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DIVISION OF AGRICULTURAL AND NATURAL RESOURCES
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THE ROLE OF GOVERNMENT IN ECONOMIC DEVELOPMENT

by

Irma Adelman

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I. Introduction

No area of economics has experienced as many abrupt changes in leading paradigm during the post Word War II era as has economic development. These changes have had profound implications for the way the role of government has been viewed by development practitioners and their advisers in international organizations.

There have been three phases in the dominant view concerning the optimal role of government in development.

The Government as Prime Mover Phase: In the first phase, lasting from 1940 to 1979, government was assigned a primary, entrepreneurial role. The intellectual roots of this view can be found in the writings of the pre-Marshallian classical economists and in their immediate post World War II followers, W.Arthur Lewis, Rosenstein Rodan, Nurkse, Singer, Prebish, Hirshman and Leibenstein. They viewed economic development as a growth process that requires the systematic reallocation of factors of production from a low-productivity, traditional technology, decreasing returns, mostly primary sector to a high-productivity, modern, increasing returns, mostly industrial sector. But, unlike the later neo-classical development economists who assume that there are few technological and institutional impediments to the requisite resource-reallocation, classical development economists assume that the resource reallocation process is hampered by rigidities, which are both technological and institutional in nature. Investment lumpiness, inadequate infrastructure, imperfect foresight, and missing markets impede smooth resource transfers among sectors in response to individual profit maximization and provide the bases for classical, structuralist approaches to economic development. Technological external economies in infrastructural and "basic" industrial projects would lead to coordination failures that would cause private agents to underinvest in them.

Classical development theorists recognized that long-run economic growth is a highly non-linear process. This process is characterized by the existence of multiple stable equilibria, one of which is a low-income-level trap. They saw developing countries caught in the low-income-level trap, which occurs at low levels of physical capital, both productive and infrastructural, and is maintained by low levels of accumulation and by Malthusian population growth. They argued that industrial production is subject to technical indivisibilities, which give rise to technological and pecuniary externalities. However, coordination failures lead to the realization of systematically lower rates of return from investments based on *ceteris paribus*, individual, profit maximization than those that could be realized with coordinated, simultaneous investment programs. Uncoordinated investments would not permit the realization of the inherent increasing returns to scale and, together with low incomes, which restrict levels of savings and aggregate demand, and Malthusian population growth, ensnare an economy starting at low levels of income and capital in a low-income-level trap. Hence the need for government action to propel the economy from the uncoordinated, low-income, no-long-run-growth static equilibrium to the coordinated, high-income, dynamic equilibrium, golden-growth path. In his seminal paper, **Problems of Industrialization of Eastern and South Eastern Europe**, Rosenstein Rodan (1943) posited the need for a government-financed series of interdependent investments, to take advantage of external economies and economies of scale and propel developing countries from a low level equilibrium trap, with no growth in per capita income, to a high-level equilibrium path, characterized by self sustained growth. Development could not be induced purely by market forces.

To remedy both the structural and coordination failures, government would therefore have to engage in an active role: subsidize investment, coordinate investment activities, and undertake direct investment itself from the government budget, despite the, hopefully, mild inflationary pressures these actions would induce. Some development economists contended that a "big push" of simultaneously undertaken investments would maximize the external economies generated by investment and generate self-sustained, growth faster. Others contended that "balanced growth" would reduce the bottlenecks and import needs of the investment programs and thereby raise the marginal efficiency of investment.

The "government as prime mover" in development was reinforced by the realization in the late fifties that insufficient entrepreneurship was leading to serious absorptive capacity constraints to the provision of foreign aid and the undertaking of government-sponsored investment projects. There were simply not enough potential industrialists willing and able to undertake industrial projects, especially when commercial, import-license related, and "non-productive" real estate investments provided such high rates of return in the inflationary and protected trade environments generated by government-sponsored, accelerated development.

Most classical development economists argued that, in the absence of private entrepreneurship, governments would have to continue to perform the entrepreneurial job while at the same time fostering the development of a cadre of private entrepreneurs willing and able to take over. Governments could foster the development of a cadre of private entrepreneurs by artificially increasing the rates of return from private investment through direct government subsidies; by engaging in joint government-private ventures; and by subsidizing management training programs. Others, (primarily Hirshman) argued that what was necessary was to economize on the need for private entrepreneurial talents by making the activities in which private investment would yield high returns more obvious through unbalanced growth.

The first rumblings against the "government as prime mover" came in the early seventies, when several International Labor Organization missions were organized to analyze the employment situation in developing countries. Their reports concluded that, despite high rates of economic growth and industrialization, overt unemployment and underemployment were very high, of the order of 20% of the urban labor force. Not only was unemployment high but it had also increased with the process of industrialization. The high rates of unemployment were in turn inducing an unequalizing process of economic growth: the owners of capital (the rich) and the owners of skills complementary to government-sponsored, capital-intensive development (the professional and bureaucratic middle class) were growing richer, while the owners of unskilled labor were not benefitting proportionately. Skilled and semi-skilled workers that had been absorbed in modern industry had become middle class while the unemployed and underemployed workers in low-productivity sectors (agriculture and unskilled services) and in low-productivity enterprises (workers in small scale firms using traditional technology) were falling increasingly behind.

Several different proximate reasons were offered for this development-failure. But, fundamentally all these explanations rested on the contention that the process of government-sponsored accelerated development had given rise to incorrect relative factor prices that did not reflect fundamental relative economic scarcities: The government-subsidization of capital had led to capital being underpriced relative to its true scarcity and labor being overpriced both relative to capital and relative to its true scarcity. This had resulted in the adoption of too capital-intensive technology. In addition, too rapid rural-urban migration, induced by expected urban wage far exceeding actual rural per capita income, was swelling the ranks of the urban unemployed and underemployed. The migration was due to a process of industrialization that was forcibly transferring resources from agriculture to industry by lowering the agricultural terms of trade through foreign-assistance-financed imports of grains and government marketing boards thereby keeping rural incomes low. Whatever the reasons for the relatively high capital-intensity of development, the remedy was "getting prices right", by reducing direct and indirect subsidies to industrialization. Raising interest rates on loans to large-scale industry and reducing tariff protection to capital-intensive, import substituting industries and allowing grain prices to rise.

While the classical development economists realized this only imperfectly at the time, the "getting prices right" school marked the beginning of ascendancy of the neo-classical school of economic development. Rather than argue for different forms of government intervention, the " getting prices right" school opened the door to the argument that government intervention should be curtailed, since its effects had obviously been counterproductive. The income distribution school continued to argue for a direct role of government in the economy, but called for a change in focus away from capital-intensive "basic" industries towards labor-intensive consumer goods industries suitable both for domestic production and for exports. The day was carried however by the "getting prices right" school.

The Government as a Problem Phase:

This second phase, lasting from 1979 to about 1996, was a continuation of the neoclassical "getting prices right" line of thought. Neo-classical trade theorists (Krueger, and Bhagwati), who came to dominate the field of economic development, emphasized that international trade can provide a substitute for low domestic aggregate demand. They argue that the main thing governments need to do to position an economy on an autonomous, sustained-growth path is to remove barriers to international trade in commodities[1]. According to this "trade is enough" school of thought, export-led rapid economic growth would be the inevitable result. Comparative advantage, combined with the Hecksher-Ohlin theorem, would then do the rest. Governments should also remove price distortions in domestic factor and commodity markets ("get prices right") to induce suitable movement of factors among sectors, encourage the adoption of appropriate technology, and increase capital accumulation. In this view, domestic and international liberalization programs would suffice to bring about sustained economic growth and structural change. To the extent that economies are trapped in the low-level equilibrium trap by deficient aggregate demand, international trade can indeed provide a substitute for deficient domestic demand. However, the moment one acknowledges that nontradable intermediate inputs, such as transport and power, are needed for efficient domestic production in modern manufacturing, international trade cannot obviate the need for a Big Push to lift the economy out of the low-level-equilibrium trap and hence provide a perfect substitute for a government-promoted investment program into domestic infrastructure and interrelated industrial investments.

The culmination of the neoclassical counter-revolution in economic development that was initiated by the "getting prices right" and "trade is enough" schools was the "evil government school" that, not coincidentally, started its life under the Reagan-Thatcher era of neo-liberalism. According to its view, government is the problem rather than the solution to underdevelopment. On the one hand, government interventions are not needed, as trade liberalization can induce development, provide for economies of scale and make industries internationally more competitive. By the same token, greater domestic marketization of goods and services, including public goods, would make development more

[1] The models of Basu (1984) and Murphy et al (1989), which produce low-level equilibrium traps in a closed economy, lose the trap in an open economy, although Murphy et al claim that their model does not. By contrast, in Bhagwati (1996) the low-level equilibrium trap persists when the economy is opened up and the need for a Big Push persists. The distinction arises when deficient aggregate

cost-effective and efficient. Governments are bloated; they are corrupt; they accept bribes for economic privileges generated by government interventions into the market; and they operate by distorting market-incentives in mostly unproductive, foolish and wasteful ways. Moreover, their discretionary interventions into markets, through regulation, tariffs, subsidies, and quotas, give rise to rent-seeking activities by private entrepreneurs, which absorb large fractions of GNP and leads to significant economic inefficiencies. As a result, reducing the role of government in the economy would lead to more rapid and more efficient development.

Under these circumstances, they argued that the best actions governments can undertake to promote development is to minimize their economic roles. Liberalizing domestic and international markets for both factors and products is the prescription of choice. Acts to promote the spread of markets and the rule of market incentives would improve the efficiency of the economy. Such acts would, in and of themselves, be taken as an indication of economic virtue, worthy of financial support by international agencies. A corollary of this view is that starving the public sector of resources is a worthwhile undertaking, in and of itself.

The "evil government" period was one of general slowdown in the world economy. It was marked by a recession in Japan, Europe and the United States; a shift from growth-promoting to inflation-fighting policies in developed countries; a slowdown in the growth of world trade and an increase in trade restrictions in developed countries; a rise in world interest rates and an effective devaluation of currencies against the dollar; the second oil-shock; and a severe debt-crisis in developing countries. All of these ushered in a decade of drastic economic decline in developing countries. During the nineteen eighties developing countries': average rates of economic growth either declined or became stagnant; balance of payments constraints became increasingly binding; priorities shifted from economic development to achieving external balance mostly through restrictive macroeconomic policies. Most developing countries experienced: rampant inflation; capital flight; low investment rates; drastic declines in living standards; increases in inequality and substantial increases in urban and rural poverty. The average developing country transferred more than its entire growth of GDP abroad annually, for debt service. Nevertheless, the debt of developing countries has continued to increase, as two thirds of them could not achieve a current-balance-surplus sufficient to service their debts.

As a result of the debt-service crisis in Mexico, Turkey and Brazil, commercial banks in developed countries became unwilling to extend further loans to **all** developing countries. Therefore, developing countries became completely dependent on the Washington-based international institutions, the IMF and the World Bank, for their economic survival. These institutions, in turn, took advantage of this opportunity to enforce their "evil government" philosophy on developing countries through their loan conditionality. The combination of " Marketize, Liberalize and Tighten- your-Belt Policies" dubbed "The Washington Consensus" became the slogan of development policy during this period. As a result, many of the economic and political institutions that form the core of capitalist development were created in a significant number of developing countries.

It is curious how completely neoclassical development theory came to dominate the policy agenda during this period despite its numerous theoretical deficiencies. First, neoclassical development economics ignored the fact that Marshalian neoclassical economics was never intended to be a growth theory; only a theory of static resource allocation. It therefore must be supplemented by a theory of accumulation and growth to be a complete development theory. It is possible for markets to be efficient for static resource allocation and be inefficient vehicles for accumulation and growth. Indeed, this is what classical development theorists would contend. Second, neoclassical development theory also ignored the fact that the postulates of neoclassical economics, which are needed to ensure the efficiency of neoclassical market equilibria, are not applicable to developing countries. Developing countries are hardly characterized by smoothly mobile factors; complete and well functioning markets; comprehensive information; and perfect foresight. In short, the institutional bases for a neoclassical economy are missing in most developing countries, and cannot be created overnight. But the absence of any of these characteristics implies that market equilibrium cannot be proven to be Pareto-optimal, and hence even statically efficient. Third, market equilibria depend on the initial distribution of wealth. If that distribution is not optimal, the Pareto optimality of a neoclassical economy will not maximize even static social welfare. Fourth, the advocates of neoclassical development also ignored the theory of the second best. Since it is impossible to remove all regulatory constraints on markets, it is quite feasible that, even when all neoclassical postulates hold, adding additional constraints on markets will improve, rather than reduce, market efficiency. Finally, all the objections to the "trade is enough" theory also apply to the "evil government" theory of development.

Rehabilitating Government:

Several forces coalesced to lead to a reevaluation of the optimal role of government in economic development. First, economists and policy-makers came to realize that, the growth performance of most developing countries during the 1980s had been abysmal. Second, despite the poor growth of the overwhelming majority of developing countries, that of East Asian and some South Asian countries, in which governments continued to play an active role, had been remarkably good. Despite the unfavorable international environment of the eighties, these countries were able to maintain, and, in some cases, even improve upon their previous development momentum. Rather than adopting deflationary government expenditure and macroeconomic policies and restrictive import and wage practices, the successful Asian countries exported their way out of the crisis. Their governments shifted from import-substitution to export-promotion regimes; devalued to promote expenditure switching among imports and domestic goods; undertook a set of market-friendly institutional and policy reforms; continued to invest in infrastructure and human capital; and engaged in the direct and indirect promotion of selective industrial policy. Third, there was a backlash in the OECD countries against the neo-liberal philosophy of the eighties, which had led to slow growth and high unemployment, towards a more activist governmental stance. Democrats replaced republicans in the United States; Labor-Governments replaced Conservative governments in most European countries; and the international influence of Japan, whose government had always played a very active economic role, increased. Fourth, the mixed success of LDCs with market-reforms during the eighties led international institutions to understand that it takes capable, committed governments to promote and manage successful reform, even market-oriented reform. Otherwise, reform efforts will flounder and be derailed or captured by special interest groups of actual or potential losers from reform. The problematique therefore shifted from minimizing the role of government towards making governments more effective.

A "revisionist" school of economic development, dubbed "The Post Washington-Consensus School" appears to be now in the making. This school advocates a dynamically changing mix of state-market interactions, in which developmental governments play a significant role in investment, its finance, human capital formation, acquisition of technology, institution-setting, and the promotion of policy and institutional reforms. And it is searching for ways to increase the capacity of governments to formulate development policy and implement it through a relatively capable and honest bureaucracy. Development economics is returning full circle, albeit somewhat sadder and wiser, to the view that government must play a strategic role in economic development held by the classical development economists. However, whether "The Post Washington Consensus" school will survive the combination of East Asian financial crisis, sex scandal in the United States and war in Yugoslavia, which may combine to sweep the democrats out of office, remains an open question.

We now proceed to a description of the role governments played in developing countries. We focus on two major periods: the spread of the Industrial Revolution during the nineteenth century; and the development of developing countries during the Golden era of economic development between the end of World War II and the first oil crisis.

II. The Role of Governments in Economic History.

This section is based on my systematic comparative historical work with Mrs Morris, **Comparative Patterns of Economic Development, 1850-1914** (1988) and on the 200-odd references cited therein. Naturally, the drawing of policy conclusions from historical evidence applying to earlier periods is subject to obvious qualifications. Historical experiences cannot provide detailed prescriptions for contemporary development because of the differing international, technological, demographic and political contexts in which historical and contemporary growth take place.

During the 19th century, governments played a central and pervasive role both in establishing the economic and institutional conditions necessary for the occurrence of the Industrial Revolution and for promoting its spread to the follower European nations. Everywhere, governments reduced the risks of private transactions by promulgating laws that limited entrepreneurial liability, increasing the security of property rights, and enforcing private contracts. For example, the most effective way of mobilizing capital in Great Britain was the chartered joint-stock company with limited liability, introduced around 1830. Governments influenced incentives by setting and changing tariffs and determining monetary policies, as needed. It is somewhat ironic in this context that the strongest advocates of free trade, Victorian Britain and post W US, were strongly protectionist during their own early development.
Governments increased the supply of factors by establishing removing legal barriers to mobility of labor among regions and sectors; by establishing immigration laws; and by setting the conditions for foreign investment and foreign capital inflows. Governments increased the domestic supply of skills by fostering investment in education and, where necessary, the import of foreign skilled workers. Governments increased the supply of domestic finance by promoting the establishment of investment banks, the formation of financial intermediaries, and, where necessary, direct finance of industrial enterprises. Governments promoted the import of technology into the less advanced European countries and hindered its export from the first comers to the Industrial Revolution. In Britain, for example, the export of technology was forbidden by law and master technicians were arrested at the border if they wanted to emigrate. Governments were also a source of externality for private investment. They fostered the buildup of transport infrastructure through various means: direct investments in different transport modes; the provision of finance for building of canals and railroads; and the granting of substantial incentives, such as rights of way, for the buildup of transport by the private sector.

In their comparative quantitative analyses of different aspects of economic development of 23 countries between 1850 and 1914, Morris and Adelman (1988) found that the extent of domestic economic role of governments explained significant portions of cross-country variance within groups similar in their initial conditions and in their choice of development-path. Intercountry differences in the extent of government sponsored investment in infrastructure and industry explained: 50% of the variance among countries in patterns of industrialization; 28% in intercountry differences in the extent of expansion of market institutions; 33% in patterns of foreign economic dependence; 35% of intercountry variance in the course of poverty; but only 11% of variance in patterns of agricultural expansion.

In 19th century Europe, the degree of government promotion of industrialization was positively, though not perfectly, correlated with the gap between Great Britain and the country in question. However, even in Great Britain and the United States, where the direct economic role of governments was least, governments played a pivotal role in promoting the industrial revolution. By 1870 in the United States and by 1850 in Great Britain, the governments of both countries had removed all promodern constraints on markets, had eliminated major legal barriers to national mobility of labor (such as slavery in the United States), and had commercialized land transactions. They had created limited-liability companies and had removed barriers to direct foreign investment. Nevertheless, self-financing remained the predominant source of most industrial capital. Both the British and United States governments financed a significant, though not predominant, portion of investment in interregional transportation and granted large subsidies for the development of different transport modes (e.g. canals and railroads). But, by contrast with the follower countries, both the British and the United States governments provided very little direct financing of investment in industry and agriculture. Before 1850, the British government had defended British entrepreneurs against outside competition through significant tariff protection and through discriminatory shipping rules. Moreover, throughout the 19th century, Great Britain supported and protected overseas trade by imposing free trade on its colonies and by promoting cheap raw material and food exports from the Commonwealth Countries through its role in the development of inland transport and the improvement of its shipping. The British government opened up its overseas territories to British competition by investing in inland transport (e.g. Indian railroads) in the colonies, and it provided externalities for private British ventures overseas, by paying an important portion of the security and administrative costs of the colonies, and by developing capital markets which enabled the export of large amounts of capital.

The role of government was especially active in the industrializing follower countries. Italy, Spain, Japan, Russia and Germany before 1870 were countries that were moderately backward but had administratively capable governments. There, governments responded to the military, political and economic challenges posed by Western European expansion by playing a significant role in eliminating existing restrictions on factor and commodity markets; by providing support for economic integration of urban-rural trade networks despite initial lack of effective political integration and despite significant economic dualism; and by fostering education. Their efforts were closely and systematically associated with industrialization and export growth though not with the diffusion of the benefits from that growth, as they did not systematically raise agricultural productivity, wages in agriculture and industry or increase per capita, as distinct from aggregate, income.

Governments in the follower countries used a large variety of instruments to promote industrialization: general and targeted subsidies; tariffs; incentives; monopoly grants; quantitative restrictions; licensing; tax privileges; and even forced allocation of labor (Landes 1998, p 235). Challenged by Britain's industrialization, governments enlarged the size of the domestic market by unifying their countries politically; by investing in inland transport; and by abolishing customs duties and tolls to stimulate the evolution of national markets. They also added government demand for manufactures (e.g. military uniforms in Russia) to inadequate private demand. Governments substituted for missing domestic factors and undertook measures to enlarge the supply of skilled labor and finance. To increase the supply of skilled labor they invested in education, imported skilled technicians from more advanced countries, and, where necessary, removed restrictions on labor mobility (slavery and serfdom), and passed immigration laws favoring the influx of unskilled labor. Where the country was too poor to finance the banks required to finance industry, the state promoted the establishment of financial intermediaries, invested in industrial enterprises directly, or participated in industrial investment together with private entrepreneurs. In sum, the governments of the follower countries engaged in manifold entrepreneurial activities to catch up with Great Britain's Industrial Revolution, in an effort to reduce its military, economic and political power. Nevertheless, in the European follower countries, industrialization and market expansion were dualistic. Before 1890, factories remained scarce and mechanized industry was limited to only some sectors and regions, with the rest of the economy largely untouched by modernization.

The promotional activities of 19th century governments were not limited to the follower countries in the Industrial Revolution. In the land abundant overseas territories settled by Europeans (Argentina, Brazil, Australia and New Zealand) governments undertook steps to remove institutional restrictions on export expansion by freeing market systems from institutional constraints on their operation, and by expanding specialized institutions facilitating land transfers, capital flows, foreign investment and commodity sales. In the land abundant British colonies, governments removed restrictions on expatriate capital, entrepreneurship and immigration. These actions led to foreign-promoted primary export expansion and eventual modest industrialization, the latter with a considerable time lag. But free immigration and rapid population growth slowed increases in domestic per capita incomes, in industrial and agricultural wages and induced a cyclical pattern (as contrasted with a positive trend) in poverty-reduction.

Naturally, then as now, the nature of the impact of governments on the economy and society depended on whose interests the government represented. In the follower Europe, it was only when the control over economic policies by landed feudal elites was weakened, that land institutions were changed to provide adequate incentives for small farmers and that the government's actions led to a wider diffusion of the benefits from growth. Similarly, in the overseas, white settler, land abundant countries, it was only when and where the political dominance of large landowners declined that dualism diminished. Under those circumstances governments invested in education and transport, and changed land policies so as to help smaller farmers serve urban groups. In Australia, for example, a shift in political power led to land settlement laws that gave farmers greater access to markets in 1850 and the 1860s. This stands in strong contrast to Argentina and Brazil, where landed elites continued to dominate politics and land ownership and the spread of benefits from growth remained highly concentrated. Finally, it also took a certain degree of political and economic autonomy from colonial powers for government initiatives to result in economic improvements of any kind. In the highly dependent, densely settled, colonial, peasant economies (Burma, Egypt and India) the construction of transportation systems by colonial governments and the foreign stimulated expansion of exports not only failed to lead to domestic economic benefits but also led to backwash effects: the promotion of more market oriented institutions by colonial governments caused wages in agriculture and industry to fall-- a not surprising result in countries in which agriculture was characterized by low-productivity and concentrated land-ownership coupled with insecure tenancies, and there was rapid population growth not accompanied by increases in productivity.

What we learn from 19th century development is that the State played a pervasive role in the initiation of development in all countries, particularly the late-comers to the Industrial Revolution. It used a large number of instruments, both direct and indirect, targeted and untargeted. It intervened most directly in the least developed late-comers, by financing investment itself, by targeting these investments to branches of industry it wanted to develop for a mix of economic and political reasons, by substituting for missing factors and underdeveloped institutions and by working to increase their domestic supply. We also learn that the process took time and required continued commitment. That administratively capable governments were needed and that they required a certain degree of autonomy in setting policies and designing its interventions. Finally, we learn that the state's influence on the economy depended critically on who controlled the state. Governments controlled by feudal landed elites could only achieve narrow-based growth without development.

III. The Changing Role of the State in Post World War II Developing Countries.

In our systematic, quantitative, comparative analysis of economic and institutional forces in economic development during the Golden age of economic development in the nineteenfifties and sixties, by Mrs Morris and myself (Adelman and Morris 1967), we found that the critical institutions for economic growth as well as the critical policy thrust changed systematically with the development process. Our 1967 study indicated that the process of economic development was highly non-linear and highly multifaceted. We found that the interaction patterns among economic and institutional changes differed sharply among countries characterized by different institutional, social, and economic initial conditions. The implication is that the major functions of and activities of government must shift as industrialization and institutional development proceed. Not only must economic institutions and the primary thrust of economic policy change but also the major functions of government must alter as development proceeds. We therefore divide our discussion of critical government actions in contemporary by levels of development: least developed, intermediate transitional countries and most developed developing countries.

The Low Group: In the set of countries at the lowest end of the spectrum in socio-economic development, the economic growth process entailed principally an interrelated process of economic and **social** transformations. In 1960, the set of least developed states comprised mostly sub-Saharan African countries but also included the least developed countries in Asia and Libya and Morocco in North Africa. These countries were characterized by minimal degrees of development of market institutions and national polities and by a predominance of social tribal influences over both individual allegiances and the economic activity of their predominantly subsistence agrarian economies. In the sixties, Kuznets (1958) compared this group of countries to 14th century Europe in its economic, social and political development.

Our statistical results for this low-development group, indicated that an important task of government, at this level of socio-economic development, is the buildup of social capital. Governments need to promote increases in the size of the professional, entrepreneurial and bureaucratic middle class; remove social and educational impediments to entry into middle class occupations; and champion increases in the degree of modernization of outlook. They can increase the degree of modernization of outlook by, inter alia, promoting the commercialization of agriculture, reducing the overwhelming proportion of the population engaged in subsistence agriculture, and by investing in human-resource development[2].

Our results show that the major economic means by which growth and social transformation were induced in this low-development group of countries during the sixties entailed the dualistic development of a modern, export-oriented, primary sector. The development of primary exports, in turn, provoked significant transformations of social structure in rural areas, encouraged the diffusion of the market economy and induced a reduction in the sway of traditional tribal customs over economic

[2] The variable representing the degree of improvement in the quality of human resources has a statistically significant, but only secondary, association with a factor explaining a large percentage of intercountry variance in rates of economic growth (Table V-5.

activity.

Despite the fact that the promotion of industrialization played a role in explaining intercountry differences in growth rates, industrialization was not the primary force responsible for their economic growth. The industrial sectors of these economies remained highly underdeveloped, with handicraft industry and putting-out systems predominant in most countries. The highest levels of industrialization achieved during the sixties by the most advanced countries in this group, were the establishment of a number of small-scale, power-driven factories, and a very small number of modern, large-scale factories that were, however, foreign financed and foreign managed. Moreover, a large number of these countries were suffering from the Dutch disease of deindustrialization, due to their primary reliance on their export-oriented extractive sectors for their economic dynamism.

The governments of this group of countries also need to increase investment. They have to invest in physical infrastructure, primarily in transport and power systems. The physical overhead capital of even the most advanced countries in this group, while adequate for their small commercialized sectors, failed to provide continuous service in most parts of the country.
And they have to invest in education.

The state should also start on the development of the critical economic institutions, their financial and tax systems, which, their efforts notwithstanding, remain rudimentary. In the sixties, local financial institutions were foreign owned or directed; investment in food agriculture was either self-financed or financed through the unorganized money market; gross domestic savings rates were below 9% and the ratio of demand plus time deposits to GNP was less than 15%. And their tax revenues depended heavily on a foreign-owned extractive sector, their tax bases very extremely narrow, and they experienced severe difficulties collecting taxes.

Even though these countries shared common severe political barriers to growth and development, political influences exercised negligible impact on economic growth in our results because there was so little variation in their political characteristics during the sixties. However, our results show that the performance of these many functions by the state requires increasing the administrative efficiency, professionalism and honesty of their bureaucracies; and a leadership that demonstrates greater than average degrees of commitment to national development[3].

In sum, in this group of most underdeveloped countries, the primary functions of government consist of social development, and institution-creation, both economic and political. The early industrializes had built up their market institutions during the 400-year protocapitalist period. The countries in this set had never gone through a comparable process of protoindustrialization, buildup of agricultural technology, and marketization. Their governments therefore have to introduce the institutional changes required to strengthen responsiveness to market incentives-- a process they accomplished by focusing on the expansion of commercialized primary exports. They have to eliminate legal and social barriers to factor mobility and trade; break down the sway of tribal influences; create domestically financed and managed credit institutions; and build institutions that facilitate the commercialization of transactions in both land and labor. And they have to invest in infrastructure and education.

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[3] The variables representing the degree of improvement in the administrative efficiency and in leadership commitment to development have statistically significant, but only secondary, associations with a factor explaining a large percentage of intercountry variance in rates of economic growth (Table V-5).

The Intermediate Group: In the next most developed group of transitional economies, that were intermediate in socio-political and economic degrees of institutional development, the process of social, economic and political modernization had proceeded far enough to profoundly disturb traditional customs and institutions without progressing far enough to set them on the path of self-sustained economic development. This set of countries was geographically diverse: it included Algeria, Tunisia, Iran, Iraq, Syria, and Jordan in the Middle East and North Africa; Sri Lanka, India, Pakistan, Myanmar, Thailand, Indonesia and the Philippines, in Asia; Bolivia, Guatemala, Ecuador, Honduras and Surinam in Latin America; and Ghana, Rhodesia, and South Africa from Africa South of the Sahara. The countries in this group were also historically and culturally most heterogeneous. They were characterized by rapid and unbalanced social transformations, which had led to high degrees of social tensions and political instability. In the sixties, they also had generally ineffective governments with weak administrative capacities.

Our statistical results for this group of countries indicate that relatively narrow-based industrialization, the buildup of economic institutions, particularly financial and tax systems, and investment in physical infrastructure dominated the explanation of intercountry differences in rates of economic growth. There was no longer evidence of a direct systematic impact of changes in social structure upon rates of economic progress, perhaps because the specific patterns of socio-economic progress, including specific social impediments to modernization, varied substantially among clusters of countries in this transitional group. Furthermore, neither the precise form of the political system nor the extent of the leadership's commitment to economic development played an important systematic role in influencing growth rates in this transitional group, because the states were "soft" and the countries were beset by high degrees of social tension and political instability.

For countries at this intermediate stage of development, our statistical results indicate that the government should concentrate on providing the institutional and physical conditions and the policy environment necessary to promote the initial stages of industrialization. It should invest in transport and power systems. It should raise the national investment rate, both through direct government investment and through subsidizing and promoting private investment. It should champion the development of modern industry: foster an increase in the variety of consumer goods produced by power driven factory methods, encourage the domestic processing of natural-resource based exports, and strive to increase the proportion of manufactured goods in total exports[4]. The government should substitute for imported skills and capital by promoting domestic entrepreneurs in manufacturing, and by investing in education[5]. It should build up the domestic banking system and domestic credit institutions by adopting policies that boost private savings, channel them to the private banking system, and enhance the effectiveness of the banking system in performing its intermediation function between savings and investment. To avoid relying too heavily on inflationary finance, the government should build up its tax institutions by raising the ratio of government revenues to GNP, and by increasing reliance on direct, rather than indirect, trade-related, taxes. The government should create the conditions for a Lewis-type

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[4] The variable representing the diversification of exports and their shift away from primary-based exports (the structure of foreign trade) has a significant correlation with the factor accounting for the largest percent of intercountry variance in rates of economic growth.(Table VI-4)

[5] The variable measuring degree of improvement of human resources has a high (but secondary) coefficients on the factor explaining the largest proportion of intercountry differences in rates of economic growth at this level of development. (Tables VI-1 and literacy in Table VI-4)

process of transfer of resources from agriculture to industry by raising the productivity of agriculture. It should make agriculture more responsive to economic incentives by expanding its degree of commercialization while reducing the proportion of the population engaged in subsistence agriculture[6]. And it should encourage a reduction of socio-economic dualism by decreasing pervasive regional and sectoral cleavages in technology, types of economic organization and styles of life between urban and rural inhabitants, large expatriate-managed factories and domestically owned and managed ones, and between export and domestic consumer goods production[7]. It should accomplish this not only through its investment patterns in infrastructure and education but also through the promotion of mass-communication media[8].

The High Group: The countries in this group comprise the socio-institutionally and economically most advanced developing countries. The majority of them had a century or more of political independence and were well ahead of the intermediate group in social achievements (larger middle class, higher literacy, more secondary and tertiary education, more urbanization, more mass communication, etc); in degrees of industrialization; and in extent of development of economic and political institutions. The sample includes: the sixteen most developed Latin American nations, the six most advanced Mid-Eastern countries, and three East Asian countries-- Japan, South Korea and Taiwan.

In this group of highly developed developing countries, leadership commitment to economic development was the major political variable differentiating among economically more and less successfully developing nations. Indeed, this variable alone accounted for 77% of intercountry variance in economic growth. The leadership commitment variable captures the contrast between the less successful, mostly low political commitment Latin American countries[9] that had already achieved high levels of socio-institutional development and high incomes, on the one hand, and the high social-development but low income East Asian ones, whose leadership commitment to development was high, on the other. In Japan, Korea, Singapore and Taiwan, no correct reading of the role government in the economy is compatible with a view that it acted like neo-liberal states. Leadership commitment is required to achieve the degree of autonomy the state needs to enable it to foster dynamic comparative advantage. This requires shifting direct and indirect state support among industries, changing trade and commercial policies towards specific sectors, thereby injuring some groups while benefiting others.

Once the social, human resource and physical conditions for development have been largely

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[6] The variable measuring the size of the subsistence agricultural sector has a high (but secondary) coefficients on the factor explaining the largest proportion of intercountry differences in rates of economic growth at this level of development.

[7] The variable measuring the extent of socio-economic dualism has a high (but secondary) coefficients on the factor explaining the largest proportion of intercountry differences in rates of economic growth at this level of development.

[8] The variable measuring the extent of mass communication has a high (but secondary) coefficients on the factor explaining the largest proportion of intercountry differences in rates of economic growth at this level of development.

[9] The Latin American exceptions to this statement in the 1957-67 period represented in our data were Mexico, Venezuela and Brazil.

established, as they have for this group of countries, our results indicate that the primary function of government consists of the promotion of industrialization while raising the productivity of agriculture. The performance of this function entails an activist government role in the adoption of an industrial policy that promotes dynamically changing comparative advantage: from resource intensive, where still appropriate, to labor-intensive manufactures, to skill-intensive industries, to high-level-manpower and capital intensive sectors. During the sixties, this transition entailed expansion of the quantity and variety of consumer goods produced domestically in power-driven factories, at first largely for domestic consumption and then, in part, also exported and finally moving into the domestic production of intermediate goods that, initially, primarily substitute for exports. Only the East Asian economies and Brazil had reached a stage in which they were exporting consumer goods and none of them were exporting producer goods at that time. This process of progressive change in the thrust of industrialization needs to be implemented through the formulation of appropriately changing international trade and commercial policies and the consistent direction of government finance, government investment and government incentives to this end. The general aim should be to make industries export-competitive and create a dynamic private sector. However, in each phase of the transition, initially infant-industry protection needs to be accorded to the key sectors; but the infant industry protection **must be** gradually withdrawn and replaced by pressures and incentives to export. In support of the industrialization effort the productivity of food agriculture must be raised to feed the urban population through investment in agricultural infrastructure and through agricultural technology and terms of trade policies leading to the increases in agricultural incomes required to boost home-demand for domestic manufactures.

This phase also involves an increase in investment, public, private domestic and foreign. It therefore presumes a greater level of development and more rapid improvements in both financial and tax institutions. In financial institutions further institutional development entails reducing the degree of financial repression; raising gross domestic savings rates above 13%; and improving the capacity of financial intermediaries to provide a fairly adequate degree of long-term finance for investment in both industry and agriculture. The improvement of tax systems, entails expanding tax revenues, to avoid having to rely on more than **mildly** expansionary macroeconomic policies and modest foreign capital inflows, in the form of foreign direct investment and foreign aid. Furthermore, the reformed tax systems must also place greater reliance on direct rather than indirect, trade-related taxes. Otherwise, the needs of tax collection will conflict with the needs to ultimately foster internationally competitive domestic industries.

Developed Countries: Finally, once the institutions of capitalism are mature and the growth, entrepreneurial, investment and savings habits are firmly entrenched in the entrepreneurial and household sectors the scope of government policy should be diminished. By and large, the government ought to limit itself to providing the macroeconomic policy framework for rational economic calculus and full resource utilization; the promotion of economic and political competition; the provision of a safety net and the protection of the weak in the marketplace; and the containment of negative social externalities, environmental and safety, inherent in unfettered profit maximization. That is, the appropriate role of the government in the final phase, but only in the final phase, should change to that prescribed by the current neo-liberal, Reagan-Thatcher, Washington consensus.

However, it should be emphasized that this phase had not been attained by any countries in the "high" groups in the sixties and has been attained by less than a handful of NICs in the highest development group in the nineties. Moreover, despite rhetoric to the contrary, even current United States and Europe are not pursuing purely neo-liberal policies. For example, the Clinton administration has been pursuing an activist industrial policy, aimed at accelerating the shift into a high-tech and service economy; an interventionist trade policy, aimed at pushing agricultural, service and technology exports through its bilateral and multilateral negotiations with other countries and through its participation in global institutions; and has been promoting a human-resource investment policy aimed at providing the human capital needed by high-tech industries, generalizing the ownership of human-capital, and increasing its rate of accumulation.

IV. Common Strands

We start by pulling together some very general common strands evident from both 19th century continental European development and the post World War II development of developing countries (see also Morris and Adelman, 1989). These common strands have obvious implications not only for the role governments must play in economic development but also for the changing role of foreign aid in assisting development and for the national and international institutions required to support it.

First, a reading of both economic history and contemporary development suggests that institutional readiness for capitalist economic growth is key to economic development, because it provides the conditions that enable technical progress and export-expansion to induce widespread economic growth. It also suggests that governments must take the lead in promoting institutional development.

The varied experiences of European countries during the industrial revolution period and those of developing countries during the golden age of economic growth underscore this point: Those European countries that had achieved widespread economic growth by the end of the nineteenth century started with institution better equipped for technological change than either the European dualistic-growth later industrializes or developing countries of the 1950s (Morris and Adelman 1989 and Kuznets 1958). They already had large preindustrial sectors well endowed with trained labor and entrepreneurs; governments that protected private property, enforced private contracts and acted to free domestic commodity and labor markets; and leaderships responsive to capitalist interests that adopted trade, transportation and education policies which fostered technological progress in either industry (the early industrializes) or agriculture (the balanced-growth countries).

Similarly, those developing countries that in the 1950s were institutionally most advanced were the ones that benefitted most from the growth impetus imparted by import demand from the OECD countries during the golden era of economic development. They had an average rate of economic growth 50% higher than that of the average non-oil country at the next-highest, intermediate, level of socio-institutional development (Adelman and Morris 1967). Furthermore, by 1973, the overwhelming majority of institutionally most developed countries in 1950 had become either NICs or developed countries while none of the countries that had lower levels of socio-institutional development had become NICs. Finally, upgrading financial and tax institutions was an important element in explaining intercountry differences in rates of economic growth at all levels of economic development in contemporary developing countries.

Second, both the overall investment rate and government investment, in infrastructure, human capital and industry, were important to development historically as well as contemporarily. Human capital and transportation made a significant difference to economic development. Indeed, in all our statistical analyses, post W and pre WWI, human resource development was critical to technological dynamism in both industry and agriculture.

Historically, no country achieved successful economic development before 1914 without adult literacy rates above 50%. And literacy was a foremost variable discriminating among more and less successfully developing countries during the 19th century (Morris and Adelman 1988, p.211). Similarly, in our historical results, breakthroughs in inland transportation were necessary to advance agriculture in countries starting with severe transportation bottlenecks and having land institutions, human resources, and political structures that provided the potential for economic growth (Morris and Adelman 1988, ch 5). Only where the structure of investment in transport accorded priority to domestic trade were technological improvements in food agriculture likely. Finally, the overall investment rate was important to historical development in all countries.

Analogously, in the sixties, intercountry differences in infrastructure and human capital additions were important in explaining intercountry differences in rates of economic growth of developing countries as long as there still were major bottlenecks in internal transport and education and the overall investment rate was important at all levels of development. Furthermore, the development of the East Asian miracle countries also benefitted from exceptionally high levels of human resource development. Indeed, starting from low levels of education and literacy, due to the legacy of Japanese colonialism, already by the mid-1960s, Korea and Taiwan had attained levels of scholarization which were triple the Chenery norm for their levels of per capita GNP. And in Korea, University enrollment rates exceeded those of Great Britain. The East Asian miracle-growth countries had both high rates of accumulation and high rates of economic growth. In fact, Paul Krugman (1994) and Larry Lau (1997) both find that in Taiwan and Korea almost all of economic growth has, so far, been due to exceptionally high rates of physical and human capital accumulation and that the contribution of TFP-growth to their income growth has been negligible.

Third, government-set trade policies and the international trade and payments regimes are critical for economic development. But, this does not mean that free trade policies are either necessary or optimal for industrialization.

In nineteenth century Europe and Japan, tariffs were usually the cornerstone of industrialization policies; nowhere except in Britain did initial factory-based industrialization occur without some tariff protection. And even in Britain the period just preceding the Industrial Revolution was one of high tariff protection, as Ricardo's tracts on the Corn Laws remind us. Thus the historical record of successful pre-WWI industrialization suggests that List and Schacht, rather than Adam Smith and Ricardo, provide the appropriate guidelines for commercial policy in countries pursuing economic development.

A correct reading of the practice of the successful industrializes, both historically and in current East Asia, indicates that **export-orientation** rather than free trade are the critical ingredients of successful development policy. Historically, export expansion systematically speeded economic growth everywhere. But the export growth led to widespread economic development only where agriculture was at least moderately productive, and modernizing governments fashioned institutional conditions favorable to technological improvements and undertook investments in education and transport favoring the development of a domestic market. Except for the firstcomers to the industrial revolution, European countries did not adopt free trade policies; rather, they obtained their start on industrialization with tariffs and quantitative controls (Morris and Adelman 1988 ch 6).

Similarly, both Korea and Taiwan engaged in import substitution policies at the same time as they pursued export-led economic growth. But, unlike the Latin American countries, they used quantitative controls, more than tariffs and effective exchange rates, to achieve their selective industrial policies. They were thus able to maintain incentives for exports at the same time as they pursued selective import-substitution. Indeed, quantitative import controls, which granted exporters a sheltered domestic market, were one of the mechanisms which made export-orientation profitable to exporting firms. During the heyday of export-led growth in Korea (1967-73), there were about 15000 commodities on the prohibited list for import. And in Taiwan, quantitative constraints on imports were specified not only by commodity but also by country of origin, with most labor-intensive imports from other developing countries barred in order to shelter domestic infant consumer manufactures from foreign competition. The critical difference between the second import-substitution phase into heavy and chemical industries in these two East Asian countries and the same phase of import substitution in Latin America was that, from the very beginning, the East Asian heavy and chemical industries were expected to export a large share of their output. Protection was withdrawn from heavy and chemical industries in about 7 years after these industries were initiated and they were thereby forced to become export-competitive.

As to the trade and payments regimes, periods of exchange rate stability, under either the gold standard or the Bretton Woods fixed exchange rate system of the golden age, were uniformly associated with high world-wide economic growth. By contrast, periods of widely fluctuating exchange rates, as during most of the 1914-1950 period and since 1973 were associated, on the average, with slow economic growth. Similarly, liberal international trade regimes, were associated with high rates of economic growth while protectionist regimes were associated with slow growth.

Fourth, the government has a critical role to play in promoting technological dynamism, industrial policy, and in increasing productivity in both industry and agriculture. Historically, governments imported technology, financed and promoted different industries, and induced domestic industrialists to climb the ladder of comparative advantage. Technological dynamism was the essence of the Industrial Revolution. The productivity of resource-use, both newly accumulated and existing and its rate of increase through technological change and resource reallocation among sectors were crucial ingredients of long term economic growth of developed countries. Technological dynamism was important in explaining contrasts in rates of economic growth during the 19th century in our results. And Kuznets, Abramowitz, Dennison, Solow, and Krugman all find that there is a close association currently between total factor productivity (TFP) growth and rates of growth of GNP, just as both classical and endogenous-growth theories would imply.

In developing countries, our results indicate that the promotion of increases in agricultural productivity were important during the sixties at all levels of development. Upgrading industrial technology became important once the major social and infrastructural bottlenecks to technical change were removed and industrialization that progressed from staple processing to consumer goods more generally and then integrated backwards into intermediate goods and machinery was the major instrument for development at all levels of development of developing countries.

Fifth, as a result of the first four propositions, the government's economic policies, particularly with respect to institutions, trade, industrial policy, agriculture, investment and macroeconomic management, mattered. This point, which permeates the discussion in our previous two sections, would hardly be worth making were it not for the now Nobel-prize hallowed rational expectations school and were it not for the "evil government" Washington Consensus school of economic development of the eighties.

Sixth, the goals of economic policy matter. When, in the 1950-73 period, the OECD countries focused on economic growth, they got it. Similarly, when, after 1973, they focused on economic stabilization, deliberately sacrificing economic growth and employment, they also got it. Along the same vein, during the 19th century, developing countries that had sufficient political autonomy from their colonial rulers to be able to set their own economic policies so as to benefit domestic industrialization (Australia, Canada and New Zealand) were able to translate the growth impulses from export expansion into widespread economic development; by contrast, those countries that were

politically and economically so dependent on the center that they had no control over domestic economic policies (India and Burma) achieved only dualistic, enclave,
sporadic growth (Morris and Adelman, 1988, ch 6).

Seventh, institutional and policy malleability are key to sustained economic development in the long run. Our historical study indicated that institutions and policies that were good for initiating economic growth were generally not appropriate for its continuation. For example, in the land-abundant non-European countries, foreign-dominated political institutions were a powerful force for the market-oriented institutional change that initiated strong primary export expansion. But the institutions that were good for export-growth brought about neither systematic agricultural improvements nor consistently rising standards of living. For ultimate success, however, the domestic economic institutions had to be transformed so that widely shared growth could ensue and a domestic market for manufactures could emerge. This required political transformation as well. At first, the establishment of political stability and political support for the promulgation of laws furthering market development were sufficient to promote rapid primary-export expansion. But unless the political institutions later adapted so as to provide support for the economic needs of rising domestic commercial and industrial classes the translation of the initial impetus from exports into long term economic development became blocked.

Similarly, in backwards European countries, initially governments and international resource-flows could substitute for the missing institutional requirements of economic growth. At first, government demand for domestic manufactures could successfully substitute for deficient home markets; government finance and foreign-capital inflows could substitute for inadequate domestic savings and financial institutions; and imports of skilled workers and technology could substitute for meager domestic human resources. But after a certain point these substitutions became inadequate. To generate development, economic institutions had to change so as to enable the domestic provision of the capital, skills and broad-based domestic markets.

More specifically, our results indicate (Morris and Adelman 1988 ch 5) that, the critical functions performed by agriculture in their countries' economic development change as development proceeds. Initially, agriculture must be capable of performing the Lewis-function, of providing capital for industrialization. In this phase, agricultural institutions must primarily be suited to the initial mobilization of the agricultural surplus and its transfer to the industrial sector; large estates, worked with semi-attached labor were best suited for this phase. Later, agriculture must be capable of providing food to the growing urban sector and markets for urban manufactures. In this later phase, the institutional structure of agriculture, terms of trade policies and investments in agricultural infrastructure must provide incentives for improvements in the productivity of food agriculture; and the agricultural surplus must be sufficiently widely distributed to enable widespread farmer-income growth and broad-based increases in demand for home-produced manufactures; at this stage, owner-operated farms of productivity and size sufficient to provide a marketable surplus were best.

In international trade, too, our results suggest (Morris and Adelman ch 4 and 8) that development requires policies to shift so as to enable structural change in the composition of domestic production and exports to occur continually. This, in turn, requires dynamic adaptations in trade-regimes. Commercial policies necessary to initiate industrialization, such as import-substitution, are not good for its continuation, when shifts to export-led growth are needed to enhance scale and provide the impetus for efficiency in production. In both Korea and Taiwan, the major thrust of government strategy with respect to trade and industrial policy shifted in rapid succession, with sometimes as little as four years spent in a given policy-regime (Adelman 1996).

Not only economic institutions and primary policy-thrust but also the major functions of government must shift as development proceeds. Initially, the primary roles of government consisted of social development, institution-creation, both economic and political, and infrastructure-buildup. The governments of the European latecomers introduced the institutional changes required to strengthen responsiveness to market incentives during the early phases of the industrial revolution. The latecomers unified their countries and markets, as in Italy and Germany; eliminated legal barriers to trade and factor mobility, as in the Russian serf-emancipation; created credit institutions and promoted joint-stock companies, as in Germany; and facilitated transactions, as in Italy and Spain.

Next, once the institutional and physical frameworks for development were established, the primary function of government consisted of the promotion of industrialization while raising the productivity of agriculture. Both during the 19th and twentieth centuries, an activist government that promotes dynamically changing comparative advantage was needed to achieve successive stages of industrialization. Climbing the ladder of comparative advantage required changing international trade and commercial policies and changing the thrust of government finance, government investment and government incentives. In each phase of industrialization, initially infant-industry protection needs to be accorded to the key sectors; but the infant industry protection **must be** gradually withdrawn and replaced by pressures and incentives to export to generate an export-competitive industrial structure.

Finally, once the capitalist institutions are mature, the entrepreneurs have acquired investment attitudes and skill, and the household sector provides adequate savings and skilled labor, the scope of government economic policy should be curtailed. But, as indicated earlier, this stage has not been reached even now by most NICs. I firmly conclude from both European and East Asian development history, that, had the neo-liberal Washington consensus been enforced on the East Asian miracle countries during the fifties, sixties and early seventies, there would not have been an East Asian miracle.

V. Four Corollaries

The importance of government policy to development, the importance of government goals to policy choices, and the need to be able to change the policy environment as development proceeds have four significant corollaries.

The **first corollary** is that a government with substantial autonomy, capacity and credibility is required for successful long term economic growth. Does this mean that a strong, autocratic state is necessary to the adoption and maintenance of good economic policies? European growth during the Golden Age of the 1950s and 1960s suggests that it is not. However, the experience of the ultimately successful European followers during the industrial revolution, in which strong leaders transformed institutions and engaged in aggressive industrial policies, indicates that a strong state is needed to initiate economic development. Perhaps most importantly, as the literature on bureaucratic authoritarianism in Latin American countries emphasizes, a state with a certain degree of autonomy from pressures emanating from entrenched economic elites, is necessary to implement switches among policy regimes (e.g. from import substitution to export-led economic growth) or engineer fundamental changes in economic institutions, such as land reform. Such policy-regime switches, which, as emphasized above, are necessary to successful long-run economic development, inflict inescapable injuries upon some entrenched economic interests, such as entrepreneurs and workers in the protected import-substitute enterprises, while only promising to confer potential benefits on other groups, such as the would be exporters and their workers, and that only after painful restructuring to become export-competitive. Popular support for major policy-regime switches is therefore unlikely, especially over a time-frame long enough for the new policy-regime to become effective. Repeated abortive trade-liberalization efforts in Latin America and recent elections of communist leaders in some reforming Central European countries underscore this point.

To accomplish the variety of tasks required for development, the government has to raise the salience of economic considerations in its polity. It also must increase its own capacity by raising the training and professionalism of its civil service, the efficiency of its public administration and reduce the level of corruption of its bureaucrats. It also needs to mobilize its commitment to development by, inter alia, reducing the political influence of the landed traditional elite on the government's economic policies.

A government with substantial autonomy, capacity and credibility is therefore required for successful long term economic growth. But such autonomy need not arise from repression of popular participation and civil rights. As long as the government is perceived as acting in the public interest, the requisite autonomy can be bestowed upon the government by: the government's independent popular support, such as enjoyed by governments led by national liberators or war-heroes; or by the government's general credibility gained through successful economic and political leadership; or by popular values supporting hierarchic leadership roles, such as Confucianism, or arising from perceived external threat to the country's national survival.

The **second corollary** from the importance of government policies and the importance of policy goals to long run economic development is that the nature of the state and its relation to civil society matter. Both historically and more recently, the structure of power represented by in the government has determined the choice of policy thrust. Political history and economic history are closely related, as the contrasts in policies between Reaganomics and Thatcher-omics, on the one hand, and Clinton-omics and Blair-onomics, on the other, indicate. In the late 19th century industrializes, when the landed political elites were modernizing (as in Germany and Japan), they invested in education, agricultural extension and credit policies favoring family-owned farms; these, in turn, enabled technological improvement in agriculture and the development of a home market for industry. By contrast, where, as in Italy and Russia, the large-estate owners that held political power were status-quo oriented, they did little for education and agriculture and growth was dualistic, and poverty and illiteracy rampant. The critical importance of the political complexion of government to widespread economic development is also confirmed by the contrasts in development paths, evident among European-settled land-abundant overseas territories during the 19th century. In Australia and New Zealand, when the sway of landed traditional elites over government policy eventually weakened, settlement laws favoring small farmers were passed and growth eventually became widespread. By contrast, in Argentina and Brazil, traditional elites remained strong throughout their histories, and the distribution of benefits from growth remained narrow. Thus, nineteenth century economic history confirms strongly that political institutions matter to the successful spread of economic development.

The crucial importance of the political complexion of government is also confirmed in postwar developing countries. In the systematic quantitative analysis of economic and institutional forces in economic development in the early 1960s, by Mrs Morris and myself (Adelman and Morris 1967), we found that leadership commitment to economic development was the major institutional factor differentiating among economically more and less successful nations in the group of countries that had already achieved high levels of socio-institutional development. Leadership commitment to development captures the contrast between most of Latin America, where commitment to development was mostly at best moderate and East Asia, where commitment to development was high.

The **third corollary** from the importance of government policy and policy goals to economic development is that a strong state that adopts self-serving, or simply misconceived economic policies and/or institutions can generate economic disaster. The last twenty five years of indifferent economic growth in most African countries and in the non-defence sector of the former Soviet Union underscore this point. A non-activist government would have been preferable to a strong government promoting bad policies.

However, these are not the only alternatives. The economic histories of Japan, the four little tigers, the seven flying geese, and post-1980 China suggest rather strongly that the combination of a developmental state with good economic policy is unbeatable. Their experience underscores that a technocratically-influenced developmental state, with an economically literate meritocratic bureaucracy, is key to long run success in economic development.

The **fourth (and final) corollary** stemming from the critical and dynamically changing role governments must play in the economic development of their countries is that they must have sufficient autonomy not only from domestic political constraints but also from international constraints on their economic actions.

After the end of World War II, the global economic system was designed so as to offer scope for increased economic interdependence while allowing national governments to pursue their own welfare and development goals. The architect of the postwar global system, Lord Keynes, knew well that the pursuit of national full employment required a global system that would permit governments to embrace anti-cyclical domestic policies; set wage policies and undertake anti-poverty measures that would be consistent with the particular government's social goals; and choose how fast it wanted to increase its rate of economic growth. He also knew that these pursuits required global economic stability and would be facilitated by enlarging the scope of world trade. The system he designed, known as the Bretton Woods system, was one of fixed, but adjustable, exchange rates with a lender of last resort and an international arbiter of when national exchange rates were systematically under or overvalued. The system stressed trade liberalization but explicitly encouraged barriers to international short and long term capital flows. National governments thus acquired autonomy in setting the macroeconomic framework for their growth. They could choose the particular combinations of: exchange rates; fiscal and trade deficits; domestic unemployment, inflation, interest rate, and wage and welfare policies that suited their special social traditions and current economic goals.

Between 1947 and 1973, (and for the first time in history) the global system extended the necessary degree of economic autonomy not only to developed countries but also to the newly decolonized underdeveloped nations. For them, the system offered even greater autonomy than it did for industrialized nations by designing national and international institutions to augment their meager supplies of saving and foreign exchange earnings through multilateral and bilateral aid and by exempting them, for a time, from free trade requirements. The result was a Golden Era of economic development. It combined full-employment growth in developed countries with development, consisting of a combination of economic growth and structural change, in the politically, socially and economically more advanced developing countries. The result was the emergence of about twenty semi-industrial countries, poised for entry into the club of industrialized nations.

This permissive, benign global economic system broke down abruptly in 1973, with the first oil crisis. The seeds for its breakdown had been laid earlier. Towards the end of the sixties, the liquidity needs of the world trading system could no longer be satisfied by the dollar-based Bretton Woods system. The supply of the international reserve currency (the dollar) became inadequate for the growing needs of international commerce. Also, there had been a slowdown in the growth of productivity in industrial nations; national wage settlements had started to exceed the growth of productivity; inflationary pressures were mounting; and a bunch of price shocks, in oil and grain prices, were imposed exogenously. The Bretton Woods system broke down and was replaced by a flexible exchange rate system with progressively more open capital markets and commodity trade, in which governments lost their economic autonomy.

Macroeconomic policies now had to become coordinated. For developed countries the coordination is accomplished through international negotiations among them. At the regular, periodic consultations among the G7 industrial nations, agreement is reached on the general thrust of national macroeconomic policies. They decide in a concerted fashion whether to stress macroeconomic stability (fight inflation and achieve balance of payments equilibrium), or pursue full employment and growth. Recalcitrant nations that try to go it alone are severely disciplined by the world's financial markets. As to developing countries, under the new global system, those with relatively open capital markets or those requiring economic assistance from international agencies, have to passively accept globally established interest and exchange rates. This means that they cannot devalue strategically, in either nominal terms or through changes in domestic inflation, to encourage exports; and they cannot unbalance their government budgets or loosen monetary policy beyond modest degrees to subsidize or finance domestic investment . Otherwise they will experience large, disequilibrating short-term capital outflows or inflows, which can quickly turn into devastating financial crises, and greatly amplify cyclical swings in their real economies. The 1980s in Latin America, and the late nineties in East Asia and Russia dramatically demonstrate the validity of this proposition.

Thus, in the post Bretton Woods global payments regime, both developed and developing-country governments are precluded from pursuing independent economic policies. They cannot set an exchange rate which does not equilibrate the country's current account balance (i.e. is out of alignment with its international competitiveness), or an interest rate which is out of alignment with world market interest rates adjusted for a country-risk premium. Globalized financial markets preclude governments from having independent interest and exchange rate policies. With respect to interest rates, if, as happened in Korea during the 1990s, the domestic interest rate is set significantly above world market, in order to mobilize more domestic savings, redirect them into the banking system, and fight inflation, then the result is a buildup of foreign private indebtedness. If, as happened in Japan and more recently in Canada, the domestic interest rate is set substantially below world market the result is an outflow of domestic savings in the form of portfolio investment in foreign bonds and securities and of real investment abroad; the consequence is lower domestic economic growth. By the same token, globalization of short term capital markets in a fluctuating exchange rate regime is also incompatible with an independent exchange rate policy, especially one that attempts to peg the exchange rate. Attempts to maintain an overvalued currency (as in Mexico and Turkey in the early 1990s and Korea in the late 1990s) require using foreign exchange reserves to sell foreign currency to prevent a devaluation; eventually, the supply of foreign exchange reserves will be exhausted and the currency will devalue anyhow, frequently much below its equilibrium rate. Attempts to maintain an undervalued currency (as in Japan in the 1990s) will, in the absence of restrictions on currency outflows, cause an outflow of domestic currency with adverse effects on domestic investment and domestic growth. Thus, financial globalization imposes severe fundamental constraints on the policy levers which governments can exercise in their management of the domestic economy thereby creating a crisis of the State. The new international environment thus has major implications for the future role of the State and the future potential for foreign assistance.

In view of the critical importance of governments to economic development, the current loss of autonomy imposed by the institutions of the current global financial system is scary.
For, it is evident from our analysis, that the process of successful long term economic development entails systematically changing dynamic interactions between institutional change, technological progress, structural change in the economy's production profile, and international trade and domestic accumulation patterns in which the government and its policies play a key role. Long-run success in

economic development therefore requires that the dynamic restyling of all processes be mutually consistent and that it be embedded in a receptive international setting that is compatible with the shifting major thrust of domestic change. To enable governments to play their fundamental role succesfully, they must thus have sufficient autonomy to shift among policy-regimes as the requirements of economic development, domestic conditions and the international environment switch.

VI. Conclusions.

Developing countries wishing to become developed cannot renounce their policy autonomy. We saw in this paper that government-led economic growth has been essential to the initiation of development both during the Industrial Revolution era and during the 20th century. And that the nature of government-civil society role must change dynamically through development history. But we also saw that the current global international financial architecture puts severe constraints upon government economic autonomy in pursuing developmental goals. So, what are developing-country governments to do in the Post Bretton Woods era? They have several classes of alternatives.

One, they can limit themselves to the instruments they retain. In particular, having lost control over more neutral indirect means of promoting structural change, they can rely increasingly on direct, targeted and untargeted means of achieving economic development. More specifically, they can use disguised subsidies[10] to industry, through infrastructure investment, cheap food, and low-wage, anti-union policies. They can use targeted subsidies in the form of tax rebates and/or monopoly privileges to specific industries, regions and firms. They can create generalized externalities in the form of investment in education, skill-import enticements, and tax holidays to promote local and foreign direct investment. They can build the physical and legal infrastructure for processing zones and industrial parks. The less developed among developing countries, that still retain the capacity to impose infant-industry protection under GATT and WHO can use selective tariffs to promote climbing the ladder of comparative advantage. Finally, as was done in Korea, Meiji Japan, and Communist China, they can create national commitment to development, through the educational system, the use of the media and national campaigns to motivate workers, entrepreneurs, bureaucrats and households to exert themselves and save in the interest of the modernization of their countries.

But the pace of modernization developing countries will be able to achieve through the concerted (and coordinated) use of this battery of direct instruments will be much slower than it was during the Bretton Woods era. It will be constrained to a balanced-budget, relatively restrictive monetary and fiscal regime. It will likely be costly, as some of the targeted efforts may be economically inappropriate, premature, ill-timed or of the wrong scale. It will also require state-institutions for coordination of industrial policies, not unlike the development agencies of the sixties and seventies. This statist-capitalism approach will therefore not have much of a chance of success if the domestic political/bureaucratic environment is not capable, honest and committed to modernization. It will also require that the international environment be committed to economic growth.

It is an ironic thought that this "do what you can" approach, which is the most statist and interventionist, is stimulated by too liberal an international environment imposed on countries and economies that are not ready for it, either economically or politically.

Second, developing countries can work to convince the international community that the current global financial system requires reform. Their efforts along these lines can be augmented by

[10] Open, direct subsidies are illegal under GATT.

lobbying by developmentally-oriented national and international aid establishments of OECD countries. International aid establishments can add their voice to those of developing country advocates of financial reform of global short-term capital markets in the international community. As we have learned from the almost seventy financial crises during the last fifteen years or so, and as pointed out by Tobin[11], international markets for foreign exchange are too smooth, permitting the transfer of vast sums to be carried out instantaneously; they are also much too large[12], enabling immense amounts of cash to be brought to bear on any currency at any moment in time; and they also have an inherent tendency to overshoot, generating waves of overoptimistic risk assessments, leading to overlending, followed by overpessimistic risk assessments, leading not only to the cessation of new loans but also to huge withdrawals of foreign currency. They are thus pro-cyclical in nature, amplifying both domestic and international recessions and prosperity. The enormous swings in capital flows that ensue constitute the essence of financial crises. These crises penalize not only domestic institutional inadequacies and policy mistakes but also, the self-defeating efforts of governments to pursue policies of economic independence during the Post Bretton Woods era. No country, however large and however developed (transparent and accountable) its domestic financial institutions, is immune from currency attacks. Indeed, of the 70 or so financial crises that have occurred lately, fully one third occurred in developed countries. There is thus common ground for agreement among developed and developing countries that reform of short term international financial markets to decrease their volatility and restrict the volume of largely speculative short term foreign exchange transactions is desirable. Iconoclastic as it may sound, some mix of regulation, disincentives, or other impediments to short-term capital mobility is required to generate a global environment that is robust and friendly to economic growth and economic development.

Third, developing countries could unilaterally delink from international capital markets to preserve their economic independence and stability. They could either, like Malaysia and, Russia, eliminate convertibility of their currencies on capital accounts entirely. Alternatively, a la India and China, they could delay convertibility of their capital accounts until their economic and financial systems are sufficiently mature. Or, like Chile, they could, unilaterately, themselves introduce differential taxes and higher reserve requirements on short term capital inflows, and foreign deposits and controls on foreign borrowing . These measures would make it more expensive to engage in short term foreign borrowing and exchange rate speculation, and thereby provide a greater degree of state independence.

None of these classes of approaches are mutually exclusive. To my mind, the second, financial-system-reform approach would be the most desirable. But it would also take longest to implement. In the meanwhile, developing countries that want to develop will have to muddle through using a mix of approaches one and three. But, unless they stay within the monetary and fiscal constraints, or unless they adopt both measures of type one and three simultaneously, they will continue to suffer from periodic financial crises with devastating real consequences to the economy, to the people and to the

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[11] Tobin, 1974

[12] During 1993-95, the Bank for International Settlements estimates that foreign exchange transactions averaged 1.3 trillions **per day**. By 1997, the daily volume of foreign exchange transactions had increased to 2 trillion! Moreover, 40% of these transactions are reversed within 2 days (and 80% within 7 days) and are thus clearly speculative in nature. The clearly speculative volume of daily foreign exchange transactions in 1997 was thus 800 billion.

State.

In the near future, OECD aid establishments can contribute most to the economic development of developing countries by adding their collective voices to developing country pressures for short-term global capital market reform. For, in the absence of reform of short term financial markets, the effects of foreign aid are likely to be more than nullified by a succession of financial crises. And the ability of foreign aid to counteract financial crises once they start is like the effectiveness of applying band-aids to stem hemorrhaging, as the **annual** collective amounts of resources over which aid establishments dispose is only about one eighth the value of the **daily** short term, speculative transactions taking place on the world's foreign exchange markets.

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