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Peter T. Bauer. *Reality and Rhetoric: Studies in the Economics of Development*. Cambridge, Mass.: Harvard University Press, 1984.

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The publication of *The State of Development Economics: Progress and Perspectives* to celebrate the twenty-fifth anniversary of the establishment of the Economic Growth Center at Yale University provides an appropriate occasion to assess the achievements of development economics. The last decade and a half has been a strenuous period for development economists. In 1976, the authoritative *Economics of Development: Empirical Investigations* reported the following opinion of a highly respected economic theor-

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ist: "Those among economists who cannot make the grade as mathematical economists, statisticians, monetary or trade economists, or economic historians usually end up either as labor economists or worse still as development economists."[1] In 1981, Albert Hirschman, one of the founders of development economics, announced the fall of the discipline; and four years later, Deepak Lal ended his excoriation of the poverty of development economics with a call for its burial.[2]

To understand the catastrophe that has befallen development economics, we must note that Keynesian economics is also suffering from a crisis of respectability. Both Keynesian economics and development economics were born out of the immediate post–World War II rejection of the neoclassical view that it is generally not possible to improve upon the market outcome. While Keynesian economics was hailed as the replacement for neoclassical economics in the study of advanced capitalist countries, development economics was hailed as the replacement for neoclassical economics in the study of underdeveloped economies. But the news of the death of neoclassical economics was greatly exaggerated. The forces of orthodoxy have regrouped and proved themselves to be much stronger than expected. The neoclassical assault on Keynesian economics has been so successful that its practitioners now prefer to be called activist macroeconomists instead.[3] The neoclassical assault on development economics has been even more successful; what began as an alternative paradigm is now usually regarded as an applied branch of neoclassical economics.

This article is a reflection on the evolution of development economics and a speculation on its future course. The first two sections of the article pay particular attention to the nexus between industrialization and external factors (foreign trade, foreign aid, international organizations, and external shocks) because the decline in the prestige of development economics came primarily from this issue. The third section discusses the introduction of noneconomic factors into the neoclassical mode of analysis in order to explain the performance of East Asia and Latin America, and the fourth section speculates on the dynamic externality effects of "getting the prices right." In order to focus on these three themes, the article forgoes the discussion of important topics such as privatization of state enterprises, sequencing of economic reforms, agricultural protectionism, and rural development.

1. Cited in Pan A. Yotopoulos and Jeffrey B. Nugent, *Economics of Development: Empirical Investigations* (New York: Harper & Row, 1976), p. 3, fn 1.

2. See Albert O. Hirschman, "The Rise and Decline of Development Economics," in Hirschman's *Essays in Trespassing: Economics to Politics and Beyond* (Cambridge: Cambridge University Press, 1981), pp. 1–24; and Lal, *The Poverty of 'Development Economics.'*

3. The first use of the term "activist" was by Arthur Okun in "Fiscal-Monetary Activism: Some Analytical Issues," *Brookings Papers on Economic Activity*, no. 1, 1972, pp. 123–63. The term was then publicly embraced by Franco Modigliani in his presidential address to the American Economics Association, "The Monetarist Controversy, or Should We Forsake Stabilization Policy?" *American Economic Review* 67 (March 1977), pp. 1–19.

It is necessary first to define terms. Hollis Chenery defined three approaches to development economics: neoclassical, neo-Marxist, and structuralist.[4] The third approach is based on the belief that structural rigidities are so pervasive in the markets of the Third World that economic responsiveness is not only extremely small but also stretched over a long period of time. Albert Hirschman also defined three paradigms of economic development: neoclassical economics (also called orthodox economics or monoeconomics), neo-Marxist theories, and development economics.[5] This article will use the term "development economics" to mean structuralist economics and the term "neoclassical (Marxian) development economics" to refer to the application of standard neoclassical (Marxian) economic theory to the analysis of developing countries. It is true that many economists are fearless eclectics, but for the purposes of this article, the construction of additional categories to capture the various shades of affiliation will not add much to the discussion.

Lending a helping hand

The political order and the neoclassical economic establishment in Europe were exhausted in 1945. The consequences for the undeveloped world were decolonization and the birth of development economics. While Keynes saw involuntary unemployment to be the norm in industrialized economies, W. Arthur Lewis saw underemployment to be the norm in undeveloped economies.[6] Keynesian economics ended the dominance of the idea that the market economy is self-correcting, and development economics ended the dominance of the idea that the market economy is self-propelling. The resulting professional consensus in that period was that two hands were better than one. The outcome of an unfettered market system was generally not optimal, and the visible hand of the state had to help the invisible one out.

Most Third World governments, noticing the structural differences between their economies and those of the rich Western economies, instinctively concluded that industrialization was the route to prosperity. This hunch coincided with what the leading development economists were saying. Raul Prebisch and Hans Singer told them that the export of raw agricultural commodities could not serve as an engine of growth because of input-saving technological advances in the industrialized countries.[7] Paul Rosenstein-

4. Hollis B. Chenery, "The Structuralist Approach to Development Policy," *American Economic Review* 65 (May 1975), pp. 310–16.

5. Hirschman, "The Rise and Decline of Development Economics," p. 3.

6. W. Arthur Lewis, "Economic Development with Unlimited Supplies of Labour," *Manchester School of Economic and Social Studies* 22 (May 1954), pp. 131–91.

7. See Raul Prebisch, *The Economic Development of Latin America and Its Principal Problems* (New York: United Nations, 1950); and Hans W. Singer, "The Distribution of Gains Between Investing and Borrowing Countries," *American Economic Review* 40 (May 1950), pp. 473–85.

Rodan and Walt Rostow provided historical analysis to vouch for the idea that one big push for capital accumulation would launch a takeoff into self-sustained growth.[8] Gunnar Myrdal and Dudley Seers dismissed the comparative advantage argument and efficiency considerations of neoclassical economics by pronouncing them to be applicable only to stationary economies.[9] The distinguishing feature of economic development was taken to be drastic structural transformations that naturally generated huge positive externalities which are ignored in standard cost-benefit analyses. Myrdal wrote that "the price system does not give rational criteria for economic planning," since "almost every new industrial enterprise yields benefits for the economy as a whole" and these benefits "are not reflected in the profit calculations."[10] The infant-industry argument was a logical outcome of this unorthodox dynamic economic theory.

Even if policymakers were skeptical of these alleged externality dividends, they could not really rely on neoclassical economics for policy guidance. A disturbing theoretical breakthrough had just appeared. The "theory of the second best" proved that a partial removal of existing distortions could actually reduce the national welfare.[11] The corollary of this theoretical result is that the imposition of a few more distortions such as quotas and licensing regulations to promote import-substituting industrialization could actually increase efficiency. Pandora's box was thus busted open from within.

To the extent that the leaders of the new states believed in the socialist rhetoric that cloaked most nationalistic movements, the belief in industrialization as the panacea was reinforced. Morally, industrialization rescued the peasants from what Marx has called "the idiocy of rural life"; economically, industrialization advanced the country one stage closer to nirvana; and, politically, industrialization created the class naturally sympathetic to the socialist state. Socialist industrialization necessarily took the import-substituting route and never the export-promoting route. Autarkic industrialization was deemed superior because commercial links with advanced capitalist countries were regarded as the channel through which growth-inhibiting impulses were transmitted from the metropolis.

Paul Baran and Andre Frank claimed that the surplus value of the Third World was being siphoned off through unequal terms of exchange and profit

8. See Paul N. Rosenstein-Rodan, "Problems of Industrialisation of Eastern and South-Eastern Europe," *Economic Journal* 53 (June–September 1943), pp. 202–11; and Walt Rostow, *Stages of Economic Growth* (Cambridge: Cambridge University Press, 1960).

9. See Gunnar Myrdal, *Economic Theory and Underdeveloped Regions* (New York: Harper Torchbooks, 1957); and Dudley Seers, "The Limitations of the Special Case," *Bulletin of the Oxford University Institute of Economics and Statistics,* May 1963.

10. Myrdal, *Economic Theory and Underdeveloped Regimes,* p. 97.

11. Richard G. Lipsey and Kevin Lancaster, "The General Theory of Second Best," *Review of Economic Studies,* vol. 24, 1956–57, pp. 11–32.

repatriation by multinational corporations (MNCs).[12] According to Frank, the "non-realization and unavailability for investment of 'potential' economic surplus" was the reason for its poverty.[13] Worse yet, these commercial links promoted structural underdevelopment of the Third World. Frank adopted Myrdal's idea that the dynamics of capitalist growth naturally generated vicious circles. The income gap between countries would widen, and the urban-rural gap within the underdeveloped countries would increase.

This neocolonial relationship was alleged to have drained the economic vitality of the bourgeoisie in the satellite countries. They had been trapped so long in the role of being comprador capitalists that they could not fulfill their historic mission of initiating self-sustaining capitalist development.[14] Because the metropolises in the peripheral nations were so dependent on the metropolis at the center of the global capitalist system for both economic and cultural direction, the Baran-Frank hypothesis became more popularly known as "dependency theory."

To be fair, many prominent non-Marxian economists were also in favor of de-linking the Third World from the industrial countries. Ragnar Nurkse and Gunnar Myrdal recognized that export-promoting industrialization could generate the same dynamic externalities as import-substituting industrialization, but they preferred the latter, for different reasons. Nurkse argued that

> industrialization for export is liable to encounter [obstacles] on the side of external demand. This pattern of industrialization depends for its success on a lenient commercial policy in the older industrial countries. From general considerations . . . it would seem that such lenience can hardly be relied upon with certainty. . . . [For the older industrial countries, it is] natural that, for their own immediate comfort, they should wish to avoid or to cushion such adjustments at some cost in terms of their income growth. They feel they can afford to pay the cost.[15]

Myrdal's preference for import-substituting industrialization does not appear to rest on pessimism about access to external markets but, rather, on his perception that this would stop the "backwash effects" of the vicious circle that permitted the rich countries to develop further at the expense of the

12. See Paul Baran, *The Political Economy of Growth* (New York: Monthly Review Press, 1957); and Andre Gunder Frank, *Capitalism and Underdevelopment in Latin America* (New York: Monthly Review Press, 1967).

13. Frank, *Capitalism and Underdevelopment in Latin America,* pp. 6–7.

14. Andre Gunder Frank, *Lumpenbourgeosie and Lumpendevelopment* (New York: Monthly Review Press, 1972).

15. Ragnar Nurkse, *Problems of Capital Formation in Underdeveloped Countries and Patterns of Trade and Development* (Oxford: Oxford University Press, 1967), pp. 199–201.

poor ones.[16] The wisdom behind de-linking the Third World from the West was long recognized; the Bible, for example, had stated that "for unto every one that hath shall be given, and he should have abundance: but from him that hath not shall be taken away even that which he hath."[17]

Thomas Balogh saw export-promoting industrialization as naturally doomed to failure because "in the poor areas, the difficulties and imperfections of effective decision making, the lack of entrepreneurial ability and capital, vitiate the assumption that potential fields of investment opened up by trade will automatically be exploited. The 'exceptional' case of infant industries expands into infant countries and regions, and discriminatory policies become essential to any sane conception of maximum economic progress."[18]

Nonneoclassical economists were not the only social scientists in favor of a great leap forward. For example, David McClelland, a psychologist, held that the key to successful economic growth lay in inculcating within the populace the psychological need to achieve.[19] To ensure this attitude change, people must be moved from the tradition-bound agricultural sector. "Centralized employment centers" should be promoted instead of cottage industries, and heavy industry should be favored over light industry. Complex machinery, McClelland claimed, "represents symbolically the new age, introduces a new kind of social mobility and ultimately should spread attitudes typical of the modern era."[20]

Hirschman expanded McClelland's use of cognitive dissonance to hasten economic development into "the principle of the hiding hand."[21] Advanced engineering industries (showcase projects such as precision instrument factories, steel mills, and hydroelectric stations) should be undertaken at the very beginning of the industrialization effort in order to combat the unjustified low confidence that the Third World elite has in its creativity. The desire to achieve can be "kick started" by deliberately underestimating the difficulties of projects in order to trick the Third World elite into undertaking tasks that they could, but otherwise would not dare, tackle. According to Hirschman, the logic of the principle of the hiding hand "inevitably leads one to reviewing the development experience of a country as importantly influenced by the kind of project it finds—or places—in its path." He adds that "such a view stresses the importance for development of what a country *does* and what

16. Myrdal presented the special reasons for protection in underdeveloped countries in *An International Economy* (New York: Harper Torchbooks, 1956), pp. 275–79, and he recognized that export of manufactured goods would perform the same functions. His strong objections to continued economic ties to the West are developed in *Economic Theory and Underdeveloped Regions*.

17. Matthew 25:29, quoted in Myrdal, *Economic Theory and Underdeveloped Regions*, pp. 12 and 24.

18. Thomas Balogh, *Unequal Partners* (Oxford: Basil Blackwell, 1963), pp. 16–17.

19. David McClelland, *The Achieving Society* (Princeton, N.J.: D. Van Nostrand, 1961).

20. Ibid., p. 403.

21. Albert O. Hirschman, *Development Project Observed* (New York: Brookings Institute, 1967), chap. 1.

it *becomes* as a result of what it *does*, and thereby contests the primacy of what it *is*, that is, of its geography—and history—determined endowment with natural resources, values, institutions, social and political structure, etc."[22]

But how could the massive industrialization effort be financed? Income was too low to permit much saving. Non-Marxian development social scientists believed that foreign aid was required to break the vicious circle of poverty and backwardness. Aid was not anticipated to be permanent. Like the Marshall Plan instituted to help war-ravaged Europe recover, the aid to Third World countries would serve to prime the pump. International aid organizations were thus considered crucial actors in determining the outcome of the African and Asian "drama" (to use Myrdal's term[23]). The extension of loans was the best way to lend a helping hand. Unlike today, when the emphasis is on allowing the invisible hands in these countries to have free play, the emphasis then was the outstretched hand from abroad dispensing freebies.

Peter Bauer was an early and vocal neoclassical critic of development economics and foreign aid. In his latest collection of essays, *Reality and Rhetoric,* he repeats his now-familiar arguments.[24] The vicious circle hypothesis popularized by Myrdal cannot be correct, since it contradicts "the very existence of the developed countries, all of which started poor, with low income per head and low levels of accumulated capital."[25] He points out that development economics tends to produce alarming forecasts because it ignores "the proposition that price affects the quantity supplied and the quantity demanded," and he cites the example of "forecasts of the level of rural unemployment in the less developed world [based on] population trends and the amount of cultivable land . . . without reference to the relative prices of labor, capital and land."[26]

Bauer attributes the survival of this ridiculous "price-less economics" to three factors. The first is that international bureaucrats invented and have propagated the belief in development economics in order to maximize their perceived usefulness and to extract resources from the guilt-ridden prosperous Western countries, which "think of aid as restitution or partial restitution for past wrongs."[27] The second factor is the existence of "influential groups within the modern political nation [who wish] to discredit or to criticize the operation of market forces."[28] The third factor is that the Third

22. Ibid., p. 5. The principle of the hiding hand is thus an early statement of the "learning-by-doing" literature and of the human potential movement.

23. Gunner Myrdal, *Asian Drama* (New York: Pantheon, 1968).

24. The two earlier collections of Peter Bauer's essays are *Dissent on Development* (Cambridge, Mass.: Harvard University Press, 1971) and *Equality, the Third World and Economic Development* (Cambridge, Mass.: Harvard University Press, 1981).

25. Bauer, *Dissent on Development,* p. 34.

26. Bauer, *Reality and Rhetoric,* pp. 158–59.

27. Ibid., p. 57.

28. Ibid., p. 156.

World created by this charity finds it convenient to adopt a theory that preaches gloom and doom in order to perpetuate the resource transfer. In short, development economics is an intellectual sham perpetrated for political reasons.

Bauer maintains not only that "economic donations have never been necessary for the development of any society anywhere" but also that they generally retard, rather than hasten, economic development.[29] Since the existence of foreign aid weakens the political resolve of recipient countries to put their financial house in order (for example, by cutting extravagant government projects and by raising taxes and private savings), foreign aid exacerbates, rather than cures, the problems of economic development.

History suggests that Bauer has overstated the case against foreign aid. Europe after World War II would have no doubt recovered without the Marshall Plan, just as it recovered earlier from the Black Death. The real issue, however, is whether the Marshall Plan aid quickened the recovery or not, and the evidence in this case is overwhelmingly affirmative. Likewise, in the case of Indonesia in the 1966–69 period, there is evidence that the timely infusion of foreign aid reduced the social costs of stopping the country's hyperinflation. Furthermore, foreign aid can serve as the "carrot" to influence a country's local elite toward more effective policies. Lal, who shares most of Bauer's sentiments toward development economics, concludes that "sensible economic advice linked to foreign aid may be the least costly way of countering those ideas which still hamper the progress of developing countries."[30]

It is interesting to note that Bauer's distaste for development economics and his faith in the universality and applicability of neoclassical economics date back to the late 1950s, before there was any systematic empirical basis for his strongly held position. The word "faith" is justified because Bauer never felt the need to confront the issues raised by the theory of second best.

Regaining the upper hand

During the heady days after political independence, it was easy for Third World countries and their well-wishers to believe that "all good things go together." Equity, democracy, stability, and national autonomy were assumed to increase with per capita income growth in a self-reinforcing manner. In retrospect, a linear relationship (positive or negative) between these variables and economic growth was just too simple to be plausible. Other variables, such as the development strategy and institutional structure, obviously matter.

29. Ibid., p. 43.
30. Lal, *The Poverty of 'Development Economics,'* p. 57.

Until the late 1960s, the optimistic assumption of compatibility among objectives sustained widespread support for the single-mindedness of development efforts to maximize income growth. Economists, however, were more guarded in their optimism because they knew from Simon Kuznets' work that the relationship between inequality and per capita income was hump-shaped.[31] Inequality increases as per capita income grows from a low to a medium level, and it falls as per capita income moves on to higher levels. As events would show, even though most economists did not believe in the compatibility assumption, they were still too optimistic. Most non-Marxian development economists believed in "trickling down" and were therefore confident that the initial increase in inequality would come from the slower income growth of the poorer classes and not from their impoverishment.

By the late 1960s, it was clear that the compatibility assumption was false. As Hirschman notes, there was a series of political disasters "ranging from civil wars to the establishment of murderous authoritarian regimes . . . that struck a number of Third World countries from the 1960s on, disasters that were clearly *somehow* connected with the stresses and strains accompanying development and modernization."[32] At this time, income inequality was also increasing within the Third World. For example, Pakistan's impressive record of income growth was tainted by a rise in the share of wealth owned by its twenty-two richest families.

Hirschman concludes that the decline in the professional prestige of development economics started with the collapse of the compatibility assumption. However, since many social scientists (especially economists) were aware of the hump-shaped Kuznets curve all along, I believe that the decline of development economics in the eyes of the policymaking community came later. The decline really started in the early 1970s, when better income data became available and when a coherent neoclassical explanation for national differences in income distribution and growth appeared. The new income data suggested that the absolute income of the poorest segment of society may have actually declined in the face of sustained economic growth. In a cross-section study of forty-three countries published in 1973, Irma Adelman and Cynthia Morris concluded that "the position of the poorest 60 percent typically worsens both relatively and absolutely when an initial spurt of narrowly based dualistic growth is imposed on an agrarian subsistence economy" and that "in an average country going through the earliest phases of economic development, it takes at least a generation for the poorest

31. Simon Kuznets, "Economic Growth and Income Inequality," *American Economic Review* 45 (March 1955), pp. 1–28.

32. Hirschman, "The Rise and Decline of Development Economics," p. 20.

60 percent to recover the loss in absolute income associated with the typical spurt in growth."[33]

The collapse of the "trickling down" assumption may have played a bigger role than the rising income inequality in undermining the acceptability of development economics as the guide to policymaking. The development economics establishment came under intense political pressure to attack poverty at its roots. The policy response took the form of a series of lurches in different directions with themes seemingly plucked from E. F. Schumacher's *Small Is Beautiful:* basic needs, agricultural development, and appropriate technology.[34]

The triumph of neoclassical economics came from the empirical front of the debate. Using the effective rate of protection (ERP) developed by Max Corden and others[35] as a measure of policy-induced price distortion, neoclassical economists confronted the issue of whether there was a marked difference in economic performance between the Third World countries that pursued industrialization strategies as if the neoclassical concepts of efficiency and comparative advantage mattered and the Third World countries that pursued strategies which flouted these concepts. The empirical findings demolished the two pillars of structuralist development economics: they not only demolished the supposition that industrialization guided by neoclassical theory would typically generate lower growth, but they also demolished the supposition that the Kuznets curve was an iron law of history regarding the time profile of income distribution. However repugnant the unintended impoverishment resulting from the growth strategies approved by development economics may have been, the empirical refutation of development economics may have been a bigger blow to its prestige in the eyes of fellow economists.

The unambiguous answer from several large studies—those of Bela Balassa (in six countries), Jagdish Bhagwati and Anne Krueger (in nine countries), and Ian Little, Maurice Scott, and Tibor Scitovsky (in six countries)—is that the countries with fewer policy-induced distortions experienced higher

33. Irma Adelman and Cynthia Morris, *Economic Growth and Social Equity in Developing Countries* (Stanford, Calif.: Stanford University Press, 1973), p. 179. The limited time series evidence now available suggests an indeterminate relationship. Fields, for example, found impoverishment of the poorest groups in three of twelve countries in his sample. See Gary S. Fields, "Income Distribution and Economic Growth," in Ranis and Schultz, *The State of Development Economics,* pp. 459–81.

34. See E. F. Schumacher, *Small Is Beautiful: Economics as If People Mattered* (New York: Harper & Row, 1973); Mahbub ul Haq, *The Poverty Curtain: Choices for the Third World* (New York: Columbia University Press, 1976); Uma Lele, *The Design of Rural Development: Lessons from Africa* (Baltimore, Md.: Johns Hopkins University Press, 1975); and Peter Timmer et al., *The Choice of Technology in Developing Countries: Some Cautionary Tales* (Cambridge, Mass.: Harvard University Center for International Affairs, 1975).

35. For a thorough treatment of ERP, see W. M. Corden, *The Theory of Protection* (Oxford: Oxford University Press, 1971). Appendix I of the book gives the history of the development of the ERP measure.

economic growth.[36] Robert Lipsey's summary of the Krueger study applies equally to the other studies:

> A bias towards exports, and particularly a pervasive, well-publicized, and stable government commitment to export, is most favorable to economic growth.... The commitment influences expectations about future government actions and encourages export suppliers to believe that currently favorable conditions will be maintained and are therefore worth adapting to.... The favorable effects of an export orientation are attributed ... not only to such traditionally cited factors as economies of scale or the stimulating effects of foreign competition, but also to the fact that such a policy limits the use of quantitative restrictions and the distortions of economic incentives that accompany them.[37]

Another finding that elevated the status of neoclassical economics was that the two countries with the fewest policy-induced distortions (Korea and Taiwan) actually experienced falling income inequality throughout the 1960s and 1970s. Just as the prediction failure of the Phillips curve caused a collapse of confidence in the validity of Keynesian macroeconomics and brought into prominence the new classical macroeconomics, the falsification of the Kuznets curve dealt a severe blow to development economics. This raised a naturally bitter question about how much of the rise in income inequality can be attributed to the neglect of neoclassical economics as encouraged by development economists.

The above-mentioned large studies on the economic effects of trade regimes and the discussions they provoked have produced a confusing terminology. "Free trade" is not the same thing as "laissez-faire," and an export-promoting (or outward-oriented) policy does not mean the twisting of the production structure away from comparative advantage and in a direction opposite to that of an import-substituting (or inward-oriented) policy. Multiple terms abound for the same constellation of policies. Bhagwati calls them "export-promoting policies," Balassa calls them an "outward-oriented strategy," and Lal calls them "free trade policies." The World Bank is replacing these three terms with the term "neutral incentive policy."[38]

36. See Bela Balassa, *Development Strategies in Semi-Industrial Economies* (Baltimore, Md.: Johns Hopkins University Press, 1982); Jagdish Bhagwati, *Anatomy and Consequences of Exchange Control Regimes* (Cambridge, Mass.: Ballinger, 1978); Anne O. Krueger, *Liberalization Attempts and Consequences* (Cambridge, Mass.: Ballinger, 1978); and Ian Little, Maurice Scott, and Tibor Scitovsky, *Industry and Trade in Some Developing Countries* (Oxford: Oxford University Press, 1970).

37. Robert Lipsey in the foreword of Krueger, *Liberalization Attempts and Consequences*, pp. xv and xvi.

38. There are, of course, numerous systems to classify policies. Bradford and Branson have proposed a broader spectrum of classification in "Patterns of Trade and Structural Change," in Colin I. Bradford and William H. Branson, eds., *Trade and Structural Change in Pacific Asia* (Chicago: University of Chicago Press, 1987), chap. 1. The theoretical inconsistency and empirical emptiness of their classification scheme has been discussed in an earlier review; see Wing Thye Woo, "Review of *Trade and Structural Change in Pacific Asia*," *Journal of International Economics* 25 (August 1988), pp. 199–204.

To clarify this specialized terminology, we should note that the output of an economy can be divided into nontradeables and tradeables. Tradeables consist of exportables and importables. In import-substituting (inward-oriented) policy, the effective rate of protection (ERP) for importables *exceeds* the ERP for exportables. In "free trade" or export-promoting (outward-oriented) policy, the ERP for importables *equals* the ERP for exportables. In short, an import-substituting policy distorts (via tariffs and quotas) the prices to favor the production of importables over exportables, while an export-promoting policy offsets (via export subsidies and rebates for duties paid on imported inputs) the anti-export bias of other existing policies. An export-promoting policy is a "free trade" policy in the sense that there is no overall policy bias toward the production of any particular product *within the tradeable sector.* Laissez-faire is the special case of "free trade" in which the ERP for importables and the ERP for exportables are equal to zero; that is, there are no policy distortions in favor of the production of any particular commodity *within the entire economy.* If a country has no nontradeables, then "free trade" is equivalent to laissez-faire.

Balassa has called Korea, Taiwan, and Singapore outward-oriented economies because their net incentive effects in nearly every industry within the tradeable sector were judged small enough to be considered negligible. Outward orientation in these three countries does not mean discrimination against the production of importables but, rather, discrimination against the production of nontradeables. In fact, none of the authors of the above studies coined a term to describe the case in which the ERP for exportables exceeds the ERP for importables, perhaps because such a case did not exist in their samples or perhaps because they judged its existence to be so rare in real life that they did not bother with an encompassing vocabulary in order to include results from future studies.

The success of trade in generating growth in East Asia has caused dependency theorists to reassess their position. Peter Evans argues that the zero-sum depiction of trade and the comprador depiction of the state in the Third World are not true.[39] He shows that in numerous cases, the presence of MNCs stimulates domestic entrepreneurial activities as well as the development of a "countervailing state bureaucracy" to regulate the MNCs. The latter is particularly evident in the extractive industries, where nationalization of foreign firms has occurred just as frequently in capitalist states as in socialist states.

The neoclassical resurgence actually occurred on a much broader front than just in the area of trade. In 1964, Theodore Schultz falsified the notion that the cause of low agricultural productivity was the economic unrespon-

39. Peter Evans, "Foreign Capital and the Third World State," in Myron Weiner and Samuel Huntington, eds., *Understanding Political Development* (Boston: Little, Brown, 1988).

siveness of the tradition-bound peasants.[40] The evidence suggested that farmers using the given technology were already getting the most output they could from available inputs. The low productivity was the direct result of traditional technology, and farmers were willing to change their technology if the result would not increase the risk of crop failure. The traditional peasant farmer is a rational economic person, just like a modern capitalist. Over time the individual findings of empirical work on agricultural, industrial, and trade issues gave respectability to the notion that neoclassical economic analysis was universally applicable.

The counterrevolution had arrived in development economics. The empirical findings of Balassa, Bhagwati, Krueger, Little, Scott, and Scitovsky convinced a large part of the profession that the theory of second best was of minor relevance. A similar counterrevolution had occurred earlier in macroeconomics when Milton Friedman demonstrated the existence of self-correcting mechanisms by showing the existence of a stable long-run relationship between money and prices.[41] Neoclassical economics was clearly on the upswing throughout the 1970s and became the dominant force in the 1980s. It was a sign of the times when structuralist Hollis Chenery resigned in 1982 as the vice president of development policy at the World Bank, and Anne Krueger, one of the leading figures in the counterrevolution, assumed this position.

The findings of Balassa, Bhagwati, Krueger, Little, Scott, and Scitovsky have been amplified in succeeding annual issues of the World Bank's *World Development Report* since 1982.[42] The 1983 issue constructed price distortion indices for thirty-one developing countries and showed that the degree of price distortion is negatively correlated with the growth rate. The 1985 issue showed that the greater the price distortion, the smaller is the export growth and the greater is the likelihood of debt-servicing difficulties. The 1986 issue pointed out that an inward-oriented trade strategy is an indirect tax on the agricultural sector, which includes the bulk of the poor. This is because the domestic prices of the homogeneous agricultural products are determined by the exchange rate and the exogenous dollar prices of the products, and the inward-oriented strategy depresses the domestic prices of agricultural products by reducing import demand and thus appreciating the currency. The 1987 issue classified forty-one developing countries by their trade orientation (strongly outward, moderately outward, moderately inward, and strongly inward) in two periods, 1963–73 and 1973–85. The data confirmed

40. Theodore W. Schultz, *Transforming Traditional Agriculture* (New Haven, Conn.: Yale University Press, 1964).

41. Milton Friedman, *A Monetary History of the United States* (Princeton, N.J.: Princeton University Press, 1963).

42. See World Bank, *World Development Report* (Oxford: Oxford University Press, various years).

that outward-oriented countries grow faster, industrialize quicker, and have higher agricultural growth.

One aspect of the trade regime studies that has gotten increasing attention is real exchange rate (RER) management. The works by Sebastian Edwards and Ching-yuan Lin are the most recent explorations of the consequences of an overvalued RER.[43] While the RER is the ratio of the price of tradeables to the price of nontradeables, the nominal exchange rate (NER) is the number of domestic currency units per unit of foreign currency. For a country with a fixed (unchanging) NER, international goods arbitrage will cause the domestic price of tradeables to be the product of the NER and the foreign currency price of the tradeables after payment of tariffs. If the country then prints money to finance increased state expenditure, the higher level of demand will raise the prices of nontradeables. As long as the NER is unchanged, international goods arbitrage will keep the domestic prices of tradeables unchanged. The result is a fall in the value of the RER, and this is called RER appreciation. RER appreciation in turn causes resources to move from the production of tradeables to the production of nontradeables. Since less production of exportables means lower export levels and since less production of importables means higher import levels, the current account balance worsens. The RER is in equilibrium when the current account position it generates at full employment is compatible with long-run sustainable capital flows. If the actual RER is below the equilibrium RER, then the actual RER is said to be *overvalued* because the economy is producing too little tradeables and the resulting current account deficit cannot be financed in the long run by additional capital inflows.

The important analytic point is that an outward-oriented strategy implemented through the *microeconomic* policies of tariff and export subsidies can be neutralized if not reversed by inflationary *macroeconomic* policies in a fixed NER setting. In a careful case study of Korea, Taiwan, Argentina, Brazil, and Chile, Lin concluded that subsequent inflation in Latin America had nearly always offset the liberalization measures undertaken during each crisis.[44] Taiwan kept inflation low in order to be compatible with its fixed NER, and Korea devalued its NER occasionally to keep the RER constant in the face of high domestic inflation. In fact, competitive RER management by East Asia may have been more important than ERPs in favoring the production of tradeables.

Both Edwards and Lin found that the typical response of Latin American countries to an inflation-induced deterioration in their balance of payments was to protect the import-substituting industries even more.[45] The result of

43. See Edwards, *Real Exchange Rates, Devaluation, and Adjustment;* and Lin, *Latin America Versus East Asia.*

44. Lin, *Latin America Versus East Asia.*

45. See Edwards, *Real Exchange Rates, Devaluation, and Adjustment;* and Lin, *Latin America Versus East Asia.*

Latin American import-substituting industrialization policies interacting with inflationary policies was thus the escalation of the ERP in the importable sector. Edwards found that there was a negative correlation between the growth rate and the degree of RER overvaluation.[46]

"Get the prices right" is clearly the slogan of the day. Inward industrialization through foreign aid has been replaced by outward industrialization through foreign trade. The handshake between nations, the symbol for foreign aid under the Alliance for Progress program, has disappeared because the handshake is now between two invisible hands. Lal's *The Poverty of 'Development Economics'* is the victory speech of neoclassical economics, and it ends with "the major conclusion . . . that the demise of development economics is likely to be conducive to the health of both the economics and the economies of developing countries."[47]

Eliminating one instance of handwaving

Neoclassical development economics is beginning to seriously address the vexing question of why the Latin American countries have performed so poorly in comparison with the East and Southeast Asian countries. In Latin America, only Colombia has not defaulted on its external debts; and in East and Southeast Asia, only the Philippines is experiencing a debt crisis. Why is it that high inflation and balance-of-payments crises are such common features in Latin America but not in East and Southeast Asia?

Vittorio Corbo attributes the poorer economic performance in Latin America to bad luck and bad judgment.[48] Up to the beginning of the Great Depression, Latin America was a stickler for economic orthodoxy. The bad luck was the sharp reduction in foreign demand for exports which began with the Great Depression and continued through World War II. The prolonged severe economic crisis led desperate policymakers to try to boost aggregate demand with import-substituting industrialization policies. The bad judgment was that the resulting recovery of the economy gave the wrong impression that these new policies were conducive to growth.

Neoclassical economics did not regain its intellectual dominance after World World II, because previous events had made policymakers receptive to false prophets, notably Raul Prebisch. The unfortunate result was that import substitution, initially a measure for short-term crisis management, became a policy to induce long-term growth. By 1974, after two decades of low growth, high inflation, and chronic balance-of-payments problems under the import-substituting policy regime, disappointed government officials reversed their policies. Chicago-trained economists implemented liberalization

46. Edwards, *Real Exchange Rates, Devaluation, and Adjustment.*
47. Lal, *The Poverty of 'Development Economics,'* p. 109.
48. Vittorio Corbo, "Problems, Development Theory, and Strategies of Latin America," in Ranis and Schultz, *The State of Development Economics,* pp. 145–86.

and stabilization programs in Argentina, Chile, and Uruguay. Just when things were improving, bad judgment on macroeconomic policies interacted with bad luck (which arrived in the form of external shocks) to produce the debt crisis of 1982.

The shortcoming of the type of analysis exemplified by Corbo is that it fails to address the question of why, given the recurring nature of the problems, the Latin American countries have not figured out the correct model. They could have just looked to the East Asian nations and imitated accordingly. The fact that economic liberalization measures have been adopted many times as the cure to the crises indicates that the Latin American governments know which policies work. The interesting question is why liberal policies have always been offset by new import-substituting policies after every crisis.

Considerations such as the above have made neoclassical development economists increasingly interested in the political science literature on the determinants of policy choice. Gustav Ranis and John Fei see an important need for research efforts to "endogenize policy change over time."[49] They argue that the new research attitude fostered by neoclassical economics has "turned economics increasingly away from its less respectable and murky border areas, e.g., with sociology, with political science, even with history."[50]

> The result is that [development economics] has tended to retreat into "fortress purity," rather than fashioning a better set of disciplinary tools to tackle partly interdisciplinary problems.... While economists have managed to achieve an improved understanding of what makes for better performance across different developing countries, we have substantially lagged behind in our effort to explore why some societies manage to move from here to there, and why most do not.[51]

The naive view of policymaking as an exercise in unconstrained optimization is being abandoned for a political economy approach. The political economy approach is simply the extension of the neoclassical mode of analysis to nonmarket situations. Observed policy choices are viewed as outcomes of constrained maximization problems faced by politicians. "Absolute" authoritarianism is the limiting case, occurring when the only effective (binding) constraints faced by the policymaker are the technical limitations of the policy instruments. "Zero" authoritarianism occurs when all the technical and political constraints are binding, while "soft" authoritarianism occurs when all the technical but only some of the political constraints are binding.

49. Gustav Ranis and John Fei, "Development Economics: What Next?" in Ranis and Schultz, *The State of Development Economics*, p. 103.
50. Ibid., p. 130.
51. Ibid.

It is this constrained optimizing framework which underlies Ronald Findlay's primary explanation for the difference between Latin American and East Asian trade regimes: the East Asian countries are just more authoritarian.[52] The East Asian governments are so much more authoritarian that they can simply impose the policies most conducive to growth with minimal accommodation to rent-seeking demands. The less authoritarian Latin American countries have to resort to import-substituting policies and money creation to buy political support.

Findlay's claim that there is less of a need in East Asia to buy political support is really not convincing by his own criterion. Latin America is alleged to be using import-substituting industrialization to accommodate the rent-seeking demands of the importable industries. But since the East Asian export-promoting industrialization strategy consists of levying tariffs and dispensing export subsidies simultaneously, is it not catering to the interests of both the import-competing and export-competing industries? By Findlay's benefits criterion, the success of East Asia actually comes from being less authoritarian than Latin America. The desire (or need) to claim political credit from both sectors may explain why the promotion of the tradeable sector was done with this clumsy but more visible method instead of the more efficient but less visible method of an undervalued RER.

Findlay gives a second reason for the difference between Latin American and East Asian trade regimes: the East Asian leviathan perceives that "its organic interest in autonomy is better served" by export-promoting industrialization.[53] In short, the authoritarian East Asian state knows the correct model and is counting on superior economic performance to legitimize its political status. But then what has been preventing the Latin American leviathan from seeking political legitimacy in the same way?

The general problem with Findlay's explanation is that he does not give *independent* evidence that the political constraints are more binding in Latin America. This is necessary to break the circularity in his argument: the use of import-substituting policies reflects the accommodation of rent-seeking demands, and the proof that rent-seeking demands are binding comes from the existence of these same policies. Detailed country-specific knowledge about the national objective function and about the domestic political structure is important because there is generally more than one constrained maximization formulation that can produce a given set of observed outcomes, and only this country-specific evidence will allow us to discriminate among the competing formulations.

52. Ronald Findlay, "Trade, Development, and the State," in Ranis and Schultz, *The State of Development Economics*, pp. 78–99.

53. Ibid., p. 91.

The need for country-specific data to supplement the constrained maximization approach is echoed in the work of Ranis and Fei, who emphasize "the importance of initial typological differences among developing countries."[54] In their opinion, the selection of different trade regimes in Latin America and East Asia can be explained by differences in "the maturity of the initial nationalism" and in resource endowment.[55] The maturity of nationalism corresponds to the degree to which the government is aware of its limitations in allocating resources vis-à-vis the market mechanism. Synthetic (immature?) nationalism takes the form of the government proclaiming to be able "to take care of everything"; that is, it takes the form of a more interventionist state. Organic (mature?) nationalism is characterized by political confidence in the ability of the market to produce an acceptable distribution of income and a satisfactory growth rate. Organic nationalism is more likely to arise in countries with a homogeneous population. These two types of nationalism explain why East Asian countries were willing to switch to export-promoting industrialization after the first stage of import-substituting industrialization and why Latin America went on to the second stage of import substitution.

The reason why the Latin American countries have always reverted to an anti-export bias after undertaking liberalization measures to cure balance-of-payments problems is that they, unlike the East Asian countries, are rich in natural resources. The availability of large amounts of foreign exchange from the export of raw agricultural products renders it unnecessary to set up export-oriented manufacturing industries for balance-of-payments reasons. Latin American countries show an oscillatory pattern of interventionist and liberalizing policies because the prices of primary commodities react with large swings to the business cycle generated in the developed countries. When export commodity prices are up, the government is so awash in revenue that it cannot resist the rent-seeking demands to increase spending. The resulting inflation overvalues the RER. Only the production of manufactured exports is really discouraged because the import-competing industries would seek and receive protection. When export commodity prices fall, the government is then forced to stimulate exports with trade liberalization. The oscillatory policy stance in Latin America is the result of an external business cycle interacting with the abundant natural resources.

The East Asian countries, however, being always reminded of the need to pay for imported inputs (notably energy), are forced to adopt and maintain export-promoting policies. This is also why they pay close attention to the RER. In addition, their organic nationalism makes the East Asians naturally sympathetic to an overall "neutral incentive policy" stance.

Of the two factors identified by Ranis and Fei, resource endowment is the only real problem. It is hard to see how synthetic nationalism can long survive

54. Ranis and Fei, "Development Economics: What Next?" p. 101.
55. Ibid., p. 110.

in the face of the success of the East Asian countries brought about by outward-oriented policies. Even if synthetic nationalism is opportunistically embraced and promoted by rent-seeking interests, there is still much wisdom in the adage that "you can't fool all of the people all of the time." The resource endowment factor will have to be addressed by the institutionalization of fiscal controls against the boom-bust pattern of state expenditure. The resulting lower inflation would then reduce demands for protectionism.

Malaysia has the two Latin American attributes—synthetic nationalism and a surfeit of raw resources—which Ranis and Fei have identified to be inimical to sustained structural transformation and high growth rates, yet this Southeast Asian country has been a success story for the last two decades. Malaysia is a veritable cornucopia. It is the world's largest exporter of rubber, tin, palm oil, and timber. It also exhibits the conditions that Ranis and Fei have pointed to as supportive of synthetic nationalism. The ruling ethnic group comprises slightly over 50 percent of the population and since 1969 has been pursuing highly interventionist policies to produce a targeted distribution of wealth.

Despite the fact that racial quotas on participation in various economic activities unleashed a round of rent-seeking demands during the peak of the commodity price cycle, inflation control in Malaysia has not been a major problem. The transformation of the economy toward manufactured products is extremely impressive. While rubber, tin, palm oil, timber, and petroleum comprised 80 percent of the country's exports in 1969, they accounted for only 41 percent in 1988. The fast growth of manufactured exports boosted the ratio of exports to gross national product from 49 percent in 1969 to 72 percent in 1988. The case of Malaysia suggests that synthetic nationalism and natural resource abundance are not sufficient explanations for why Latin America did not move on to export-promoting industrialization after the first stage of import-substituting industrialization and for why Latin America exhibits an oscillatory policy pattern.

Jeffrey Sachs offers the explanation that the choice of trade regime depends on the relative political power of the urban and rural sectors.[56] He points out that 72 percent of the people live in urban areas and 22 percent of the workers are unionized in Latin America, while the corresponding figures for East Asia are 32 percent and 3.7 percent, respectively. These differences have political consequences:

> To a first approximation, the Latin American governments—whether civilian or military, right-wing or left-wing—find their most important constituencies among urban workers and capitalists. For decades, the agricultural sector has been relatively weak, though certainly not powerless, almost everywhere in Latin America, with peasants only loosely

56. Jeffrey Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia," *Brookings Papers on Economic Activity*, no. 2, 1985, especially pp. 548–65. East Asia in Sachs' usage includes Southeast Asia.

organized and, with some exceptions, large-scale agricultural interests unable to hold decisive sway. Moreover, political unrest is most dangerous in the cities, so that urban interests must be bought off first in difficult periods. Interestingly, the opposite seems to be true in most of East Asia. Governments there, whether Japanese colonial rulers before World War II or nationalist governments, have felt the pressing need to win support of, or at least to appease, the rural sector.[57]

Overvalued RER is favored in Latin America but eschewed in East Asia because the consumption bundle of urban dwellers has a higher import content than that of rural dwellers. Import-substituting industrialization policies transfer income from the rural sector to the urban sector through the distorted manufactured goods–agricultural goods terms of trade. The overvalued RER reinforces this transfer of income because it obliges the states to protect their import-competing firms to prevent a rise in the urban unemployment rate. In East Asia, however, the political check on urban-bias policies is the reason why export-promoting industrialization is the norm.

Just as the hypothesis of Ranis and Fei fails when their East Asian and Latin American sample is enlarged to include Southeast Asia, the thesis of Sachs is incomplete when his Latin American, East Asian, and Southeast Asian sample is expanded to include South Asia. India is a much-cited example of extreme orientation toward import-substituting industrialization, and yet it is more rural than any of the Asian countries in Sachs' sample. Moreover, this rural power has had ample opportunity to express itself, since India has been a democracy since 1947.[58]

In a recent study of Indonesian policy, I found the rural-urban conflict emphasized by Sachs to be a key variable in the explanation of many Indonesian policy decisions.[59] A dramatic example was the 50 percent devaluation of the currency in November 1978. At the time of devaluation, foreign reserves were at their historically highest levels, and observers had predicted that a balance-of-payments crisis was unlikely in the near future. The devaluation was undertaken to effect an income transfer to the countryside and the outer islands (the centers of traditional agricultural export industries) to compensate them for a profit squeeze created by other policies. The economic conditions in both the countryside and the outer islands are important to Indonesian policymakers because the former has a long history of agrarian radicalism and the latter a history of secessions.

The implication of the evidence in my study on Indonesia is that the agricultural variable is important for Indonesian policy decisions only because it proxies for the two historical factors. It also works for Malaysia because it coincides with the ethnic division there. The agricultural variable

57. Ibid.

58. The exception is the brief interlude of emergency rule in 1975–77.

59. Wing Thye Woo, "The Economic Policy-Making Equation in Indonesia," Pacific Rim Studies Program Working Paper no. 5, University of California, Davis, 1988.

fails for India and Africa because their main social cleavages (for example, tribal tensions) do not correspond to the rural-urban demarcation.

The attempts by development economists to use neoclassical analysis to model the policymaking process have focused on the nature of the structural and political constraints. Such an approach may be a dead end, however. What if the policy outcomes are less a reflection of constraints than of the objective function?[60] Chalmers Johnson and Lucian Pye have persuasively argued this possibility.[61] Johnson calls Japan, Korea, and Taiwan capitalist developmental states in that they are tightly controlled by political elites with three common attributes. In each case, the political elite is committed to economic growth, is "not committed first and foremost to the enhancement and perpetuation of its own elite privileges," and "appreciates the fact that socialist displacement of the market threatens its goals."[62] This implies that the failure of the authoritarian states in Latin America to become economic powerhouses is due to a lack of selfless dedication to economic growth, a lack of education, or a lack of both. If it is the first factor, then there is not much that development economics can offer.

Pye's analysis for the prospect of economic development in Latin America is even more bleak. He ascribes the economic success of East Asia to the Confucian origins of its authoritarianism. The paternalistic East Asian states differ from the Latin American states in that they "recognize merit, extol technocratic skills, encourage national development, and generally press for modernization and egalitarian economic development."[63] Until Latin America embraces Confucianism, it will just have to settle for economic confusion.

An interdisciplinary approach of incorporating political constraints and "unusual" preference structures into neoclassical economics is no doubt more satisfactory than an approach that offers ignorance and bad luck as explanations for repeated policy failures. Economists are naturally interested in understanding political constraints because this would not only mean more realistic policy recommendations in the short run but would also raise the possibility in the long run of introducing institutional features that could change the political incentive structure to make it more supportive of economic growth.

Economists are much more hesitant, however, about allowing preferences to generate a richer set of outcomes in their models. To most economists,

60. This implies that the constraints are not binding.

61. See Chalmers Johnson, "Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea, and Taiwan," in Robert Scalapino, Seizaburo Sato, and Jusuf Wanandi, eds., *Asian Economic Development: Present and Future* (Berkeley: University of California Institute of East Asian Studies, 1985), pp. 63–89; and Lucian Pye, "The New Asian Capitalism: A Political Portrait," in Peter Berger and Michael Hsiao, eds., *In Search of an East Asian Development Model* (New Brunswick, N.J.: Transaction Books, 1988), pp. 81–98.

62. Johnson, "Political Institutions and Economic Performance," p. 67.

63. Pye, "The New Asian Capitalism," p. 83.

consumer sovereignty is sacred. This research attitude cuts across the main divisions in economics. As Keynesian economist Robert Gordon argues, "Macroeconomists still have a way to go in building and testing models of growth, debt, and accumulation before we throw in the towel and appeal to the help of other disciplines, particularly comparative sociology and religion, to explain the outstanding economic performance of East Asia."[64] And in the opinion of the leading new classical economist, Robert Lucas, a satisfactory theory should "be able to account for sudden large changes in growth rates of individual countries. Do we want a theory that focuses attention on spontaneous shifts in people's discount rates or degree of risk aversion? Such theories are hard to refute, but I will leave it to others to work on this side of the street."[65]

Another instance of handwaving

Is "getting the prices right" all that a country can realistically do in order to promote economic growth? The near total rejection by neoclassical economists of the dynamic externality effects claimed by Hirschman and Myrdal appears to be contradicted by history. Many of the manufacturing export industries in Japan, Korea, Taiwan, and Brazil began as protected industries. If all that export-promoting policies have done has been to almost exactly offset the anti-export bias of other policies, why have the East Asian countries not taken the simpler route of laissez-faire? Are there dynamic externality effects to be gained from this contrived free market mechanism but not from the natural free market forces?

Although Lal does not explain why this contrived free market is maintained, he clearly thinks that laissez-faire is best and that free trade is second best:

> Government intervention [is not] responsible for Korea's success. Indeed, it could be argued that success has been achieved *despite* intervention. To have two sets of intervention, each to neutralize the harm the other would do alone, is hardly a glowing recommendation for government intervention in trade, and certainly not "the lesson" that can be drawn from the experience of Korea and other East Asian countries.[66]

It is interesting that Lal's opinion is not shared by Balassa, a key figure in the counterrevolution. Balassa favors "preferential treatment of the manufacturing sector in developing countries" because he believes that it gen-

64. Robert J. Gordon, "Fresh Water, Salt Walter, and Other Macroeconomic Elixirs," expanded version of a paper that appeared in *Economic Record,* March 1989.

65. Robert E. Lucas, Jr., "On the Mechanics of Economic Development," *Journal of Monetary Economics* 22 (July 1988), p. 14.

66. Lal, *The Poverty of 'Development Economics,'* pp. 46–47.

erates "production externalities [that] include the creation of new skills as well as technological improvements."[67] Indeed, the evidence in Balassa's work shows that it is more accurate to characterize Korea and Taiwan as states pursuing an outward industrialization strategy rather than an outward development strategy. There has been no equal treatment of sectors within the tradeable goods category, in which manufacturing was blatantly favored over agriculture until very recently.

Since the best policy of production subsidies is impractical for budgetary reasons, Balassa advocates a *uniform* tariff-subsidies alternative. He supports policies that discriminate in favor of the manufacturing sector but not policies that discriminate in favor of particular industries within the sector. The market alone should determine the output mix of the manufacturing sector. The preceding statement is crucial because it means that Hirschman and Myrdal did not err when they attributed externalities to industrialization. Rather, they erred in not recommending that the externalities be harnessed by market forces.

I want to suggest here another explanation for the high growth consequence of export-promoting industrialization policies without having to resort to handwaving about production externalities. I think that the success of these policies comes from the opportunity to manufacture a succession of high value-added products. When conditions are made favorable to the production of tradeables, domestic entrepreneurs are willing to risk investing in simplifying the production techniques of new products developed in the technologically advanced countries. With standardized procedures, the less educated but lower-cost labor in the East Asian states can produce new products. In brief, Japan, Korea, Singapore, and Taiwan have grown because their outward-oriented policies have placed them in the front of the queue of those seeking to manufacture new high value-added products developed elsewhere. "Free trade" policies (contrived free markets) are superior to laissez-faire policies (natural free markets) because the former encourage the production of tradeables.

Is it possible that there is a different set of optimal policies for each stage of economic transformation? For Kuo-ting Li, Taiwan's Minister of Economic Affairs from 1965 to 1969 and Minister of Finance from 1969 to 1976, the answer is unambiguously yes:

> The policy experience of Taiwan shows that economic development benefits from a consistent and irrevocable trend of changes in the direction of a free market.... A free market is not a given in the social calculus. It must be constructed, slowly, through a process of changes in policy focus.... Many things that are appropriately government-operated in the early stages of growth can become less so as the economy

67. Bela Balassa and Michael Sharpston, *Export Subsidies by Developing Countries: Issues of Policy* (Geneva: Graduate Institute of International Studies, 1977), p. 34.

matures and grows, with the exception of public utilities, transportation systems, and the like which enjoy a natural monopoly because of economies of scale.[68]

Since a free market is not a naturally occurring phenomenon, the market at the beginning of industrialization should not be allowed to freely respond to consumer demands. The government desires to transform the economy, and the demands of the populace are based on expectations shaped by the existing economic structure. Li offers a good case in point: "In India, the desire to go into white-collar work, particularly government service, has not been overcome, so the educational system is in some ways almost a drag on development. Taiwan faced this problem and found policies to overcome it."[69] Taiwan's policy was to expand vocational education on a massive scale and to restrict the number of universities, despite popular desire to expand the latter.[70] Only in this decade has the government yielded some control over the composition of skill training to the private education sector.

The lesson from Li's book is that the things to do in the first stage of industrialization are straightforward, and a well-meaning government can speed up industrialization through direct resource allocations as long as it uses prices as a planning feedback. As the complexity of the economy multiplies with its growth, the government must shrink to the minimal role of providing infrastructure. Li's account of "irrevocable" liberalization, put in neoclassical parlance, is that the state should initiate manufacturing growth with interventionist tariff-export subsidies and then replace the subsidies with competitive RER management once the manufacturing sector has established itself.

It is interesting to note that Li may not think that the Taiwan model is transferable: "The rapid growth of the East Asian NICs [newly industrializing countries] may be due to their economic pragmatism, with its roots in traditional Chinese culture."[71]

Conclusion

This review has traced how development economics began as an alternative paradigm to neoclassical economics and ended up as an applied branch of it. Development economics lost its credibility among policymakers when "trickling down" did not seem to occur and among economists when the Kuznets curve failed to hold up. The early notion that the market could be ignored because production externalities were extremely widespread and

68. Li, *The Evolution of Policy Behind Taiwan's Development Success*, pp. 104 and 142.
69. Ibid., p. 106.
70. Jennie Hay Woo, "Taiwan as a Case of Successful Educational Planning," *World Development*, forthcoming.
71. Li, *The Evolution of Policy Behind Taiwan's Development Success*, p. 147.

could be easily induced by government policies is just wrong. The revival of neoclassical economics may have been due as much to the resulting intellectual vacuum as to the success of the "free trade" economies of Korea and Taiwan. The term "free trade" is unfortunate because it implies laissez-faire to the uninitiated, rather than offsetting policies in a limited sense.

The fact that the neoclassical economic theory developed in the West is applicable to the Third World setting implies that there are no perverse economic mechanisms in the developing world which prevent their growth. The chief obstacles to growth are more likely to be incompetence, inappropriate institutional arrangements (for example, overcentralized decision making), and social attitudes that influence growth (for example, a preference for religious purity over economic pragmatism). Development economics may not become more useful but will certainly be intellectually more complete if it can incorporate insights from other disciplines about the policy-selection process in the developing countries.

The oft-expressed assertion that a political prerequisite for economic growth is authoritarianism seems unwarranted. Authoritarianism is wrongly equated with the capacity of the state to act autonomously for economic development. The point is that an astute state can marshall a developmental coalition from members of its myriad interest groups. The Indonesian experience shows that widespread rent-seeking demands need not render a developmental elite impotent. With different policy instruments catering to different coalition partners, the overall policy stance may seem incoherent, but it certainly does not exhibit the gross bias toward import-substituting industrialization apparent in Latin America.[72]

The view that Confucianism is the deus ex machina of growth in the East Asian countries may also be unwarranted. To dismiss the irksome fact that no industrial revolution occurred in China during the two thousand years when Confucianism was official ideology, purveyors of this Weberian-like proposition have claimed that it is only bastardized (vulgar) Confucianism which is progressive. Unadulterated Confucianism is like raw opium; it kills. Japan and Korea have succeeded only because the opiate of their masses is not the real thing. This "vulgar" Confucianism explanation, however, begs the fact that Taiwan, the last stronghold of "pure" Confucianism, has also experienced rapid growth. The analytically relevant issue is that Confucianism has never been stagnant. Since "pure" cannot be defined, neither can "vulgar."

The preceding discussion raises the general issue of how much plausibility should be accorded to explanations of economic performance that highlight a single, all-important variable such as authoritarianism or Confucianism. I think that none of the advocates of single-variable theories would (or could) really argue that nothing else matters at all. It is more likely that

72. Woo, "The Economic Policy-Making Equation in Indonesia."

such advocates see economic development as a multiplicative (interactive) process rather than an additive (separable) process. Formally, the "one-variable" theorists would regard the following formulation (1) rather than formulation (2) as the correct specification of the growth process:

Formulation (1): $y = ax^b w^c z^d$
Formulation (2): $y = e + fx + gw + hz$

where y is a measure of economic development (for example, per capita income multiplied by an index value of the equality of income distribution); x, w, and z are variables that are manipulable by government policies; and a, b, c, d, e, f, g, and h are technical coefficients.

In the interactive view of the development process, y is zero as long as any of the variables (for example, authoritarianism) is zero. In the separable process conception, a high value for y can be achieved even if w and z are zero as long as x is set at a high value. The interactive formulation is gloomier than the separable formulation on the prospects for economic development because the former emphasizes the primacy of prerequisites, while the latter stresses the existence of substitutes for any particular variable.

Neoclassical economists in general have tended to think of economic development as an additive process rather than a multiplicative process. This is why neoclassical economic research has focused on what variables affect growth rather than on what combination of variables has the greatest impact. There is, of course, no logical contradiction to combining the multiplicative and additive views to get a more "holistic" formulation such as the following:

Formulation (3): $y = ax^b w^c z^d + e + fx + gw + hz$

A more holistic approach may greatly enrich neoclassical development economics. The phenomenon of the whole being greater than the sum of the individual components is a frequently observed one. Economists call this holistic dividend "total factor productivity," sociologists call it "organization efficiency," and Californians call it "synergy."

What must be stressed is that the works of Balassa, Bhagwati, Krueger, Little, Scott, Scitovsky, Edwards, and Lin have clarified only the conditions under which growth is stimulated and not the mechanics of growth. Their lesson can be simply summarized: governments should *intervene* in a market-compatible manner to promote the production of tradeables. A market-compatible manner is one that allows external market forces (international prices) to determine the composition of the tradeable sector. The key is "broad neutrality between import substitution and exporting."[73] In terms of the formulations above, we can interpret the state of knowledge as follows: one, that the coefficient associated with the variable that measures the degree

73. Lal, *The Poverty of 'Development Economics,'* p. 46.

of market-based promotion of the production of tradeables has a large value; and, two, that the variable is at least entered additively in the growth equation. We know the cause and effect of this outward-oriented strategy, but we do not know the transmission mechanism. Whether the resulting growth comes from production externalities (for example, learning-by-doing effects) or from occupying a higher position in the international product cycle queue is an open question.

Reservations must be expressed about the validity of the export-promoting policy recommendation because it is, after all, based on only four reliable data points: Hong Kong, Korea, Singapore, and Taiwan. The conclusion that the success of Taiwan and Korea came from the more or less equal treatment of all industries within the manufacturing sector may not be generalizable. There is impressive evidence suggesting that the Japanese miracle came from selective targeting of industries.[74] In addition, the favorable income distribution effects of export-promoting industrialization that make it so politically attractive may be ephemeral. Since 1980, income distribution in Taiwan has worsened every year, despite the escalation of trade liberalization. If enthusiasts of export-promoting industrialization continue to oversell the equity aspects of it, then the social rejection that development economics experienced when the compatibility assumption failed is just waiting around the corner.

It is important to emphasize that the favorable evidence on growth is from countries that implement market-compatible trade policies and not laissez-faire trade policies. There is no theoretical reason to believe that a laissez-faire trade regime would actually cause a *sustained* rise in the growth rate. Robert Lucas points out that the removal of trade barriers is "a level effect, analogous to the one-time shifting upward in production possibilities, and not a growth effect."[75] A level effect is a one-time *parallel* shift in the balanced growth path, and a growth effect is a one-time change in the slope of the balanced growth path.[76] This is why the socialist economies, despite their gross allocative inefficiencies, have about the same growth rates as the capitalist ones.

Lucas goes on to suggest that the statistical evidence on growth is better explained by a growth model with learning-by-doing effects accumulated behind trade barriers than by a growth model without such effects. There is some irony in the fact that Lucas, the person most responsible for the downfall of interventionist Keynesian economics, has come to the rescue of the key idea behind the interventionist development economics of Hirschman and Myrdal. What is the sound of Hirschman's hiding hand clapping?

74. Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford, Calif.: Stanford University Press, 1982).

75. Lucas, "On the Mechanics of Economic Development," p. 12.

76. The slope of the balanced growth path is known as the steady-state growth rate, and it equals the sum of the population growth rate and the rate of technical innovation. The trade regime can affect the slope only if it affects either of these two rates.