Chapter 4

FISCAL REFORMS IN EAST ASIAN ECONOMIES

4.1. Harmonization of World Economy

With increasing globalization and integration of various economies into the international world economic order and the World Bank taking interest in formulating liberalization and structural adjustment programmes and integrating economic aid with the implementation of such programmes, public finance and fiscal policy have acquired a new dimension: international aspect of fiscal policy and its repercussions upon other countries. Severe macro-economic imbalances on balance of payment account in a developed country like U.S.A. could have destabilizing effect upon the economies of developing countries. (World Development Report 1988).[1]

(1) *Global Adjustment and Harmonization*

This is an important aspect of international division of public finance. The formulation of fiscal policy and tax structure should be such that they can harmonize and be compatible with existing systems of international economic and financial relationships and obligations and be conducive to avoidance of serious distortions in the movement of commodities, capital goods and foreign direct investment. Most developed countries in the western world have largely open economies and since World War II, they built up an international system which was based upon comparatively freer movement of capital and goods. This resulted in considerable economic development and prosperity.

During the seventies, however, a new wave of protectionism resorted to by America and other industrialized countries not only militated against developing countries' efforts to stimulate their exports, but also contributed to a diminution

of productivity and growth in their own economies.

Besides, mismatch of fiscal policies in the developed world itself can cause turbulence and uncertainty not only in third world countries, but in the entire world economic order. As *The Economist*[2] sees it. 'If over the next few years, liberal trade gives way to managed trade, if the global economy does splinter, as some fear, into separate trading blocs, and if the recent revival of protectionism accelerates, the economic losses could eventually put all three oil shocks to shame. The last great cycle of recession and protection reached its climax in the Great Depression of the 1930s'.

Moves are afoot for the formation of three blocs, the European Community, the Americas, and the Asia Pacific Region with Japan as the kingpin or central force. GATT, however, has been striving to establish an open multilateral system of trade negotiations and significant international liberalization of trade, with reciprocity, non-discrimination, and transparency as the guiding norms; and these principles have in the past stood in good stead in promoting international trade and industrial development. Much of the remarkable economic progress during the second half of the twentieth century is attributable to growing trade and GATT which promoted it.

(2) *International Equity and Efficiency in Resource Use*

This is an important aspect of public finance. Taxes on incomes and profits arising to foreign personnel and branches of multinational companies have to be decided on an equitable basis. Avoidance of double taxation is effected through tax treaties. Differential levels of taxes, particularly excise duties, can draw resources for investment from an efficient use to an inefficient use in another country. Such location of industrial enterprises and production is not decided by comparative advantage or relative resource cost but is determined by differential tax costs.

(3) ***Adjustment of Domestic Tax Rates to International Rates.***

Tax levels constitute an important determinant of investment climate in a country. With limited supply of foreign direct investment (F D I) funds in world, there exists keen competition among developing countries to attract F D I. South East Asian countries, with low rates of taxation – generally around 30 per cent – have been attracting sizeable volume of F D I. If follows that if other developing countries have to vie with them, domestic tax rates have to be adjusted to bring them in alignment with such tax rates abroad, in order to induce inflow of F D I into the country.

(4) ***Tariffs, Trade Barriers and Protectionism***

The impact of fiscal policy in regard to high tariffs and protectionism in developed countries have an adverse impact upon world trade and the economies of developing countries. They can cause destabilization and uncertainty.

A degree of co-ordination and harmonization of fiscal policies is necessary. The various member countries in the European Economic Community are gradually adjusting their fiscal policies and their objective is to harmonize their policies and to conform to the set pattern mutually evolved in regard to taxes, subsidies and other areas. The recently concluded agreement in regard to GATT amongst the vast majority of countries in the world augurs well for international harmony and cooperation. Implemented in the right spirit by both developed and developing countries, and with reduced tariff barriers and protectionism, it could be the harbinger of a new era and result in multifold increase in international trade, with consequential benefits to all the participating countries.

4.2. Fiscal Reforms for Growth in East Asian Economies : An Overview

Detailed analysis and study of the East Asian Miracle have opened up new vistas of thought, and strategies of growth need to be revised in the light of conclusions reached with regard to the proximate causes of growth. In the light of these studies, the objectives and functions of fiscal policy also need to be

restated. We shall now take up an analysis of the causes and means of growth in East Asian economies.

(1) *Modernization and Rise of East Asia*

Future historians would regard the modernization and economic advancement of Asia as one of the most important events – at least in the economic sphere – of the second half of the twentieth century, not only because it resulted in the emancipation of a cognizable section of mankind from the shackles of poverty, illiteracy and squalor, their ongoing progress towards rich world income levels, and the entry of a number of East Asian countries into a Pacific-centred golden age, but also because it contributed to a tremendous expansion of world trade, and the creation of some of the biggest business and financial opportunities for the western world[3]. These included, *inter alia*, participation in the building up of infrastructure such as power, irrigation, ports, roads, airports on a huge scale and catering to the needs of a few million consumers having considerably increased purchasing power, many of whom would have disposable incomes almost equal to the current rich-world average incomes. Their expenditure on automobiles, houses, education, health, recreation *et al* would provide a remarkably high level of orders for business firms.

The economies of East Asia, during the period 1960-95 achieved remarkably high and sustained growth in G D P and per capita incomes on the basis of export-led growth and a manufacturing revolution. (Vide Table 4.1) Eight economies were conspicuous and their substantial growth gathered momentum in the second half of the twentieth century: Japan in early fifties; Four Tigers - South Korea, Hong Kong, Singapore and Taiwan - in sixties; and others 3 N I Es - Indonesia, Malaysia and Thailand - in seventies.

Between 1960 and 1985, per capita income in real terms in Japan and the Four Tigers increased by more than four times, and in the three N I Es by more than twice. The remarkable feature of their development was that rapid growth

was accompanied by increase in human welfare, life expectancy, education and housing, and decline in absolute levels of poverty. For instance, the number of people living in complete poverty was reduced from 37 per cent in 1960 to 5 per cent in 1990 in Malaysia and 58 per cent to 17 per cent in Indonesia during this period. These empirical findings also provided confirmation that growth and equity were inter-linked, and in fact they reinforced each other.

(2) ***Strong Basics***

Accelerated growth was a function of certain vital factors: physical accumulation, high standards of human capital, efficient allocation of resources, improving levels of productivity emanating from induction of modern technology and stimulated exports. The East Asian economies were able to achieve phenomenal progress basically because their economic policy fundamentals, which provided stable foundation for growth, were strong. With good economic management and equitable fiscal and monetary policies, they ensured low rates of inflation. They allocated capital to highly productive investment. Price distortions were kept to the minimum so that prices reflected scarcities and promoted allocative efficiency. They generally maintained open markets and encouraged domestic and international competition. The East Asian economies created through taxes, incentives and liberal policies a climate that was most favourable for domestic private investment, as also foreign direct investment and inflow of modern and sophisticated technology which they adapted. They encouraged export oriented direct foreign investment.

The eight East Asian economies (including Japan) had certain common characteristics which distinguished them from other developing economies and also accounted for the greater portion of their growth[4] :

(1) higher rates of growth of physical capital amounting to an average 20 per cent of G D P between 1960 and 1990, accompanied by higher rates of domestic savings.

(2) higher initial standards of human capital, which were further increased through education – particularly primary and secondary, as also acquisition of technical skills – to greater levels by achieving high growth rates; as also reduction in fertility consequent upon increase in female education;

(3) higher rates of productivity growth through technological upgradation;

(4) stimulated rate of increase of manufactured exports, with their share of world exports of manufactures increasing from 9 per cent in 1965 to 21 per cent in 1990;

(5) greater increase in production and productivity in agriculture.

These economies adopted the functional approach to growth and they succeeded in creating the overall environment, motivation and causational factors, which combined with the distinctive characteristics of Confucian culture – obedience to authority –, resulted in the achievement of tremendous economic advance. Policies for improvement in agriculture contributed to rural development and better equity in distribution.

In East Asia high rates of human capital formation, savings and investment have been fostered by macro-economic stability and rapid economic growth. Growth, savings, and investment constituted a virtuous circle as high investment initially stimulated growth, which resulted in increased savings, which fostered continued high rates of investment. In addition, three general principles have been particularly important to investment: first, principle of shared growth, secondly, that of secured property rights, and thirdly, complementary public investment in infrastructure, especially in the export sector. These constituted key elements of the market-friendly institutional environment for promotion of investment. The financial system was conducive to high levels of capital formation. Effective monitoring, competent civil service and supportive institutional mechanisms promoted rapid development.

The East Asian economies resorted to state intervention to boost exports and succeeded in stimulating export oriented growth. Exports were stimulated through subsidized credit at low interest rates and external borrowings, subsidized technology developed and adapted by the state, identification of foreign export markets and tax incentives. However in Japan and South Korea, despite state intervention, markets were kept relatively open, free flow of investment and technology was maintained and inflation contained. Producers had to counter domestic and international competition. South Korea endeavoured to directly encourage heavy and chemical industries, but the effort met with failure and change in policy was effected.

The Economist[5] referred to the controversy in regard to the role of the state in East Asian economies' success. The revisionist school attributed the success to state intervention in industry, trade and finance, providing subsidized credit, foreign exchange and technology to select industries to promote exports, as also price and other distortions, while the neo-classical school stated that the Asian Miracle was attributable to strong fundamentals. *The Economist* stated that the truth lies somewhere in between and the latter were right: 'To explain the miracle, it is necessary to find what East Asia's successful economies had in common with each other, but not with the third world's more numerous failures. That thing was not an ambitious economic role for the state.. What most clearly separates East Asia from the third world losers is getting the fundamentals right'.

4.3 Fiscal Policies and Growth in East Asian Economies

The economies adopted varied tax policies to increase investment by increasing retained earnings of companies. While Hong Kong provided for a simple tax structure with low tax rates (presently 20 per cent maximum personal tax rate and 17.5 per cent corporate tax rate), Korea, Taiwan, Malaysia and Thailand provided complex tax structures, but with several tax incentives for promoting investment. The former two countries also used tax policy to direct the pattern

of their industrial development. Singapore garnered fiscal policy to promote industralization and achieve social objectives. It provided incentives particularly to foreign investors for investment and to stimulate domestic savings. Contributions to their deeply pervasive Central Provident Fund stimulated aggregate savings by about 4 per cent of G D P during 1970s and 1980s. Many of the East Asian economies stimulated corporate retained earnings by improvising low corporate taxes. Some of them facilitated investment by reducing the cost of investment by adjusting tax, tariff, and exchange rate policies to keep down the prices of capital goods.

Governments in East Asian economies accepted and implemented the principle of shared growth which implied that the fruits of expansion and growth would be available to all groups in society. They adopted 'explicit mechanisms' to demonstrate to the people that sharing growth was a reality. Comprehensive land reform programmes were instituted in Korea and Taiwan; Indonesia used rice and fertilizer prices to enhance rural incomes; Malaysia introduced explicit wealth sharing programmes to improve the lot of ethnic Malays as compared to the better-off ethnic Chinese; in several countries, workers' co-operatives were set up and funded, while small and medium-sized enterprises were provided financial and other support. These measures by various East Asian economies provided motivation to their citizens to outperform others and stimulated productivity, which was aided by the basic Confucian culture of hard work and subservience to authority.

It would be observed that the principle of shared growth constituted an important factor in achieving high rates of economic growth. Successful fiscal policy should incorporate adequate budgetary measures to improve social welfare, provide for social security measures and improve distribution in society, consistent with other fiscal objectives and least efficiency costs.

East Asian economies used interventionist policies to achieve rapid economic growth. Intervention in these economies was most pronounced and explicit in

regard to stimulating exports. The measures, *inter alia,* included: generous incentives for manufactured exports with automatic access to imports of intermediate goods at reasonable prices required for exports; subsidized credit, low interest rates for export purposes and repressed financial markets; contests and rewards for achieving export targets in the form of access to foreign exchange, credit and investment licences (Japan, Korea and Thailand); location of foreign markets by the state for exports; access to state-developed technology at subsidized prices for export-oriented production; and liberalization of exchange rate policies and frequent devaluation of currencies to promote growth of exports which in turn resulted in better access to state-of-the-art technology. Hong Kong and Singapore provided housing on a massive scale to labour both as a welfare measure and to keep down labour costs. Most countries repressed interest rates on deposits and bank lending to stimulate export performance. Besides governments intervened in credit markets and selectively promoted industries, ownership groups, and, in some instances, individual firms. In Japan and Korea, governments actively promoted private domestic investment in heavy and chemical industries, but the policy was changed owing to indifferent success. In Taiwan and Indonesia, governments directly invested in technologically sophisticated industries, while Singapore and Thailand tried to attract foreign capital in high technology and capital intensive industries. Total factor productivity performance of industries in Japan, Korea and Taiwan prove the importance of exports to rapid productivity growth.

Delineating the functional approach to growth in East Asian economies, Figure 4.1 shows, in four coloumns, the interaction among two sets of policy choices (fundamentals and selective interventions); two methods of competitive discipline (market and contest based); the three central functions of economic management; and the outcomes of growth and equity. The three critical functions were: accumulation of resources, efficient allocation of such resources, and productivity growth which implied increasing output with given resources. With

policy choices (Col. 1) operating through the attainment of these functions (Col. 3), the outcomes of rapid and sustained growth and equal income distribution (Col. 4) were achieved (Vide solid lines in the figure). Many of the policies contributed to the achievement of more than one growth function.

The six fundamentals affected the attainment of growth functions primarily through market based mechanism of competitive discipline[6] :

(a) Stable macro-economic management contributed to accumulation through high rates of investment, and improved allocation by reducing instability in relative prices.

(b) Escalating investment in human capital contributed to accumulation of human capital and economic growth (Vide Table 4.2); and productivity based catching up through improved absorption of technology.

(c) Effective and secure financial systems assisted in accumulation through increased financial savings; and channelizing to high productivity investment (allocation).

(d) Limiting price distortions, and keeping domestic prices aligned with international prices. Control of inflation proved to be good for allocation, and provided incentives to firms to adopt technologies and innovate.

(e) Openness to foreign technology resulted in productivity based catching up and improved skills.

(f) Agricultural development policies contributed to promotion of rural development and growth; and improved distribution of income.

The dotted lines in the figure from Col. 4 to Col. 1 and arrows in both directions (Cols. 3 and 4) indicate self-reinforcing feedbacks. Rapid growth and equitable distribution contributed to increase in human capital accumulation and increased savings and investment, as also effective use of human capital in labour markets. They also helped in the 'development and protection of institutions, particularly the civil service, by reducing incentives for corruption'.

Sustained growth is a function of the interaction of four aspects of economic policy: macro-economic stability, human capital formation, openness to international trade, and an environment that encourages private investment and competition. Besides, modern technology, efficient economic and social infrastructure and export promotion are imperative for growth. Fiscal Policy has an important role in achieving these objectives. During the Reforms period, India has been pursuing these policies, and the beneficial results are evident.

(a) *Malaysia*

(i) *Malaysia's Successful Liberalization and Structural Reforms*

During the first half of the 1980s, Malaysia experienced economic difficulties of high magnitude: severe economic imbalances, structural weaknesses and clouded prospects for growth. Malaysia embarked in a determined manner upon a successful programme of liberalization and structural reform, which came to be regarded as 'a model of structural adjustment for other developing countries'. The authorities modified the role of the public sector and considered private sector activities as the engine of growth and relied upon it to take new initiatives for industrial development and induction of modern technology and skills, creating employment and increasing exports of manufactured goods. These changes in policy framework were incorporated in the Fifth Malaysian Plan (1986-90), and by the end of the decade of eighties, Malaysian economy recovered.

(ii) *Fiscal Reforms: Reduction in Budget Deficit*

The corporate tax structure was brought more in alignment with other East Asian economies through a reduction in corporate tax rates during 1988-89 and abolition of excess profit tax.Greater stress was laid on broadly based consumption taxes than on direct taxes and commodity based taxation (Vide Table 4.3). Import duties were reduced on manufactures which had enjoyed a high level of protection. Coverage of sales tax was widened and tax incentives were rationalized.

Administration was improved and tax loopholes closed, improving tax collection.

The pioneer status incentives which improvised tax exemption for profits and dividends for 10 years for risky ventures incorporating new technologies, were allowed to continue. This contributed to establishment of risk taking ventures with modern technologies.The real exchange rate was depreciated by about 35 per cent which helped exports; growth was also stimulated by liberal foreign trade and investment policies.

(iii) ***Reduction in Budget Deficit and Balanced Budget***

The authorities drastically reduced budget deficit from 0.5 per cent of G N P in 1986 to a surplus of 1.5 per cent of G N P in 1990. The overall fiscal deficit was reduced from 11.4 per cent of G N P in 1986 to about 5 per cent of G N P in 1990. This was effected through (a) strict fiscal discipline regarding public expenditure, (b) freeze on public employment and 'deferral of civil service salary adjustments in the initial period'.

Infrastructure and public services were provided to facilitate private sector industrial growth. Even when public investment was increased in the next two years, emphasis was placed upon increasing infrastructure, stimulating education and human resource development, and alleviating poverty. The basic objective was to complement private sector investment. Foreign direct investment predominantly took place in petroleum and export-oriented manufacturing sectors and accounted for 25 per cent of private capital formation.

While instituting operational improvements in public enterprises, the authorities denationalized several large and small concerns, and also formulated privatization plans for the nineties. The proceeds were being used to retire government debt. This was in contrast with the policy in India where proceeds of sale of shares of public enterprises were utilized to reduce deficit on revenue budget.

(iv) *Analysis of Macroeconomic Trends*

A mid-term review of the Sixth Malaysian Plan (1991-1995) at the end of 1993 showed that the plan targets had been exceeded in all sectors of the economy, other than agriculture and mining. The authorities decided to step up outlays on infrastructure and poverty alleviation projects. The total development expenditure under the plan was increased from M $ 55 billion to M $ 58.5 billion. Attention may be drawn to certain essential features of the Malaysian economy, which continued to be one of the fastest growing economies in the region, and probably the world:

(1) Gross Domestic Investment as percentage of G D P increased from 26 per cent in 1988 to 37.2 per cent in 1994. The corresponding figures for Gross Domestic Savings were 36.3 per cent in 1988 and 35.6 per cent in 1994 (Vide Table 4.4). Thanks to high rates of Investment and Savings and strong fundamentals, including macroeconomic stability and low fiscal deficits, G D P maintained a steady annual growth rate between around 8 per cent and 9.8 per cent per annum between 1988 and 1994.

(2) Despite pressure on prices due to the effect of capital inflows owing to its being a strong economy and high interest rate differential, inflation continued around 2.8 per cent during the period 1988-90 and between 3.6 and 4.7 per cent in the period 1991-94. Due to moderate inflation, real interest rates were far more stable than in other developing countries. Macro-economic stability encouraged long-term planning and private investment, and through its impact on real interest rates and the real value of financial assets, helped to increase financial savings.

(3) Exports maintained a high rate of growth, and during the period 1988 to 1994, exports increased between 17.1 per cent and 24.2 per cent per annum. This maintenance of strong growth of exports was attributable not only to an outward orientation of trade policy in general, but also increase in export of manufactures such as electrical machinery and electronic products, textiles,

clothing, footwear *et al.* Even when commodity exports such as rubber, tin, cocoa and crude oil declined due to low international prices, high exports were sustained because of export of manufactures. Besides Malaysia developed non-traditional markets also.

(4) Increase in Imports ranged between 27 and 30 per cent per annum between 1988 and 1990, but since then there had been a decline, and growth in imports ranged between 9.8 per cent in 1992 to 13.5 per cent in 1995. (36 percent in 1994)

(5) Strong foreign trade and foreign exchange position helped Malaysia to reduce the debt-service ratio as percentage of exports from 16 per cent in 1989 to 5 per cent in 1995. The ratio of foreign debt to G N P came down to 43 per cent, while its foreign exchange reserves were satisfactory.

(v) ***Fiscal Policy***

A remarkable feature of the Budget for 1993 was that total expenditure increased marginally, while revenue increased at a more rapid pace. Consequently a budget surplus of 0.1 per cent of G D P emerged, compared to a deficit of 0.8 per cent of G D P in 1992. This occurred despite shortfall in petroleum related revenue, which accounted for 20 per cent of total revenue.

For the first time in several years, there was an overall budget surplus, after accounting for capital receipts This reflected the success of fiscal discipline, and the country's privatization programme. In total 77 projects had been wholly or partially sold off to the private sector, reducing government employees by more than 80,000 persons. The Government obtained M $ 8.6 billion from the sale of assets and equity from the listing of 15 state controlled companies on the stock market.

Malaysian authorities further reduced taxes in the 1994 Budget in order to stimulate private investment : (a) Company profits tax was cut from 34 per cent to 32 per cent. The Finance Minister stated, 'In view of intense international

competition, the income tax rate for companies should be reduced to make Malaysia an attractive location for investment and entrepreneurship'. (b) Reinvestment allowance for expansion,modernization or diversification was increased. (c) Taxes on oil sector were further reduced to promote exploration. (d) Duties on 500 items were reduced to contain inflationary pressures and improve standards of living. A major housing programme was provided for low-income and middle-income groups. (e) In order to offset loss of revenue on account of above measures, coverage of the sales and service tax of 5 per cent was widened. Fiscal policy sought to maintain fiscal discipline through cautious management and control over public expenditure. Thanks to abolition of development tax and further reduction in corporate and individual income tax rates, private sector initiative and competitiveness were maintained at a high level. These factors contributed to the success of Malaysia's liberalization and structural adjustment programme.

(b) ***Thailand***

The spectacular progress made by Thailand during the last 25 years is reflected in increase in G D P from US $ 7087 million in 1970 to US $ 1,24,862 million in 1993, which is more than 17.6 times the former. Growth in real G D P between 1980 and 1986 amounted to 5.5 per cent; thereafter the growth rate accelerated to between 10 and 13 per cent during 1988 to 1990; and around 8 per cent during the nineties. Subsequent to the second oil shock, Thailand in early eighties changed over from import-substitution policy to export-oriented trade policy. Export taxes were reduced and the currency devalued. The official Board of Investment (B O I) announced in 1983 various incentives for export promotion and targeted them to labour intensive, export oriented, geographically dispersed industrial activities. The incentives included tax exemptions and rebates, reduction in electricity charges, availability of concessional credit and assistance in marketing. Customs procedures were simplified in order to expedite export.

Considerable inflow of foreign investment capital and technology, particularly in export-oriented industries, contributed substantially to the structural transformation of the economy from a primary product producer and exporter into a major manufacturing country. Thailand's major export item of rice lost its premier position to textiles; and it exported sophisticated products such as hard disc drives for computers, integrated circuits and precision micro ball bearing, as also machinery, electrical appliances, components for transportation industry and chemicals, which were mostly produced by foreign firms or those with foreign collaboration. Foreign direct investment increased from US $ 200 million in mid 1980s to US $ 2 billion in 1990. The inflow has since been maintained, and it played an important role in the remarkable development of the economy.

The B O I focused its policies to the promotion of export-oriented foreign investment, which was provided with several incentives. 100 per cent shareholding and acquisition of ownership in land was permitted to 100 per cent export-oriented foreign companies. They could also bring their technicians and managers. Contests for foreign exporters were also arranged; exports were the performance criteria and B O I promotion was the reward (*The East Asian Miracle,* World Bank Study 1993).[7] Export-oriented industries were provided with full tax exemption on imported plant & machinery and raw materials and refund of all taxes paid on inputs in the process of production. In 1990-91, tariffs on capital goods, automobiles and computers were reduced to liberalize imports.

(i) *Seventh Plan*

Thailand formulated its Seventh Economic and Social Development Plan (1992-96), with emphasis upon growth with stability, human resource development and better income and regional distribution of prosperity. Its principal targets were: increase in G D P 8.2 per cent per annum, industrial growth 9.5 per cent, agricultural expansion 3.4 per cent, increase in export values 14.7 per cent, and energy production 8 per cent.

A distinctive feature of Thailand's plan was to set economic stability targets as also income distribution goals : inflation below 5.6 per cent per annum; trade deficit to be limited to 9.4 per cent of G D P per year; current account deficit 5.2 per cent of G D P per annum on an average (set to decrease to 2.5 per cent in the last year of the plan) and private sector savings 23 per cent of G D P in 1996. Population below poverty line was to be reduced by the end of the plan to 20 per cent thereof, particularly by increasing employment and raising earnings of small - income groups. Expansion of primary and secondary education, health services and better quality of life and environment were also highlighted in the Plan.

Serious infrastructural constraints and bottlenecks have been impeding development; the Seventh Plan emphasizes upon its extensive growth to meet the demand for infrastructure and increasing participation of private sector in its development. Greater emphasis has been placed upon competition for industry and trade and more liberal policies will be undertaken for monetary, fiscal and capital market development. Reform of tax system and restructuring of monetary system and capital markets would be effected to stimulate savings and facilitate raising of capital by private enterprises which should serve as core for industrial development. The investment climate is conducive to inflow of foreign investment capital and there are hardly any restrictions, except that the level of foreign equity participation varies in regard to various categories of industry.

Since 1986, exports increased by almost 20 per cent annually; even during periods of world recession, the increase in exports amounted to 15 per cent in 1990 and since then they have maintained a steady trend (Vide Table 4.5). With high invisibles from tourism and foreign remittances, it was possible for Thailand to offset the current account deficit and import a large volume of capital goods required to buttress its industrial development.

(ii) *Fiscal and Monetary Policies*

Thailand maintained a stable macro-economic environment which facilitated private sector decision making, and high level of savings, investment and economic growth. This was achieved through prudent fiscal and monetary policies and balanced budget laws. Strict control was exercised by the Budget Bureau over the quantum of aggregate expenditure and deficit financing, which was determined with a view to ensure that it would not increase inflation. Budgetary laws provided for limiting deficit to a small percentage of the year's total expenditure and a cap on the percentage of the budget (currently 13 per cent) that could be spent on servicing the foreign debt. Monetary policy was targeted to kept a check on the expansion of money supply which should be consistent with growth and stability. The Bank of Thailand in its Annual Economic Report 1992[8] stated, 'Fiscal discipline is still fundamentally important given the less favourable factors affecting revenues. This is attributed to the recent restructuring of the tax system while government expenditure continues to increase leading to a successive decline in government cash surplus. As a result, the consideration of government expenditure should proceed cautiously, with careful attention given to the issue of economic benefits and the efficiency of resource use... Monetary policy should aim to ensure an appropriate expansion of money supply consistent with the maintenance of growth and stability.' A remarkable feature of Thailand's fiscal scenario was that while most countries in the world had a fiscal deficit, Thailand had a fiscal surplus as percentage of G D P amounting to 2 per cent in 1988, 3.3 per cent in 1989 and 5 per cent (US $ 4 million) in 1990. It was envisaged that the strong fiscal situation would continue throughout the nineties.

Consequent upon prudent fiscal and monetary policies followed, inflation amounted to 6 per cent in 1990 and declined to between 3.5 per cent and 5 per cent in the first half of the decade of nineties. Thailand also maintained a high quality in regard to debt management. Thanks to its disciplined budget policies

and rising exports, the debt service ratio declined from over 21 per cent in 1985 to less than 12 per cent in 1995. Its foreign exchange reserves in March, 1991 amounted to $ 16 billion equal to imports of about 6 months. The balance of payments position was healthy and a surplus of US $ 2 billion was achieved in 1990.

(iii) ***Taxes and Incentives***

There was a wide range of incentives available for 'promoted investments' approved by B O I. The basic corporation tax was 30 per cent for domestic and foreign companies. However, branch profits remitted to foreign head office and disposition of profits abroad were subject to an additional tax of 10 per cent.Capital gains were treated as ordinary income. A distinctive feature was that tax depreciation was required to conform to book depreciation.

B O I maintained a list of promoted industries, which were entitled to various privileges:

(1) Exemption from corporate taxation from 3 years to 8 years depending upon the nature and importance of the industry; and exemption from withholding tax on dividends during such period.

(2) Exemption from tax deduction at source in respect of fees and royalties for 5 years.

(3) Exemption or concession in regard to import duties on capital goods, raw materials and components.

Export incentives included:

(a) Waiver of customs duties and business taxes on imported raw materials and components used in export industries.

(b) Incremental incomes upto 5 per cent derived from exports were deductible from taxable income.

Thailand liberalized its foreign exchange services and provided commercial banks with wider scope in adjusting interest rates. In the fiscal domain, tax reforms were introduced in 1990-91 incorporating value added taxes. The guidelines for such reforms were 'equity, enforceability and savings promotion and the system promises to greatly reduce tax evasion'. It was envisaged by the Government that Thailand would maintain its record of steady economic development and become more internationally oriented. To sustain growth and globalization, it was imperative to successfully liberalize and reform its financial and industrial markets. Thailand was implementing these policies in the nineties with commendable results.

(c) ***South Korea***

South Korea achieved spectacular economic growth, particularly during the last 25 years. Its G D P increased from US $ 9025 million in 1970 to $ 330831 million in 1993. Per capita income increased from $ 100 three decades ago to $ 8500 at present. The Korean model of development was structured basically upon that of Japan. It was an amalgam, inter alia, of macro-economic stability, private enterprise, competition, investment in education and health and provision of export subsidies. The model developed by president Park Chung Hee achieved high growth, inter alia, through (a) securing hard labour and high productivity from workers, (b) mobilizing savings through taxes, (c) supporting investment by leading industrial conglomerates (Chaebols) and (d) intensive promotion of exports.

A comparison of South Korea and Taiwan is instructive. On the eve of take-off in the sixties, both the countries were poor in natural resources, but had effected successful land reforms and had institutional environment conducive to economic growth. Both the countries changed over from import substitution policies to outward oriented policies and export promotion. They largely maintained realistic nominal interest rates and fiscal budget surpluses which

contributed to high rate of savings and moderate inflation. They stimulated labour intensive export oriented manufacturing industries. They also maintained an investment climate conducive to inflow of foreign capital. Investment in education increasingly provided skilled workers with capabilities of imbibing improved technologies.

Certain differences however were discernible between the economies: (a) While Taiwan pursued policies of growth with equity, South Korea developed greater income inequality, largely as industrial growth centred round the chaebols, the ten largest amongst whom accounted for 75 per cent of G D P. Taiwan on the other hand had lakhs of enterprises competing with each other; (b) South Korea borrowed heavily from international sources to finance its investments, while Taiwan relied greatly on domestic savings; (c) Both in regard to price stability and exchange rate stability, Taiwan scored over South Korea, which had to devalue its currency several times between mid 1960s and early 1980s, and encountered higher inflation; (d) While state intervention took place in both the countries, it was more pronounced in South Korea. Government even directed industrial conglomerates as to what kind of factories were to be built, and caused prices to be moulded to suit its industrial and export policies; and it provided them with funds at subsidized interest rates.

The South Korean economy in 1980 faced a severe crisis: external debt 49 per cent of G N P ; current deficit about 9 per cent of G N P. Thanks to the second oil shock, G D P shrank by 2.2 per cent, while inflation rose to 29 per cent. The Government increasingly adopted an I M F - guided austerity package, devalued the currency (won), and reduced subsidies to heavy industry. Fiscal and monetary restraint was adopted and inflation in 1982 came down to 7.1 per cent and since then it has averaged 5.3 per cent a year. While the economy maintained steady growth during the decade, two features of the economy continued to persist: concentration of economic power in the hands of chaebols and 'the habit of state intervention'.

South Korea's Seventh Five Year Plan projecting a growth rate of 7.5 per cent per annum on average basis during the 1992-96 period, commenced in 1992. However, after two years of robust growth and buoyancy in exports, there was distinct slowdown in the economy: G D P increase about 5 per cent in 1992 as compared to 8.3 per cent in 1991; Savings and Investment down to 35 per cent and 36 per cent as compared to above 35 per cent and 39 per cent respectively, and export increase by 8 per cent against 10 per cent. Inflation however rose by 6.2 per cent only in 1992 as compared to 9.7 per cent in 1991, consequent upon lower increase in money supply by 15 per cent as against 22 per cent in the previous year. The economy was having a high trade deficit, high rate of increase in wages and prices, and infrastructural deficiencies, which were affecting its competitive capacity in regard to exports. Macroeconomic stabilization had become imperative; its adoption improved the fundamentals.

East Asian economies attuned their fiscal and monetary policies so as to achieve low inflation and competitive exchange rates. They improvised low fiscal deficits, positive real interest rates, high quality of fiscal adjustment and undervalued currencies. They liberalized exchange rate policies and devalued their currency from time to time to promote exports. Budgetary provision of a high order was directed towards primary and secondary education, and small amounts as were allocated to higher education were channelized to engineering and technology institutes.

East Asian economies imbibed foreign technologies through licences, capital goods, imports and overseas training. Low tariff rates and even subsidies were provided for capital goods and other imported inputs, and interest rates for financing investment in imported plant and machinery were kept low. This was in contrast to the high interest rates between 16 and 20 per cent charged by financial institutions in India. With inflationary increase in costs of plant and machinery, high interest charges and depreciation which enter into cost of

production, reduce competitive capacity of Indian industry.

The private sector was the principal engine of growth in East Asian economies. Fiscal policy was directed towards providing adequate incentives for investment. Taxes were kept low. Fiscal discipline of a high order was maintained in most economies. Prudent macroeconomic management encouraged long-term planning and investment by the private sector and foreign investor. The institutional structure was generally congenial for such investment. Saving rates ranging between 20 per cent to 40 per cent were achieved by Japan, Singapore and other economies. Besides providing incentives for savings, Singapore and Hong Kong improvised high provident fund contributions to generate savings. Japan and Taiwan established postal savings system to mobilize small savings. Most of the economies set up effective and secure financial systems to achieve exceptionally high savings rates.

The economy during 1994 resumed its path of growth with G D P rising by 8.3 per cent, industrial growth by 10 per cent, exports by 14.3 per cent (7.7 per cent in 1993), and current account balance down to – 1 per cent (Vide Table 4.6). Debt-service ratio declined to 5.1 per cent. The prospects for next two years were equally good, with inflation at about 6.4 per cent. The principal problems facing the economy were: chronic trade surpluses (like Japan) leading to rise in exchange value of the currency which could adversely affect exports. Deregulation and reduced state intervention were necessary to allow market forces to operate in the economy.

(i) *Fiscal and Monetary Policies*

Korea's fiscal and monetary policies contributed to stabilization of short-term economic fluctuations and control of inflation, and promotion of long-term high growth rate. The Korean economy experienced multi-dimensional resource gaps in the process of rapid economic development: (1) On the domestic front, there was an excess of demand for funds for investment over savings; this was

financed by deficits in budget. The budgetary deficits in turn were financed by new borrowings from the Bank of Korea and reduction in cash balances. By altering the net domestic sources of the monetary base, these changes affected M3 and monetary credit. (2) Secondly, foreign resources gap developed owing to excess of imports, including capital goods, over exports. This shortage was covered by foreign capital borrowings and foreign aid. Since 1977, the Government has been selling treasury bills to general investors in order to minimize the quantum of direct borrowings from the Bank of Korea for meeting budgetary deficits.

South Korea's External debt in 1984 amounted to more than 52 per cent of G N P, thanks to heavy borrowings to finance private sector investment and accumulate foreign exchange reserves. However, due to its large export - G N P ratio and high growth rates, Korea was able not only to service the foreign debt, but also to repay them in 1986 and subsequent years out of its sizeable foreign exchange reserves buttressed by export earnings. By 1990, the ratio of total debt to G N P had come down to 15 per cent.

South Korea's productivity of investment was amongst the highest, according to a study of 18 developing countries (Little *et al*). Investments were channelized into most profitable sectors such as labour intensive export industries; low capital costs were achieved through low construction costs and short gestation periods. The Government actively stimulated investment and exports by providing specialized highly subsidized loans for equipment purchase and export loans at between 6 and 10 per cent interest. Import duties on capital goods were waived and loans in foreign currencies made available in case of selected industries whose development was targeted by the Government. Investment incentives were provided particularly for such targeted industries and export oriented industries. Tax and other incentives were also improvised for stimulating the rate of savings in the economy.

Thus, the rate of savings and investment varied between 1992 and 1995 between 35 per cent and 37 per cent, which were remarkably high.

(ii) *Corporate Tax Rate and Incentives*

The top marginal company tax rate on corporate income in 1994 was 32 per cent plus surcharge 4.5 per cent, amounting to 36.5 per cent on incomes above Korean Won 100 million (equivalent to about $ 1,28,000). The basic rate was reduced to 30 per cent plus surcharge in 1995. Korea introduced nine major tax reforms between 1953 to 1986 in order to stimulate industrial growth. Tax incentives for exports included accelerated depreciation, tax credits and special exemptions. Korea among East Asian countries was the first to introduce V A T. Revenues derived from V A T were utilized to provide incentives for investors in industry ; they were particularly used to mould the pattern of industrial development and induce the flow of capital into desired sectors.

(iii) *Major Tax Incentives in South Korea's Tax Structure*

The major tax incentives are the following :

(a) A 100 per cent tax exemption for first four years and 50 per cent for the next two years for enterprises in hi-tech sectors, free trade zones and export-oriented industries.

(b) 10 per cent of capital increase by an enterprise was allowed to be deducted from income for three years.

(c) Exemption from tax for five years on royalties arising from technology inducement contracts.

(d) Investment in special equipment for pollution control, energy saving, vocational training facilities *etc.* qualified for 8 per cent investment tax credit.

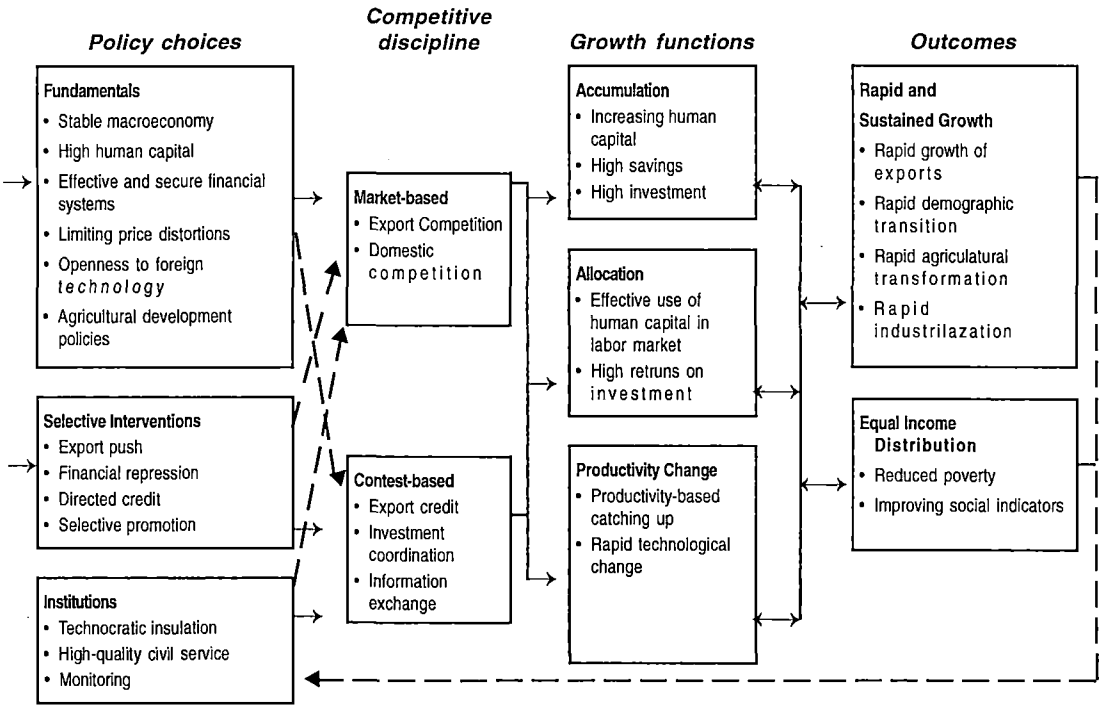
(e) Enterprises in designated agriculture area were eligible for 100 per cent tax exemption for four years and 50 per cent exemption for the next two years.

(f) Expenditure on research and development qualified for certain tax credits.

Large industries had acquired 'formidable momentum' and South Korea's economy will probably remain among the world's top performers during the nineties owing to the strength of its large industrial conglomerates.

Figure 4.1

A Functional Approach to Growth (East Asian Countries)

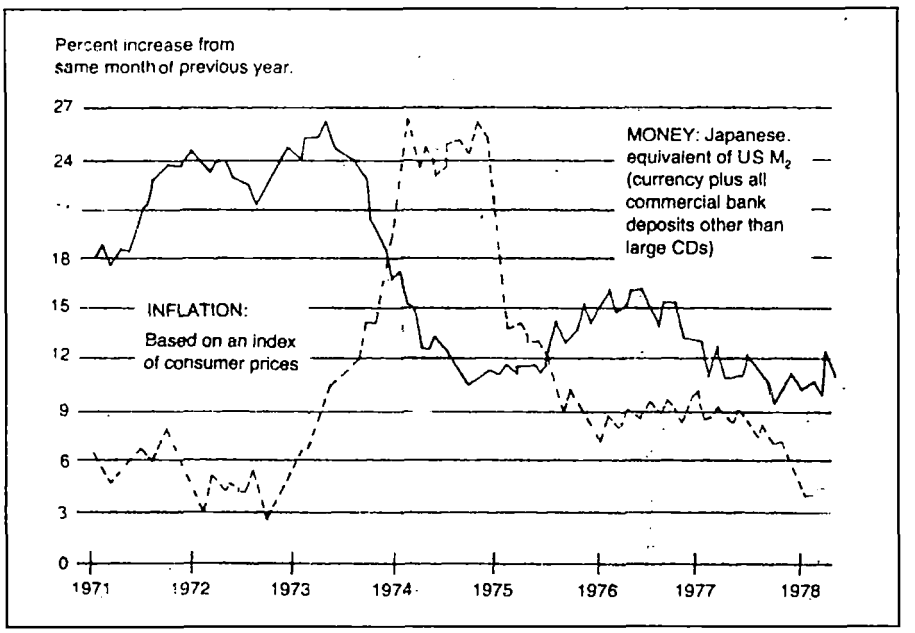


Source : *The East Asian Miracle*, World Bank, O U P, 1993, p 88.

Figure 4.2

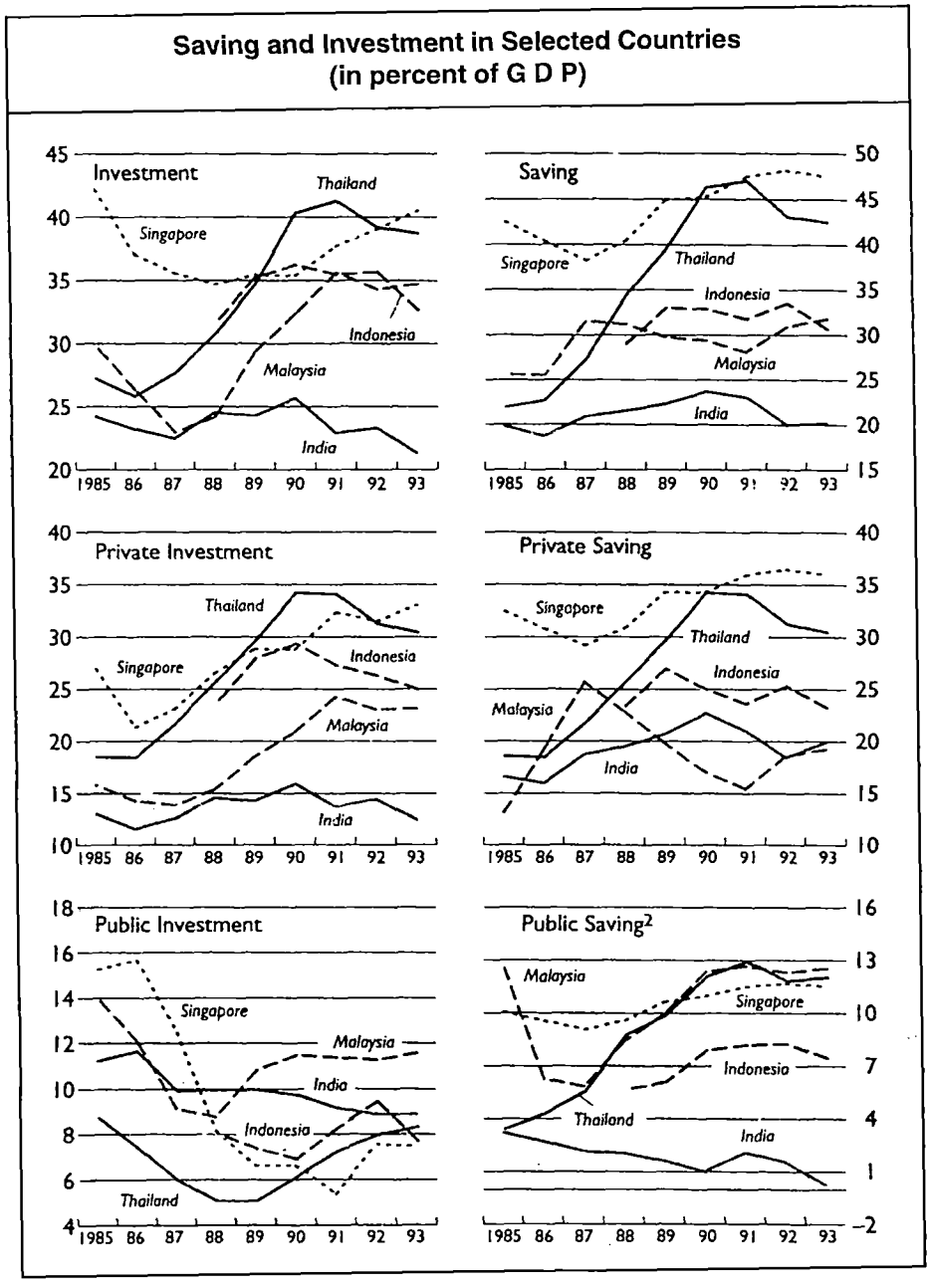
Inflation Follows Money :

The Case of Japan



Source : Japanese Economic Planning Agency, from Milton and Rose Friedman, *Free to Choose*, Secker and Warburg, London, 1980.

Figure 4.3



Source : *India : Economic Reforms and Growth,* Ajai Chopra *et al,* Occasional Paper 134, IMF, Washington, December 1995.

Table 4.1

Distribution of Gross Domestic Product (Percentage)
1970 and 1993 - Selected Countries

Name of the Country	Agriculture		Industry		Services	
	1970	1993	1970	1993	1970	1993
Malaysia	29	–	25	–	46	–
Indonesia	45	19	19	39	36	42
Hong Kong	2	0	36	21	62	79
Singapore	2	0	30	37	68	63
South Korea	25	7	29	43	46	50
Thailand	26	10	25	39	49	51
Japan	6	2	47	41	47	57
Australia	6	3	39	29	55	67
France	–	3	–	29	–	69
West Germany	3	1	49	38	47	61
Sweden	–	2	–	31	–	67
United Kingdom	3	2	45	33	52	65
United States	3	–	34	–	63	–
India	45	31	22	27	33	41

Source : *World Development Report 1995,*
World Bank, O U P p. 167

Table 4.2

Major Heads of Total Expenditure of Selected Countries (Percentage)

Name of the Country	Education		Health		Housing, Social Sector Welfare		Defence	
	1980	1993	1980	1993	1980	1993	1980	1993
Malaysia	18.3	20.3	5.1	5.7	7.0	11.4	14.8	11.8
Indonesia	8.3	10.0	2.5	2.7	1.8	1.6	13.5	6.2
Singapore	14.6	22.3	7.0	6.1	7.6	9.0	25.2	24.5
South Korea	17.1	16.8	1.2	1.0	7.5	11.2	34.3	20.1
Thailand	19.8	21.1	4.1	8.2	5.1	6.7	21.7	17.2
Japan	–	–	–	–	–	–	–	–
Australia	8.2	7.2	10.0	12.6	28.5	33.7	9.4	7.9
France	8.6	7.0	14.8	16.1	46.8	45.5	7.4	6.0
Germany	0.9	0.8	19.0	16.8	49.6	45.9	9.1	6.4
Sweden	10.4	7.3	2.2	0.4	51.5	53.3	7.7	5.3
United Kingdom	2.4	3.3	13.5	14.0	30.0	32.5	13.8	9.9
United States	2.6	2.0	10.4	17.1	37.8	31.7	21.2	19.3
India	1.9	2.2	1.6	1.9	4.3	7.1	19.8	14.5

Contd. ...

Table 4.2 (Contd.)

Major Heads of Total Expenditure of Selected Countries (Percentage)

Name of the Country	Economic Services 1980	Economic Services 1993	Others. 1980	Others. 1993	Total Expenditure as % of G N P 1980	Total Expenditure as % of G N P 1993	Overall Surplus/deficit (% of G N P) 1980	Overall Surplus/deficit (% of G N P) 1993
Malaysia	30.0	18.5	24.7	32.4	29.6	26.7	- 6.2	1.7
Indonesia	40.2	27.3	33.7	52.2	23.1	18.9	- 2.3	0.7
Singapore	17.7	11.5	27.9	26.6	20.8	19.7	2.2	12.6
South Korea	15.6	18.8	24.3	32.1	17.6	17.1	- 2.3	0.6
Thailand	24.2	26.2	25.1	20.7	19.0	16.3	- 4.9	2.1
Japan	–	–	–	–	18.4	–	- 7.0	–
Australia	8.2	8.0	35.8	30.5	23.1	28.2	- 1.5	- 2.3
France	6.8	5.0	15.6	20.4	39.3	45.5	- 0.1	- 3.8
Germany	8.7	9.7	12.6	20.4	–	33.6	–	- 2.4
Sweden	10.9	16.2	17.3	17.4	39.5	53.9	- 8.1	- 12.2
United Kingdom	7.5	6.6	32.9	33.7	38.2	43.4	- 4.6	- 5.1
United States	9.7	6.2	18.2	23.7	21.7	23.8	- 2.8	- 4.0
India	24.2	16.2	48.3	58.0	13.2	16.9	- 6.5	- 4.8

Source : *World Development Report 1995*, World Bank, O U P New York p 180, 181

Table 4.3

Major Heads of Current Revenue of Selected Countries (Percentage)

Name of the Country	Income Tax & Corporation Tax		Social Security		Excise Sales Tax etc.		International Trade & Transactions Customs Duty	
	1980	1993	1980	1993	1980	1993	1980	1993
Malaysia	37.5	34.5	0.4	0.8	16.8	22.0	33.0	13.8
Indonesia	78.0	49.3	–	–	8.6	26.4	7.2	5.2
Singapore	32.5	30.0	–	–	15.8	16.7	6.9	2.0
South Korea	22.3	31.4	1.1	8.3	45.9	34.2	15.0	5.8
Thailand	17.7	27.9	0.2	1.1	46.0	39.8	26.2	18.2
Japan	70.8	–	0.0	–	20.8	–	2.4	–
Australia	60.8	63.8	0.0	0.0	23.4	19.7	5.4	3.5
France	17.7	17.3	41.2	44.5	30.9	27.0	0.1	0.0
Germany	18.7	15.0	54.2	46.2	23.1	24.5	0.0	0.0
Sweden	18.2	5.8	33.2	36.7	29.1	32.7	1.2	0.9
United Kingdom	37.7	35.3	15.6	16.4	27.8	32.1	0.1	0.1
United States	56.6	50.7	28.2	34.2	4.4	3.8	1.4	1.6
India	18.3	18.7	0.0	0.0	42.5	32.1	22.0	24.9

Contd. ...

Table 4.3 (Contd.)

Major Heads of Current Revenue of Selected Countries (Percentage)

Name of the Country	Others		Nontax Revenue		Total Current Revenue (percentage of G N P)	
	1980	1993	1980	1993	1980	1993
Malaysia	1.8	3.5	10.5	25.4	27.3	28.7
Indonesia	1.2	3.2	4.9	15.9	22.2	19.4
Singapore	13.9	15.1	30.9	36.1	26.3	26.6
South Korea	3.2	7.6	12.5	12.6	18.0	18.9
Thailand	1.8	3.0	8.1	9.9	14.4	18.3
Japan	0.8	–	5.2	–	11.6	–
Australia	0.3	1.4	10.1	11.6	22.1	25.3
France	2.7	4.1	7.4	7.1	39.4	40.7
Germany	0.1	7.9	3.9	6.4	–	31.6
Sweden	4.3	6.7	14.1	17.2	35.2	40.1
United Kingdom	5.7	7.6	13.1	8.5	35.2	36.2
United States	1.2	1.0	8.2	8.7	19.9	19.7
India	0.6	0.4	16.6	23.9	11.7	14.4

Note : Except the last two columns, figures are percentages of total current revenue.

Source : *World Development Report 1995*, World Bank, O U P New York p 182, 183

Table 4.4

Major Indicators for Malaysia

Malaysia	1989	1990	1991	1992	1993	1994	1995
Growth Rate of G D P (Percentage per annum)	8.7	9.8	8.7	7.8	8.3	8.5	8.5
Gross Domestic Investment (Percentage of G D P)	28.8	32.3	37.0	33.8	35.0	37.2	37.6
Gross Domestic Savings (Percentage of G D P)	33.9	32.3	31.1	35.5	35.9	35.6	36.7
Inflation Rate Percentage Change in C P I	2.8	2.6	4.4	4.7	3.6	3.8	4.2
Money Supply (Percentage per annum)	16.1	12.8	14.5	19.1	23.5	22.0	18.0
Growth Rate of Exports	18.3	17.4	17.1	18.1	15.9	24.2	20.8
Growth Rate of Imports	35.6	30.2	26.9	9.8	17.3	36.0	13.5
Current Account Balance Percentage of G D P	- 0.6	- 3.9	- 8.9	- 2.8	- 3.3	- 9.0	- 6.1
Debt Service Ratio as Percentage of Exports.	16.0	11.7	7.6	6.6	7.9	4.7	5.0

Source : *Asian Development Outlook, 1995 and 1996,* Asian Development Bank, O U P New York, p 108. *Ibid* 1993, p 108. *Ibid* 1992, p. 128.

Table 4.5

Major Indicators for Thailand

Thailand	1989	1990	1991	1992	1993	1994	1995
Growth Rate of G D P (Percentage per annum)	12.0	10.0	7.5	7.9	8.2	8.5	8.6
Gross Domestic Investment (Percentage of G D P)	31.5	36.8	35.7	39.6	40.0	42.9	44.9
Gross Domestic Savings (Percentage of G D P)	31.1	31.0	33.3	35.7	35.5	37.2	38.0
Inflation Rate (Percentage Change in C P I)	5.4	6.0	5.8	4.2	3.5	5.0	5.0
Money Supply (Percentage per annum)	n a	n a	19.8	15.6	18.4	16.2	16.0
Growth Rate of Exports	25.7	15.0	21.0	13.7	13.4	17.5	16.8
Growth Rate of Imports	27.4	29.8	13.8	6.0	11.8	16.4	16.0
Current Account Balance (Percentage of G D P)	- 3.6	- 8.8	- 8.6	- 5.7	- 5.5	- 5.2	- 5.0
Debt Service Ratio as Percentage of Exports.	16.3	17.2	15.1	14.1	18.6	11.2	11.8

Source : *Asian Development Outlook, 1995 and 1996,* Asian Development Bank, Manila, O U P, p 120.
Ibid 1992 p. 142.

Table 4.6

Major Indicators for South Korea

South Korea	1989	1990	1991	1992	1993	1994	1995
Growth Rate of G D P (Percentage per annum)	6.2	9.0	8.3	5.1	5.5	8.3	7.3
Gross Domestic Investment (Percentage of G D P)	33.4	37.0	39.3	36.6	34.3	36.9	36.9
Gross Domestic Savings (Percentage of G D P)	35.6	35.6	35.3	35.2	35.1	35.1	35.1
Inflation Rate (Percentage Change in C P I)	5.6	8.6	9.7	6.2	4.8	6.4	6.3
Money Supply (Percentage per annum)	n a	n a	21.9	14.9	16.6	18.9	11.7
Growth Rate of Exports	3.0	2.8	10.1	8.0	7.7	14.3	12.0
Growth Rate of Imports	17.9	14.6	17.6	1.0	2.3	18.7	14.6
Current Account Balance (Percentage of G D P)	2.4	- 0.9	- 3.2	- 1.5	- 1.0	- 1.0	- 1.3

Source : *Asian Development Outlook, 1995 and 1996*, Asian Development Bank, Manila, O U P, p 66.
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