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Rethinking the Role of the State in Economic Development

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Swing from liberalism to state interventionism I

- The laissez faire policies of classical liberalism that dominated much of the world in the late 19^{th} and the early 20^{th} century gave way to a more interventionist approach since the 1930s.

- The 1930s and the 1940s witnessed the successes of the Soviet planning, the New Deal, the Latin American ISI (import substitution industrialisation), and wartime planning in the US and Britain.

Swing from liberalism to state interventionism II

- Between the end of WWII and the mid-1970s, this trend was further strengthened.

- The spread of socialism

- In the rich capitalist world, there emerged a consensus on the need for the state to take an active role, under the slogan of the 'mixed economy'.

- In the developing world, newly-independent countries of Asia and Africa joined the Latin American countries in rejecting free-trade, free-market policies that had been imposed on them by the former colonial masters and adopted what may be called the state-led industrialisation (SLI) model.

Theoretical arguments for SLI

- Traditional infant industry argument
- The ‘late development’ thesis of Alexander Gerschenkron
- Various Neoclassical theories of market failure, especially those related to knowledge as a ‘public good’ (e.g., R&D) and the capital market failure
- ‘Interdependence’ arguments: Big Push (Rosenstein-Rodan, Nurkse, Scitovsky), Linkages (Hirschman)

Policy Package for State-led industrialization (SLI), a.k.a., Import-substitution industrialization (ISI)

The policy package typically consisted of:

- Economic planning (of various details and effectiveness)
- State-ownership of key industries (especially but not exclusively heavy industries, utilities, infrastructure) and banking
- Import protection (tariffs, quotas, bans)
- Restrictions on foreign investment (usually portfolio investments were banned, while conditions were attached to direct investments, such as local contents, technology transfer, export)
- State control over foreign exchanges
- Industrial licensing
- Control over technology imports

The Rise of Neo-liberalism: Reasons

- The results of SLI in many countries were deemed disappointing.

- The success of the East Asian countries in economic growth and export was hailed as proving the superiority of liberal policies like free trade, courting of foreign direct investments (FDI), and conservative macro-economic policies (tight monetary and fiscal policies).

- New theories criticising the interventionist arguments emerged.

  – 'Get the prices right' argument (re-assertion of Neoclassical theory of comparative advantage)

  – 'Government failure' argument (informational asymmetry, low bureaucratic capability, interest group politics, corruption, rent-seeking)

Neo-liberal Policy Package

- Trade liberalisation
- Privatisation of state-owned enterprises (SOEs)
- Abolition of entry regulation and licensing in domestic markets
- Deregulation of FDI
- Financial market deregulation and, hopefully, capital account liberalisation
- Strict inflation control (Stanley Fischer, the former chief economist of the IMF, recommended target rates of 1-3%) through tight monetary policy (high interest rates) and tight budgetary policy

Problems of Neo-liberal Diagnosis I

The ‘failures’ of SLI were exaggerated

- During the ISI period (1960-80), the developing countries grew faster than they did under laissez-faire policies during colonialism and ‘unequal treaties’.

- At about 3% per year in per capita terms, they grew nearly as fast as the rich countries (3.2%)

- More importantly, they grew at more than twice the rate that the rich countries did during the Industrial Revolution (1-1.5% per capita per year)

- At 1.6% per capita per year, even the SSA (Sub-Saharan Africa), the worst performing region during this period, grew faster than the rich countries during the Industrial Revolution.

Problems of Neo-liberal Diagnosis II-1

The East Asian success was misrepresented: 1

- The East Asian success in export was crucial
  - It allowed them to buy better technologies
  - It exposed them to higher quality standards
  - It made their balance of payments problems manageable
- However, their export successes were not due to liberal policies.
  - Export was highly subsidised.
  - More importantly, continued export growth was possible only because of active industrial policy, continuously producing new generation of export industries through the protection and promotion of infant industries (Korea: fish and wigs – garment, textile, cheap electronics – steel, ships – cars, advanced electronics).

Problems of Neo-liberal Diagnosis II-2

The East Asian success was misrepresented: 2

- SOEs extensively used in Singapore (22% of GDP) and Taiwan (16%).
  - Korea also had some spectacular success stories with SOEs (e.g., POSCO), although Japan did not use SOEs very much after WWII.
- FDI was strictly regulated (Japan, Korea, Taiwan) or welcomed but with the use of active industrial policy (Singapore; also today's China).

Problems of Neo-liberal Diagnosis II-3

The East Asian success was misrepresented: 3

- Fiscal policy was conservative, but monetary policy was quite loose, especially in Korea.
  - As a result, inflation was quite high, resulting in negative or very low positive real interest rates – especially in Korea, annual inflation was nearly 20% during 1960-80.
  - Despite this, savings kept rising, because growth was fast.
- The central bank and the government made it sure that increased liquidity went into investments rather than consumption through ‘directed credit programmes’, tax incentives (e.g., accelerated depreciation), and ban on the imports of luxury goods

Problems of Neo-liberal Diagnosis III-1

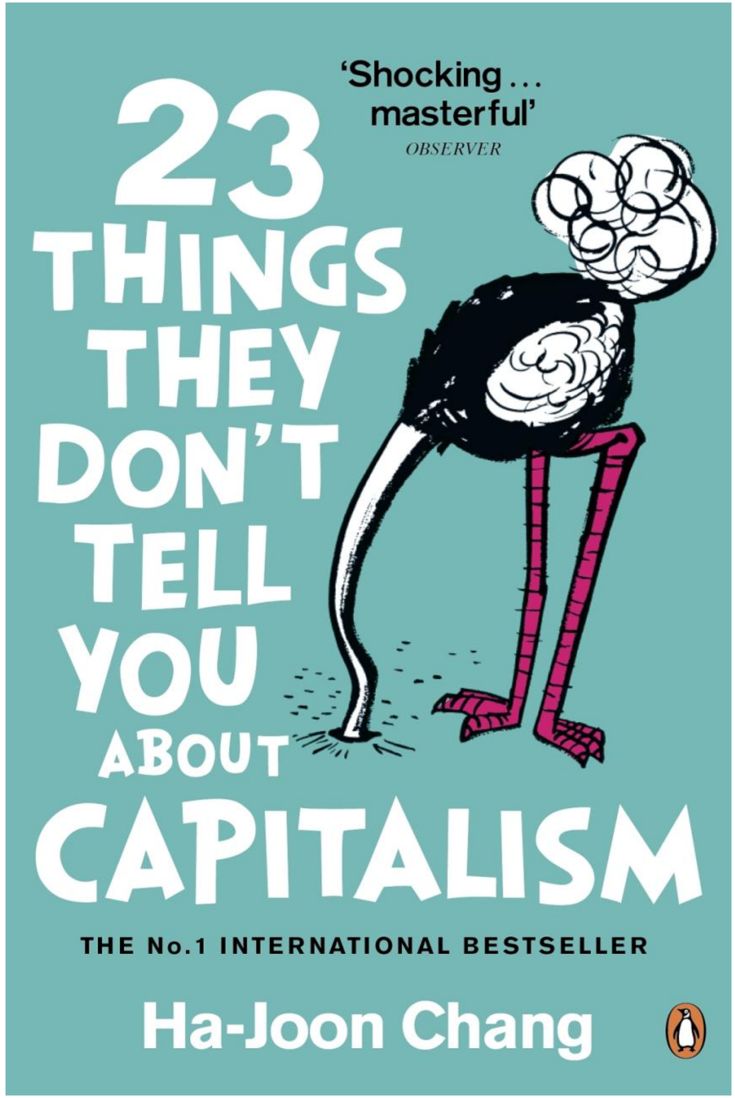
Criticism of the 'Get the prices right' argument: 1

- What the right prices are depends on your economic theory.
  - If you subscribed to infant industry argument, the capital market failure argument, and other interventionist theories that justified the SLI, the prices given by 'free markets' are actually 'wrong' prices (Alice Amsden "Korea developed by getting the prices wrong")

Problems of Neo-liberal Diagnosis III-1

Criticism of the ‘Get the prices right’ argument: 2

- Even if you believed that ‘free markets’ give you the right prices, it is ultimately impossible to define what a ‘free market’ is.
  - Slavery in the 19th century US
  - Sanitary conditions imposed by the rich countries today
- In other words, like beauty, the freedom of a market is in the eyes of a beholder.
- “The American system of free enterprise rests on the conviction that the federal government should interfere in the market only when necessary” (George W. Bush, announcing the $700 billion TARP, or Troubled Asset Relief Program, in September 2008).
- That is, the ‘free market’ is fundamentally an ethical and political definition.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Problems of Neo-liberal Diagnosis III-1

Criticism of the ‘Get the prices right’ argument: 3

- Even accepting that the ‘right’ prices are given by the most deregulated markets, ‘get the prices right’ argument is a static argument about the allocation of current resources, rather than a dynamic argument about economic growth.
  - Even as Anne Krueger admits, there is nothing in standard Neoclassical economic theory that allows us to say that a more deregulated economy will grow faster.
- Indeed, in East Asia, at any given point of time, resource allocation was not ‘efficient’ because numerous monopolies, oligopolies, and government-sanctioned cartels existed.
  - Despite this, the economy grew fast, because these firms were engaged in intense competition amongst themselves, as well as with competitors in the export market, in terms of innovation and quality improvements.

Problems of Neo-liberal Diagnosis III-2

Criticism of the 'government failure' argument: 1

- "Given the information problem, the state cannot "beat the market".
  - However, quite a few examples in which government officials made decisions that blatantly went against market signals, only to build some of the most successful businesses in history (e.g., Japanese auto industry, POSCO, EMBRAER).
- Moreover, in order to explain these success cases, we do not *need* to assume that government officials are cleverer than capitalists.
  - Many of the "superior" decisions by the state were made *not* because the government officials were superior *but* because they looked at things from a national and long-term, rather than a sectional and short-term, point of view.

Problems of Neo-liberal Diagnosis III-2

Criticism of the ‘government failure’ argument: 2

- “Political economy problems of state intervention”
  - Leadership commitment to economic development,
  - The coherence of the state machinery
  - The state’s ability to discipline the recipients of its supports
- However, we should not let the best to be the enemy of the good.
  - If we wait for the perfect state to emerge, we will never get anything done.
  - In the real world, successful countries are the ones that have managed to find “good enough” solutions to their political economy problems and went on to implement policies.

Problems of Neo-liberal Diagnosis III-2

Criticism of the ‘government failure’ argument: 3

- “Developing countries lack bureaucratic capabilities”.
  - The East Asian cases as the counter-examples
- At one level, it is a sensible point, but it is often exaggerated into the policy-world equivalent of “do not try this at home” warning that they show on TV when they show dangerous stunts.
- However, quality of bureaucracy in Korea and Taiwan not very high until the 1960s.
- Of course, these countries improved the quality of their bureaucracy through investment in training and organizational reforms
  - Their examples actually show how quickly bureaucratic capabilities can be built, if there is a political will.

Disappointing results of neo-liberal policies I

- The rich countries grew at 3.2% in per capita terms during the 'mixed economy' period between 1960 and 1980.

- In the next 30 years of neo-liberalism (1980-2010), they grew at 1.7%.

- In the 'bad old days' of SLI, during the 1960s and the 1970s, per capita income in the developing countries grew at about 3% per annum during this period.

- In contrast, their per capita income grew at around 1.8% during the height of neo-liberalism between 1980 and 2000.

Disappointing results of neo-liberal policies II

- There was a growth pick-up in the 2000s in the developing countries, so the growth rate for the period between 1980 and 2010 was 2.9%

- But this was largely due to the growth of China and India, which did not fully adopt neo-liberal policies.

- Even if we include the 2000s, growth performances of Latin America and Sub-Saharan Africa have been much inferior to what they had in the LSI period.

- In the Latin American case, the growth recovery in the 2000s also owed to the explicit rejection of neo-liberal policies by a number of countries (Argentina, Ecuador, Uruguay, and Venezuela).

Table 1. Per capita GNP Growth Performance of the Developing Countries, 1960-80

	1960-70	1970-80	1960-80
Low-income countries	**1.8**	**1.7**	**1.8**
Sub-Saharan Africa	1.7	0.2	1.0
Asia	1.8	2.0	1.9
Middle-income countries	**3.5**	**3.1**	**3.3**
East Asia and Pacific	4.9	5.7	5.3
Latin America and the	2.9	3.2	3.1
Middle East and North Africa	1.1	3.8	2.5
Sub-Saharan Africa	2.3	1.6	2.0
Southern Europe	5.6	3.2	4.4
All Developing Countries	**3.1**	**2.8**	**3.0**
Industrialised Countries	**3.9**	**2.4**	**3.2**

Table 2. Per capita GDP Growth Rates of the Developing Countries, 1980-2010

	1980-90	1990-2000	2000-10	1980-2010
Developing Countries	**1.5**	**2.0**	**5.1**	**2.9**
East Asia and Pacific	6.4	6.0	8.6	7.0
Europe and Central Asia	1.5	-1.8	5.2	1.6
Latin America and the Caribbean	-0.3	1.7	2.6	1.3
Middle East and North Africa	-1.1	0.8	2.9	0.9
South Asia	3.5	3.7	5.9	4.4
Sub-Saharan Africa	-1.2	-0.2	2.5	0.4
Developed Countries	**2.5**	**1.7**	**0.9**	**1.7**

Dearth of neo-liberal success stories

- Other than Hong Kong (which isn't even a proper city state like Singapore), the only success story is Chile.

- Even in Chile, the real growth spurt came after the late 1980s, when the new democratic government diluted the extreme neo-liberal policies and introduced more pragmatic policies, including subsidies to agricultural research and capital control.

- Moreover, it is not clear whether Chile can sustain its growth and become a truly developed economy with its neo-liberal policy regime

  – Its growth rate (per capita) has fallen from 5.3% in the 1990s to 2.9% in the 2000-10 period (e.g., questions over the environmental sustainability of the salmon industry).

- Another 'poster boy' of neo-liberalism – Mexico after it signed the NAFTA – turns out to be total failure (its per capita income has grown at barely 1% during the last decade).

‘Rediscovery of History’

- An increasing number of research has shown that the rich countries themselves used protectionism, subsidies, state-owned enterprises, regulation of FDI, and many other ‘bad’ policies, when they were developing countries themselves.

  – Paul Bairoch

  – Ha-Joon Chang

  – Kevin O’Rourke

  – Erik Reinert

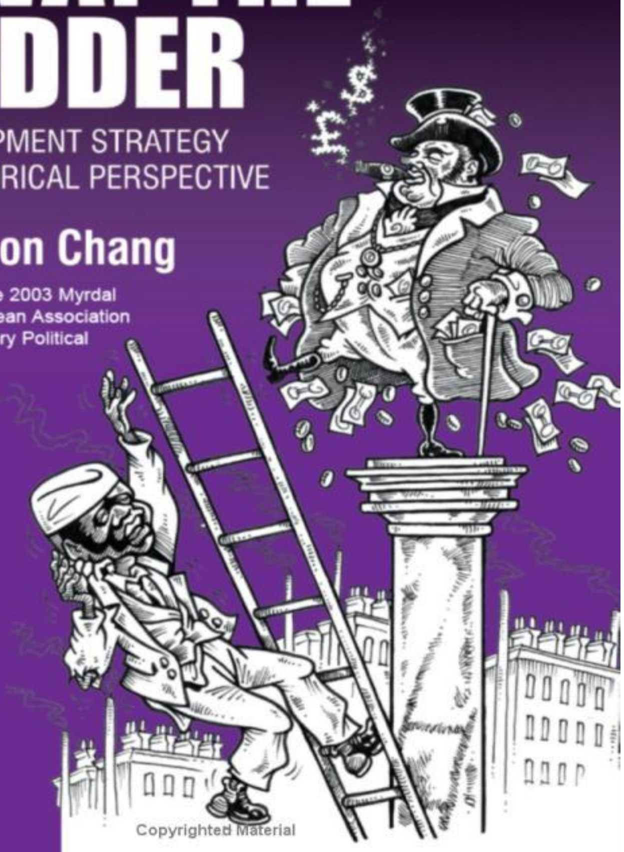
  – And many others

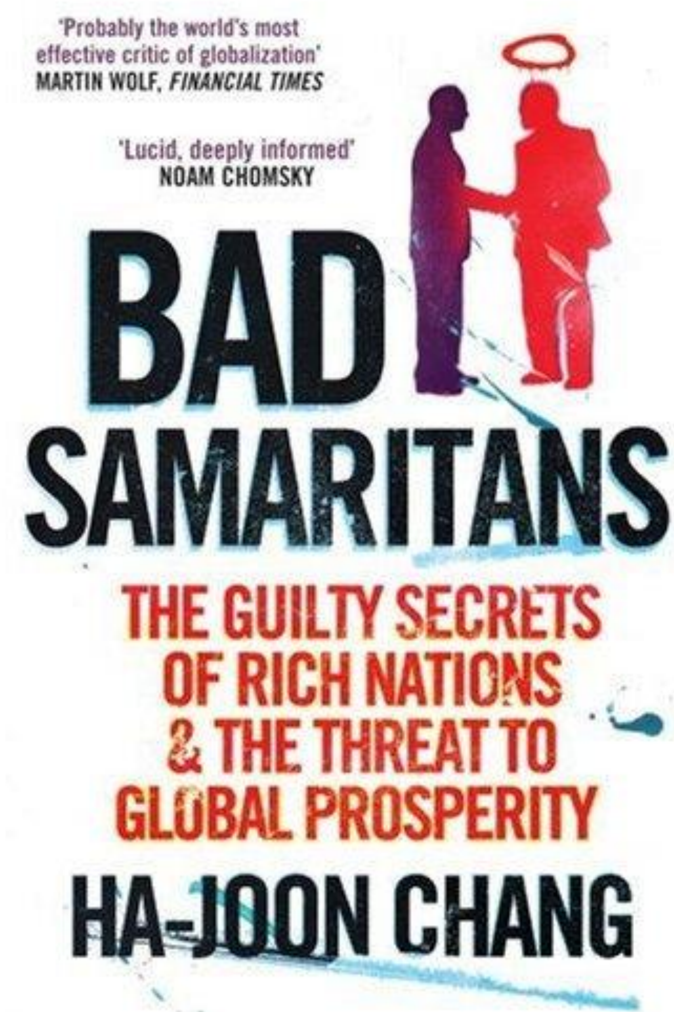
KICKING AWAY THE LADDER

DEVELOPMENT STRATEGY IN HISTORICAL PERSPECTIVE

Ha-Joon Chang

Winner of the 2003 Myrdal Prize, European Association of Evolutionary Political Economy

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Real History of Capitalism - Trade Policy

- All of today's rich countries, except for the
- Netherlands and (pre-WWI) Switzerland used
- Protectionism for substantial periods.
- Britain and USA were the most protectionist
- Economies in the world in their catch-up periods.
- Germany, France, and Japan – the supposed homes of protectionism – were much less protectionist than Britain or the USA.
- Even in the post-WWII period, protection was quite high until the 1960s.

Table 3. Average Tariff Rates on Manufactured Products for Selected Developed Countries in Their Early Stages of Development

(Weighted average; in percentages of value)

	1820	1875	1913	1925	1931	1950
Austria	R	15-20	18	16	24	18
Belgium	6-8	9-10	9	15	14	11
Canada	5	15	n.a.	23	28	17
Denmark	25-35	15-20	14	10	n.a.	3
France	R	12-15	20	21	30	18
Germany	8-12	4-6	13	20	21	26
Italy	n.a.	8-10	18	22	46	25
Japan	R	5	30	n.a.	n.a.	n.a.
Netherlands	6-8	3-5	4	6	n.a.	11
Russia	R	15-20	84	R	R	R
Spain	R	15-20	41	41	63	n.a.
Sweden	R	3-5	20	16	21	9
Switzerland	8-12	4-6	9	14	19	n.a.
U.K	45-55	0	0	5	n.a.	23
U.SA.	35-45	40-50	44	37	48	14

Real History of Capitalism – Regulation of FDI

- US (19th century)
  - Regulated FDI in finance, shipping, mining and logging.
  - Especially in banking; only American citizens could become directors in a national (as opposed to state) bank and foreign shareholders could not vote in AGMs
- Japan (Korea and Taiwan to a lesser extent)
  - Virtually banned foreign direct investment until the 1980s
- Finland
  - Classified all firms with more than 20% foreign ownership as “dangerous enterprises”

Real History of Capitalism - State Ownership

- Important in Germany (textile, steel) and Japan (steel, shipbuilding) in the early days

- Extensively used in France, Finland, Austria, Norway, Taiwan, and Singapore in the post-WWII period

  – Singapore: 22% of GDP (Singapore Airlines and others)

  – Taiwan: 16% of GDP

  – France: Renault, Alcatel, St. Gobain, Usinor, Thomson, Thales, Elf Aquitaine, Rhone-Poulenc

  – Other examples: POSCO (Korea), EMBAER (Brazil)

Real History of Capitalism - Central banking

- In addition to enhancing financial stability and controlling inflation, central banks in today's rich countries played a key role in the economic development of their countries

- Even before WWII, when most of them were private banks with special relationship with the state, they funded the state and lent directly to priority sectors

- After WWII, they were made public institutions and some of them actively engaged in development policy (especially, but not only, in France, Belgium, Italy, Japan, Korea, and Taiwan)

  – Keeping real interests low, to promote investment (for example, -1% in Switzerland to 2.6% in Germany during 1960-73)

  – Lending at favourable rates to, or taking equity stakes in, development banks and special purpose banks (e.g., for agriculture, SMEs, housing)

  – Rediscounting of bills at preferential rates for priority sectors

  – Encouraging lending to priority sectors by setting differential reserve requirements (for assets) and differential credit ceilings (for sectors)

Real History of Capitalism - Agricultural Policy

- Inputs Policy
  - Land (Land tenure reform, Land quality improvement)
  - Knowledge (public research or subsidies to private research, extension services, farmer education, dissemination of information)
  - Credit (rural banks, promotion of credit co-operatives)
  - Physical Inputs (public provision or subsidies to the private provision of irrigation, transport, electricity, seeds, fertilizers, and machinery)
- Outputs Policy
  - Measures to increase farm income stability (price stabilization, crop and livestock insurances, trade protection)
  - Measures to improve marketing and processing

Lesson I-1

There is no dearth of economic theories that justify state intervention, so the real question is the quality of the design and the implementation of actual policies.

- Not just so-called ‘heterodox’ theories.
  - Virtually all types of state intervention can be justified by using the Neoclassical market failure approach.
  - Even the famously anti-interventionist Austrian economic theory can be used to justify certain types of industrial policy, as I have done myself in my previous work.

Lesson I-2

There is no dearth of economic theories that justify state intervention, so the real question is the quality of the design and the implementation of actual policies.

All of this suggests that policy success depends a lot more on detailed policy design and implementation issues, rather than the validity of some abstract economic theory that could be used to justify particular policy.

- In this respect, it is important :
- To have a clear overall strategy (so that we minimise the possibility of someone inventing a clever argument to promote sectional interest over national interest)
- To constantly review policies (to see whether the expected improvement are happening and whether external conditions are changing)

Lesson II

State intervention has always been there all the time, whatever the rhetoric, so the real issue is how to make it work, rather than whether to have it.

In reality, there is no country, perhaps except Hong Kong, that does not have state intervention.

- Even after WWII, the US government has had a vast influence on the evolution of its economy through R&D funding (70% of total R&D at the height of it)
- Computer and the internet (the Pentagon) semiconductor (the US Navy), aircraft (the US air forces), pharmaceutical and bioengineering (the National Institutes of Health)

So, the real question is how to make state intervention work better, not whether we should do it.

Lesson III

There are many different ways to mix state intervention and markets, so it is important to learn lessons from others and also to experiment.

Many different types of capitalism and each type have its strengths and weaknesses.

This means that policy-makers should be open-minded about learning from different ‘models’ and be ready to experiment with their own ‘innovations’.

Lessons IV

In learning and experimenting, policy-makers should remember that life is often stranger than fiction.

Successful countries have succeeded through very ‘unusual’ combinations of policies.

The world is too complex for any single theory, so successful policies are always pragmatic combinations of different theories.

So we need to devise solutions that work, rather than believing in particular theories and trying to find ‘excuses’ when they don’t work in practice (e.g., ‘Africa growth tragedy’ literature).

Lessons V-1

Especially in developing countries, we need to look at capabilities, not just incentives

First, it means that ramping up competition through liberalisation of trade and FDI is not enough for enhancing productivity.

- If the gap between the productive capabilities of the domestic producers and those of foreign producers is too large, those liberalisation measures can wipe out domestic producers, rather than make them shape up.

- This suggests that those policies should be calibrated according to the existing capability gap and gradually introduced.

Lessons V-2

Especially in developing countries, we need to look at capabilities, not just incentives

Second, conversely, emphasising capabilities means that protection from foreign competition is <u>not</u> enough.

- Protection creates the space in which DC companies can ‘grow up’, but it does <u>not</u> guarantee such outcome.
- This will happen only when there are conscious investments in capability-enhancing activities – investments in machinery, training, and R&D.
- The state needs to make it sure that the firms in protected industries make these investments.

Lessons V-3

Especially in developing countries, we need to look at capabilities, not just incentives

Third, enhancement of productive capabilities in developing countries requires putting emphasis on exports.

- This is because, given their technological backwardness, they need to import machines and technology licenses from abroad, which in turn requires that they have foreign exchanges to do so.

- But to repeat, this does not mean free trade – export subsidies (including government marketing support) and infant industry protection are needed for export success.

Lessons V-4

Last but not least, emphasising capability development means that we need to take long-term perspective in devising policies.

- Even with the most aggressive investments and efforts, capabilities cannot be accumulated overnight.
- Of course, taking a long-term perspective should not mean waiting forever for the 'infants' to grow up.
- Before government support is continued, it should be ascertained that the infants are growing up and, more importantly, making efforts to grow up through investment in capability building.