has been an important factor in Japan, South Korea and Taiwan’s rapid productivity growth. This is linked to result from a successful mix of pro-export incentives with a domestic sector protection. However it also argues that such miraculous growth would not have been possible without factors such as “domestic saving mobilization, broad based human capital and good macroeconomic management, and limited price distortions” (WB,1993: p. 23).

Export has grown for economies like Taiwan and South Korea which at the beginning could only export plywood and wigs of human hair, while they currently are among the top ten exporters in the world (Amsden, 2008). Government intervention was required in the two economies to make the export sector competitive. The textile industry in South Korea and Taiwan for example offers an interesting scenario that seems largely to be the case for other export sectors in these countries. Even if these countries were, in the 1960s, better placed than their Japanese counterparts in terms of market price and lower cost production advantage they could not compete with the latter. This was the case even if they had new equipment, courtesy of the US aid, good infrastructure and had the “Third World’s best education system”
(Amsden, 2008: p. 98). The lower costs advantage by South Korea and Taiwan against Japan, during that time, could not match the latter’s productivity, since the skills and market information in this industry according to Amsden (2008) requires more time and money than private entrepreneurs could sustain. This compelled the government to use industrial policy measures to complement their lower labor cost advantage. Such policies were conducted by giving investment funds through export subsidies and other measures (Pempel, 1999). Had these countries not used industrial policies to “overwrite free trader policies” they would have been stuck in exporting lowest skill requiring products (Amsden, 2008: p. 98). Their fate was turned by an active industrial policy that not only selectively nurtured industries but also helped them penetrate international markets through policies targeted at overcoming the risks and costs they would face in new international markets.

Whenever the East Asian countries of South Korea, Taiwan and Japan had selective industrial policies they also had selective policies to promote exports. In Taiwan, Lall (1997) observes that the export drive was led by local enterprises, mostly small and middle scale enterprises, which firstly targeted the Asian market through their Chinese connection. Later it would expand to Japan where Japanese trading companies sold 60 percent of Taiwan’s exports by 1960s and finally they would penetrate the American market. Such companies in Taiwan were supported by government in terms of subsidies and preferential tax treatment. They were also provided with access to credit and by establishing contacts in foreign markets such as the US for small exporting firms (Lall 1997). The government also provided them with marketing information while prizes for exporters were part of the incentive (Wade, 2004). This emerging market access will lead to the formation of small Taiwanese trading houses which Lall (1997) credits to giving the Taiwanese exporters valuable technical, design and marketing information. Lall (1997) finds that Taiwanese industrial policy has been less selective than South Korea, but a mix of both functional and selective polices were conducted. Functional as opposed to selective industrial policy involves the provision of incentive along the whole spectrum of industries, not targeted ones which defines much of the industrial policy conducted in the three countries of Japan, South Korea and Taiwan. However Taiwan for example had encouraged and offered incentive for firms interested in export by offering subsidized loans to cover costs incurred prior to export and to pay for imported raw material (Aryeetey and Moyo, 2012).

A performance criteria mechanism was the most important measure of allocating credit for firms engaged in export markets (Lee, 2002). Export provided an “incentive-based criteria for
allocating credit, encouraged the adoption of international standards and accelerated the diffusion of technology” (Stiglitz, 1996: p. 173). The incentives are provided through allocation of credit, while contests are widely used as incentive devices. The East Asians are also credited for having clear and preannounced criteria on which to judge performance. Part of the success in the industrial transformation of South Korea, which according to Wade (1992) had jumped from the 40th biggest exporter to the US to become the 5th by 1986, to be, according to Bardhan (1999: p. 5) due to the government’s “strict adherence to the criterion of export performance”. The rationale is exposure of the local firms to foreign competition aimed at learning as well as quality and cost consciousness, something that is said to lack in interventionist policies elsewhere in the world (Bardhan, 1999).

We have seen so far that incentive and performance criteria have been used to stir firms to export. The target is an international exposure to provide not only new markets, but also technology flows as well as quality and product diversification. While government intervention has been instrumental, Vos and Ocapo (2008) find that it has been supplemented by a good mix of monetary, financial and industrial sector policies. Managed interest rates influenced investment and saving while competitive exchange rates were considered essential to support export and export diversification. Lall (1997) also goes further to note that there has been deliberate undervaluing of exchange rates in a bid to help exporters. When a given country’s exchange rates are undervalued the exporters in a given country gain a competitive advantage over others since the products will become cheaper compared with other currencies. Continuous effort by the government and the private sector in upgrading production capacity for export is also credited for the fast and continuous industrialization of the East Asian countries. Vos and Ocapo (2008) contrast these to the Latin American, African and Central and Eastern European shift in development strategy, which they argue happened in a “big-bang” way instead of the persistent industrialization carried out by the East Asian countries. They argue that the “big-bang” shift led to the loss of previous production capacity and disabled the emergence of strong production linkages. The governments in East Asia also used directed and subsidized credit schemes to encourage export. The success in the East Asian country’s export sector has not only been in terms of an increase in export volume but the economies of these countries have also enjoyed dynamic economies of scale. Export has also created domestic production linkages and ultimately helped transform the production structure through identification of products and services with high potential for growth (Ocapo and Vos, 2008).
4. LESSONS FROM EAST ASIA’S EXPERIENCE

This chapter builds on the previous chapter to draw lessons for Ethiopia. The chapter is divided in three sections discussing selective intervention, coordination failure and export orientation.

4.1 Selective Industrial policy

We have established in the previous chapter how selective intervention has been used by the East Asian governments. In terms of drawing lessons for Ethiopia, two aspects emerge from the results on selective intervention in East Asia. Firstly, selective intervention has targeted competitive advantage in world markets. Secondly even if the emphasis was on targeting sectors through subsidies and other measures, they have also maintained sound macroeconomic policies. The focus on selective intervention is a good lesson for economies like Ethiopia, if not for much of the late industrializing economies. This is because firstly, late industrializers like Ethiopia trail far behind the industrialized nations against whom they must compete in the international markets and market forces fail to compensate such disadvantages. This leaves room for a targeted role for the government to support industries. Secondly, poor countries like Ethiopia are constrained by resources and have to prioritize their means thus selective polices are better than functional support, whose impact on key sectors will be uncertain. Ethiopia’s industrial policy identifies sectors such as leather, apparel and flower sector to be key sectors.

The other lesson to draw from the East Asian experience is that interventions should not be only about selecting some sectors and channeling support. The targeting of sectors has to be constant and consistent by focusing on sectors with huge potential for high productivity. Such selection must not focus on short run profit but focus on sectors with forward and backward linkages, inducing other economic activities while also allowing the diffusion of technology. Next, selective intervention has to be phased and focused on changing the production pattern of the country aimed at product diversification to capture a share of the world market. This will ensure a departure from shocks that affect countries like Ethiopia depending on a few resource based sectors. Through phased intervention policies, the government can support each industry at a given time and diversified the country’s economy. The experience of Taiwan and South Korea where they moved from consumer products to the production of high value sectors such as automobile and ships from beginning as exporters of human wig is an interesting case. The phased intervention also allows sectors previously selectively
supported to face competition and become efficient as government support moves to other sectors.

The other major lesson that flows from the above is that recognition that intervention of any sort has a great cost, as demonstrated through direct cost to household and firms as well as the problem of rent-seeking addressed in chapter two. One form of rent-seeking we identified in theoretical part has been the social waste that comes from lobbying to capture government created rent. The second type of rent-seeking is the lobbying by firms to maintain an already created rent. In chapter three we have shown how the East Asian countries have avoided this problem through a strict performance requirement, a variant of endogenizing rent in firm’s performance. We have argued government intervention does not have to be socially wasteful if firm behavior is disciplined as such. Endogenizing rent-seeking in firm performance solves the problem of social waste due to lobby, since firms will focus on performance instead. However as long as such performance requirement is not pre-established as the East Asian did, such social waste cannot be avoided as firms spend resources in lobbying. Some of the measures used by the East Asians, such as contests, can be applied based on performance while the commitment to let go of some selected sectors when they do not perform is an important lesson to avoid inefficiency due to protracted protection.

4.2 Coordination Problem

Coordination problem forms a case for government intervention as well as a source of its criticism, as shown in chapter two. We have noted that problem of complementarity of investment makes coordination necessary. In developing countries like Ethiopia where there is an absence of a network of business, the case for government intervention becomes more pronounced. On the other hand lack of a wide range of information required to make coordination effective leads to government coordination failure. Governments in East Asia coordinated private investment and resolved coordination failures that blocked their industrial growth.

A primary lesson from the East Asian experience is that the use of coordination forums helps identify convergent interests between the government and the private sector. This allows a proper identification of the industries that must be developed and the problems that hamper their growth. This way governments complement markets, whereas firms are encouraged to channel resources to sectors in line with national development, as was the case in East Asia. Instead of either a strict top down approach where identification devolves from the
government to the firm level or where firm level short run profit interests prevail, such forums help converge interest. Measures by the government to complement the absence of upstream investment or downstream ones by providing incentive to private sector is a good lesson for Ethiopia to solve coordination failures. However such incentives should be tied to performance as in the case of East Asia where firms were expected to present performance reports.

The government-firm relationship in the Ethiopian context is based on state autonomy. The need for state autonomy is justified on the ground that the government must be autonomous enough to discipline and give incentive to private agents without encouraging rent-seeking behavior. Problem of rent-seeking can be addressed by performance requirement, as demonstrated in chapter two. However when considering the coordination problem, such autonomy may limit the greater partnership between the private sector and the government that is the key to solve coordination problems. This is manifested in the attentiveness to firm level as well as industry level problems made possible by the interaction with the private sector, as amply demonstrated by the experience of the East Asian countries. The lesson for Ethiopia is that such coordination mechanism ensures governments have greater information so that coordination becomes effective, which without the engagement with the private sector will largely be made by government bureaucrats with limited information at their disposal. This is an important lesson for Ethiopia since government policy as demonstrated in the industrial policy of the country, ADLI (Agricultural Development Led Industrialization) aims to create an input-output linkage between industry and agriculture and ultimately move the country to an industrialized one. Such linkage networks would require a coordination of a variant of economic actors and resources that require more than the policy makers can access. This is true since some information is tacit in firm level engagements.

With a proper coordination of economic activities private sector can be induced to focus on sectors that have greater agricultural industry level linkages and invest in line with the national development plan. The Japanese example is a good lesson here. We have seen in the previous chapter how the Japanese solved the problem of simultaneous investment through government private sector collaboration. Government raised funds, assisted in market creation and mediated loans with the banks as well as inducing private banks to collaborate in the country’s industrial policy. On the other hand the private sector reciprocated with channeling investment towards nationally desirable sectors. The various mechanisms to ensure the private sector does this has been demonstrated amply such as subsidies, preferential tax and access to
credit, which can be done through Ethiopia’s development bank for example. The lesson from this section should not be what instruments to use, since this has been well covered, but rather that coordination problem is a complex problem which if not addressed through a market enhancing way participating the private sector would be ineffective due to government coordination failure.

According the World Bank (2011) one of Ethiopia’s few targeted sectors is the leather and apparel industry which has a huge potential, given the country’s position as Africa’s leading cattle producer. The country has duty free access to the EU and US markets. It has a conducive climate and soil condition. Low wage advantages also give Ethiopia a comparative advantage in the sector. The problems identified by the report on the industry include lack of quality processing of raw hides and skins, lack of entrepreneurial skills and poor trade logistics. Such problems can be solved through successful government private sector coordination by inducing complementary investment. In chapter two we have stated that training might be underfunded unless coordination by government corrects such labor market externality quoting Jomo (2001), such coordination might solve the quality problem stated above.

4.3 Export Orientation

Exports helped the East Asian firms through exposure to international competition, a virtue of market mechanism. The government had also supplemented these market mechanisms by providing incentive to firms engaged in export. However incentives such as allocation of credit have been tied to performance. The East Asian governments avoided problems of socially wasteful rent-seeking by preannouncing performance requirement. Besides, such selective intervention for firms engaged in export has also been benefited from proper exchange rate policies. The East Asian governments have also helped firms penetrate international markets through identification of markets and later helping local trading firms to prosper. They have also helped firms in skills upgrade and made investment funds available through export subsidies to supplement the lower cost advantage they had over industrialized countries.

Drawing lessons from the experiences, firstly exposing firms to international competition has been captured by Ethiopia’s policy document which stresses that it aims to select some industries and then those industries will diffuse knowledge to other sectors. These will gear industrialization through a linkage between not only agriculture and industry but also between
various industries. The policy document is clear about the motives of export push, it is a policy of export led industrialization which given the practical experience of the East Asian countries is desirable. However there is more room for lessons from the East Asian experience in terms of what they have actually done. The industrial policy document of Ethiopia FDRE (2002) states export orientation will expose firms to extreme competition in the international market, which will compel them to build capacity and skill upgrade. Ultimately as firms build skills, such competitive skills will be transferred to other firms and build a competitive industry. Such a competitive industry will, through forward and backward linkages, create other competitive industries. Skill transfer is supposed to be linked from one firm to another through managerial and workers shifts. However, what the East Asian experience shows and the lesson that should be taken is that, these countries focused on product diversification and upgrading not just skills transfer based on a gradual shift from a single firm or industry. The phased intervention was a good example of such policy. They made a comprehensive study of industrial sectors and accessed information through coordination forums with the private sector. Industries were selected with a focus on international competitiveness and capturing a share in the world market than on currently profiting sectors. They were also identified based on the domestic forward and backward linkage they created. The lessons therefore is that instead of focusing on a gradual shift of skills and technology from a firm to industry and then to national competitiveness through a slow mechanism, the selective support of firms has to go beyond a short list of sectors. Sectors have to be targeted with potential for higher value production and linkages and progressively target high value goods. Firms have to be supported to penetrate international markets as well like the case of Taiwanese firms which the government helped penetrate first Japanese markets, then Asian markets and ultimately the US market. Ethiopia can target nearby regional markets and then find trading firms in developed markets to connect with local firms, solving the information problem of local firms.

The skill diffusion in the Ethiopian policy document is explained by an example of a strong leather shoe industry that becomes competitive in the international market. With knowledge diffusion this will lead to a strong leather industry which in turn leads to a quality livestock sector industry. In fact the leather sector is a promising sector in the country while still being constrained by skills and management quality problems also faced by the South Korean and Taiwanese firms in the beginning of their growth period. Government could for example fund training while the private sector would invest in the industries that support the export sector.
The leather industry is a good example of an export industry with agricultural and industrial linkages and appropriate for economies like Ethiopia which is largely an agrarian economy. However an export target to upgrade the industry must not only target the shoe industry for example and then expect a gradual competitive industry in the leather industry as a whole. Incentive must be provided for the private sector to invest in the sectors with linkage to it since the problem of complementarity will hamper the overall competitiveness of the industry. Ultimately the export sector will not be limited to some primary products we identified in the introduction but diversified products with competitive advantage in world markets. Betting on gradual shift will also be hampered by first mover problem since firms will be discouraged to target new sectors for export market if they fail to benefit because of the movement of trained staff with skill. Instead of betting on a gradual spillover there must be a mechanism where pioneers are rewarded and skill development is given through a government support program of R&D. Ultimately success in industrialization is determined by the share of world market and the presence of domestic linkages, thus gradual shift will only create few competent firms without the contagious effect on the overall industrial structure.
5. CONCLUSION

This paper examines the role of government in East Asian development by presenting two views on how best to allocate resources. One is an argument for a greater role for market mechanisms, the other a greater role for government. We have identified the problems that lead to this polarity in terms of the presence of market failures, especially in developing countries where markets are weak or do not exist in some sectors. Problem of complementarity of investment adds to the problem. Since unfettered markets fail to address such problems it has been argued that there is a role for government. However there is also government intervention failure. Two such failures have been presented, problem of rent-seeking and government coordination failure.

An investigation of the experience of the East Asian countries of Japan, South Korea and Taiwan has revealed that they used government intervention mechanisms such as subsidized credit through targeting industries with high potential for productivity. The lesson for Ethiopia is that a mere selective intervention is not enough to make industries competitive. Firms have to be subjected to performance requirement and duration of protection has to be limited. Otherwise protection of selected industries will make them inefficient due to lack of competition. Selection criteria have to be predetermined so that firms will not engage in socially wasteful lobbying to capture rent created by government. This addresses the problem of government failure due to rent-seeking activity. Basing performance for allocating support such as credit allocation helps resolve this.

Selective intervention is better than functional measures due to the uncertain effect of functional policies on selected industries. While the Ethiopian industrial policy selectively promotes some limited sectors, the East Asian selective intervention was a phased approach, moving from primary goods to higher value goods. This phased intervention changes the structure of the economy by targeting almost all sectors in the economy at some point than depending on production of consumer goods that will be vulnerable to external shocks. The formerly protected firms in an industry will also be let to compete in a free market, allowing market forces to guide competition thus making them efficient.

The other lesson from the East Asian experience is the export push strategy that exposes firms to international competition. Government intervention has also been helped by proper exchange rate polices which made the East Asian firms competitive in the international markets. Government has also helped firms in securing foreign markets as well as skill
upgrade. Funding R&D as well as facilitating condition for firms to penetrate the world market is advisable. Economic development is dependent on the coordination of a large number of economic activities, mostly interdependent investment. The East Asian experience suggests that government has to be more active to coordinate such investment, especially in the absence of an extensive network of businesses. Such coordination of economic activities has benefited in the East Asian countries from government-firm collaboration forums that identified firm level, industry level and national level problems and prospects. This is an important lesson in the coordination of economic activities. Government minimizes government coordination failure by getting information from firms. Firms are provided incentives to engage in sectors beneficial to national development.

The Ethiopian government policy is a need for government autonomy to solve the problem of rent-seeking and be able to discipline firm behavior, however too much autonomy that impedes a government-private sector interaction will ultimately lead to government coordination failure. Besides, rent-seeking can be addressed though attaching incentive with firm performance. A phased intervention with limits on selective support is also beneficial to avoid lobbying to maintain protection. The pace of industrialization determines the share of a country in international market, indicating an ample requirement for a greater role of government. However the advantage of market forces in terms of efficiency as demonstrated by the export market in the East Asian countries clearly indicates that it is not about a government market dichotomy but finding the right mix. Solving market failures is important, while at the same time being cognizant that government involvement does not create its own failure. Policy should not be left entirely with the policy makers only, given information asymmetry and the greater advantage of government-private sector interaction.

6. FURTHER RESEARCH
Firstly, since measures of protection and subsides raise serious concerns with regard to WTO (World Trade Organization) rules, a study analyzing the instruments available for Ethiopia given its pending application for WTO accession is crucial. Secondly a study assessing the issue of resource mobilization to channel resource for incentives in government intervention would be an important contribution to the study. Lastly, a study into government policy implementation capacity is recommended to assess impact of costly government failure.
References


26


