5

States and Markets

Who is it that makes economic development happen? Is it all done by individuals pursuing their various goals, relying on the market to coordinate and make sense of their diverse actions? Or does the government play a central role in achieving sustained increases in per capita income and output? The debate over the proper role for government in achieving economic progress has been going on for more than two centuries. In the *Wealth of Nations* (1776) Adam Smith argued against conventional wisdom of the time, which assumed it was government that led the development process. For example, the king and queen of Spain supported Columbus's exploration of the Americas, and a royal monopoly gave the British East India Company its dominant role in development of trade with India and beyond. Smith proposed instead that economic progress was achieved by individuals who worked through the market to specialize in the production of one particular product (his example was the manufacture of pins) and then exchanged that product on the market for what else they, as producers, needed.

In England at least, Smith's view dominated development thinking for much of the country's growth in the 1800s, as the leaders of the nation promoted free trade and a minimal role for government in the economy. Elsewhere, the state often played a major role in the development of new industries. As one moved eastward from England to France, Germany, and finally Russia, the government played a steadily increasing role in nineteenth-century economic development.[1]

[1]This is the basic thesis of Alexander Gerschenkron in *Economic Backwardness in Historical Perspective* (Cambridge: Belknap Press of Harvard University Press, 1962).

After David Ricardo and later Karl Marx, however, the attention of most economists shifted to trying to understand how markets worked, and economic growth was more or less taken for granted, at least in Europe and North America.[2] This focus changed dramatically after the end of World War II, which had devastated much of Europe and Japan. The challenge was how to achieve economic recovery before wartime devastation brought to power new totalitarian regimes and further warfare. In what we now know as the developing countries of the world, former colonies were rapidly becoming independent states. These countries wanted programs that would facilitate their rise out of poverty and make it possible for them to catch up with the already industrialized nations. The United States, the one industrialized country not devastated by war, stood ready to help.

The first decades after the end of World War II witnessed a major effort to achieve modern economic growth throughout the world. There were some successes, mainly the rapid recovery of western Europe, but also many failures, and that set off a debate that continues to this day over just what countries need to do to achieve sustained economic development. At the center of this debate is the question of the proper role for government in development. In the remainder of this chapter we trace the evolution of ideas since the end of World War II about the proper role of the state in economic development. For the most part thinking about the role of the state has been a learning process because successes and failures have helped develop a more sophisticated understanding of the role of government and government-created institutions in the development process. In addition, old ideas that did not initially work well have crept back into the debate. And despite all of the development thinking since the 1950s, there are still a great many poor countries and poor people in the world. In the remainder of this chapter we describe and analyze how thinking about the role of the state has evolved through these debates. In the chapters that follow we return again and again in much greater detail to the role of government as part of the solution to the full panoply of specific development questions.

DEVELOPMENT THINKING AFTER WORLD WAR II

There were several key influences on development thinking after the end of World War II. For economists, the main ideas about growth dated back a century or more. Adam Smith had stressed markets and technological progress as the key, but David Ricardo writing three decades later stressed the importance of saving and investment and of the accumulation of capital. Karl Marx published *Das Kapital* in 1867 and also took the accumulation of capital as the central driving force of growth. Furthermore, the Harrod-Domar model (see Chapter 4) put investment and capital at the center of

[2] The notable exception in the first half of the twentieth century was Joseph Schumpeter.

growth. One influential book published in 1960 argued that the key to growth was to raise the rate of investment and capital formation to a level above 15 percent of gross domestic product (GDP), although there were numerous voices at the time that said the process was more complicated than that.[3]

If capital is at the center of the growth story, it would seem to follow that one key to growth would be to raise the rate of saving so that one could increase the rate of investment. But in poor countries, it was argued, there was a vicious circle of poverty that had to be broken first. Poor countries were too poor to save much and so did not have the resources to invest and so could not grow. The obvious solution was for rich countries to contribute some of their saving to poor countries to break this cycle. In the 1960s the idea was refined further with the development of Hollis Chenery's two-gap model.[4] There was not just a saving gap but also a foreign exchange gap, and the latter was the major constraint on development in most countries. Emphasis on the foreign exchange gap reinforced the view that the key to economic development was for rich countries to provide aid (in the form of dollars or another convertible currency) to fill both the savings and foreign exchange gaps.

This view of development was greatly reinforced at the time by the experience of the Marshall Plan in rescuing the economies (and the democracies) of western Europe and Japan. The Marshall Plan supplied $25 billion to rebuild western Europe, with immediate and dramatic results.[5] Europe recovered rapidly, with GDPs growing so quickly that these countries caught up to the level of income that they would have achieved if they had not been engulfed by war. Much the same experience occurred in Japan. In 1945 virtually all of the cities of Japan lay in ruins, and malnutrition was common throughout the country. But by the 1950s the nation was well launched on two decades of unprecedented 10 percent a year GDP growth. Large injections of capital, mostly from the United States, had done the trick, or so it seemed.

What was missing from the analysis of these success stories was the role of the supporting institutions required for economic development. Western Europe had fully developed legal systems designed for a modern industrial economy; had education systems capable of providing required training; and despite the enormous loss of life, had large numbers of people who knew how to organize a company (and a government) and who understood modern technology. Much of the physical infrastructure was gone, but many of the key institutions were embodied in people, and all that was needed was a little help to get started. When the same emphasis on foreign aid, capital, and foreign exchange was applied a decade later to developing countries,

[3]Walter W. Rostow, *The Stages of Economic Growth: A Non-Communist Manifesto* (Cambridge: Cambridge University Press, 1960).

[4]Hollis Chenery and Alan Strout, "Foreign Assistance and Economic Development," *American Economic Review*, 56, no. 4 (1966).

[5]Technically the Marshall Plan itself supplied only half of the $25 billion; the other half was contributed by the United States in the years between the end of World War II and the formal beginning of the plan in April 1948. The total amount of aid converted into today's dollars would be over US$200 billion.

many of the critical institutions were missing. *Developing* poor and underdeveloped nations proved to be a very different process from *reconstructing* already developed economies destroyed by war.

Most developing countries did not start with the Smith view that well-functioning markets were the key to successful development. To begin with, markets in developing countries were associated with capitalism, and capitalism in the minds of many was associated with colonialism and being kept poor by colonial powers. Many leaders in developing countries were looking for an alternative path, and they had plenty of support from people and events elsewhere.

In the industrialized West there was the obvious fact that markets had not functioned all that well before the war. The Great Depression of the 1930s was a market failure on an unprecedented scale. But economists and others had long been aware that all economies suffer market failures, albeit on a smaller scale (Box 5-1). The question was not whether these market failures existed but how prevalent they were and thus what (if anything) the government should do about them. Among the Fabian socialists in Britain whose ideas were reflected in the Labour Party then in power in Britain, market failures were common and called for active intervention by government in many areas of economic activity. The British Labour government of the time also supported outright government takeover of certain major businesses. The relevance of this to developing countries is that many were former British colonies whose leaders had been educated in Britain at universities where Fabian socialist views were common and widely discussed. It is interesting to note that this was true of Jawaharlal Nehru and other leaders of the Indian Congress Party, which ruled India for several decades after the country achieved independence from Britain in 1948.

Some of the most prominent theories of development economists in this early period also argued that the situation facing developing countries required broad government intervention. The **big push** idea of economist Paul Rosenstein-Rodan argued that it was difficult for one modern industry to start up in a developing country (his example was shoes) because there would not be enough people with the money to buy the products of one shoe factory.[a] Instead one needed to develop a wide range of industries all at the same time so that the workers in each factory would have the income needed to buy the products of the other factories. The only way to achieve this broad-based development of a wide range of industries was to have a government plan that could guide individual producers and guarantee that the demand would be there when they went into production. Economist Albert Hirschman countered this argument with the view that countries instead could start by emphasizing industries with strong **linkages** so the creation of one industry, machinery for example, would create demand for steel and steel would create

[a]Paul Rosenstein-Rodan, "Problems of Industrialization of Eastern and South-Eastern Europe," *Economic Journal* 53, nos. 210–11 (1943), 202–11.

BOX 5-1 MARKET FAILURE

The term *market failure* refers to situations in which markets fail to achieve efficient outcomes. *Efficiency* in this context has a precise definition, based on the concept of **Pareto efficiency**. A Pareto efficient market outcome is one in which no one can be made better off without making someone else worse off. (Note that this definition, conceived by nineteenth-century Italian economist Vilfredo Pareto, says nothing about equity.) Market failures can occur for various reasons, including the presence of externalities and the existence of monopolies, public goods, and information asymmetries. The common theme across these categories of market failure is the divergence in equilibrium between **marginal social costs** and **marginal social benefits**. Market equilibrium occurs when private actors equate their marginal costs with their marginal benefits. Under conditions of perfect competition, with no externalities and no public goods, the marginal costs and benefits faced by private actors equal the marginal social costs and benefits faced by society. Yet, imagine a situation in which a factory sits along a riverbank upstream from a fishery. That factory chooses a profit-maximizing quantity of output by equating its private marginal costs and benefits and thus releases the related quantity of effluent into the river. If the cost of the pollution is reflected in the loss of revenue to the fishery, that cost is borne by society but does not enter into the private cost–benefit calculations of the factory owner. It is an externality and leads to a divergence between marginal private costs and marginal social costs. This constitutes a market failure in which the factory overproduces both its output and pollution. On a larger scale, the overproduction of greenhouse gasses, widely seen as a cause of global warming, has been called, "the biggest market failure the world has ever seen."[a] (We return to this theme extensively in Chapter 19.)

A similar divergence between private and social marginal costs and benefits occurs in the presence of monopolies. Profit-maximizing monopolists restrict output below the level that would occur under perfect competition. In doing so, the monopolist is equating private marginal costs and benefits (the basic condition for profit maximization). Yet, reducing the quantity of product available in the monopolized market results in an equilibrium in which the marginal social benefits of an additional unit of output exceed the marginal social costs of producing that last unit, another instance of market failure. Society would be better off with additional output in this market.

The market failure associated with public goods arises from the incentive for individuals to act as free riders. Public goods have the characteristic that no

[a] N. Stern, *Stern Review on the Economics of Climate Change* (London: HM Treasury, 2006).

one can be excluded from consuming them (for example, national defense). The resulting distinction between public and private goods is that to consume the latter, each individual must reveal his or her true willingness to pay for that good, but with the former, because no one can be excluded, the incentive is for individuals to conceal their true willingness to pay for consumption. Markets thus fail by undersupplying public goods (here, too, implying a divergence between private and social marginal costs and benefits).

Information asymmetries are situations in which one party to a transaction has more information than the other party. Such situations commonly arise in insurance markets, where the insured knows more about his or her own risk profile and behavior than does the insurer. Thus, high-risk individuals will tend to drive up the price of insurance for low-risk individuals and drive them out of the market (the adverse selection problem). Similarly, having insurance might lead some to engage in riskier behavior than otherwise, thus driving up the price of insurance for those who continue to behave more cautiously (the "moral hazard" problem). In both cases, the information asymmetry creates an externality, leading to market failure.

Faced with these (and other) potential sources of market failure, the challenge for government policy makers lies in deciding if, when, and how to intervene. Potential policy interventions to correct market failures are varied and complex. They might include taxing polluters (to internalize the cost of externalities), breaking or regulating monopolies, and directly providing public goods. In practice, diagnosing market failures is rarely a straightforward task, and public intervention brings with it the risk of making the situation worse than it would have been without the intervention. Such instances are known as **government failure**. The tension between the risks of market failure and government failure lies at the heart of the debates described in this chapter.

demand for iron ore and coal (what Hirschman called **backward linkages**).[7] The big push theory implicitly assumed that solving the demand problem by exporting a new product was not a realistic option, an assumption that was not unreasonable given that Rosenstein-Rodan was writing during and shortly after World War II. Some analysts still use the term *big push,* but mostly when arguing for making a large effort, such as an unprecedented increase in foreign aid to get over one or another major

[7]Albert O. Hirschman, *The Strategy of Economic Development* (New Haven, CT: Yale University Press, 1958).

obstacle to growth. More recent uses of the big push terminology are discussed at greater length in Chapter 14.

Of comparable or greater influence than these intellectual debates was the perceived success of the model of growth pioneered by the Soviet Union.[8] This model had three basic components:

1. The proponents of the model, like Marx, emphasized the role of capital and high rates of investment achieved by limiting consumption by farmers and others.
2. The model gave priority to the development of heavy industry that would provide physical capital products, such as machinery, that were assumed not to be available unless produced domestically.[9]
3. Management of the economy rejected the use of market forces except in areas peripheral to most economic activity.

The allocation of goods was to be done by large government bureaucracies guided by a central plan drawn up in Moscow. The appeal of the Soviet approach was based on the widely held perception that it had transformed a poor and backward country into an industrial powerhouse that defeated the strongest military power in the world, Nazi Germany. Three decades later this economic model would appear to be far less formidable within the Soviet Union itself as well as elsewhere, but in the 1950s many developing countries were inspired by it. Ghana under Kwame Nkrumah, for example, the first African nation to achieve independence from its colonial ruler, focused on heavy industry during its initial growth phase. India went even further in attempting to adapt major parts of the Soviet economic model, and China, after the 1949 revolution, adopted the Soviet system in its entirety.

Finally, the attitude toward the prospects of achieving growth through reliance on foreign trade had limited appeal in most developing countries. The belief among many was that dependence on foreign trade would force these countries to be forever the source of raw material from their mines and agriculture and never industrialized countries in their own right. More important, the one region of the developing world that had begun industrial development before World War II (South America, in particular Brazil, Argentina, Columbia, and Chile) had done so by developing industry behind high protective barriers, called *import substituting industrialization* (discussed at greater length in Chapter 18). There was no belief at the time that growth could be achieved to a large degree by the export of manufactures, and there was a solid reason for this belief. During World War I and II, there were few international markets for South American manufactures because submarine war, among other

[8]Strictly speaking, the Soviet model of economic growth was patterned in part on the German wartime economic model used during World War I (1914–18).

[9]Strictly speaking, the Soviet model assumed that the economy was basically closed to foreign trade; hence exporting consumer goods or natural resources to purchase capital goods from abroad was not an option or was, at best, a very limited option.

things, prevented most normal trading relationships. In between the two wars was the Great Depression, when industrialized countries vied with each other to raise tariff barriers to protect their own domestic industry. The very high Smoot-Hawley Tariff, enacted in 1930, was the American contribution to this trade war.

By the 1950s and 1960s this emphasis on import substituting industrialization was further reinforced in South America. Industries developed behind high trade barriers were an important part of those economies and gave them substantial political influence to keep the trade barriers in place. In addition, economists such as Raul Prebisch, based at the Economic Commission for Latin America (ECLA) in Santiago, Chile, and Hans Singer, based at the United Nations Industrial Development Organization (UNIDO) provided an intellectual rationale for import substituting industrialization. The low income and price elasticities of demand for developing countries' exports of raw materials and the inability of such nations to compete against the economic head start of the industrialized nations meant that all or most of the benefits of foreign trade went to the already industrialized nations, or so Prebisch and Singer argued.

The result of these various influences is that most developing countries in the 1950s and 1960s believed that a high level of government planning and government intervention in the economy was desirable and even absolutely necessary if economic growth were to be achieved. All over the world, countries introduced one government intervention after another. Sometimes these interventions were based on strategy articulated in a national plan; at other times they had a much narrower focus, including the personal interests of the government officials introducing the measures. All of this was occurring, however, while the governments of the industrialized nations were in the process of dismantling most of their trade barriers under the auspices of the General Agreement on Tariffs and Trade (GATT), formed in 1949 and now superseded by the World Trade Organization (WTO). Economists from industrialized countries who had lived through the trade wars of the 1930s and a much wider group of political leaders felt that these trade disagreements had contributed directly to global warfare and were determined to move the industrialized world back to the open trading system that had existed before World War I. Some of these same economists argued vigorously against the protectionist trends in the developing world, but not many policy makers in developing countries were listening.

The main approach of economists working with developing countries in the 1950s and 1960s was not to try to reduce the role of government in the economy but to try to make government intervention more rational and geared to achieving well thought out development objectives. One such measure was to help countries set up planning commissions that would draw up economic development plans and provide sound economic advice to development officials in general. The Harvard Development Advisory Service (later the Harvard Institute for International Development), heavily funded by the Ford Foundation, for example, provided technical

support mostly in the form of economic analysis and training to planning commissions in Iran, Pakistan, Indonesia, Malaysia, Ghana, and other countries in the 1960s and early 1970s.[10]

By the early 1970s, therefore, a high level of intervention and a high level of government investment in the economy of developing countries was the norm, although there were exceptions. The role of industrialized countries was to provide aid mainly to governments either through bilateral or multilateral aid programs (for example, the World Bank) and to provide technical assistance to help design and manage aid projects and help more generally with government economic policy making. In countries within the sphere of influence of the Soviet Union, the full Soviet model, where the government controlled and administered most economic activity outside of agriculture, was the norm.

FUNDAMENTAL CHANGES IN THE 1970s AND 1980s

By the 1970s a reaction against the approaches of the earlier decades was building, particularly among economists and other policy makers in the bilateral and multilateral aid agencies and in the governments of the industrialized world. There was a growing disillusionment with the results of the considerable amounts of aid given out over the previous two decades. In Africa, most governments that had gained independence in the 1960s were experiencing little or no growth, and total factor productivity in the continent as a whole was negative. In Latin America import substituting industrialization had run into the limits caused by the small size of most of the domestic markets and growth had slowed in much of the region. By the 1980s (and in China by the late 1970s), interest in the Soviet model had waned because most of the countries with a Soviet-type economic system began to stagnate and in certain cases to build up unsustainable levels of international debt.

The analysis of what had gone wrong, however, had several different strains to it, and analysts and policy makers often did not agree about which one was the major source of weak performance. One strain of criticism of the policies of the 1950s and 1960s argued that too much attention had been paid to the growth rate of GDP and not enough to how the benefits of growth were distributed.

Too many of the benefits of growth, it was argued, were going to a narrow group of wealthy business people and their government and politician supporters. The share of the population trapped in poverty was not declining rapidly enough even in areas where GDP growth was relatively robust, and it was not declining at all in

[10]Edward S. Mason, *The Harvard institute for International Development and Its Antecedents* (Cambridge: Distributed by Harvard University Press, 1986).

much of the developing world.[11] Inequality also had a regional component. In many countries growth appeared to be concentrated in one part of the country, often near the capital city, while other regions stagnated. The breakup of West Pakistan and East Pakistan with the latter becoming Bangladesh in 1971, for example, was in part caused by the belief that all or most of the benefits of foreign aid and development were flowing to West Pakistan.

Economists had recognized for decades that an efficient economic system did not necessarily mean the system was equitable or that the fruits of the system were fairly distributed. Efficiency in economic theory was typically defined as a system that could not make anyone better off without making someone else worse off, a concept called **Pareto optimality**. Markets were efficient in this sense (or at least perfectly competitive markets were efficient), but that could be consistent with an economy with a concentration of income and wealth in the hands of the few. If markets could not necessarily solve the problem of inequality, it seemed to many economists that it was up to the government to correct this failure. They argued that government was best suited to address basic needs and target aid to the poor. Private charities and other nongovernmental organizations (NGOs) could play a role in these efforts, but they lacked the resources possessed by governments.

Counter to this argument for even more government intervention in the economy was a growing awareness based on research and experience that many government interventions did not work out as intended or planned. Many simply created obstacles to economic growth. Trade restrictions in Indonesia, for example, forced importers to obtain 70 different stamps of approval before a good could be brought into the country. This approach may have protected a few domestic industries, but it made it difficult for most businesses to get needed inputs in a timely manner, something that was essential if they were to compete in the international marketplace. Other interventions such as those of Kwame Nkrumah in Ghana were based on a flawed development strategy unsuited to the conditions then prevailing in the country (Box 5–2). Many governments had no economic rationale at all for their interventions or justified their actions as solving some particular market failure when the real motivation lay elsewhere. Often policies that had the stated goal of helping the poor were really designed to provide jobs or illicit income for well-off government officials. Other interventions, whether well intended or not, provided government officials with discretionary authority to issue permits, providing the opportunity for illegal payments.

For the increasing number of economists and policy makers who held these views, the clear implication was that governments of developing countries needed to

[11] One study at the time that had an important influence on thinking about redistribution, particularly in the World Bank, was the book by Hollis Chenery, Richard Jolly, Montek S. Ahluwalia, C. L. Bell, and John H. Duloy, *Redistribution with Growth: Policies to Improve Income Distribution in Developing Countries in the Context of Economic Growth* (World Bank, 1974).

BOX 5-2 GHANA AFTER INDEPENDENCE

On March 6, 1957, with great celebration, Ghana became the first sub-Saharan African country to gain its independence. Optimism was in the air: Ghana was the world's largest cocoa producer, it had the highest per capita income in sub-Saharan Africa (except South Africa), and its foreign exchange reserves were equivalent to over three years of imports. Ghana's prospects looked bright.

But it was not to be. President Kwame Nkrumah, who was brilliant in leading Ghana to independence, proved to be much less effective as an economic and political leader. In a push for rapid industrialization, Nkrumah introduced extensive state intervention in the economy, with many controlled prices, restrictions on trade and investment, and state-owned enterprises. Based on its cocoa earnings, Ghana borrowed heavily to establish a wide range of industries designed to substitute for imports and for processing many of Ghana's raw materials. But cocoa prices collapsed in the mid-1960s, and the state's heavy hand led to widespread corruption, poor investment decisions, distorted prices, and growing instability. In 1966, a group of army officers overthrew Nkrumah in what was only the first of a series of coups and countercoups over the following 17 years. The economy fluctuated wildly, with growth plunging to −6 percent in 1966, then climbing to 7 percent in 1970 as cocoa prices recovered, only to collapse again to −5 percent 2 years later and to a disastrous −14 percent in 1975. By 1983, the economy had collapsed. Cocoa production was only half as large as it once had been, inflation exceeded 120 percent, growth had been below −6 percent for 3 years in a row, and per capita income was about one-third lower than it had been 26 years before at independence.

In 1983, President Jerry Rawlings (who had taken power himself in a coup 2 years earlier as Flight Lieutenant Rawlings), with few options at his disposal, turned to the International Monetary Fund (IMF) and World Bank for financial assistance and, in return, accepted their strict conditions for changes in economic policy. Rawlings introduced Ghana's Economic Recovery Program, which in many ways was a prototype for reform programs introduced by many other developing countries under the auspices of the IMF and World Bank in the 1980s and early 1990s. The reforms were widespread: Ghana devalued its currency, freed interest rates from restrictions, and substantially reduced its budget deficit. It removed or modified a range of price controls (including raising the price paid to cocoa farmers), reduced tariffs on many imported products, and otherwise took steps to liberalize the trade regime. It partially or fully privatized dozens of enterprises over several years, including transport, the marketing of cocoa, banking, and other areas. The IMF and World Bank heralded Ghana's progress in reforms

and predicted that these changes would lay the foundation for greater macroeconomic stability, sustained economic growth, and a reduction in poverty.

The results were a clear improvement although not as dramatic as many at the time had hoped. The economy stabilized: Inflation fell (although it still remained above 20 percent), the trade deficit shrank, and foreign exchange reserves grew. Growth became far less volatile, and per capita GDP grew at 1.6 percent through the mid-1990s and at a higher rate of just over 2.9 percent from 1996 through 2010. Growth after 2004 was further boosted by the international community forgiving nearly $6 billion of Ghana's debt, although Ghana then borrowed another $750 million in 2007. The discovery, also in 2007, of major off-shore oil reserves promised further support for Ghana's economy. The first oil began to flow in 2010 and the per capita GDP growth rate in 2011 jumped to over 8 percent. Whether this oil windfall will lead to sustained higher growth or will be mismanaged with negative consequences for growth remains to be seen. The evidence as to whether this will be the case as of 2011 is mixed.

step back from meddling in the economy and better design whichever existing policies seemed to be working. The shortcomings of import substituting industrialization have been particularly well documented.[12] Even Nobel laureate Gunnar Myrdal, an early advocate of import substituting protection as a means of mobilizing underemployed labor, eventually recognized that intervention often leads to corruption, which in turn inhibits development.[13] By the 1970s and early 1980s the World Bank also began to push harder on these issues.

While these debates over the role of government were proceeding, two major developments occurred that were to have a profound impact on how the role of government in development was perceived. The first development was the rise in oil prices engineered by the Organization of the Petroleum Exporting Countries (OPEC) in 1973 and 1979. These price increases led to large amounts of money flowing into the treasuries of oil-exporting countries, expanding the role of government investment in those countries, often by a very large amount. Of equal if not greater importance over the

[12]One of the early influential articles questioning import substitution industrialization was John Sheahan, "Import Substitution and Economic Policy: A Second Review," Research Memorandum No. 50 (Williamstown: Williams College, Center for Development Economics, 1972). See also his study of import substitution in Latin America, John Sheahan, *Patterns of Development in Latin America: Poverty, Repression and Economic Strategy* (Princeton: Princeton University Press, 1987).

[13]In his *Asian Drama: An Inquiry into the Poverty of Nations*, 3 vols. (New York: Twentieth Century Fund, 1968), Gunnar Myrdal introduced the concept of the *soft state*, which was ineffective in carrying out its development goals and was typically riddled with corruption arising from these ineffective efforts.

longer run, however, was that several of the largest exporters acquired large reserves of foreign exchange that they reinvested with the cooperation of the international banks.

The enormous amount of money involved led to low interest rates on loans worldwide, and governments of developing countries were encouraged to borrow large sums to fund their development programs. Particularly in Latin America, debts to the major private international banks began to accumulate. By the mid-1980s, the situation had changed dramatically. Alarmed by rising inflation, due in part to the OPEC oil shocks, the U.S. Federal Reserve sharply contracted the U.S. money supply, causing interest rates to rise precipitously. This had two highly detrimental effects on developing nations that had borrowed abroad. First, many loans were written with variable interest rates; second, they were denominated in dollars, not local currency. When the U.S. dollar rapidly appreciated as markets responded to the policies of U.S. monetary authorities, heavily indebted nations had trouble servicing their debts as their interest payments rose and the value of their currencies against the U.S. dollar fell. The ensuing debt burden on Latin American countries forced several major countries to consider defaulting on their debts. The full nature of the debt problem in this period is discussed at length in Chapter 13; here we note that the buildup of debt first made it possible for developing country governments to finance a wide array of development projects, and then created a payment crisis that brought many of these projects to a premature end in what in Latin America has often been called the lost decade of the 1980s. The impact of this lost decade went far beyond the immediate debt problems. It called into question the whole subject of the appropriate role for government in development.

The other profound event of the 1970s really began in the 1960s, but its impact on development thinking was felt only a decade later, and its lessons are still being debated today. This event was the rise of the Four East Asian Tigers: South Korea, Taiwan, Hong Kong, and Singapore. By the late 1970s these economies had been growing at rates comparable to those of Japan for over a decade and were increasingly seen as economic success stories. The basis for their growth was a direct challenge to the view that the path to successful development rested on an emphasis on import substituting industrialization. All four built their rapid economic growth on the export of labor-intensive manufactures. There was a period of import substitution, but the four quickly moved to a reliance on exports, manufactured exports in particular. The model for the economies of South Korea and Taiwan was Japan, which had pioneered a similar strategy during the first phases of its development and again after World War II. Hong Kong and Singapore had long been trading entrepôts and possessed all of the infrastructure and institutions that trading economies required. What was added in the latter two economies was a manufacturing sector oriented toward export markets. In Hong Kong's case, it was manufacturers in Shanghai who moved their base of operation to Hong Kong after the Communist revolution in China in 1949. All Four East Asian Tigers exported first and foremost to the United States whose market, unlike in the 1930s, was wide open to foreign imports. These nations demonstrated that a development strategy based on the export of manufactures was

not only possible but superior to the import substituting strategies then prevailing in much of the developing world.

More controversial is the influence of the Four East Asian Tigers on the role of government in their economic development strategy. The facts themselves are not really in dispute. The governments of South Korea and Taiwan were actively involved in export promotion and in industrial development more generally. They devalued their currencies, subsidized exports in various ways, and promoted education and research in technology in support of industry. Government support, including temporary protection against imports, was predicated on performance, and performance by Korean and Taiwanese firms was measured by their ability to export. By any standard these governments were interventionist, but they had a clear strategy behind their intervention, which was not allowed to be diverted toward the private interests of government officials. Corruption existed in the two economies, but it had little influence on industrial and export policies. It is also the case, however, that state-led economic development became less and less viable as these economies became more sophisticated and complex. By the first decade of the twenty-first century, both South Korea and Taiwan had eliminated much of the intervention that characterized their first decades of rapid growth (Box 5–3).

The experience with the role of government in development in Hong Kong and to a large degree Singapore as well could not be more different. Hong Kong was as close to a pure laissez faire market economy as any in the world. The government of Hong Kong maintained a completely open free trade economy. In the few areas in which it did intervene, such as land policy, the government imposed policies unrelated to the main development strategy. The role of government was to maintain a stable macroeconomic environment, support education and health, and maintain security. Singapore's government was similar in most respects, but there the government did play a role in supporting particular industries and several of the key corporations (Singapore Airlines, for example) were government owned. For the most part, however, Singapore's industrial policy focused on creating a favorable climate for foreign direct investment (see Chapter 10).

Some studies have tried to press these rather different experiences of the Four East Asian Tigers into a story consistent across all the groups.[14] More common has been the selective choice of one experience over another to support a particular preconceived view of the role of government intervention (Hong Kong for those who support laissez faire markets;[15] South Korea's heavy and chemical industry drive of

[14]World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993), ably describes many of the reasons for the success of the four economies but less successfully tries to fit the experiences of the four into a single development model that relied mostly on market forces for its success. This reasonably portrays the policies of Hong Kong and Singapore but not those of South Korea and Taiwan.

[15]See for example Milton Friedman, "The Real Lesson of Hong Kong," *National Review*, December 31, 1997.

BOX 5-3 THE DECLINING EFFECTIVENESS OF GOVERNMENT INTERVENTION IN THE MARKET: KOREA, 1960s–2010

South Korea in the 1960s and 1970s pursued an industrial policy that involved heavy intervention by the government to promote exports in general and specific industries in particular. The government provided bank loans to favored industries at below-market rates, gave these industries special access to government-controlled foreign exchange and imports, and helped build the infrastructure they required. The president of the country even met monthly with the heads of the major industries to review and help solve their problems, many of them related to intervention by government in their efforts to expand. The government saw itself as correcting for market failures, even though many of these market failures were the creation of earlier and continuing government controls that were part of its import substituting policies.

These industrial policies appear to have worked reasonably well, although the heavy industry and chemical industry drive of the 1970s remains controversial to this day. President Park Chung Hee, who led this effort, kept politics and corruption out of most of these industrial policy decisions. Because he ran an authoritarian regime supported mainly by a modern army, he felt no need to use industrial policies to pay off his political supporters. By the early 1980s, however, many Korean economists and others felt that this activist government industrial policy was causing too many economic distortions and the country should move toward a more market-oriented system. This change proved to be difficult because of promises made to private companies that had carried out the government's wishes in the past. Such companies felt that they had an implicit guarantee that they would be helped out if, by doing the government's bidding, they got into trouble. In the 1980s, they did get into trouble, and the government spent much of its time in that decade providing them with subsidies and other means of support.

By the 1990s, Korea had a democratic government led, from 1992 to 1997, by President Kim Young Sam, who had little interest in an activist industrial policy. Like his predecessors, however, he saw how these policies could be used to raise large sums of money to support his political campaigns. Increasingly the principal criterion for getting government support for a particular firm or industry depended on whether that firm contributed to the political campaigns. Such contributions existed in the 1960s and 1970s as well, but they were not allowed to influence major industrial policy decisions. By contrast, in the 1990s, industrial policy interventions were driven more by politics than by a concern for building efficient, competitive industries. Industrial policy in the earlier period had produced

such firms as POSCO, one of the largest and most efficient steel companies in the world, a firm that remained profitable right through the Asian financial crisis of 1997–98. The industrial policy in the 1990s produced such firms as the Hanbo Steel company, whose bankruptcy contributed in a significant way to Korea's involvement in the Asian financial crisis.

Finally, in the 1998–2008 period, the Korean government under two new presidents, Kim Dae Jung and then Roh Moo Hyun, began to make a major effort to get themselves out of the business of supporting particular industries and firms. The objective was to create a level playing field for all, but to do so without triggering another financial crisis caused by the collapse of the older firms that had relied so much on government support. Moving away from extensive government intervention and relying entirely on market forces, however, is not as simple as simply telling the government to stop intervening. In many cases, the government felt it had to introduce new interventions to undo the damage of previous ones. This same conflict of goals continued during the government of President Lee Myung-Bak who took office in 2009.

the 1970s for those who believe in extensive government intervention). As the experience of these four economies became better understood, however, two conclusions became increasingly clear. One was that developing countries could grow at very rapid rates with the right policies. The other was that growth could be based on exports, at least on exports of manufactures. Exports based on natural resources (discussed in Chapter 17) were another matter, but none of the four tigers had significant exports of natural resources.

The influence of the experience of the Four East Asian Tigers was particularly strong regionally, notably in China after 1978 and Vietnam after 1986, but it also changed the thinking of many economists and policy makers in South America and elsewhere in the developing world.

STRUCTURAL ADJUSTMENT, THE WASHINGTON CONSENSUS, AND THE END OF THE SOVIET MODEL

The response of the multilateral and bilateral aid agencies, particularly the World Bank, was to use their aid programs to support changes in the approach to development in countries whose economic performance was weak. By the late 1980s the list of countries struggling but largely failing to achieve rapid economic development included most of those in Africa, Latin America, and South Asia. The term used by

the World Bank for many of the changes it proposed was *structural adjustment,* a broad term that includes reforms aimed at changing the structure of the economy to be more market based, more efficient, more open to international trade, and more focused on the production of tradable commodities. The result was a wide range of reform proposals, initially somewhat ad hoc, that were often made conditional if a country wanted to receive assistance from the World Bank or other aid agencies.

A major objective of structural adjustment reforms was to reduce or remove distortions generated by government intervention. In the majority of developing countries, the list of distorted prices was long and included high and uneven tariffs, cheap interest rates on loans (which discourage saving and lead to poor loan decisions), high minimum wages that help some workers but hurt others, subsidized fuel or food, and limits on prices paid to farmers to control food prices. For every government-determined price, there are winners who receive more for their output or pay less for their inputs, and losers who experience the opposite. Price distortions most often occur when the beneficiaries of a price change are few and concentrated, and the losers are many and dispersed. A tariff raises profits for the well-connected factory owner. But even though millions of people might be paying a higher price for the tariff-protected goods, they are scattered unevenly across the country and unlikely to organize to protest the increase. Because the tariff is built into retail prices, consumers may not even be aware that government intervention caused the higher prices. The owners of the company, however, know and are happy to share their increased profits with those who helped them, thus creating political barriers to reform.

Sometimes, correcting a distortion may lead to lower prices, as in removing a tariff, but it can also lead to higher consumer prices, as in the removal of food or fuel subsidies. These subsidies are often paid for out of the budget and can be major contributors to budget deficits and inflation, or they can come from scarce tax revenues that might be better spent on schools, roads, or health clinics. However, removing such subsidies can create enormous political pressure because consumers immediately see the costs but not always the benefits. Removal of a food or fuel subsidy frequently triggers rioting that can topple governments.

Thus there is often stiff resistance to structural adjustment reforms designed to correct price distortions, either because they hurt powerful and well-connected people or because they affect many consumers. In central and eastern Europe and in Russia and China, most state enterprises saw themselves as beneficiaries of state price controls because it meant that they received key inputs at artificially low prices. To get around the resistance of large state enterprises, China created a dual price system in the 1980s by which steel going to a large enterprise in accordance with the annual plan was charged a low state-set price and all other steel was sold on the market at much higher market-determined prices. This dual system overcame much of the political resistance to price reform, but it also created opportunities for corruption by those who could use their influence to buy at the low state price and quickly resell at the high market price, corruption that contributed to the discontent that

fueled the demonstrations on Tiananmen Square in 1989. Many of the other socialist and former socialist countries, from Russia to Vietnam, therefore, opted for eliminating state-set prices altogether and using one market-determined price for most goods and services. By the latter half of the 1990s, China had largely eliminated the two-price system in favor of a unified market-price system. The gradual elimination of the dual price system resulted in part from deliberate decisions by the Chinese government to reduce the quantity of goods sold at low state-set prices. For the most part, however, the state-set prices disappeared because producers increasingly were unwilling to sell their goods at below market prices, and they found numerous ways to circumvent government instructions requiring them to do so.

There were many other elements to most structural adjustment programs, and over time what started as an ad hoc country-by-country approach gradually evolved into a comprehensive view of what successful development involved. In later years this came to be known as the Washington Consensus, but a comprehensive view of what was wrong began to appear well before that term was coined. In 1981, for example, the World Bank published an influential report, *Accelerated Development in Sub-Saharan Africa: An Agenda for Action*, better known as the Berg Report after its principal author, economist Eliot Berg. It presented a wide range of policy changes that would be needed if Africa were to reach its potential growth. The report focused heavily on agriculture because that is where most people lived and worked. The Berg Report called for an end to overvalued exchange rates then common in Africa, and an elimination of trade restrictions that favored inefficient industries over efficient farms. The expanding role of the state in managing the economy, particularly the role of state marketing boards as substitutes for private marketing mechanisms, came in for criticism. These marketing boards, such as the Ghana Cocoa Board, often extracted high taxes from farmers by setting output prices far below the true export price for the commodity. There also were recommendations for better debt and aid management and more emphasis on improving human resources through education and health measures. Similar reports followed in subsequent years but through the 1980s African development remained sluggish.

It was a seminal essay by economist John Williamson, however, that laid out clearly the view of what the international and bilateral aid agencies thought was the core set of problems that countries needed to face if they were to accelerate their development. This growing strong agreement among the International Monetary Fund (IMF), the World Bank, the U.S. government, and other key international actors focused on the steps that were necessary for Latin American countries to reform their economies, but the implications went beyond Latin America. Williamson was the first to label this broadly agreed reform agenda *the Washington Consensus*.[16] Williamson's

[16]The original article is John Williamson, "What Washington Means by Policy Reform" in Williamson, ed., *Latin American Readjustment: How Much Has Happened* (Washington, DC: Institute for International Economics, 1989).

purpose was to identify "the lowest common denominator" of policy advice prevailing at the time. In so doing, he highlighted how these policies differed from the conventional wisdom that had prevailed 20 years before. The 10 components of Williamson's Washington Consensus are as follows.

- *Fiscal discipline.* Balanced government budgets are essential to avoid inflation, balance of payments deficits, and capital flight. Government budget deficits of more than 1 or 2 percent of GDP are considered to be excessive and evidence of policy failure.
- *Reordering public expenditure priorities.* Expenditures on subsidies of various kinds (gasoline, food, and many other products) and politically sensitive areas, including the military, should be cut back and instead should be concentrated on education, health, key infrastructure, and maintaining essential public administration (but cutting back on bloated bureaucracies).
- *Tax reform.* To alleviate budget deficits, improve incentives, and achieve equity, reforms call for modest marginal tax rates and a broadening of the tax base.
- *Liberalization of interest rates.* Market forces should determine interest rates and the allocation of credit. Interest rates need to be positive in real terms—that is, the nominal interest rate should be higher than the rate of inflation.
- *Competitive exchange rates.* The exchange rate also should be determined by market forces and at a level that maintains a balance-of-payments equilibrium and, in particular, facilitates the expansion of exports.
- *Trade liberalization.* Elimination of quantitative restrictions (import quotas and import licensing) and a move toward uniform and low tariffs on imported goods. Such measures, in part, would encourage domestic firms to sell to foreign markets rather than focus on protected domestic ones.
- *Liberalization of foreign direct investment.* Restrictions on foreign direct investment should be removed so as to facilitate the inflow of needed capital, skills, and know-how.
- *Privatization.* Public enterprises should be privatized, to both relieve pressures on the government budget (from subsidies to loss-making public enterprises) and promote greater efficiency. This reflected the prevailing view that private firms generally are more efficient than those in the public sector.
- *Deregulation.* The primary vehicle for promoting competition within the domestic economy is to greatly reduce or eliminate government regulation, especially those that limit the entry and exit of firms. However, regulations that ensure safety, environmental protection, and the supervision of the banking sector remain justified.
- *Secure property rights.* Private property rights matter and steps should be taken to strengthen these rights, including providing them at reasonable cost to the small-scale, informal sector.

The common thread of all of these recommendations was that growth was being inhibited by major distortions in the market, distortions for the most part introduced by inappropriate government policies. Removing these distortions was seen as the key to accelerating growth. Government failure, more so than market failure, was viewed as the primary impediment to economic growth and development.

Williamson's original essay was written at the end of what was referred to above as the *lost decade* for economic growth and development in Latin America. The paper was meant both as a *description* of the policy reforms recommended to Latin American economies and a *prescription* for reforms needed in the region. This package of reforms, or close variants of it, which advocated prudent macroeconomic policies, greater outward orientation, and increased reliance on free markets, was also applied outside of Latin America. After the fall of the Berlin Wall in 1989, a large group of transition economies emerged, and they were encouraged to pursue similar policies. Sub-Saharan Africa, which had been stuck in its own growth crisis, also was urged to follow this same approach. When financial crises reemerged, first in Mexico in 1994, then in East Asia in 1997, followed soon thereafter by crises in Russia, Brazil, Turkey, and Argentina, elements of the Washington Consensus were applied to these situations, even though the underlying reasons for financial crises (see Chapters 12 and 13) were often different from a failure to achieve sustained economic growth.

The 1980s and 1990s witnessed a significant shift toward the reform agenda captured by the Washington Consensus. The pendulum swung away from state planning toward the market. Fiscal discipline became more widespread, with budgets moving in the direction of greater balance; hyperinflation, which especially had plagued Latin America, became less common; exchange rates worldwide became less overvalued, with black market premiums tending to fall if not disappear entirely; financial repression (by which nominal interest rates are held below the rate of price inflation, with governments allocating scarce credit to favored firms) fell out of favor; produce marketing boards were disbanded and other forms of direct price control dismantled; trade barriers were reduced; and privatization of state-owned enterprises proceeded on all continents.[17]

SOVIET COMMAND MODEL TO MARKET ECONOMIES: THE GREAT TRANSITION

As the Latin American economies were beginning to pull out of the debt crisis of the 1980s and were moving in the direction of the Washington Consensus, one of the

[17]In Latin America, fiscal discipline reduced the average budget deficit from 5 percent of GDP to about 2 percent—and lowered public external debt from about 50 percent of GDP to less than 20 percent. Trade liberalization brought average tariffs down from more than 40 percent to nearly 10 percent. . . . Banks, power plants, telecommunication systems, and even roads and water and health services were sold off to the private sector. More than 800 public enterprises were privatized between 1988 and 1997. Nancy Birdsall and Augusto de la Torre, *Washington Contentious: Economic Policies for Social Equity in Latin America* (Washington, DC: Carnegie Endowment for International Peace, 2001).

major events of the late twentieth century was occurring in Eastern Europe. Under the leadership of Mikhail Gorbachev of the Soviet Union, the countries in Eastern Europe were freed up to go their own way. In rapid succession beginning in 1989, the wall separating East Germany from West Germany was torn down and throughout the countries of Eastern Europe, the ruling authoritarian communist parties were replaced by multiparty parliamentary systems. Soon thereafter, the Soviet Union itself collapsed and was broken up into 15 separate and independent countries.

For the countries of central and eastern Europe that had been independent before World War II and in the newly independent three Baltic states, the economic goal of the new governments was clear—they wanted to become as much like western Europe as possible, and that included the rapid replacement of Soviet-style central planning and administrative allocation of most industrial products with a market economy. In Russia there was more division of opinion, but there too under President Boris Yeltsin the country set out to transform itself into a market economy as well as a more democratic polity.

The question in all of these transition economies was how to carry out this transformation. Should the transition be carried out across the board in one dramatic leap, as many foreign and domestic economists were advising? Or should the process be gradual? What exactly did the transition to a market economy involve? Some of these economies had allowed the market to exist alongside the command economy, notably in agriculture and in the distribution of many consumer products, but now the challenge was how to introduce market forces into the economy as a whole. Introducing a market system into an economy governed primarily through nonmarket mechanisms is not the same as removing distortions in an existing market system, but that difference was not well understood at the time. In a distorted market system, the institutions needed for a market system to function are often in place but are being distorted by government interference—for example, in the setting of prices. In a command economy in which most goods are distributed through government bureaucracies and not through markets, many of the institutions needed for a well-functioning market system do not exist.

There are five key elements required for a market to function well:

1. *There must be a reasonable degree of macroeconomic stability.* High inflation, large balance of payments deficits, and large-scale unemployment are generally not consistent with a well-functioning market economy.
2. *Most goods and services must be distributed through the market.* This seems obvious, but remember that the Soviet-type economy mostly distributed goods and services using administrative means implemented by large government bureaucracies. Even in Western economies during wartime, it is typical for a large part of distribution to be handled by government officials rather than by the market. Commanders in the field do not buy their weapons on the market—the weapons are allocated to them by a government bureaucracy, such as a defense ministry. For goods to be distributed on the market, a

market must exist. In the case of simple markets (for example, a farmer selling an egg to a consumer), markets can spring up overnight. More complicated markets, however, require institutions that often do not exist. Stock markets and futures markets, for example, operate in accordance with an elaborate set of rules that define what kinds of activities are allowed and what kinds are not allowed. Even the sale of automobiles typically requires a distribution network of dealers who not only sell the car but also service it. Because automobiles are expensive relative to the income of the typical consumer, there must also be a mechanism set up to help finance the purchase of the auto.

3. If the goods are going to go to their most efficient uses, *prices must be freed up to reflect the relative scarcities in the economy*. Prices are the signals that guide producers on what to produce and consumers on what best to consume. The wrong prices send the goods to the wrong (less efficient) uses.
4. *There must be competition in the markets*. Monopoly power distorts prices and hence distorts the signals sent by prices to producers and consumers. A mechanism thus needs to be in place that prevents producers from colluding with each other to establish monopoly control of particular markets.
5. Getting prices right in part through competition, however, is only half of the battle. If goods and services are to be directed to their most efficient uses, producers must respond to these prices in the appropriate way—they must behave in accordance with the rules of the market, which in their most basic form say that *producers should attempt to maximize profits*. Furthermore they need to maximize profits by increasing their sales or cutting their costs, not by getting larger subsidies through their connections with government.

The standard advice of economists involved in the Eastern European and Russian transitions was similar in many key respects to the program of the Washington Consensus, and it dealt with many key aspects of what a well-functioning market requires but not all. These economic advisers typically recommended that governments should eliminate high levels of inflation and restructure the international debts that had built up because of long periods with balance of payments deficits. Assuming that as background, or going ahead even if the macro situation was not under control, the remaining steps were to have all or most goods and services sold on a market and prices freed up to find their appropriate level. The final step was to privatize as much of the economy as possible so that producers would thus focus on the maximization of profit. All of these steps were to be taken as quickly as possible, preferably all at once in a year or two.

Not all of the countries involved in this transition process followed this advice closely, but many did. The result in almost all cases was a catastrophic drop in GDP and a rise in unemployment. The transition economies fell into an economic depression that lasted for years. What went wrong? Were the recommendations about how to make the transition from a state managed economy to a market economy wrong or

did the transition uncover problems in several of these economies that had been hidden from view? The answer involves some of both.

The Soviet Union and several Eastern European countries had industries whose products were no longer as much in demand as in the past. The end of the cold war, for example, meant that the demand for military products fell off sharply in both Eastern Europe and the former states of the Soviet Union. Many other products had enjoyed captive markets through the trading system developed by the Soviet Bloc. The quality of many of those goods was too low to compete with similar products from Western Europe and other market economies, and it would take considerable time and learning to upgrade them to a competitive level. Many enterprises simply could not accomplish the necessary upgrading, and they lost their markets as consumers in the former Soviet Bloc switched to higher quality goods that were available from elsewhere if one had the necessary foreign exchange to pay for them.

But the model of how to make the transition to a market economy was itself seriously flawed in two ways. One was the view that everything had to be done together and rapidly more or less at the same time, the so-called big bang or shock therapy approach to reform. It was easy enough quickly to free up the prices of many products. It was also plausible to try to get inflation under control quickly. Bringing down inflation gradually from say 1,000 percent the first year to 500 percent the next, 200 percent the next, and so on seldom makes sense. The anti-inflationary effort is much more likely to be credible and sustaining if the money supply is brought down sharply to a level compatible with price stability in a matter of weeks or months.

What does not make sense is the view that one can change the behavior of the management of a large industrial sector over night simply by privatizing the industries involved. Most of the enterprises in the Soviet Union and Eastern Europe were run by managers who had learned to manage in the context of the Soviet command economy. They knew little about markets or how one organized a company to meet market demand. The concept of marketing as something that could be taught in business schools was unknown to most of these people. They produced what the plan told them to produce, and another bureaucracy delivered the end product to its user. Privatization could be a first step toward changing the behavior of these managers, but there were many other steps required to obtain the necessary knowledge and skills, and those took time.[18]

It is also the case that markets that did not exist in the past do not necessarily spring up quickly. This is particularly true for financial markets such as stock markets for which elaborate rules to guide and control transactions on the stock exchange need to be devised and enforcement mechanisms need to be introduced. But it also applies to less complex markets. In the early stages of the reforms in eastern Europe, the rush

[18]Privatization of state-owned enterprises was done for political and economic reasons. Privatization was seen by many reformers as a way of breaking the power of the existing political system in which senior government and party officials were closely allied with state enterprise managers.

to change sometimes led to the abolition of the existing state-run purchasing and distribution system (for grain in one case) before an alternative system was in place.

In terms of the five criteria needed for a functioning market economy, the reforms advocated by those reflecting an approach similar to that of the Washington Consensus were on target with respect to items 1 (control of macro imbalances), 3 (freeing up prices), and 4 (promoting market competition), but were less than adequate with respect to 2 (creating the institutions needed for well functioning markets) and fell far short of what was required with respect to item 5 (changing the incentives and hence the behavior of plant managers in an appropriate way).

While Latin America was recovering from its lost decade, and the countries of eastern Europe and the former Soviet Union were undergoing their radical transformation, at the other end of the Eurasian continent a similar and equally radical economic transition was already under way, only this one by any reasonable measure was a success. China began its reform effort in late 1978 with decisions to open up its economy to foreign trade and foreign direct investment and to return the management of agricultural production back to the household where before it had been managed by production teams of 20 to 30 households working together collectively. China did not begin these reforms with a complete well thought out theory or view about how reform should proceed. What China's leaders did know was that the previous system had worked badly and they wanted a system that would make China wealthy and powerful in as short a time as possible. The reforms in agriculture were followed in 1984 by replacing allocation of products by the administration with allocation through markets at market prices. That led to a boom in what was called township and village industries. By the 1990s the legal and incentive environment for foreign investors had improved to a point where foreign companies were investing more than $50 billion a year in China—a figure that would more than double by 2010. GDP growth continued at over 9 percent per year for three decades, and China was well on its way to transforming a poor rural economy into a middle-income urban and industrial economy.

China, therefore, demonstrated that a sustained high growth rate was possible if one opened up the economy to the outside world, promoted the export of manufactures, and introduced competitive market forces into most transactions. For simpler markets and production, China made some of these changes rapidly, but when large enterprises had to be transformed from creatures of central planning into internationally competitive market-oriented firms, change was very gradual. Further, China still lacks, for example, many of the institutions needed for a Western-style market economy and a legal system capable of settling major economic disputes without political interference. The more complex the institutions required, the longer it takes to introduce them and make them function properly.

Beginning in 1986 and accelerating after 1989, Vietnam followed a reform path similar to that of China. This demonstrated, among other things, that the success of China's step-by-step approach was not a fluke.

The other major country that introduced broad-based reforms designed to increase the role of market forces and free up technical and entrepreneurial energy was India. India, as pointed out earlier, had been heavily influenced by both the Soviet economic model and the British Fabian socialists' views on the importance of active regulation of the economy. The result for decades had been a slow rate of growth of GDP that raised per capita incomes by a little under 2 percent per year between 1952 and 1980 a rate similar to that of China in the same period. Modest reforms reducing regulation and freeing up markets led to some acceleration in per capita growth in the 1980s to a bit over 3 percent a year; then major reforms beginning in and after 1991 led to East Asian-style growth rates of nearly 5 percent per capita through 2010. (Total GDP grew at nearly 8 percent per year over the reform period.) Unlike China where the most rapid growth was in industry, in India the highest growth sector was in services. The reason is that industry still retained a high degree of regulation and India's political leaders had not yet made a full commitment to opening their economy. Hence, Indian manufactured exports remained far below those of the Four East Asian Tigers and particularly China, but India did achieve significant success in exporting services. India's lower level of dependence on exports, it should be noted, also reduced the impact of the 2008–10 world recession on India.

China and India thus present important examples of large economies that grew with a mixed model of state involvement, both adopting selective dimensions but neither adopting all of the Washington Consensus. Together India and China account for 37 percent of the world's population, in contrast to 16 percent for all of the high-income countries of Europe, North America, and Japan combined. Arguably their rise out of extreme poverty into middle-income status is the most significant event of the past half century.

WAS THE WASHINGTON CONSENSUS A SUCCESS OR A FAILURE?

During the first decade of the twenty-first century there has been a growing backlash against the forces of globalization, which in effect is also a backlash against many elements of the Washington Consensus. Demonstrations, often violent, have disrupted some international meetings set up to further the liberalization of international trade, for example in Seattle in 1999 and Cancun in 2003. The global recession of 2008–10 also led many economists to question the effort of the past decades to reduce sharply the amount of government regulation in the economy. All of the high-income countries introduced new regulatory measures for their financial markets, and many developing countries have pulled back from efforts to further liberalize their systems. Was the earlier effort to reduce the government regulatory role in the economy wrong? Was it wrong for all countries or for only the few that took the process too far?

The issue for developing countries as of 2010 was whether the Washington Consensus approach to development was wrong or whether it furthered their economic goals, even if it did not offer a complete solution. To begin with we note that many

developing countries across the globe did make an effort to implement many of the recommended policies contained in the Washington Consensus. In Latin America in particular most countries succeeded in ending decade after decade of high rates of inflation. Exchange rates for the most part were no longer overvalued and import barriers were greatly reduced. Fiscal discipline was much improved, although this was not universal. Argentina, for example, tried to ensure stability by pegging its currency to the dollar from 1991 to 2002 in what amounted to a currency board arrangement (that is, allowing full convertibility between the peso and the dollar at a fixed rate of exchange), but the central government could not control the spending of local governments, and maintaining the currency peg became impossible.

The data in Table 5-1 compare Latin America's ability to control inflation and its rate of per capita GDP growth starting with the lost decade of the 1980s through to 2008 and the beginning of the global financial crisis and inflation. The data are for the region as a whole (including the Caribbean nations) and for several of its largest and most important countries. The rate of inflation is chosen not only because it is an important indicator in its own right of the quality of government economic management but because high rates of inflation are closely associated with government budgets that are out of control and with a wide variety of other undesirable interventions, many of which are designed to ameliorate the effects of inflation.

The data in Table 5-1 make clear what was meant by the lost decade of the 1980s. Per capita GDP growth in the region as a whole and in most of the major countries was low or negative. In per capita terms the region as a whole suffered a decline in income. The 1980s were also a period of hyperinflation, the kind of inflation in which prices change almost daily (see Chapter 12). During the 1990s, particularly during the later years, Latin America began to get control of inflation, and by the first decade of the next century the rate of annual price increase was in the single digits throughout the region.

TABLE 5-1 Economic Growth and Inflation in Latin America

	PER CAPITA GDP GROWTH (%)			INFLATION RATES (%)		
REGION/COUNTRY	1980–90	1991–2000	2001–08	1980–90	1991–2000	2001–08
Latin America and Caribbean	−0.4	1.6	2.3	14.6	17.5	6.1
Brazil	0.1	1.0	2.3	396.4	308.9	8.1
Mexico	0.3	1.8	1.3	60.7	16.3	7.8
Colombia	1.5	0.7	3.0	24.7	22.5	6.7
Argentina	−2.4	2.2	3.2	490.7	10.3	12.7
Venezuela	−2.4	0.0	2.7	22.1	40.1	25.0
Chile	2.5	4.8	3.1	20.9	8.5	5.7

GPD, gross domestic product.

Source: World Bank, "World Development Indicators," http://databank.worldbank.org.

Did control of inflation together with all of the other reforms introduced in the 1990s and after improve the overall performance of the economy? For the most part economic stagnation came to an end in the region as growth resumed, but the growth rates achieved were modest, particularly compared with what was happening in East and Southeast Asia and in India. The most plausible explanation for this performance was that the reforms designed to improve the functioning of markets in Latin America were necessary if higher growth was to be achieved, but were not by themselves sufficient to achieve the very high catch-up growth rates experienced in Asia in recent years. There is more to achieving a high rate of GDP growth than simply getting the prices right by removing market distortions caused by inappropriate government interventions. There is a need for new technologies appropriate to the conditions in specific countries. It is also essential to have high-quality human resources, people who are well educated and healthy. Investors also require a stable political environment. These other elements in the development equation will come up again and again in the chapters that follow. Here we simply note that the level and nature of government intervention in Latin American in the 1980s and before was excessive, and the efforts to reduce and redirect the nature of government intervention in the 1990s and during the first decade of the twenty-first century appear to have had a positive impact but not as large an impact as many of the advocates of the Washington Consensus reform program had hoped for.

It is also the case that market-oriented reforms in Latin America did little to improve the highly unequal distribution of income that characterizes many of the countries in the region. This in turn is part of the reason for the reaction in the first decade of the twenty-first century that brought many leftist governments to power. Some of these governments, notably Brazil, retained market oriented reforms while making a greater effort to improve social welfare initiatives. Others, notably Venezuela, reverted to earlier approaches that used high oil prices to increase subsidies to political supporters, an approach that has generally proved to be unsustainable once oil prices fall.

Any attempt to assess the impact of market reforms on development in Africa is even more complex than for Latin America. Many countries in sub-Saharan Africa during the turn of the century did make a major effort to remove distortions in markets caused by inappropriate government intervention. Overvalued exchange rates were devalued, and the role of government marketing organizations was reduced. Trade restrictions were also cut back in much of the region. But sub-Saharan Africa is made up of 47 countries, some of which have made a major effort to reform, while others are mired in civil war or rampant corruption. To understand the impact of market-oriented reforms, therefore, one needs to separate out the countries that have made a major reform effort from those that have not. A recent study by Steven Radelet has done precisely that, dividing the countries in sub-Saharan Africa into three groups: emerging nations that have made major reforms and have enjoyed sustained increases in per capita income, oil-exporting countries whose income has

TABLE 5-2 **Emerging African Countries and Growth in Average Incomes, 1996–2008**

EMERGING COUNTRIES	ANNUAL PER CAPITA INCOME GROWTH (%)	CUMULATIVE INCREASE IN AVERAGE REAL INCOME (%)
Botswana	4.1	68
Burkina Faso	2.8	43
Cape Verde	4.0	67
Ethiopia	4.1	65
Ghana	2.6	40
Lesotho	2.3	33
Mali	2.5	37
Mauritius	3.7	61
Mozambique	5.3	96
Namibia	2.4	36
Rwanda	3.7	60
São Tomé and Principe	5.0	40
Seychelles	2.5	37
South Africa	2.0	29
Tanzania	3.0	46
Uganda	3.8	61
Zambia	1.8*	25
Average	3.2	50

*We include Zambia even through its 13-year growth rate is slightly lower than 2 percent because its annual average growth rate for the 10-year period was 2.3 percent.

Source: Steven Radelet, *Emerging Africa: How 17 Countries Are Leading the Way* (Washington, DC: Center for Global Development, 2010).

tended to fluctuate with the ups and downs of petroleum prices, and the others that have not made much of a reform effort and/or are mired in civil war. He identifies 17 emerging African countries that have carried out substantial reforms and have achieved sustained per capita growth since 1996 (Table 5-2).

These reforming or emerging African economies have lowered tariff rates, eliminated overvalued exchange rates, and in a variety of other ways improved the climate for private businesses more than in the countries in Africa that did not perform as well (Table 5-3). Among the countries that had generally not done as well were the oil exporters that took in large amounts of foreign exchange from oil revenues; African governments typically could not manage the funds efficiently or without large-scale corruption. The poorest performers included countries wracked by civil war (notably the Congo) or those that were badly managed by an oligarchy willing to do almost anything to hold on to power (for example, Zimbabwe).

As in the case of Latin America, market-oriented reforms in parts of Africa did not eliminate all of the barriers to high growth in the region. The growth rates achieved by the emerging African countries were far below the per capita GDP growth rates achieved in Asia. But the growth rates in the 17 emerging African countries were also

TABLE 5-3 **Average Rank in Doing Business of Sub-Sahara African (SSA) Countries out of 181 Countries Worldwide, 2009**

INDICATOR*	EMERGING SSA	OTHER SSA	LOW INCOME (WORLDWIDE)
Total ease of doing business	108	158	141
Starting a business	97	146	118
Dealing with construction permits	109	121	124
Employing workers	100	132	114
Registering property	113	129	118
Getting credit	100	135	123
Protecting investors	87	131	115
Paying taxes	85	128	120
Trading across borders	128	139	141
Enforcing contracts	92	134	113
Closing a business	108	140	135

*The lower the ranking, the greater the ease of doing business.

Source: Steven Radelet, *Emerging Africa: How 17 Countries Are Leading the Way* (Washington, DC: Center for Global Development, 2010).

far above what those countries had achieved in the past before 1996 and were also significantly above what other sub-Saharan African countries were achieving after 1996.

What then can one conclude about the appropriate mix of market influences and the role of government intervention? Was the Washington Consensus approach and its variant dealing with reform of former Soviet-type economies the right answer? Or was that approach far off the mark? Economists and others continue to actively debate this question. Discussions of a post-Washington Consensus have tended to moderate the original's exclusive focus on market liberalization, highlighting instead the role of good governance and strong institutions as pillars of development.[19]

The first conclusion that can be derived from an overview of the actual experience of developing countries is that there was considerable variation in the degree to which these countries, including the most reform minded among them, applied the policies recommended by the Washington Consensus. China and Vietnam, for example, did not carry out privatization of most of their state-owned enterprises. Other countries retained restrictions on imports, and the Four East Asian Tigers model that inspired many reform efforts actually retained tight restrictions on imports during the first three decades of rapid growth. While few if any of the countries that attempted to implement market-oriented reforms carried out all of them, virtually all of the more successful countries, whether in Asia, Latin America, or sub-Saharan Africa, did make significant moves in the direction of reduced government intervention and greater

[19]A good review of these debates as seen by one analyst is Derek Heady, "Appraising a post-Washington Paradigm: What Professor Rodrik Means by Policy Reform," *Review of International Political Economy* 16, no. 4 (2009), 698–728.

reliance on market forces. No country, however, had to move all the way to a perfect market economy to achieve positive results.

When it comes to the question of what is the appropriate level and nature of government intervention in the economy of a developing country, there is no one-size-fits-all formula. The governments of some countries such as South Korea and Taiwan have actively promoted particular industries using a variety of subsidies and other interventions and have done so successfully, at least in the early stages of their accelerated growth period. Governments elsewhere, Indonesia in the 1990s, for example, pursued government-led industrial policies that put increasing emphasis on large state-supported import substituting industrial projects with disastrous results. Yet, Indonesia before the 1990s had done well as a result of policies that had steadily reduced the regulation of trade and industry and had created an environment conducive to the export of labor-intensive products. Governments in most developing countries have played a dominant role in the provision of infrastructure (roads, railroads, electric power, and so on), and some have carried out these large capital investments with comparative efficiency, while in others the process has been riddled with corruption and waste.

The point here is that some governments in developing countries are capable of carrying out a relatively efficient interventionist industrial and infrastructure development policy, but other countries lack this ability. The terms sometimes used to describe these two kinds of governments are **hard governments**, which can intervene actively in a way that promotes growth, and **soft governments**, which are not able to do so. Hard governments can carry out Korean-style interventionist policies with success; soft governments can also achieve successful development but must rely as much as possible on market forces to guide the effort. Being hard or soft is not something that is a permanent condition for the government of a particular country. Governments can move from being unable to set priorities and stick to them when implementing a development program to being able to do so and vice versa. What makes some governments hard and others soft at a point in time takes one back to the underlying conditions prevailing in particular countries—the nature of their colonial experience, their culture and politics, their natural resources, and much else. These topics go far beyond what can be covered in this book. Hard or soft, however, as economies become more advanced and sophisticated intervention becomes more and more difficult, market forces need to play a larger and larger role. Government intervention should be carefully targeted toward areas in which market guidance alone is clearly insufficient (the financial sector, environmental controls, and amelioration of extreme poverty are three important areas).

A second conclusion is that market-oriented reforms do not require that everything be done at once and as quickly as possible. Reform can be achieved step by step over a substantial period of time—the big bang or shock therapy approach was not necessary, and in most cases was probably not feasible or even desirable. Finally, making greater use of market forces and reducing the role of government intervention

in the economy is not a magic bullet that solves all of the problems of development. A highly interventionist approach by which government actions are driven as much by politics and rent seeking or corruption can slow or even stop growth, but reliance on market forces by itself does not guarantee high economic growth rates. A large degree of reliance on market forces is generally helpful to development, but there is much more to the development process, as the chapters that follow make clear.

SUMMARY

- The respective roles of states and markets in shaping economic development have been a central focus of debate since the time of Adam Smith. This debate took on new urgency in the period after World War II, when today's developing countries began to emerge from colonial rule.
- Early postwar development thinking focused on the accumulation of capital as the key to economic growth. This idea was formalized in early growth models, such as Harrod-Domar; yet, the intellectual origins of the focus on capital accumulation arose from such divergent sources as David Ricardo and Karl Marx.
- The experience of rebuilding western Europe after the war bolstered the capital-oriented view of development, but early analysts failed to note the important role played by supporting institutions that had long existed on the Continent.
- The experience of the Great Depression and massive market failure before World War II contributed to widespread skepticism among economists and policy makers in both emerging industrialized countries and developing countries about the ability of markets to guide development. The perceived early success of the Soviet growth model that rejected reliance on market forces in favor of an economy run almost entirely by large state bureaucracies also influenced developing country thinking, particularly in China and India.
- Market skepticism extended to international trade as well, leading many countries to turn inward and erect trade barriers to protect their domestic economies from what appeared to be unreliable international market forces. This import substituting approach to development was particularly prevalent in South America, where early industrialization had begun in the first half of the twentieth century, when two world wars and the Great Depression made export-oriented industrial growth virtually impossible; but industry began to stagnate as small domestic markets became saturated.

- By the late 1970s, poor economic performance in many developing countries following government-led models of development and import substitution, together with the rising debt burden of many Latin American countries, led to a broad questioning of that approach and a reexamination of the potential benefits of markets and trade for development. At the same time, economists and policy makers were becoming more aware of alternative and successful growth models being pursued in East Asia. These models stressed the export of manufactures as central to growth and limited import substituting protection to the first few years when a new industry was learning how to compete. The role of government in these successful countries, however, varied considerably from the highly interventionist model of South Korea, Taiwan, and Japan to the almost laissez faire model of Hong Kong.
- By the 1980s and early 1990s, the perceived development failures in the developing world outside of East Asia had led the major international development agencies and the U.S. government, among others, to be advocates of a development model that came to be known as the Washington Consensus. This model called for developing countries to practice fiscal discipline and rely for the most part on market forces to guide the economy. Foreign assistance and debt relief was often made conditional on a country implementing the components of this consensus.
- The Washington Consensus was first promoted in sub-Saharan Africa, even before the term was coined, but it was later central to international efforts to help Latin America recover from the lost decade caused by the debt crisis of the 1980s. This same set of policy prescriptions was then advocated for and to some degree implemented by the states of Eastern Europe and the former Soviet Union as they rejected the Soviet-style command economy in favor of market forces. The economic performance of the countries that adopted many or even most of the policies called for by the Washington Consensus, however, was often disappointing.
- While much of the international aid effort was focused on implementing the goals of the Washington Consensus, China, beginning in 1978, was implementing a model that had some of the components of that consensus but lacked many others. China moved step by step toward a model that relied increasingly on markets but with a high degree of state intervention and continued state ownership of many of the larger enterprises. By 2011, that model had produced decades of high, near double-digit growth.
- India and Vietnam by the 1990s were also moving away from the extreme levels of government intervention in the economy that characterized their earlier development strategies, but like China they implemented only some of the components of the Washington Consensus. Like China, they began to

grow very rapidly throughout the 1990s and the first decade of the twenty-first century.

- Was the Washington Consensus a failure? There is no question that it oversimplified what was required to achieve sustained economic development. Not all of the elements in the consensus were necessary in all developing countries, and certain key elements, notably the quality of governance, were largely absent from the consensus. Nevertheless, when one looks at the performance of nations in Africa and Latin America, it is the countries that implemented much of what was called for by the consensus that have performed better than those that did not do so.