SBP Research Bulletin
Volume 9, Number 1, 2013

Review

Rethinking the Role of the State in Economic Development

19th Zahid Husain Memorial Lecture by Professor Ha-Joon Chang

***Reviewed by* M. Ali Choudhary**[1]

Zahid Husain Memorial Lecture series was launched in 1975 on the occasion of the silver jubilee of the State Bank of Pakistan. The purpose of these lectures is to recall Mr. Zahid Husain, the very first governor of the State Bank of Pakistan, and to create a public debate on issues relevant to the Pakistani economy. Since 1975, 18 different lectures have been organised. The latest was given by Dr. Ha-Joon Chang, Cambridge University, on 18 June 2013 at Pakistan National Council of the Arts in Islamabad. The purpose of the two hour lecture was to revisit the role of the government in economic policy. This is a synopsis of the lecture.

The lecture was a culmination of ideas found in three books authored by the lecturer namely: (i) 23 Things They Don't Say About Capitalism, (ii) Bad Samaritans and (iii) Kicking Away the Ladder.

The crux of the lecture was on the one hand to challenge the diagnosis that led to the development of conventional wisdom, i.e. neo-liberal economic policies, which dominate contemporary economic thought. While on the other hand, it also attempted an evaluation of the neo-liberal policies wherever in force. Both these aspects are considered from a unique historical perspective and I discuss each in turn next.

Before moving on to consider the diagnosis, let us take a small diversion to recall elements of the most commonly known neo-liberal policy package, also promoted by the IMF and the World Bank, which amounts to (i) trade liberalization, (ii) privatization, (iii) abolition of entry regulations and licensing in domestic markets, (iv) deregulation of foreign direct investment, (v) deregulation of financial markets and (vi) inflation targeting and tight budgetary policies.

[1] Director Research Department, State Bank of Pakistan.

These policies came to the limelight because of the alternative promoting State-led Industrialization (SLI henceforth), mainly characterized by policies for import-substitution, deemed disappointing during the period starting in World War II leading up to 1970s. Moreover, the success of the East Asian growth miracle was considered proof of superiority of neo-liberal policies. Furthermore, fresh theories emerged criticising government failure while supporting the theory of comparative advantage which essentially emphasized the role of 'getting prices right' or 'market prices.'

However, a historical review suggests that the case for the failures of SLI may have been misrepresented and overstated; a topic we turn to next.

First, let us consider some numbers. SLI policies were actively pursued during 1960-80. In this era countries using such policies grew as much as their richer counterparts- three percent in per capita terms per annum. However, when compared with the industrialization stint of richer countries, these developing countries have grown twice as much using SLI.

Second, the idea that the East Asian miracle was the result of neo-liberal policies has to be revisited on four grounds: (i) the export-led growth of East Asian success was based on subsidies, an active industrial policy, protection and promotion of infant industries, (ii) extensive use of state-owned enterprises, (iii) a selective application of foreign direct investment (FDI) policy, (iv) a loose monetary policy that was geared towards investment with further tax breaks, (v) a highly regulated consumption of import goods and (vi) a conservative fiscal policy. In this light, the miracle of East Asian countries has a different explanation altogether.

Third, the idea that 'market prices' are always the superior option is a relative notion, for it appears to depend on the economic system and the economic cycle. Indeed, if the policymaking environment is one of underdeveloped capital markets, state-owned enterprise and protectionism, then relying on market price signals is incorrect to begin with. Moreover, circumstances might dictate otherwise. Indeed, the American system, guardians of free enterprise, heavily intervened with the 'Troubled Asset Relief Program' when the U.S. house market collapsed in 2008. Therefore, the notion of relying on price-signals as the ultimate goal depends upon the system and circumstances. Furthermore, even if we accept that the goal is not about 'getting prices right' but the deregulation mechanism which leads to it, one must then evaluate this notion of deregulation from the barometer of 'economic growth.' For example, Asian miracle economies grew faster despite their regulation. Another example is Singapore where state-owned enterprises account for 22 percent of GDP. The point being that these economies appear to do well despite government intervention. This raises the obvious question on the complementary measures which government undertakes to make interventions successful.

Fourth, there is some truth to the idea that government is less capable of delivering output since it is mired with inefficiency but this argument cannot be treated as a universal one. The counter examples are given by East Asia and Korea and Pakistan pre-1980s. However, let us delve deeper into three aspects supporting the thesis of 'government failure.' The prime aspect is that government lacks necessary information to challenge the market. However, there exists a great deal of historical evidence showing that governments all over the world have repeatedly taken decisions against market signals; for example, the French, Japanese and American auto sectors and the Korean steel industry. However, these success stories are not explained by government officials possessing superior information but rather by them taking a national and long-term vision.

A secondary aspect is the lack of commitment of political leadership to economic development, the incoherence of state machinery, and the inability of the state to discipline the recipient of its support. While this aspect is important one should also recognise some countries have managed to find 'good-enough' arrangements to their political economy hurdles and went onto implementing appropriate policies.

The final aspect argues that effective government intervention depends on capabilities of bureaucrats. Acquiring these capabilities is a matter of political will. Therefore, this last aspect takes us beyond the economic theory of incentives, where interest of the state (the principal) would be aligned with that of the bureaucrat (the agent) using monetary incentives. When taken beyond incentive theory, it is in fact a matter of political economy to invest in the training of bureaucracy and engineer an organisational reform.

To summarize, the case against state interventionist policies is exaggerated and misrepresents important historical facts. Taking a balanced view shows that interventionist policies may have been equally successful, if not more, in generating growth. Let us move to the second part of this synopsis which is to evaluate the extent to which neo-liberal policies have been successful.

Consider the following figures first. During 1960-1980, when today's rich countries were following a partially planned system, their income per capita grew on average at 3.2 percent. However, using neo-liberal policies, that is the period of 1980-2000, their average growth rate was 1.7 percent. In a similar vein, developing economies using SLI in 1960's and 1970's grew on average at 3% per. However, during 1980 through to 2000 when SLI was abandoned, their growth rates dropped to 1.8%. Meanwhile, some exceptional growth stories were witnessed in developing countries from the 1980s through 2000 but these countries explicitly applied non-neo-liberal policies; examples of such countries are India, China, Argentina and Ecuador.

Furthermore, an increasing volume of research has shown that rich countries themselves used protectionism, subsidies, state-owned enterprises, regulation of FDI to reach their ‘developed’ status. Indeed, revisiting the history of today’s capitalist countries such as UK, USA, Germany, France, Japan, Korea and Finland invariably show that they too are tainted with protectionism, state ownership and central banks with a development focus. These countries, even today, use an active and comprehensive state agriculture policy by intervening in agricultural inputs on the one hand while supporting output on the other. On the input side, measures include land reform, knowledge dissemination using public channels, directed agriculture credit policies and subsides on physical capital. On the output side measures include support prices to farmers, state insurance policies and trade embargoes. Therefore, the empirical evidence in favour of neo-liberal policies is far from being clear cut.

In sum, five important lessons can be drawn from this debate. Lesson one is that there exists economic theories which justify state intervention and that ironically use the neo-classical approach to market failure. Past the academic debate, a key question about the quality of design and the implementation of policies arises. In this respect, having a clear overarching strategy that avoids favoring one interest group over another and a regular and effective policy evaluation to reassess the intended results is quintessential.

Lesson two is that irrespective of negative perception state intervention remains a reality in everyday life but the real question is how to make it effective.

Provided that we accept that state intervention is reality, the third lesson is that around the world examples exist proving that there is no perfect mix of market and state intervention. The real point is the mental flexibility of policy makers to implement a fresh mixture of these since each country has its own colour.

A connected fourth lesson is that while implementing and experimenting new policy designs, espousing one specific theory over another distracts policy makers from the intended outcome. In fact successful countries have deployed rather unusual policy combinations to move forward.

A final learning pertains to the issue of raising capabilities at various levels of the economy (e.g. firms and government machinery). At the firm level, when domestic entrepreneurs are underdeveloped relative to their foreign counterparts than protection, together with targeted investment will allow these firms to acquire capabilities where they may challenge foreign competitors. An important point about this capability argument is that an active export-oriented policy will allow firms to acquire the very capabilities (new technology, measurement capital etc.) that will challenge international incumbent but these exports will also allow firms to streamline their businesses. Therefore, a combination of exports, together with protection from foreign firms and some liberalization of trade and FDI may be considered a healthy mix. At the bureaucracy level, the argument of capability implies that policy-setters take a national and a long-term perspective of economic development regular reviewing of growth-orientated projects.

To conclude, there is no set path for growth. But there exists some useful historical choices which appear to have helped economies do better. There is no theory or schools of thought which can single-handedly aid developing countries develop better. But there exits some interesting ideas that can help guide their development. Having said that, each country has to live through her own destiny. This invariably implies asking those in decision-making positions to make choices that are in the national and longer term interest for their economy even when the face-value of such choices appears controversial and unconventional.