CHAPTER TWELVE

The State and Economic Development

THE HERCULEAN task of raising the great mass of humanity from poverty to acceptable levels of economic welfare is one of the most difficult tasks facing the world economy.[1] There is intense disagreement among economists, public officials, and other experts over the best ways to achieve this goal. Indeed, there is not even a generally accepted commitment to accord priority to economic development. Early attempts by India and other less developed countries (LDCs) to make economic development an explicit objective of the postwar world economy at the 1944 Bretton Woods Conference were rejected by the United States and other industrialized countries.[2] The World Bank, the International Monetary Fund, and regimes governing the world economy were established primarily to serve the interests of the dominant powers. Although industrialized countries have subsequently provided technical and financial assistance and given trade preferences, they have continued to resist LDC demands for a development regime.

Among both scholars and public officials, there are strong disagreements regarding the relative importance of the state and the market in economic development; these disagreements have been central to the conflict between the developed and the less developed countries.[3] Throughout much of the postwar era, a debate has raged between the neoclassical proponents of reliance on the market and the proponents of state intervention. In the early postwar period (1945–1970), development economics, which emphasized the role of the state, was preeminent. Development economists argued that developing countries required an activist government; moreover, they believed that the in-

[1] A sweeping study of why some nations have become rich and most others have remained poor is David S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Poor and Some So Rich* (New York: W. W. Norton, 1989).

[2] This discussion is based on Harold James's magisterial history of the IMF: *International Monetary Cooperation Since Bretton Woods* (Washington, D.C.: International Monetary Fund; New York: Oxford University Press, 1996).

[3] A very useful history of the debate over the best route to development is John Rapley, *Understanding Development: Theory and Practice in the Third World* (Boulder, CO: Lynne Rienner, 1996).

ternational community should play a central role in LDC development. Then, during the 1970s and 1980s, the neoclassical belief in the free market triumphed both in academia and in international institutions, and the ideology of "neoliberalism" and the doctrine of "structural adjustment" became dominant in the International Monetary Fund and the World Bank.[4]

In the late 1980s and early 1990s, the "theory of the developmental state" arose to challenge neoliberalism. Differing with the policy prescriptions of neoliberalism but consistent with development economics, the theory of the developmental state emphasized that the state should play the central role in economic development. The controversy between proponents of the "developmental state" and of neoliberalism has focused on differing interpretations of the rapid and extraordinary economic success of the Newly Industrializing Countries (NIEs) of East and Southeast Asia. Neoliberalism argues that the success of these economies has been due to their reliance on the market and the minimal role of the state in the economy. The theory of the developmental state, on the other hand, credits the central role of the state for the rapid industrialization of the East Asian economies. This position gained many adherents among noneconomist scholars of economic development. Then, in 1997, the East Asian financial crisis shifted the weight of the argument to the neoliberal emphasis on the importance of the market and the dangers of state intervention in the economy. Proponents of the developmental state strongly disputed this assessment and argued that the crisis was caused by international economic and political pressures. And so the debate continues. To a significant degree, the fate of the great mass of mankind located in LDCs will be affected by whether the state-centric or market-centric approach to economic development is ultimately dominant. To understand the nature of this crucial debate about the best path to economic development, one must begin at its origins in the early post–World War II era.

The Rise and Demise of Development Economics

Development economics was the first systematic effort to deal with the problems of the less developed countries.[5] Flourishing in the

[4] Neoliberalism refers to the application of the principles of neoclassical economics to economic development and other aspects of economic affairs. Neoliberalism and structural adjustment will be discussed in more detail below.

[5] A useful overview of theories and writings on economic development is James M. Cypher and James L. Dietz, *The Process of Economic Development* (London: Routledge, 1997).

1940s and 1950s, this theory became the predominant theoretical position in the United States and elsewhere to explain why some nations remained impoverished and what should be done to overcome the problems of the LDCs. In a strict sense, of course, the term "development theory" was a misnomer. Actually, a number of specific development theories competed with one another; these theories differed in their analysis of the precise causes of economic underdevelopment and appropriate solutions to economic problems. Moreover, development theory as a whole was a collection of general ideas rather than a single coherent theory. Among the more prominent members of the development school were Albert Hirschman, Arthur Lewis, Gunnar Myrdal, Raul Prebisch, Paul Rosenstein-Rodan, and Max Singer. These economists attempted to provide an overall explanation of economic underdevelopment and a strategy to lift the less developed nations out of poverty.

Development theory assumed that the less developed countries were fundamentally different in kind from the more advanced industrialized countries and functioned according to different economic principles. Development theorists believed that, although the precepts of neoclassical economics were applicable to the advanced industrialized economies, these theories were inapplicable to the LDCs because of their special conditions. For example, as Arthur Lewis argued, less developed economies were burdened by excess labor and low productivity in the agricultural sector; surplus workers were paid subsistence wages and constituted an immense reservoir that could be tapped to accelerate economic development.[6] These theorists also noted that the LDCs, which were mainly exporters of commodities and tropical products, suffered from unfavorable terms of trade. "Trade pessimism" led these economists to believe that trade could not serve as an "engine of growth" as it had for developing countries in the north during the nineteenth century. Furthermore, a number of market failures, including inflexible economic structures, very low savings rates, and poor educational systems, were believed to have locked the less developed economies into a vicious circle from which they could not escape without a strong interventionist state and significant international assistance.

Development theorists also believed the less developed countries were victims of "late-late" development. These economists argued that in the nineteenth century the then-developing countries such as

[6] W. Arthur Lewis, "Economic Development with Unlimited Supplies of Labour," *Manchester School* 22 (May 1954).

Japan and Germany enjoyed what Alexander Gerschenkron called "the advantages of backwardness," when they were able to draw upon the capital, technology, and experience of the early developers.[7] The late, late developing countries of the second half of the twentieth century, on the other hand, were considered to be so extremely far behind that they would face overwhelming problems competing with more developed economies, and would be unable to catch up with the more advanced economies unless extraordinary measures were taken. Development theorists therefore believed that the state and the international community had to play major roles.

The industrialized economies were judged so strong that LDC firms could not possibly compete against them and acquire market shares in the international economy. This view discouraged private entrepreneurship and undermined the belief in free trade and open markets. Some proponents of development theory thus believed that the path to economic development was trade protectionism and the strategy of "import substitution," and that every LDC should build an industrial structure behind high tariff walls. These ideas were set forth by Raul Prebisch, the Economic Commission for Latin America (ECLA), and the United Nations Commission for Trade and Development (UNCTAD) and became important in the import-substitution strategies of Latin America.

For Swedish economist Gunnar Myrdal, the essence of the underdevelopment problem was that the less developed economies were caught in a vicious circle of poverty or, according to his formulation, were locked into a process of "circular and cumulative causation" from which they could not escape without a massive state-led effort and generous international assistance.[8] Myrdal's argument proceeded like this: The less developed countries by definition were impoverished. As these countries were poor, they had very low rates of national savings. Because they had low savings rates, they also had low investment rates. Because they had low investment rates, their industries were inefficient and uncompetitive in world markets. Because their industries had low rates of productivity growth and were uncompetitive, these countries continued to be impoverished. And because they were poor. . . . and so on. The task of economic development, therefore, was to break this vicious circle of poverty in which the less developed countries were trapped.

[7] Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge: Harvard University Press, 1962).

[8] Gunnar Myrdal, *Economic Theory and Underdeveloped Regions* (New York: Harper Torchbooks, 1957).

Following the implications of such ideas, development economists formulated the strategy of the "Big Push," which would enable LDCs to break through both domestic and international barriers to successful economic development. Set forth originally in an influential 1943 article by development economist Paul Rosenstein-Rodan, the idea of the Big Push may be said to have launched the field of development economics.[9] He argued that the state had to play a much more activist interventionist role in the economy than was needed in more advanced economies. In LDCs, it had to overcome such market failures as the lack of entrepreneurship, low national savings, and various economic uncertainties that weighed down these backward economies. In addition, due to low national savings rates and the absence of a strongly entrepreneurial private sector, the state itself had to become an entrepreneur and promote public investment. Development economists, however, differed among themselves about a number of issues, such as the importance of balanced growth strategies.

In addition, development economists prescribed that industrialized nations should provide massive foreign aid and other forms of financial and technical assistance. Moreover, they argued that the developed countries ought to extend trade preferences to the less developed countries and should not require the latter to reciprocate by opening their less competitive economies. If such policies were followed and a development regime were established, development economists believed that both the more developed and the less developed economies would benefit. Their optimistic belief that every economy had an interest in the development of all, set development economists apart from dependency theorists, economic nationalists, and Marxists, all of whom regarded the interests of undeveloped and those of developed economies as antithetical.

Triumph of Neoliberalism

The late 1970s and early 1980s witnessed the defeat of both development economics and the LDC strategy of import-substitution that had been intellectually supported by development theory. The foundations for the overthrow of development economics within the economics fraternity were laid in the 1960s with a profound change in the character of economic thought and methodology. The writings of

[9] Paul N. Rosenstein-Rodan, "Problems of Industrialisation of Eastern and South-Eastern Europe," *Economic Journal* (Quarterly Journal of the Royal Economic Society) 53, nos. 210–211 (June-September 1943): 202–211.

development economists had been mainly literary and descriptive; one can read Arthur Lewis and Albert Hirschman, for example, and only rarely encounter a graph or an equation. Then in the 1960s, influenced by Paul Samuelson's *Foundations of Economic Analysis* (1949) and the methodological writings of other neoclassical economists, formalization and abstract modeling began to displace the more literary style of most economists.[10] This shift meant that if an idea, however intellectually interesting it might be, could not be expressed in an abstract model, it was of little or no interest to the rising generation of mathematically inclined and model-oriented economists coming out of the Massachusetts Institute of Technology and elsewhere. One unfortunate consequence of this development was that problems of economic development suffered neglect because they were impossible to model.[11]

In addition to this methodological shift from literary to formal analysis, there was an intellectual revolution against development economics in the 1970s. As Hirschman pointed out in an intriguing essay entitled "The Rise and Fall of Development Economics," the emergence of development economics had been facilitated by the Keynesian revolution that posited two different types of economics and, therefore, also posited differing policy prescriptions.[12] On the one hand was what Keynes called "classical economics," with its emphasis on a full-employment equilibrium; this classical economic universe was composed of flexible prices and wages that could easily adjust to changes in demand and thereby restore a full-employment equilibrium. In this economic universe, the market did all the work and there was little that the state could or should do.

On the other hand, Keynes pointed out that there were situations characterized by market failure (as in the Great Depression) where equilibrium could not be restored by the free play of market forces and the government therefore had to intervene with demand management policies (macroeconomic policies) that would reestablish a full-employment equilibrium. Such departures from full-employment

[10] Paul A. Samuelson, *Foundations of Economic Analysis* (Cambridge: Harvard University Press, 1983).

[11] The interesting story of this methodological shift has been told by Paul R. Krugman in his *Development, Geography, and Economic Theory.* (Cambridge: MIT Press, 1995).

[12] Discussed in Albert O. Hirschman, "The Rise and Fall of Development Economics," in Hirschman, *Essays in Trespassing: Economics to Politics and Beyond* (New York; Cambridge University Press, 1981), Chapter 1. See also Lloyd G. Reynolds, *The Three Worlds of Economics* (New Haven: Yale University Press, 1971).

equilibrium were produced by economic behavior fundamentally different from that predicted by classical economics and that thus necessitated state intervention in the economy in order to overcome market failures. In effect, Keynesianism not only created a rationale for government intervention, but implied that classical economics was not a unified, universal science applicable to every economy and economic situation. In this way, Keynesianism supported the fundamental assumption of development economics that less developed economies were different from developed economies, and therefore the state should play a central role.

The attack on Keynesian economics in the 1960s and 1970s by monetarists and by the theory of rational expectations undermined the intellectual foundations of development economics. The essence of this criticism was that there is only *one* economics, and that economics is a universal science equally applicable to all societies. These arguments challenged the basic idea of development economics that the LDCs were fundamentally different from developed economies and functioned according to a different economic logic. The critics of development economics argued that such behavioral assumptions of neoclassical economics as individual rationality, the principle of marginal utility, and the importance of relative prices were as applicable to less developed as they were to developed countries. For example, in an important study for which he received the Nobel Prize, Theodore Schultz demonstrated that LDC farmers were rational maximizers who responded to market incentives and were not the hapless people depicted by development economists.[13]

Neoclassical economists argued that the principal source of underdevelopment is government policies that distort economic incentives, inhibit market forces, and actually work against economic development.[14] Neoclassical economists argued that the LDCs' problems were due to government failures rather than, as development economists contended, to market failures requiring government intervention. The

[13] Theodore W. Schultz, *Transforming Traditional Agriculture* (New Haven: Yale University Press, 1964). Schultz's research showed that peasants were rational and responded to price incentives. In one of the more bizarre episodes in the history of the Nobel Prize for economics, the award was made jointly to Arthur Lewis and Theodore Schultz for contributions to economics that contradicted one another. It is hardly conceivable that two physicists would get the physics prize for research that came to opposed conclusions about the nature of the universe. This curious episode is discussed by Hirschman, *Essays in Trespassing: Economics to Politics and Beyond,* Chapter 1.

[14] An important critique of development economics and statement of the neoclassical position is Ian M. D. Little, *Economic Development: Theory, Policy, and International Relations* (New York: Basic Books, 1982).

LDC state, neoclassical economists concluded, was the problem and not the solution in the failure of these economies to develop. They pointed out that, for example, reckless government policies were responsible for the excessively high rates of inflation and the huge government debts that distorted economic incentives and discouraged entrepreneurship. Their message to LDC governments was to "get the prices right," rely on the fundamentals of the market, and get their hands off the economy. If these simple neoclassical policy prescriptions were pursued, they contended, the less developed economies would permit a proper environment to emerge in which private initiatives would lead to economic development.

This neoclassical attack on development economics considered the world of economics to be unitary and the theories and principles of neoclassical economics to be just as applicable to the less developed countries as they were to the developed countries. State intervention, however, had distorted these economies and bore primary responsibility for their failure to develop. Fiscal irresponsibility, hyperinflation, and markets closed to international competition were among the major problems afflicting them. Neoclassical economists totally rejected the argument that the less developed economies were caught in a vicious circle of poverty and cumulative causation that could be broken only by state intervention and massive international assistance. Instead, they argued that if the governments of less developed countries stepped aside, pursued sound or "market-conforming" economic policies, and opened their markets to the world, their growth rates and national wealth would eventually converge with those of the more developed countries. That is, market openness, fiscal discipline, and noninterventionism constituted the route to economic development.

By the late 1970s, neoclassical orthodoxy had triumphed in the economics profession. Development economics literally disappeared, and development economists despaired and took up other intellectual interests. Albert Hirschman, for example, began to write about social theory, and the writings of the pioneers of development economics rarely appeared on the syllabi of American departments of economics. The ideas and policy proposals of development economics survived only in those less developed countries that continued to pursue import-substitution strategies and in certain specialized agencies of the United Nations that advocated the strategy of import-substitution. However, even in these remaining outposts, development economics and the policies it advocated suffered a severe defeat in the 1980s.

The Debt Crisis and Structural Adjustment

The international debt problem that surfaced in the Mexican financial crisis of 1982 spread rapidly throughout the developing world, especially in Latin America and a number of African and East European countries. When Arab oil-producing countries had suddenly and sharply raised oil prices in 1973, severe balance of payments deficits were incurred by LDCs. Recycling of the resultant OPEC surplus to deficit LDCs through loans by large international banks increased the likelihood of an eventual crisis. The decision of the Federal Reserve in the fall of 1979 did precipitate a crisis when it shifted from a loose to a tight monetary policy in order to defeat hyperinflation. LDC debtors then suddenly found themselves saddled with huge interest payments on their debt and were unable to service their debt because of the global recession and loss of income from their exports.

The consequent LDC debt crisis during the 1980s had a devastating impact on a large number of developing countries and, subsequently, also had profound consequences for the economic policies of the LDCs, the role of the International Monetary Fund in economic development, and the relations between industrial and developing economies. In effect, the debt crisis signaled the failure of the development strategy based on import-substitution and of the idea that the state should play a substantial role in the less developed economy. Throughout the 1970s, LDCs had financed their economic development through "sovereign borrowing," that is, government borrowing, in Western capital markets, a strategy that permitted escape from dependence on both northern MNCs and the "conditionality" policies of the IMF and the World Bank.[15] By the mid-1980s reliance on bank loans had become impossible. Later in the decade, the collapse of the Soviet Union and the failure of its command economy further strengthened belief in the superiority of the market system. However, it was the LDC debt crisis, more than any other development, that led to the triumph of the doctrine of neoliberalism and the policy of structural adjustment.

When Mexico informed the United States in 1982 that it could no longer service its huge debt, the Federal Reserve launched a concerted effort to contain the crisis so as to prevent damage to the American banking system and extension of the crisis to other debtor countries in Latin America. While the Fed arranged for short-term loans to

[15] "Conditionality" refers to the imposition by the IMF of certain requirements that must be met before assistance is forthcoming.

prevent a Mexican default, the IMF assumed responsibility for working out a long-term solution. The arrangement for dealing with the Mexican debt crisis became the model followed with other LDC debtors. Although the debtors attempted to present a united front against imposition of the strict terms dictated by the lender countries, the latter were in firm control. However, it soon became apparent that the initial assessment of the debt crisis had been deeply flawed. The debt problem in many countries was really one of *insolvency*—they could not service their debts without major economic and structural reforms—rather than a *liquidity* problem that could be solved by short-term lending and policy adjustments. Many debtors could not possibly repay or even service (pay the interest on) their debts under the best of circumstances. It became obvious that a long-term, more fundamental solution to the debt problem was required.

In 1985, responding to this reassessment of the nature of the debt crisis, U.S. Secretary of the Treasury James Baker initiated the policy of structural adjustment.[16] This doctrine, resulting from the neoorthodoxy of the 1970s, assumed that the debtor countries' persistent trade and fiscal imbalances had deep structural causes. Therefore, along with changed macroeconomic policies, such structural reforms as a shift toward export-led growth, reductions of the role of the state in the economy, and public sector reforms were required. This approach was also based on the lessons drawn from the East Asian successes in the 1960s and 1970s. This new conventional wisdom coincided with rising opposition to big government in the United States, the United Kingdom, and elsewhere.

The doctrine of structural adjustment meant that a debtor country applying for financial assistance from the IMF and/or World Bank had to commit itself to a number of stringent economic and structural reforms. Over the short term, these reforms were intended to achieve balance of payments adjustment; over the long term, restructuring of these economies would be necessary if they were to return to successful economic development. Underlying this significant policy reorientation of lender governments and the IMF was the realization that only more rapid rates of economic growth would enable the debtors to overcome the problem of national insolvency.

The doctrine of structural adjustment was based on what John Williamson called the "Washington Consensus."[17] This term refers to

[16] Joan M. Nelson, ed., *Economic Crisis and Policy Choice: The Politics of Adjustment in the Third World* (Princeton: Princeton University Press, 1990).

[17] John Williamson, "Democracy and the 'Washington Consensus,'" *World Development* 21, no. 8 (1993): 1329–36.

Williamson's perception of broad agreement among public officials in both the industrial economies and international institutions on the importance of the neoliberal program for economic development and its emphasis on free markets, trade liberalization, and a greatly reduced role for the state in the economy. Although some LDCs charged that the demand for structural adjustment was a new form of capitalist imperialism, the LDCs had little choice other than compliance if they wanted financial assistance. While later developments complemented or supplemented the policy of structural adjustment, this basic approach soon defined the position of the industrial countries and the IMF toward the LDCs and economic development.

Belief that the role of the state in the economy should be drastically reduced and the economy should be opened to the outside world was a vital component of this neoliberal consensus; governments should deregulate and privatize the economy as well as shift from an import-substitution to an export-led growth strategy. Another component of structural adjustment was that governments should pursue prudent fiscal and monetary policies and should definitely maintain balanced budgets in order to eliminate runaway inflation. It was particularly important that the economy should "get prices right" and not permit government policies to distort them. After such reforms, it was argued, private initiatives and desirable social outcomes would be likely to emerge. Nations were encouraged to recognize that economic development requires an "effective" state, meaning a government run by incorruptible economic technocrats. Although a number of important disagreements (primarily of a political nature) persisted within this broad neoliberal agenda, the Washington Consensus became the principal approach of the developed countries to the less developed countries.[18]

The debt crisis transformed the international role of the IMF and the World Bank. The IMF had originally been established as a monetary institution to manage the Bretton Woods system of fixed exchange rates; for example, it provided short-term loans to deal with balance-of-payments problems. To receive such a loan, the recipient country had to fulfill certain macroeconomic policy conditions (conditionality). These conditions were imposed to force the country to bring its international payments back into equilibrium. In response to the debt crisis, the role of the IMF changed dramatically as it began

[18] These political disagreements have been over such matters as economic priorities, the speed and sequencing of economic liberalization, and how to reform the civil service. These highly controversial issues are at the core of the political problems that must be resolved if economic development is to succeed.

to make medium-term loans. In addition, implementation of the doctrine of structural adjustment meant that conditionality was expanded from requirements of changes in *macro*economic policy to fundamental changes in *micro*economic policies and in the overall economy. This made the IMF become an economic development agency with considerable influence over the economic affairs of less developed countries.

With its response to the debt crisis, the Fund joined the World Bank to play a major role in the affairs of both developing economies and the transitional economies in Eastern Europe and the former Soviet Union. Warranted or not, the Fund became known as the "bad guy," and was subjected to severe criticism by many economists, less developed countries, and politicians on both the political left and right. The Left turned against the IMF because of its inflexible demands that governments seeking assistance had to carry out major reforms and austerity programs, whose impact proved heaviest on the poor. The Right believed that IMF policies had actually harmed less developed countries and thus preferred a market solution to the financial troubles of developing and transitional economies. Opposition to the Fund reached its zenith during the 1997 East Asian financial crisis and led to proposals for fundamental reforms.

Theory of the "Developmental State"

In the late 1980s and early 1990s, the theory of the developmental state arose to challenge neoliberal orthodoxy explaining the rapid and successful industrialization of the Newly Industrializing Economies (NIEs) in East Asia. According to this position, the outstanding economic success of Japan and other East Asian countries was due to their adoption of the developmental state model in which the state had to play the central role in guiding economic development and had to lead rather than follow the market. The acrimonious debate between proponents of the developmental state and proponents of the neoliberal, market-centered approach has become central to determination of the best route to successful economic development.[19]

[19] Two useful analyses of this debate are Stephan Haggard, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries* (Ithaca: Cornell University Press, 1990); and Richard F. Doner and Gary Hawes, "The Political Economy of Growth in Southeast and Northeast Asia," in Manochehr Dorraj, ed., *The Changing Political Economy of the Third World* (Boulder, Colo.: Lynne Rienner, 1995), Chapter 6.

The neoliberal interpretation of the extraordinary economic success of the NIEs (South Korea, Taiwan, Hong Kong, and Singapore) was that these economies had pursued "market conforming" economic development strategies; markets rather than government policies had determined the path of development. The extraordinary performance of these "miracle" economies, neoliberal thinkers believed, provided strong support for the Washington Consensus, the doctrine of structural adjustment, and neoclassical reliance on the market. According to this interpretation, East Asian governments had followed neoliberal policy prescriptions; they had opened their economies to the world, reduced the role of the state in the economy to permit markets to function properly, and pursued export-led growth strategies. This interpretation of Japanese and East Asian economic success, however, was challenged by theorists of the developmental state, who argued that success was due to the crucial role played by the state and its industrial policies in the process of economic development.

The theory of the developmental state is really a collection of several theories sharing important ideas. These several theories assert that East Asian governments have played a central role in the development of their economies. Two outstanding interpretations of East Asian economies as developmental states are found in Alice Amsden's *Asia's Next Giant* (1989), which analyzes the industrialization of South Korea, and Robert Wade's *Governing the Market* (1990), which deals with the industrialization of Taiwan.[20] Although Amsden's and Wade's ideas differ on a number of issues, I shall emphasize those points on which they and most other proponents of the developmental state are in agreement.

Theories of the developmental state argue that the governments of Taiwan, South Korea, and the other NIEs devised an array of incentives that encouraged private investment in strategic industries. Also, through a variety of techniques, these governments played a key role in creating an entrepreneurial class, identified critical economic areas for development, and exposed priority sectors to international competition that forced them to become efficient. These state policies encouraged development of an industrial and economic structure that would not have arisen merely in response to market signals. According to the theory of the developmental state, the policies of these governments deliberately got prices "wrong" in order to change the

[20] Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989); and Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990).

behavior of firms; they also used nonprice means to alter firm behavior. Scholars argue that this state-led industrialization strategy worked by using the price mechanism to encourage private entrepreneurs to take actions that the government considered to be in the interest of rapid industrialization.

The industrial, protectionist, and other policies employed by the developmental state were based on the assumption (which had been shared by members of the first generation of development theorists) that these economies suffered from the consequences of "late, late industrialization." Market failure was assumed to be prevalent among these less developed economies, and market failure necessitated an active role for the state. Governing elites believed that their societies faced "collective action problems"; that is, they had to find a way to motivate members of their societies to work together. State policies were needed to bring private returns in line with public returns. States had to create an incentive structure to ensure that private entrepreneurs invested in those economic activities that would be the most socially beneficial. In addition to trade protection and government subsidies, their industrial policies included such "financial repression" policies as selective credit allocation and deliberate distortion of interest rates in order to channel cheap credit to favored economic sectors. Elites also believed that government policies should anticipate the future comparative advantage of the economy and that industrial policy should lead rather than follow the market.[21]

Although proponents of the developmental state agree with neoclassical economists that the strategy of export-led growth was a key factor in the economic success of the East Asian economies, they argue that neoclassical analysis is not sufficiently comprehensive. For example, they ask why business firms selected particular products for export.[22] As Amsden points out in her study of South Korean industrialization, that government used a number of mechanisms to promote particular industrial sectors and encourage export drives, including export contests to promote rapid industrialization of those sectors considered of strategic importance to the overall economy. Those industries that performed best in export markets were especially favored by government industrial policies and programs of financial assistance.

[21] Richard Auty makes the interesting point that industrial policy was a consequence of the uncertain political situation after the defeat of the United States in Vietnam. Richard M. Auty, *Economic Development and Industrial Policy: Mexico, Indonesia, and China* (New York: Mansell, 1994).

[22] Another area of disagreement has been the relationship of exports and growth. Did exports cause growth, as neoclassical economists assume, or did growth cause exports, as proponents of the development state believe?

Proponents of the developmental state maintained that the theory of the "governed market," to use Wade's appropriately descriptive term, rather than the neoclassical theory of the free market, accounted for the outstanding economic success of the East Asian NIEs.

The theory of the developmental state maintains that the East Asian state was able to play a guiding role in economic development because of a number of unique domestic and international factors. In all these societies, the state has been relatively autonomous and therefore able to pursue policies free from public pressure. Yet, this state autonomy was deeply embedded in a society where the state worked very closely with business interests to promote rapid industrialization.[23] Some observers believe that such Asian social values as hierarchical deference, a tradition of hard work, and subordination of the individual to the community played a crucial role; celebration of Asian values also provided ideological support to the authoritarian regimes of the region. The national political economy was based on trust and subordination rather than Western-style compliance and accountability. Although these states were authoritarian, they also carried out important reforms and implemented policies favorable to economic growth and social harmony; for example, they promoted land reform, education, and income equality.

At the core of the developmental state and the reason for its outstanding success were close ties among government, local banks, and industry. These intimate relationships, which Wade calls "alliance capitalism," facilitated channeling bank capital into promising industries and thus promoted rapid industrialization. At the same time, domestic governments frequently restricted both foreign direct and portfolio investments by international firms and thus insulated their economies from disruptive external influences. Although this system produced liabilities disproportionate to their assets in the larger enterprises such as the South Korean *chaebol*, the system worked very effectively and was stable as long as local governments controlled domestic financial markets and the capital account, a situation that changed dramatically in the 1990s and was a significant factor in the post-1997 East Asian financial crisis. Development of these economies was also supported by a number of sociological and political factors, such as a hard-working labor force and only moderate levels of inequality.

In addition to these domestic features, a number of international factors were of benefit to the Newly Industrializing Economies (NIEs). As Cold War allies of the United States, they received special

[23] Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton: Princeton University Press, 1995).

treatment in American economic and other policies. National security concerns motivated Taiwan and South Korea, in particular, to place a high priority on rapid economic development. Moreover, as some writers have pointed out, Japanese imperialism had left a legacy of physical infrastructure, an educated population, and effective institutions that favored economic development. Another very important factor was that these economies were able to pursue an export-led growth strategy because of the global free-trade environment.

Despite the importance of East Asia's unique domestic and international circumstances, governments in other parts of the world have looked to this Asian experience for guidance and have sought to incorporate key components of that developmental model into their own strategies. Although many developing economies have been strongly influenced by the neoliberal agenda of export-led growth and structural reforms and have made important market-conforming reforms, many also have tended to be very pragmatic and have not been prepared to adopt completely the neoliberal emphasis on open markets and noninterference in the economy by the state. Also, they continue to be wary of what Stephan Haggard calls "deep integration" in the global economy.[24] As a consequence, industrializing economies and even most developed countries tend to pursue strategies of selective opening to the world economy, in which the state mediates between domestic and international markets and thereby attempts to guide the economy so as to promote the nation's economic and political interests. For example, although Brazil has given up its futile effort to create its own computer industry, it has continued to use protectionist devices to promote the development of a Brazilian automobile industry.

For Latin America and other industrializing countries, the ultimate attractiveness of the theory of the developmental state is that it appears to be the appropriate means for combining economic development with political independence.[25] Economic development and industrialization have never been considered ends in themselves. The ultimate goal of developing economies has always been to achieve economic autonomy and political independence. In a world of highly concentrated market power, states desire to control their national economies as much as possible and do not want their position in the

[24] Stephan Haggard, *Developing Nations and the Politics of Global Integration* (Washington, D.C.: Brookings Institution, 1995).

[25] I am indebted to Peter Kingstone of the University of Vermont for his assistance in my understanding of these matters. A relevant interpretation is Luiz Carlos Bresser Pereira, *Economic Crisis and State Reform in Brazil: Toward a New Interpretation of Latin America* (Boulder, Colo.: Lynne Rienner, 1996).

international division of labor to be determined solely by the free play of market forces.

Despite the strong support in many LDCs for the theory of the developmental state, most neoclassical economists reject it. Paul Krugman, writing in the *Foreign Affairs* journal (1994), attacked the idea that East Asian governments had succeeded because government policies had substantially raised the productivity levels of their economies.[26] Krugman argued that these societies were successful primarily because of their rapid accumulation of capital and labor, the basic factors of production. He further argued that the development experience of these countries supported the neoclassical growth model; there was no "miracle." While there had been a one-time leap forward, future growth would require increased emphasis on innovation and productivity growth, except in China. Whether or not Krugman's critique is correct, these societies should at least be credited for effective mobilization of their human and material resources.

The East Asian Miracle Project

The developmental state interpretation of East Asia's economic success could have remained an academic dissent from the Washington Consensus; however, the Japanese government's agreement with the theory's basic assumption about the important role of the state in economic development gave prominence to the theory.[27] In the 1980s,

[26] Paul R. Krugman, "The Myth of Asia's Miracle," *Foreign Affairs* 73, no. 6 (November/December 1994): 62–78. The emphasis on factor accumulation rather than technological progress was first set forth by Alwyn Young in the *1992 NBER Macroeconomic Annual*. Krugman, drawing upon Young's finding, downplayed the East Asian "miracle." The success of East Asia, he argued, was attributable mainly to capital investment and high population growth rather than to technological innovation and productivity growth. This argument is extended in Alwyn Young, "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," *Quarterly Journal of Economics* 110 (August 1995): 641–80. Other economists have given support to the important role of technological progress in the "miracle." This work is discussed in Robert J. Barro, "The East Asian Tigers Have Plenty to Roar About," *Business Week*, 27 April 1998, 24. A report by the Paris-based Organization for Economic Development supports the Krugman-Young position that these economies suffered from serious weaknesses in technological development, skilled workers, and other technology-related matters. Organization for Economic Development, *Asia and the Global Crisis: The Industrial Dimension* (Paris: Organization for Economic Development, 1999). And thus the argument continues.

[27] The Japanese criticism of the Washington Consensus is set forth in The Overseas Economic Cooperation Fund, *Issues Related to the World Bank's Approach to Structural Adjustment: Proposal from a Major Partner* (October 1991), OECF Occasional Paper No. 1 (unpublished).

the World Bank (WB), having subscribed to the Washington Consensus, rejected what the Japanese believed to be their own superior model of economic development based on the central role of the state in the economy. The Japanese had been especially irked by the WB's *World Development Report 1991*, which praised the neoliberal position and had little good to say about the Japanese model.[28] As John Page, a high World Bank official, had told a Princeton University audience, the Japanese continued to sign the checks, but they felt that the World Bank did not appreciate the reasons for Japan's own outstanding economic success. Japan wanted the bank to pay greater attention to the distinctive features of the East Asian economies. It also wanted greater emphasis in World Bank policy on the important and necessary role of the state in economic development rather than a nearly exclusive emphasis on macroeconomic issues and structural adjustment. Therefore, the Japanese insisted that the World Bank carry out an empirical study to determine the specific reasons for the economic success of the East Asian economies before deciding on policy advice for other developing countries. This Japanese demand generated what became known as the East Asian Miracle Project.

The East Asian Miracle Project was intended not only to meet Japanese concerns but also to review the World Bank's policies toward less developed countries and to evaluate alternative approaches to economic development. John Page, director of the Project, labeled one possible approach "fundamentalism"; that is, the Solow or neoclassical theory of economic growth, which attributes economic growth primarily to "getting the prices right" and to accumulation of the basic factors of production.[29] The alternative approach, pejoratively labeled "mystical" by Page, was based on the theory of endogenous growth set forth by Paul Romer and other economists. This "new growth theory" implied that state interventionism could accelerate the process of economic growth and that, through industrial and other policies, the state could expedite technological innovation and productivity growth. The Project was intended to determine once and for all whether economic growth is better explained by factor accumulation, and thus accords with neoclassical theory and World Bank orthodoxy, or by technological advance and productivity growth, which would be in accord with endogenous growth theory and the idea of the "developmental state."

[28] World Bank, *The Challenge of Development: World Development Report 1991* (Washington, D.C.: World Bank, 1991).

[29] As the reader will recall, according to this theory technological change and productivity growth are exogenous and the role of the state in economic growth is negligible.

The Project concentrated on the East Asian NIEs and their unique development experience. Economic growth in these economies had been rapid and persistent; moreover, the benefits of economic development had been broadly distributed throughout the societies. The study looked for answers to particular questions: What did the process of economic development actually look like in these economies? What, if anything, did the industrial and other economic policies of various governments contribute to the process of economic growth? And, was the experience of the NIEs in any way transferrable to the great majority of less developed countries that were falling farther behind rather than converging as economic theory predicted? Answers to these questions would greatly facilitate World Bank decision-making regarding the economic policies it should pursue in promoting development. Unfortunately, the study and its report did not resolve the issue, at least not to the satisfaction of proponents of alternative explanations of East Asian economic development.

Report on the Project

The *World Development Report*'s main finding was that there had been no East Asian miracle. It concluded, instead, that the outstanding success of the East Asian NIEs was due to the fact that these economies had pursued market-conforming economic policies and had fostered such economic fundamentals as high rates of savings/investment, education, and prudent macroeconomic policy.[30] These economies were successful because they conformed to the Solow model of economic growth based on factor accumulation. Neither state intervention, technological progress, nor the theory of endogenous growth, the Report concluded, had much to do with the rapid industrialization of these economies. The Report included the following specific conclusions:

(1) The East Asian economies followed prudent macroeconomic policies that kept government deficits down or even reduced accumulated deficits, kept inflation low, and held foreign debt to modest levels. Pursuing market-conforming economic policies and minimizing price distortions, they got prices right by allowing domestic prices to fall into line with international prices, thereby encouraging industries with a natural comparative advantage to flourish.

[30] World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993).

(2) They maintained higher levels of savings and investment and had harder working and more skilled workers than did other LDCs. For example, 7 to 10 percent of Gross Domestic Product (GDP) went into investment; this high rate of investment greatly facilitated rapid capital accumulation.
(3) The export push or export-led growth strategy of these economies was another reason for their success. Focus on foreign markets promoted economic efficiency by keeping domestic prices closely in line with international prices and also accelerated introduction of foreign technologies; this then facilitated increased productivity.

The Report was very critical of the "mystics," the theory of endogenous growth, and the idea of the developmental state. Although it acknowledged that industrial policy and other forms of state intervention might indeed have assisted the process of economic development, its message was quite negative about the efficacy of state intervention. The Report reached the following conclusions about the developmental state:

(1) Industrial policies to promote particular sectors, to determine the structure of the economy, and thereby to accelerate development and productivity growth failed to explain the region's rapid growth. State intervention was ineffective at best and counter–productive at worst. The major source of economic growth was capital accumulation, which accounted for 60 to 70 percent of the growth, whereas productivity growth—technological input—accounted for only about 30 percent of economic growth.
(2) Even without public-sector intervention, market forces by themselves would have brought about the changes in industrial structure that were encouraged by governments.
(3) Government controls of financial markets, the Report did point out, had lowered the cost of capital and directed credit to favored sectors. In light of the crisis of 1997, it is ironic that the Report had praised governments' interventions in financial markets.

The *World Development Report*, based on such findings, described the theory or model of economic growth it used to explain East Asian economic success as functionalist and concluded that a developing country would be successful if it carried out specific mutually reinforcing functions. The country had to find a way to rapidly accumulate such assets as human capital and capital investments. It had to allocate resources efficiently. And the country also had to achieve

rapid productivity growth by catching up technologically with advanced countries. Although the Report gave some credit to effective state intervention in the economy, this was played down due to concern that LDCs with less competent and/or more corrupt governments might attempt to use the Report to defend undesirable interventionist policies. Ironically, this project that began as an attempt by the Japanese to support their heterodox concept of an Asian model of economic development had been transformed into a defense of neoliberal orthodoxy and was hailed as a decisive vindication of neoliberal emphasis on the central role of the market in economic development.

Criticisms of the Report

Release of the *World Development Report 1991* precipitated debate between its supporters and its critics.[31] Although some neoclassical economists believed that the Report had erred in giving even minimal credit to East Asian governments for promoting rapid economic development, the most severe critics were proponents of the developmental state who fiercely denounced it as blatantly ideological, representative of the laissez-faire position of the United States and the interests of private capital, and as an effort to assuage growing Western fears of competition from the rapidly industrializing countries of East Asia. The following criticisms of the Report are especially noteworthy.

The Report's emphasis on fundamentals suggests that economic growth is a fairly straightforward process of factor accumulation through private domestic investment, education, and exports. Such a view is contradicted by the emphasis in the new-growth models on the importance in the developmental process of imperfect information, increasing returns, multiple equilibria, path dependence, self-reinforcing mechanisms, historical lock-ins, and other dynamic properties. Critics argue strongly that growth processes are so complex that there can be no single explanation and that therefore the Report's considerable emphasis on factor accumulation was inappropriate.

Furthermore, the Report's assumption that one can disentangle macro basics or fundamentals—investment, education, exports—

[31] Excellent evaluations of the Report are Albert Fishlow, Catherine Gwin, Stephan Haggard, Dani Rodrik, and Robert Wade, *Miracle or Design? Lessons from the East Asian Experience*, Policy Essay no. 11 (Washington, D.C.: Overseas Development Council, 1994); and Robert Wade, "Japan, the World Bank, and the Art of Paradigm Maintenance: The East Asian Miracle in Political Perspective," *New Left Review* 217 (May/June 1996): 3–36.

from their micro foundations, or supporting sociopolitical institutions, is deeply flawed. Critics charge that fundamentals and institutions cannot be separated from one another; a high savings rate does not just happen but is the result of government policies and financial institutions. When one factors in domestic policies and institutions, the growth process becomes as complex as the new growth models suggest.

The authors of the Report deliberately played down their own findings regarding the important role of the state and of industrial policies in expediting rapid industrialization, and they also neglected the crucial importance of public financial institutions in mobilizing savings, evaluating projects, managing risk, monitoring managers, and facilitating transactions. For example, although the Report acknowledged that the most successful interventions by the state were the generous subsidies provided for manufactured exports, critics of the Report charge that this important point was not accorded appropriate weight in the overall assessment of industrial policy. In fact, many of the "market-friendly" policies praised by the Report, such as export contests, are actually examples of successful industrial policy.[32] According to Report critics, these contests proved a very effective method for the state to "pick winners" and thus to accelerate economic development.

Moral of the Tale

A close reading of the *World Development Report 1991* brings to mind the sage advice to literary critics set forth by D. H. Lawrence in his *Studies in Classic American Literature* (1964).[33] The critic, Lawrence admonished, should always contrast the author's proclaimed moral with the moral of the tale itself, as derived from a close reading of what the author had actually written. The proclaimed moral of the Report is that state interventionism did not work; however, this moral is contradicted over and over again as the Report describes the successful policies actually followed by East Asian gov-

[32] Under the terms of these contests, the government set forth certain conditions under which private firms competed for a valuable asset controlled by the government, such as access to easy credit or foreign exchange. The contest was organized so that the companies most likely to make successful use of the resource would win. Thus, an important criterion of success was export penetration of foreign markets. The state, it should be added, also protected these sectors from imports and foreign direct investment.

[33] D. H. Lawrence, *Studies in Classic American Literature* (New York: Viking, 1964).

ernments. The Report's own assessment of the results strongly suggests that state intervention and industrial policy were indeed vital factors in the economic success of the East Asian economies. And there was a particularly excellent example of this in South Korea's export contests.

However, the most basic weakness of the Report is its assumption that one can disentangle economic fundamentals—investment, education, exports—from government development strategies and the overall society in which an economy is embedded. The Report assumes that markets already exist and that economic development takes place in an economic and social vacuum. This approach totally neglects the national system of political economy—ideology, public institutions, and private business practices—that nurtures, facilitates, or frustrates the efficacy of markets. Although there is no single East Asian model, the countries' economic and political institutions have set the East Asian economies apart and produced their economic fundamentals. Would or could the economic fundamentals in East Asia have been put into place if there had been no developmental state or certain sociopolitical institutions? That is unlikely! The economic fundamentals and the developmental state are closely interrelated. Recognizing that the state and the fundamentals are integrated with one another and that economic fundamentals are anchored in their institutional context really supports the new growth theory. It is clear that understanding economic development requires greater knowledge of a society's economic and political system than the Report indicates. Although the fundamentals provide the sufficient causes of successful economic development, a well-functioning state is the necessary cause; without an effective state, the fundamentals would not even exist.

The Report erred by separating national economic policies from the fundamentals of these economies. In these societies, the state played a crucial role in accumulation of the factors emphasized by neoclassical economists. The high savings rate, the skilled and disciplined workforce, and large investments in education were all promoted by the state and did not just happen in response to the invisible hand of the market. Moreover, the Report relies excessively on Solow-type capital accumulation and ignores the importance of technological innovation and productivity growth. Despite the argument put forth by some prominent economists, the rapid and successful industrialization of these economies was due to both factor accumulation and technological progress. And both capital accumulation and productivity gains, at least indirectly, resulted from effective government policies.

This interpretation of the important part played by the developmental state in the East Asian Miracle Project is supported in part by Paul Krugman's qualified vindication of the insights of early postwar development economics. "High development theory," Krugman points out in *Development, Geography, and Economic Theory* (1995), was essentially correct in its emphasis on "strategic complementarity" with respect to investment and the problem of coordination.[34] Early development economists recognized the need for coordinated investment to assure individual firms that other firms would make complementary or supportive investments. The less developed countries, economic development theorists believed, are at a decided disadvantage in their attempts to develop in the world of the strong. How could these impoverished nations possibly develop industries capable of competing in world markets against such strongly established firms as Mitsubishi and General Motors!

Krugman argues that economies of scale and imperfect competition were missing from development theory and that without these two central ideas, the theory and policies for economic development could not be sustained. Development theorists did recognize the need for economies of scale at the plant level to give the less developed economy the comparative advantage it needed for economic development and international competitiveness. However, these theorists ignored the importance of scale economies and of imperfect competition at the national level.[35] Development requires promoting strategic complementarity through investment decisions, supporting domestic firms until they achieve scale economies in their production, and breaking the vicious cycle of poverty in which the LDCs have been trapped. These tasks in turn require the guiding hand of a strong state. Economic development cannot be left to the market alone. The state must play the key role in starting and managing the process of economic development. Solow himself has written that neoclassical growth theory tells us what determines the rate of economic growth, but Solow does not tell us what gets growth started in the first place.[36]

[34] Paul R. Krugman, *Development, Geography, and Economic Theory* (Cambridge: MIT Press, 1995).

[35] Economists identify two types of economies of scale: internal and external. The former refers to the expansion of production by an individual firm and the resulting reduction of production costs. The latter refers to expansion of an industry that makes possible greater specialization and other benefits that reduce the costs of the whole industry. David W. Pearce, ed., *The MIT Dictionary of Modern Economics*, 4th ed. (Cambridge: MIT Press, 1992), 12.

[36] Quoted in *IMF Survey*, 16, December 1991, 378.

A few comments are in order about a highly controversial issue in economic development. The initial success of the East Asian economies raised the important but unresolved issue of the relationship between development and democracy. Successive American administrations, following Milton Friedman although not necessarily knowingly, have believed that development and democracy proceed hand in hand.[37] During East Asia's miracle period, conservatives such as Nobel Laureate Gary Becker attributed the outstanding success of the East Asian economies to their "democratic" regimes; subsequently, conservatives blamed the problems following the 1997 financial crisis on the "authoritarian" nature of these political regimes. From the other side of the intellectual/political spectrum, Laureate Amartya Sen also argued that democracy and development complement, or at least should complement, one another.[38] Other scholars are not convinced that there actually is a close connection between democracy and development. Robert Barro believes that the relationship of democracy and development is ambiguous, and political scientist Atul Kohli, after a careful review of the literature, finds the connection equally elusive.[39] A United Nations report released in April 2000 concludes that successful economic development requires "good" government, a quality scarce in too many LDCs.[40]

The East Asian Financial/Economic Crisis

In the summer of 1997, the East Asian economies suffered a severe blow when a serious financial crisis and subsequently a much more general economic crisis brought the East Asian miracle to an abrupt halt. By the summer of 2000, the stricken nations had rapidly recovered from the crisis and its consequences. Nevertheless, it will take many years for the full social and political effects of this economic

[37] Alberto Alesina and Roberto Peroti, "The Political Economy of Growth: A Critical Survey of the Recent Literature," *World Bank Economic Review* 8, no. 3 (1994): 351—71.

[38] Amartya Sen, *Development as Freedom* (New York: Alfred A. Knopf, 1999).

[39] Robert J. Barro, *Getting It Right: Markets and Choices in a Free Society* (Cambridge: MIT Press,1997), 3; and Atul Kohli, "Democracy Amid Economic Orthodoxy: Trends in Developing Countries," *Third World Quarterly* 14, no. 4 (1993): 671–89.

[40] United Nations Development Program, *Overcoming Human Poverty: UNDP Poverty Report 2000*. Included in the Report's definition of good government were free elections, accountable and noncorrupt officials, and ambitious national programs to alleviate poverty. For LDC governments that tend to blame the rich countries for their economic difficulties, the Report was not well received. *New York Times*, 5 April 2000, A11.

disaster to be fully understood. Despite the inconclusive nature of this situation, there has been an acrimonious debate over the explanation and meaning of the crisis. The devastating setback of these miracle economies was immediately seized by many Western economists, public officials, and commentators as a convincing indictment of the developmental state; it is clear, they proclaimed, that the East Asian economies should adopt the neoclassical development model based on free markets and minimal state intervention in the economy. Many defenders of the East Asian developmental state model charged, in turn, that these economies were hapless victims of international financial interests and the reckless policies of the Clinton Administration. They contended that the developmental state model remains the most appropriate model for successful economic development.

According to the prominent Western "crony capitalism" interpretation, the East Asian developmental state contained the seeds of its own destruction. Those characteristics of the Asian model of economic development that have been credited with the extraordinary success of these economies and their rapid industrialization were alleged to be the very ones that led to the financial crisis and to subsequent economic disaster. Critics, who have included high officials in the IMF and the American Treasury, blamed the following "flawed" components of crony capitalism: (1) the intimate ties among local politicians, banks, and industry; (2) bank rather than stock market financing of economic development; and (3) nontransparent (or secret) financial arrangements involving government-favored businesses and banks. This government-manipulated system encouraged questionable overinvestment, especially in particular economic sectors, by appearing to guarantee investors, at least implicitly, that their investments were not at risk. In this way, the developmental state created moral hazard that ultimately led to the crisis.

Proponents of the developmental state reject the above analysis and instead blame the crisis on the pernicious behavior of international financial markets. As had happened many times before, investors became caught up in a frenzy of investment in these "miracle economies." The excitement surrounding the possibility of "easy money" caused investors to throw caution to the winds and ignore such obvious signs of impending trouble as the large number of short-term liabilities that had been assumed by East Asian borrowers. The huge investments in the region, well above rational profit expectations, were driven by the irrational euphoria of international investors. In addition, the premature liberalization of financial markets and capital accounts (freedom of capital movements) in these countries (for

which the United States bears a large responsibility) must be assigned much of the blame. Thus, the crisis was due to the irrational functioning of international financial markets along with certain irresponsible policies of the U.S. Treasury.

And, thus, the controversy over the developmental state continues.

The Future of the Developmental State

It is obviously too early to reach final conclusions regarding the future of the East Asian developmental state and the proper role for the state in the process of economic development.[41] Yet there is strong evidence to support the idea that states must be very involved in economic development. It is worth noting that several months prior to the crisis, the World Bank had devoted its annual *World Development Report 1997* to the crucially important issue of the political prerequisites of successful economic development.[42] In this report, titled *The State in a Changing World,* the World Bank declared that economic development is dependent on a society's getting its *political* as well as its *economic* fundamentals "right." Without the former, such characteristics of the latter as openness to trade and sound macroeconomic policies cannot work because social norms, institutions, and customs determine how economic inputs will be used and whether success will in fact be forthcoming.[43]

The Report rejected the implicit logic of the "retreat-of-the-state" doctrine that the minimal state is the optimal state; a minimal state, the Report pointed out, can do no harm, but a weak state can do no good either. Neither state-dominated nor stateless development constitute the means to successful economic development. Although the Report refused to set forth "a single recipe for state reforms worldwide," it did provide a two-part strategy to forge an effective state capable of supporting rather than distorting economic development: (1) the state must match its activities with its capabilities and not attempt to do too much; and (2) improvement of the state's effec-

[41] Economists tried to assess these matters in the symposium, "The State and Economic Development," *Journal of Economic Perspectives* 4, no. 3 (summer 1990).

[42] World Bank, *World Development Report 1997: The State in a Changing World* (Washington, D.C.: World Bank, 1997).

[43] As Dani Rodrik has argued, contrary to the impression given by some economists, trade by itself will not lead to economic development. Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work* (Washington, D.C.: Overseas Development Council, 1999).

tiveness requires vigorous public institutions and includes "restraints to check corrupt behavior" by public officials.[44]

In the same report, the World Bank recognized that economic development entails much more than solution of technical economic problems and is, at its core, a social and political problem. In its early years, the World Bank had followed the prescriptions of economists that economic development results when crucial economic and technical obstacles have been overcome. During the 1980s, under the reign of neoliberalism and the Washington Consensus, the doctrine of structural adjustment assumed that economic reforms and elimination of state interventionism would release economic forces that would speed development. The Bank and its economists have since learned to appreciate that more than "economic fundamentals" are necessary to achieve economic development.

The *World Development Report 1997* returned to a truth first set forth in 1952 by Moses Abramowitz, a pioneer in the study of economic growth.[45] The fundamental requirement for economic development, Abramowitz wrote, was "social capacity." Economic development is not a technical economic problem involving factor accumulation and getting the "fundamentals right"; it is a social process that cannot be completed unless the state creates economic institutions, fosters social behavior, and pursues policies favorable to economic development. The then-new formal modeling of economic growth, Abramowitz pointed out, deals with the immediate source of economic growth and not with the social and other factors behind the immediate factors. His emphasis on the social and political aspects of economic development suggested that there was no single best way for a society to foster economic development.

At the turn of the century, efforts to understand the task of economic development again emphasized the need for a national development strategy.[46] Official thinking about economic development has,

[44] World Bank, *World Development Report 1997: The State in a Changing World.* A valuable history of the central role of states in economic development is Linda Weiss and John M. Hobson, *States and Economic Development: A Comparative Historical Analysis* (London: Polity Press, 1995).

[45] Abramovitz first set forth his notion of social capacity in *Thinking About Growth and Other Essays on Economic Growth* (Cambridge: Cambridge University Press, 1989); a restatement of his position is "Following and Leading," in Horst Hanusch, ed., *Evolutionary Economics: Applications of Schumpeter's Ideas* (New York: Cambridge University Press, 1988), 339.

[46] Dani Rodrik in his book, *The New Global Economy and Developing Countries*, argues that a country needs a strategy for domestic investment and a sound framework for resolving political conflict. Also, see Rodrik, "Getting Interventions Right: How South Korea and Taiwan Grew Rich," *Economic Policy* (April 1995): 55–107.

in fact, passed through several distinct stages. In the 1960s, the World Bank regarded economic development as a matter of solving a number of discrete technical problems regarding efficient use of resources and capital transfers. In the 1970s and early 1980s, emphasis was on trade liberalization and elimination of market dislocations caused by government intervention (structural adjustment). Later in the 1980s, the focus shifted to macroeconomic adjustment intended to eliminate inflation and macroeconomic instability (the Washington Consensus). In the 1990s, the World Bank and many experts began to appreciate that development requires transformation of the society. Joseph Stiglitz, an economist's economist, is purported to have conceded at a meeting that economists are beginning to understand that development is complex and that there is more to development than trade liberalization and macroeconomic adjustment. Similar lessons are applicable to the problems facing transitional economies.

Transitional Economies

The transition of the former command or communist economies of China, the Soviet bloc, and elsewhere to democratic, market-based societies is one of the most important issues of the post–Cold War era. I use the term "transition" advisedly. As Stephen Holmes has pointed out, transition suggests that these economies are on a known and predictable trajectory from communism to democratic capitalism.[47] The truth is that no one really knows what economic, political, and other factors led to the overthrow of communism, and even less is known about the forces at work in these "postcommunist societies" or about the direction in which economic and political forces are propelling them. Theories and speculations of various kinds abound as scholars, intellectuals, and public officials attempt to provide an overall explanation of this extraordinary and historically unprecedented situation. Yet, as Holmes suggests, no guidelines can help us to determine where these unfortunate postcommunist societies are heading: democracy, fascism, or even a return to communism. Nevertheless, despite its misleading implications, I shall follow convention and use the term "transitional societies."

The mere size of the transition problem is overwhelming. The magnitude and diversity of the swath of countries from the Baltic to the Balkans and from Eastern Europe across the steppes of central Asia to the Pacific Ocean defy comprehension. The twenty-seven or more

[47] Stephen Holmes, "Cultural Legacies or State Collapse? Probing the Postcommunist Dilemma," in Michael Mandelbaum, ed., *Postcommunism: Four Perspectives* (New York: Council on Foreign Relations, 1996), 22–76.

countries involved (excluding China) contain more than 400 million people. Many of these countries are mired in economic and political chaos with declining economies and corrupt governments. The end of communism has taken many different forms, and each different form strongly influences the path of the transition. Also, consideration of the transition issue is greatly compounded by the fact that individual countries are in very different economic and political situations. At one end of the spectrum is Russia, which has sought to create simultaneously both a democratic and a market economy. At the other end is China, where an effort is being made to combine a highly authoritarian political regime with a market-type economy. In between these extremes are numerous unfortunate countries with a host of social, economic, and political problems.

There is no historical experience on which one can draw for insights, nor are there economic, political, or other social theories on which one may rely for guidance, and economics has failed miserably as a guide. The transition problem is novel in the sense that the world has never before experienced the transition from one type of highly industrialized economy to a different type of highly industrialized economy. Although the rise of capitalism in the modern period provides some lessons, such as the need for an entrepreneurial class and a nonoppressive state, the implications of these lessons for a developed economy in transition are not clear. The former communist countries must first tear down corrupt and inefficient structures before they can begin to build new, effective, and publicly responsible economic and political institutions. Therefore, this discussion of the transitional economies must be sketchy as well as tentative.

Transition Theories

Following the collapse of communism, every formerly communist country in East Europe, including Russia, suffered severe recession, deindustrialization, and economic chaos; by one estimate, recession reduced by one-quarter the national product of Eastern Europe.[48] These economic troubles set back reform and, in some cases, resulted in a retrenchment of the reform effort. More generally, recession and its aftermath had a profound negative impact. Reform has been recognized as much more complicated and difficult than most econo-

[48] Kazimierz Z. Poznanski, "The Post-Communist Transition as an Institutional Disintegration: Explaining the Regional Economic Recession" (unpublished and undated); Janos Kornai, "Transformational Recession: Main Causes," *Journal of Comparative Economics* 19, no. 1 (August 1994), 39–63.

mists, public officials, and others had anticipated.[49] Scholars and others have set forth different explanations of what went wrong. One explanation is based on the doctrine of neoliberalism, another is the theory of cultural legacy, and yet another emphasizes the crisis of governance. Although each of these theories provides insights into the nature of postcommunist societies, the third is the most compelling explanation.

The neoliberal convergence explanation is strongly influenced by the neoliberal ideas and perspective on structural adjustment and includes a minimal role for the state in the economy and heavy reliance on the market.[50] According to this position, the postcommunist recession was an inevitable consequence of the transition from a command to a free market economy. In a communist-type economy, a number of serious hidden problems exist that only become known following the collapse of communism. For example, a major aspect of the transition problem is "unwanted production." Under a planned economy, firms produce a large number of goods that consumers are not interested in buying. The shift from a seller-oriented economy to a buyer-oriented, or market, economy takes time, and not enough time has yet elapsed to solve the resultant problems. For example, it takes time to create the type of middle class essential to the functioning of a market-type economy. It is the nature of reforms, this position argues, that matters get worse before they get better.

According to the cultural legacy explanation, the bad habits and mentalities of the past change slowly. Communism created passive and dependent peoples. Communist culture molded societies characterized by duplicity, disinformation, extreme self-interest, reliance on personal connections, and avoidance of any responsibility for one's actions. In addition, the triumph of communism suppressed issues, traditions, and problems that resurfaced when communism disappeared and that have made the transition process more difficult. Among these vestiges from the past, the revival of nationalism and ethnic conflict has proved particularly important. The collapse of Yugoslavia into internecine war exemplifies dramatically just how extreme the possible problems can be.

The most valuable explanation for the severe problems of the post-

[49] Joseph Stiglitz, "Quis Custodiet Ipsos Custodes?" *Challenge* 42, no. 6 (November/December 1999): 26–67.

[50] A powerful critique of this position is in Alice H. Amsden, Jacek Kochanowicz, and Lance Taylor, *The Market Meets Its Match: Restructuring the Economies of Eastern Europe* (Cambridge: Harvard University Press, 1994).

communist countries is the crisis-of-governance explanation.[51] For a number of reasons, the political elites of Eastern Europe engineered the collapse of the state as rapidly as possible and before society was ready for such drastic change. There had been uncritical acceptance of the neoliberal doctrine of the minimal state, and the important functions of the state in democratic market-oriented societies were not really understood. Another reason for abandoning the state as quickly as possible was the intense fear of a communist resurgence; elimination of the state bureaucratic apparatus would make a return to power by the communists much more difficult. Another cause of the collapse of the state was the extraordinarily rapacious and corrupt behavior of public officials. These officials had an interest in elimination of the state, and through one means or another they and their allies, including criminal elements in Russia, grabbed state assets for self-enrichment. Political elites in most postcommunist societies forsook the commonweal for short-term private advantage.

The Transition Record

Application of the three transition explanations to the experience of postcommunist society supports the crisis of governability or collapse-of-the-state explanation. In general terms, the transition problem involves implementation of several complex and difficult tasks. New public institutions must be established and old institutional structures, reformed or eliminated, while rules and regulations required for a market-type economy must be established. Privatization of state-owned economic sectors and change of ownership of the means of production from public to private owners must be accomplished. The inefficient state-managed economic structure must be liquidated, and privately owned firms that can adapt to a market-type economy must be installed. Marketization must also be implemented; the command or plan system of communism must be replaced by the price mechanism, in which economic decisions and the direction of the economy are determined by the response of individuals and firms to changes in relative prices. Beyond these economic reforms is the far more demanding challenge of creating a new civic culture of public virtue as well as a national sense of social responsibility. Without such a moral or psychological change in the sentiments of the people,

[51] See Holmes, "Cultural Legacies or State Collapse?", p. 50. Holmes's position is supported by Andrei Shleifer and Daniel Treisman, *Without a Map: Political Reform in Russia* (Cambridge: MIT Press, 2000).

the goal of a successful transition to a democratic capitalist system will never be achieved.

Institutional Reform. The experience of institutional reform has differed greatly across Eastern Europe. At one extreme is Poland, which has moved slowly but has implemented a number of important reforms; at the other is Bulgaria, which has made few efforts to transform its economy. However, the task of institutional reform everywhere has been strongly influenced by neoliberalism and its emphasis on the market. It is not excessive to state that the guiding idea of transition was that private enterprises were considered to be key agents of economic and political change in Eastern Europe and other former communist countries. Institutional transformation was believed to entail the simple substitution of the market for the state. The market in turn would lead to creation of impersonal public institutions and a civic culture required for the proper functioning of a market economy.

The collapse-of-the-state position, however, argues that the reformers eliminated a state apparatus that was necessary for managing the economy and did not replace it with public and private institutions required for an effective market-managed economy. The greater the reform or "state withdrawal" (e.g., in Russia and East Germany), the greater the depth of the postcommunist crisis. According to this position, it was essential that the state manage the transition from communism and make a market economy work. An effective and accountable state must elicit voluntary cooperation from its citizenry if it is to solve collective problems. It must also rebuild the infrastructure of the society laid waste by communism: education, the judicial system, and institutions concerned with energy, banking, health, and other necessities. State policy must establish the rules governing the market economy and guaranteeing private property rights; policies should be fair and consistent. The neoliberal-inspired transition process produced many corrupt and ineffective states. Without an effective and responsible state, successful transition could not take place.

Privatization. The purpose of privatization in Eastern Europe was to transfer state-owned property to the private sector. For reasons that I have already discussed, selling-off of state assets was carried out as rapidly as possible and with many disastrous consequences. In a number of countries there was a rush to create an indigenous middle class that would ensure political stability and strongly resist the return of communism. However, the various types of privatization schemes,

such as property vouchers and sales to workers, were abject failures or at least resulted in very serious problems.[52] In many countries, state property was "sold" to former communists, corrupt public officials, and political favorites at very low prices; privatization in Russia even spawned a powerful criminal class. Although it is too soon to make a definitive judgment on privatization, at least one can say that it failed to create the strong middle class desired by many reformers. It also constituted one of the most significant redistributions of wealth in world history.

In addition to the speed of privatization and prevalence of corruption as obstacles to successful privatization were a low level of savings and serious troubles within the banking systems. Reforms had weakened the financial position of local firms and of the banking systems; many countries suffered from a liquidity crisis, and potential investors in these countries lacked sufficient capital to purchase those businesses and factories put up for quick sale. As a consequence, foreign firms, especially German, purchased a substantial portion of the assets sold. The resulting level of foreign ownership is quite high, particularly in Poland, the Czech Republic, and Hungary; few countries have so many business enterprises and important industries in foreign hands. Kazimierz Poznanski has estimated, for example, that 70 percent of Hungarian industry and banking are foreign-owned.[53] This situation has both benefits and possible costs for the host societies. On the one hand, foreign ownership has meant a rapid inflow of needed capital, technology, and know-how. On the other, it has fostered a highly oligopolistic economic structure that could result in exploitation, and it raises the fear of being drawn into a German sphere of economic domination.

Marketization. The principal goal of transition is to change from a command to a market system based on the price mechanism. This important structural change entails "a move from a sellers' to a buyers' market" and "enforcing a hard budget constraint" through privatization and elimination of such government support mechanisms as subsidies to favored enterprises.[54] Such reforms constituted, according to the neoliberal agenda, incentives to encourage profit-maximizing market behavior by all economic actors. Incentives would lead to a

[52] The various methods to privatize the economy are briefly discussed in Oleh Harvylyshyn and Donal McGettigan, *Privatization in Transition Countries: Lessons of the First Decade* (Washington, D.C.: International Monetary Fund, 1999), 7–9.

[53] Poznanski, "The Post-Communist Transition."

[54] Harvylyshyn and McGettigan, *Privatization in Transition Countries*, 2.

shift from old to new and more efficient economic activities and to restructuring (labor rationalization, new product lines, etc.) of those firms not eliminated by the shift to a market-based system based on private enterprise. Released economic forces would then transform postcommunist economies to market-type economies.

The necessary conditions for marketization have not been fully achieved. The rules, laws, and regulations necessary to a well-functioning market economy have been put in place only partially. Privatization has been very uneven throughout the region and has been distorted by corrupt behavior in many instances. Many government support mechanisms are still in place, and backtracking on privatization has appeared in response to public protests. A large part of economic activity is, in fact, still in state hands. In addition, withdrawal of financial support and protection through elimination of state subsidies and drastic lowering of trade barriers ruined many enterprises and set back the process of marketization. The overall impact of these developments has been extraordinarily harmful. In effect, partial and uneven reform has created what Joel Hellman has called a "winner take all" politics.[55] The beneficiaries of partial reform who were able to take advantage of the absence of a competent, honest state and to profit from the spoils of privatization have become powerful opponents of further economic reform. This situation in some countries has resulted in a new class structure of winners and losers that could make further reform much more difficult.

The postcommunist experience has taught that creation of an effective market economy requires a state with the power to establish and enforce the rules of the market. In some countries, especially Poland and Hungary, considerable progress toward a market economy based on private enterprise and impersonal rules has been made. Too many postcommunist countries, however, have failed to create a civic culture based on mutual trust and public responsibility, a culture that can support a market-type economy. It is illusory to speak of a transition because it is anyone's guess where these postcommunist countries are really heading.

Conclusion

As this is written in the year 2000, the international community has not yet come to terms with the immense problems of economic devel-

[55] Joel S. Hellman,"Winner Take All:The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50, no. 2 (January 1998).

opment. Whether or not a development regime is a possible or appropriate solution may be moot. In an era of neoliberalism with stress on the free market, a development regime is out of the question. On the other hand, free trade and economic openness do not by themselves constitute an adequate solution to the problem of underdevelopment or to the problems of the transition economies. A compromise must be found somewhere between the two extremes of abandonment of neoliberalism and total reliance on the market. Jeffrey Sachs has made an important start in this direction with his argument that the long-term solution to LDC problems will require that the fundamental problems that they face be solved by the international community: tropical and arid agriculture must be improved (a similar point was made long ago by Arthur Lewis), science and technology must be mobilized for development purposes, and major problems of environmental degradation and public health (HIV, malaria, and other tropical diseases) must be reduced or, better, eliminated.[56] Solving such problems would benefit rich and poor alike.

[56] "Sachs on Development," *The Economist,* 14 August 1999, 17–20.