The Role of Government in Economic Development

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1 – 1. Korea’s Economy

World ‘s 12th largest Economy

GDP 12th
- GDP(2005) : $ 788 Billion
  - Malaysia + Indonesia + Thailand + Philippines = $ 687 Billion
  - Russia = $ 764 Billion

Per Capita GNI(2005) : $ 16,291

Trade 12th
- Trade Value(2005) : $ 545 Billion
  - Exports : $ 284 Billion (12th)
  - Imports : $ 261 Billion (13th)

Growth Rate 3th
- Average Growth Rate(1970~2005) : 7.0% (3th)

Foreign Reserves 5th
- Foreign Reserves (Jun 2006) : $ 224 Billion (5th)
I. Introduction

1 - 2. Government’s Role

- Mobilization and Allocation of Resources
- Stabilization of the National Economy
- Promotion of Technological Development

- Guardian of Political Stability
- Provider of Development Funds
- Major Investor in Industries of the Country
- Investment Decision of Private Enterprises
- Motivator behind the Scene
- Preservation of the Law and Order
- A Strong Agent of Social Change
- Protector of Social Security
2 – 1. The Neoclassical View

- A Stable Macroeconomic Environment
- A Reliable Legal Framework
- Orientation of International Trade
- The Absence of Price Controls & other Distortional Policies
- Investment in People, Education, Health
- Stress on Human Capital

Getting the basics right!

Korea’s Economic Miracle
2 – 2. The Revisionist View

Korea does not wholly conform to the neoclassical model!!

- Industrial policy and interventions in financial markets are not easily reconciled within the neoclassical framework.
- Some policies in some economies are much more in accordance with models of state-led development.
- The policy mixes used by the Korean government were diverse and flexible.
II. Overview of the Role of Government

2 – 3. The Market–Friendly View

The appropriate role of the government in the market–friendly strategy

- Securing sufficient investment in human resources
- Ensuring an environment that promotes competition among private enterprises
- Maintenance of an economic system open to international trade
- Maintenance of stable macro economy

Otherwise, the government intervention will do more harm than good!!
### II. Overview of the Role of Government

2 – 4. The Functional Approach

Korea’s rapid growth based on “three functions of growth”:
Accumulation / Efficient allocation / Rapid technological catch-up

<table>
<thead>
<tr>
<th>Fundamentals</th>
<th>Selective Interventions</th>
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</thead>
<tbody>
<tr>
<td>• Macroeconomic stability</td>
<td>• Mild financial repression</td>
</tr>
<tr>
<td>• Investment in human capital</td>
<td>(positive but low interest rate)</td>
</tr>
<tr>
<td>• Stable and secure financial system</td>
<td>• Directed credit</td>
</tr>
<tr>
<td>• Limited price distortions</td>
<td>• Selective industrial promotion</td>
</tr>
<tr>
<td>• Openness to foreign technology</td>
<td>• Trade policies for</td>
</tr>
<tr>
<td></td>
<td>nontraditional exports</td>
</tr>
</tbody>
</table>
The government distributes rewards on the basis of performance.

Selective interventions must be disciplined by competition.
A high-quality civil service that has the capacity to monitor performance and is insulated from political interference is essential to contest-based competition.

A high-quality civil service also augments a government’s ability to design and implement non-contest-based policies.

Pragmatic flexibility in the pursuit of economic objectives—the capacity and willingness to change policies—is as much a hallmark of the Korean economy as any single policy instrument.
3 – 1. Review of Development Strategies in Korea

(1) Launching economic development in the 1960s

- **Government Strategies**
  - Economic development → Outward-oriented development strategy
  - Establishing new institutions and strengthening existing organizations to mobilize both internal & external resources → EPB, tax administration, foreign capital promotion act
  - Eliminating the fiscal deficit
  - Increasing savings deposits
### III. Korean Experiences

※ One of the most important reforms was a revamping of trade policy.

- The Korean currency, the won, was devalued by nearly 100 percent.
- A unified exchange rate system was adopted that eliminated the bias against the export sector.
- Short-term export credit was made available at a preferential rate.
- Tax rebates were allowed on raw materials imported for the production of exports.
- A number of free trade zones were also established.
- Customs procedures were simplified.
III. Korean Experiences

(2) Extensive Intervention in the 1970s

Policy 1: Modernization of Rural Areas
- Boosting price supports for the major grain crops in 1969
- “Saemaul Undong” (New community movement) in 1971

Policy 2: Development of the Heavy & Chemical Industries
- To develop a new source of strategic export industries
- To promote the import substitution of intermediate materials and capital goods

Heavy and Chemical Industry Development Plan (1973)
III. Korean Experiences

To achieve the necessary economy of scale in a limited domestic market, the government made the following efforts:

- Permitting monopolistic production in a few industries.
- Establishing the National Investment Fund which was channeled into heavy industry projects at lower interest rates.
- Setting up and maintaining high protective barriers for these “infant” industries until they became internationally competitive.
- Providing many incentives for training workers and for R&D.
(3) Economic Liberalization in the 1980s

Solving the economic problems from the development of the heavy & chemical industries in the 1970s!!

- Strong economic stabilization measures to curb the inflationary trends
- Economic deregulation for reducing government intervention and for allowing more individual freedom
- Steps toward the internationalization & liberalization of the economy
- Fair trade and competition policies to reduce the inefficiencies of domestic industrial structures and curtail abusive practices of monopoly enterprises
(4) Shifting towards New Economy in the 1990s

Korea must develop a new policy framework to sustain its economic development!!

Democratic principles should replace government guidance & control as the economy’s engine of growth.


- Securing the economic potential
- Expanding the foreign markets
- Improving the standard of living
III. Korean Experiences

Fiscal Reform
- Freezing hiring at government agencies
- Establishing a global income tax system
- Levying comprehensive land taxes on the basis of officially announced land prices

Financial Reform
- Relaxing regulations
- Removing business boundaries of financial intermediaries
- Liberating foreign exchange and overseas capital transactions

Administrative Reform
- Relaxation of regulations on all aspects of business activities
- Change in the attitudes of government officials toward public service.
(5) Crisis and Structural Reforms after 1997

Consecutive bankruptcies of several large chaebol, coupled with financial crisis in Thailand and other East Asian countries.

Foreign banks refused to roll over credit lines to Korean financial institutions and foreign investors pulled out of Korea en masse.

By mid-December 1997, Korea’s foreign exchange reserves were almost depleted.
By and large, the three-year IMF-supported program has been successful and the objectives of the program has been met.

Bold policies and a commitment to reform have led to the overhaul of many domestic institutions and increased the market orientation of the economy.

As a result, many of the weaknesses that contributed to the crisis in 1997 have been addressed.

But much remains to be done to ensure that the gains endure and that the Korean economy is sufficiently sound and flexible to adapt and prosper as conditions change.
3 – 2. Pattern of Economic Management

(1) Leadership Commitment to Economic Development

- Syngman Rhee in the 1950s
  - “Anti-communism”
  - “Antipathy toward Japan”
  - “Patriotism”

- Park Chung-Hee in the 1960s
  - “National modernization”
  - “Economic planning”
  - “Administrative reform”

President Park argued and stressed:
- Economic development was the main course of national modernization.
- A self-supporting economy could not be achieved only by foreign aid.
- The need for purposeful planning in economic development.
- The need for attracting foreign loans at the early stage of industrialization.
(2) Functional Realignment through Organization Reform

- This organization was responsible for economic planning, national budgeting, foreign capital management, and statistics.
- In 1963, the role and functions of the Board were broadened when it was decreed that the Minister of EPB would concurrently hold the position of Deputy Prime Minister.
- In line with the greater emphasis on economic planning, the Office of Planning and Coordination was established under the Prime Minister in 1961.
- The organization has since been responsible for assisting the Prime Minister in evaluating and monitoring the performance of major projects and programs.
To stabilize the economy, government spending was reduced from 17.2% of GDP during 1960~1964 to 14.6% during 1965~1969.
### IV. Mechanism of Government Interventions

< Government Expenditures As a (Percentage of GDP) >

<table>
<thead>
<tr>
<th>Period</th>
<th>Non-Defense</th>
<th>Defense</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960~1964</td>
<td>12.2</td>
<td>5.0</td>
<td>17.2</td>
</tr>
<tr>
<td>1965~1969</td>
<td>10.7</td>
<td>3.9</td>
<td>14.6</td>
</tr>
<tr>
<td>1970~1974</td>
<td>11.4</td>
<td>5.0</td>
<td>16.4</td>
</tr>
<tr>
<td>1975~1979</td>
<td>12.4</td>
<td>5.4</td>
<td>17.8</td>
</tr>
<tr>
<td>1980~1984</td>
<td>14.7</td>
<td>5.1</td>
<td>19.9</td>
</tr>
<tr>
<td>1985~1989</td>
<td>13.5</td>
<td>4.3</td>
<td>17.8</td>
</tr>
<tr>
<td>1990~1997</td>
<td>17.3</td>
<td>3.4</td>
<td>20.6</td>
</tr>
<tr>
<td>1998~2003</td>
<td>22.2</td>
<td>2.7</td>
<td>25.0</td>
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</tbody>
</table>
### IV. Mechanism of Government Interventions

#### < Government Consumption, Savings, and Fixed Investment > (%)

<table>
<thead>
<tr>
<th>Period</th>
<th>Consumption</th>
<th>Savings</th>
<th>Fixed Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960~1964</td>
<td>12.3</td>
<td>-1.0</td>
<td>3.7</td>
</tr>
<tr>
<td>1965~1969</td>
<td>10.0</td>
<td>4.2</td>
<td>5.6</td>
</tr>
<tr>
<td>1970~1974</td>
<td>9.6</td>
<td>3.7</td>
<td>3.9</td>
</tr>
<tr>
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<td>10.8</td>
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<td>8.7</td>
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<td>12.8</td>
<td>10.8</td>
<td>5.6</td>
</tr>
</tbody>
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IV. Mechanism of Government Interventions

4–2. Public Enterprise

Public enterprises constituted a leading sector in the national economy

- Public enterprises created “forward linkage” effects, transmitting growth to other industries, and contributed to capital formation, value-added, employment & technological development.

The government’s purposes in operating public enterprises have been:

- To promote basic industries or public infrastructure activities that required capital-intensive technology
- To undertake large-scale business operations under monopolistic or oligopolistic conditions
- To cope with market failures involving entrepreneurial inadequacies, the imperfect capital market, shortage of market information, and unwillingness of the private sector to bear the risk
4–3. Regulatory Measures

The Price Control Act of 1961

- To control the prices of five essential commodities: rice, barley, coal, anthracite, and fertilizer.

The Monopoly Regulation & Fair Trade Act of 1980

- To ensure free market competition and protect consumers by controlling the abuse of monopolistic or oligopolistic power and prohibiting the formation of new companies wielding such power.

The 1997 Basic Act on Administrative Regulation

- To establish a comprehensive and long-term approach to regulatory reform aimed at promoting private-sector initiative and creativity as a means to improve the quality of life and enhance national competitiveness.
The Regulatory Reform Committee (RRC) in the Prime Minister’s Office

- The committee was given the task of eliminating half of the 11,095 existing regulations within the year beginning in April 1998.
- 49 percent of regulations were abolished, and 43 percent of the remaining regulations were improved.
- The reform process involved the submission of 344 pieces of legislations to the National Assembly, of which nearly 300 have been approved.
- One particular concern was the widespread use of “administrative guidance”
- The RRC identified 1,849 “informal regulations” that had no legal basis. 162 were formalized, while the remainder were abolished.
- Finally, to improve transparency, the RRC has compiled a list of all regulations currently in force.
### IV. Mechanism of Government Interventions

< Detailed measures of regulatory reform by area >

<table>
<thead>
<tr>
<th>Area</th>
<th>Detailed Measures</th>
</tr>
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</table>
| Foreign Direct Investment                 | • Reducing number of restricted areas  
                                            • Facilitating land purchase by foreigners  
                                            • Improving financial environment for FDI  
                                            • Improving living conditions for foreigners in Korea |
| Business Enterprise Activities             | • Easing of land-use regulations  
                                            • Liberalization of rules on factory location  
                                            • Easing reform of controls on housing and construction  
                                            • Liberalization of regulations on public utilities |
| Finance, Retail Sales, Trade              | • Easing entry barriers into the financial sector  
                                            • Liberalization of distribution and transaction facilities  
                                            • Improvement of freight transportation in the retail sector  
                                            • Liberalization of trade policies |
| Inconveniences in the Lives of Citizens    | • Cars, construction, environment and fire regulations  
                                            • Improving procedure for complaints about regulations  
                                            • Reducing administrative burdens  
                                            • Increasing transparency |
The focus of the RRC is shifting to new tasks!!

First, it is moving away from a quantitative approach and towards a focus on improving the quality of the remaining regulations. ( "Comprehensive Regulatory Improvement Plan" )

Second, the RRC is supporting regulatory reform at the local government level.

Third, the RRC is trying to include non-governmental organizations, which now number 8,000, more fully in the work of regulatory reform.
### IV. Mechanism of Government Interventions

#### 4-4. Inducement Policies

<table>
<thead>
<tr>
<th>Tax Policies for Desired Resource Allocation</th>
<th>Financial Sector as a Tool for Supporting Development Plan</th>
<th>Foreign Exchange Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax incentives &amp; Disincentives</td>
<td>The Interest Realization Program(1965~1968)</td>
<td>Floating Foreign Exchange Rate System</td>
</tr>
<tr>
<td>Preferential depreciations, Subsidies, Tax exemptions, Differential commodity tax rates ...</td>
<td>Low interest rate ▼ High interest rate in both deposits and loans</td>
<td>Financing of development projects, Encouraging exports &amp; discouraging imports</td>
</tr>
</tbody>
</table>
Blocks to the policy regime shift toward greater private sector participation

- Many private economic agents have lost their sense of independence and fear that liberalization may create chaos.
- Active government economic management has created various barriers to entry.
- The widespread distortion in the economic incentive structure has tended to discourage the individual economic agent’s will to economize and motivation for innovation.
- With an excess demand for intervention beyond its true capability or necessity, the effectiveness of government economic management has been rapidly reduced.
5-2. The Evolving Role of the Government

The Hayekian Philosophy: Market Order & Competition!!

The role of the government should be limited to defining the economic & social environments.

**Government Role**
- Preserving the spontaneity and endogeneity of the market order
- Cultivating a better environment for the working of the market order
- Establishing a regime of fair competition in the economic and social system
VI. Conclusion

- The roles that the government plays in the national economy and its choice of instruments depend on the pattern of interaction between the polity and the economy.

- In this process, the government as an agent of polity tries to influence the private sector in economic development by utilizing either its own financial resources or state power as instruments.
VI. Conclusion

- The Korean government played its role in promoting economic development with a mixture of diverse policy measures.

- This policy mix was comprised of complementary use of finance and power as instruments for intervention in the private sector,

- as well as of the option between direct and indirect government control over business.

- And the style of the political leadership and the degree of legitimacy in exercising government influence are additional factors shaping the government’s role.
Thank you!