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FROM PLAN TO MARKET:

Post War Evolution of Thought

On Economic Transformation and Development

by

Deepak Lal*

James S. Coleman Professor

Of International Development Studies

University of California, Los Angeles

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Permanent Address: 8369 Bunche Hall
Dept. of Economics
UCLA
405 Hilgard Ave.
Los Angeles, CA 90024-1477
Tel: (310) 825-4521
Fax: (310) 206-2382

ABSTRACT

This paper provides a birds eye view of the evolution of thought on public policies for economic development since the Second World War. It outlines the origins and effects of the postwar "dirigiste dogma", and how ideas and events undermined it, leading to the neoclassical resurgence of the 1970s. The origins of the debt crisis and its denouement which led to economic liberalization (through structural adjustment -- World Bank -- and stabilization -- IMF -- programs) is outlined. The new policy consensus of the late 1980s and 1990s is shown to be based on the revival of classical political economy which had been suppressed by neoclassical technocracy. It is shown how this revival provides a historically relevant framework for understanding the dynamics of economic reform. A final section examines various new and current areas of debate concerning good governance, poverty alleviation and culture.

JEL Classification: 01, 02; A13; B10

FROM PLAN TO MARKET:

Post War Evolution of Thought on Public Policies For Economic Transformation and Development

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This paper provides a highly compressed survey of the evolution of thought on the public policies required for the economic transformation and development of non-industrial countries, encompassing both the Second and Third Worlds. In a nutshell the mainstream view soon after the war placed primary emphasis on economic planning and on an autarkic pattern of development but has now evolved towards emphasizing the market, and integration in the world economy. Both ideas and events have contributed to this remarkable transformation.

I. The Postwar Dirigiste Dogma -- Origins and Effects

The post-war story must begin with the long shadow cast by the Great Depression on the minds of both theorists and practitioners of economic development. The collapse of world trade and the drastic decline in the prices of primary products fed a post war export pessimism, which became the dominant assumption underlying the early theories of economic development. The inter-war collapse of the international capital market which had funnelled essential finance to the Third World through the relatively impersonal and arms length bond market, led to widespread default and the imposition by the U.S. of the "blue sky" laws which forbade U.S. financial intermediaries from holding foreign government bonds. In Europe exchange controls closed their capital markets to the Third World -- in the U.K. till 1979! It seemed natural therefore to assume that neither foreign trade nor foreign capital could be re

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strategy of import substituting industrialization. Agriculture it was hoped would eventually prosper as a result of the backwash effects of industrialization, including the transfer of most of the surplus labor purported to exist in agriculture to industry. Some hope was placed on land reforms as a means of both improving efficiency and equality in Third World agriculture. In the interim, however, besides providing this perfectly elastic supply of labor, agriculture would continue to be the major source of foreign exchange -- however limited because of the inelastic world demand for primary products -- and of the savings required for industrialization. In the latter task a colonial instrument -- the marketing board proved provident. These boards had been set up in Africa and Asia to insulate the incomes of domestic agricultural producers by stabilizing domestic product prices of export commodities from the chronic instability of world markets for primary products. These boards were increasingly used to tax agriculture -- with domestic producer prices being lowered below their average world prices.

This direct taxation of agriculture was supplemented by indirect ones, as import controls, buttressed exchange controls, in order to husband the limited foreign exchange for "essential" purposes. These controls raised the effective protection offered to industrial products substantially. And all users of industrial goods in particular agriculture bore the tax burden. These controls were usually formulated and justified in the framework of a Five Year Plan, mimicking the instrument that many thought explained the successful transformation of a backward stagnant economy into an industrial giant -- the Soviet Union. Its experience was also resonant, insofar as it provided a justification for the heavy industry biased industrialization that came into favor. If foreign exchange is limited because of inelastic world demand and hence its supply cannot be increased by the usual price reliant means (e.g., devaluation) and imports are essential inputs in domestic production for which there are no domestic substitutes, then foreign exchange can place an independent constraint on growth independent of savings. This was the doctrine of the foreign exchange bottleneck. Stalin's Soviet Union had faced a similar problem -- less due to economics but rather to the politics of a trade embargo. A young Soviet theorist provided the solution to break the bottleneck -- the limited foreign exchange should be used to only import essential raw materials, while the country produced all the required industrial inputs -- including heavy machinery -- domestically. Stalin accepted the message but shot the messenger! Much later an Indian physicist rediscovered the same model and provided the rationale for the Indian Second Five Year Plan which epitomized the planning strategy which was the hallmark of development economics until the mid-1960s.

Apart from import and exchange controls, the instruments to be used for implementing the Plan were industrial licensing, price controls and state enterprises. Typically the plans were based on input-output tables, which assumed that, for technological reasons, the inputs were required in fixed proportions. Beginning with a desired rate of growth of aggregate consumption, the quantities of different commodities required in fixed proportions either as inputs into production or outputs for consumption were derived. The production of these outputs was then sought to be legislated through a panoply of controls and state provision of those goods considered unlikely to be produced by the private sector in the requisite amounts.

This planned, balanced growth of commodities was supposed to overcome the foreign exchange bottleneck as well as the limitations of domestic markets. But, some theorists argued for a policy of unbalanced growth, based on a Big Push in industrialization under state aegis, because of the purported indivisibilities and strategic complementarities in investment, in much of modern industry. This latter argument was particularly persuasive in land and natural resource abundant economies as in Latin America (e.g., Brazil). But they found that the resources required for an etatist Big Push could not usually be obtained through normal taxation. They resorted to a combination of foreign borrowing and inflationary domestic financing -- hoping to generate forced savings through levying the inflation tax.

Finally, in this "policy package" an important role was given to foreign aid. This was supposed to be doubly important. Besides supplementing meager domestic savings, for investment -- which could no longer count on private foreign capital for its finance -- foreign aid also provided the foreign exchange to break the foreign exchange bottleneck. By contrast the major form of private flows in the form of direct foreign investment by multinationals were frowned upon and discouraged except in so-called "priority" sectors because of the fears that they might engender a new neo-colonialism.

II. The Neoclassical Resurgence

A few small countries on the Pacific Rim without much land or natural resources began to break away from this dirigiste consensus from the mid-1960s. Based more on pragmatism than theory, South Korea, Taiwan, Singapore and Hong Kong (the Gang of Four) discovered that their domestic markets were too small to support the planned autarkic "balanced" growth policies. Moreover, their only resource was their people. They adopted "outward oriented" development policies whose centerpiece was the promotion of labor intensive manufactured exports. This was done by in effect, allowing exporters (but not necessarily importers) to operate under conditions of virtual free trade.

The results were stupendous. They achieved growth rates of income and employment, which were unprecedented, based on an explosive growth of exports. This belie

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that, either the market interest rate used to determine the net present value of investment projects was much higher than the social cost of capital, or that there were externalities in labor training, or dynamic economies of learning by doing. The modern theory demonstrated that while these "domestic distortions" required government action, and hence a departure from laissez faire, intervention in foreign trade was not the best way to deal with them, and could in principle actually lead to a lower level of welfare than doing nothing. The best way to deal with domestic distortions was to get to the heart of the matter and remove them by some suitable domestic tax -- subsidy scheme, which did not discriminate among goods and services by origin.

This intellectual case against protection was strongly buttressed by the evidence of the disappointing results achieved by the set of dirigiste trade and industrial controls that were ubiquitous in the Third World by the early 1960s. Though riding on the back of the general expansion of the postwar Golden Age, the overall growth performance of most developing countries (including those in Africa) was respectable, it was not as good, nor of the sort that theorists and policymakers had expected. Whilst, most developing countries (including those in Africa) had substantially raised their domestic savings rates, and thence investment rates, there was wide variation in the efficiency of this investment, with resulting differences in growth rates. These differences in efficiency were moreover increasingly recognized to be due to the dirigiste system of trade, industrial and price controls, and the disappointing performance of state enterprises. Worse from the planner's viewpoint, the actual pattern of industrial production diverged widely from that planned. This was because there was little relationship between the pattern of nominal protection designed to implement the plans and the pattern of effective protection it engendered. The pattern of effective protection usually had lower and sometimes negative effective rates on exportable commodities. This reduced their relative profitability and meant that, export growth was not as high as it could have been and chronic balance of payments problems were the result.

The pattern of effective protection also discriminated against agriculture. This indirect tax combined with its direct taxation led to agricultural growth being much lower than was feasible. For by the late 1960s the new agricultural technology associated with the "Green Revolution" made it possible for a large increase in the output of various cereals -- where the requisite ecological conditions (an assured water supply) were present. Nor was it possible to argue that peasants were non-economic men, when they reacted to the tax squeeze on agriculture (through the marketing boards, the maintenance of overvalued exchange rates which hurt exports and industrial protection) by reducing agricultural supply -- just as farmers in the U.S. or Europe would have been expected to react. Thus for example cocoa output and exports, and with it Ghana's output and incomes collapsed as a result of Nkrumah's dirigiste policies.

Most heinous of all was the bias against employment resulting from the discrimination against the labor intensive sectors -- agriculture and manufactured exports -- which the dirigiste package entailed. Populations had burgeoned in the Third World largely as a result of the reduction in death rates -- in particular infant mortality rates -- with the ubiquitous spread of modern public health measures, in particular, vaccinations and inoculations against infectious diseases. The resulting increase in the labor supply met the less than adequate increase in labor demand, leading to stagnant wage levels and the growth of what was labelled the urban "informal sector". As industrial wages, particularly in state enterprises, were set above market clearing levels, large rural to urban migration was induced accompanied by urban unemployment and underemployment of the "search" variety -- whose physical manifestation were the slums which increasingly spread through many Third World cities.

The ensuing continuance and in some cases aggravation of endemic poverty, despite seemingly respectable growth rates of output till the late 1960s, led many international agencies to advocate more direct attacks on poverty. One advocated redistribution with growth, another a "basic needs" program modelled on Western welfare states. In primarily rural countries the major asset is land, so land redistribution formed a major component of these proposed programs of poverty alleviation. An empirical finding across many countries found that the productivity of land declined with the size of landholding. Though this has been questioned more recently, it provided the basis for promoting an agrarian structure which would promote <u>both</u> equity and efficiency based on small farms reliant entirely on family labor -- by breaking up the larger farms. Apart from Korea and Taiwan which had undertaken such a land reform under American tutelage soon after the Second World War, few other countries were able to garner the requisite political support for such reforms. Some, however, like Tanzania and China -- did have the means, but their preferred agrarian structure based on their socialist ideology was the collective farm. Both attempts at collectivization ended in tears -- with the implosion of the Tanzanian economy following "ujaamisation", and the biggest famine in human history, estimated to have cost nearly 25 million lives in China after it established its communes. Both disasters arose from the perverse incentives faced by peasants on collective farms.

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It has been known since J.S. Mill that, if a country has some monopoly or monopsony power in its foreign trade, then in the absence of foreign retaliation, it can garner more of the cosmopolitan gains from trade by levying the so-called optimum tariff to turn the terms of trade in its favor. This is what the OPEC cartel, in effect did. Many other developing countries sought to do the same. Commodity power seemed to be the new Third World weapon in its ongoing skirmishes with the West. But as Marshall had noted, even though the short term elasticities of demand and supply for many traded goods were likely to be low, in the long run they were likely to be high. This proved to be the case with oil. The massive rise in its price promoted successful substitution through various conservation measures, and increased the returns from extending exploration -- so that known reserves rose. Compared to oil, the elasticities of demand and supply for most other primary commodities were even higher. So nothing came of commodity power -- its death knell being pronounced by the decline in the real price of oil in the 1980s.

An enduring myth that had fuelled NIEO, and the program for raising the prices of commodities formulated by UNCTAD was the belief that the terms of trade between primary commodities and manufactures would inexorably decline. Basing themselves on past export structures, this was translated into an inexorable tendency for the terms of trade of developing countries to decline. Suffice it to say that, as far as the most relevant index, the <u>income</u> terms of trade of developing countries are concerned there is no such tendency. With the eventual collapse at most attempts at rigging international commodity markets -- the latest being the collapse of the International Tin Agreement -- the commodities issue has hopefully been buried -- at least for the time being!

The 1973 OPEC price coup, however, also led to a large transfer of resources from oil importing countries to OPEC, whose ability to absorb the resultant foreign exchange accruals in their domestic economies were limited. They had to find a home for this new-found wealth. Much of this was deposited in Western banks, particularly in their offshore subsidiaries -- which formed the eurodollar market. With the deflationary impulse transmitted by this transfer of resources from countries with low to high savings propensities, cries for recycling the OPEC surplus became clamorous. The banks obliged. The beneficiaries were Third World countries -- particularly in Latin America -- which had endemic problems in financing their budgets. They now found a new source of borrowing and at negative real interest rates! The seeds of the debt crisis were sown.

For with the inevitable attempts to deal with the stagflation of the 1970s deriving from the OPEC oil price rise, there was a general tightening of macroeconomic policy in the West in the late 1970s. The resulting slowdown in world demand and rise in world interest rates dealt a double blow to the governments of heavily indebted countries. The loans had been incurred at floating interest rates and were in most part directly or indirectly underwritten by the government's of the borrowers. Real interest rates rose to unknown heights. To finance the large increase in debt service, governments needed to raise the fiscal resources and to convert them into foreign exchange. Some countries, mainly in East Asia, managed this transfer problem in textbook fashion. They were helped by the capacity of their economies to convert domestic resources into foreign exchange because of their past outward oriented trade policies, and because they had established viable fiscal systems. Many debtors in Latin America and Africa had neither attribute. The debt crisis created an acute fiscal crisis for these states most often reflected in acute inflation. While given their past neglect of exports, the only way to obtain the necessary balance of trade surplus was through import compression, which in turn led to domestic recession. It was to deal with these joint fiscal, foreign debt and balance of payments crises that economic liberalization was undertaken, most often under the aegis of the World Bank and the International Monetary Fund (IMF).

IV. The Revival of Classical Political Economy

These structural adjustments (World Bank) and stabilization (IMF) programs increasingly embodied the intellectual consensus that was emerging at the beginning of the 1980s in favor of markets against the plan. The final nail in the coffin of the "old" development economics was the realization, both in theory and practice, of the immense corruption that a system of controls engenders. Though some forms of corruption -- which are a form of arbitrage, albeit illegal -- aid efficiency, the unproductive scramble for the valuable licenses on which the Permit Raj was based, led to additional losses of economic welfare. Thus, an import quota, for example, is a gift of a license by the government to print money to the lucky beneficiary, who can tax consumers by pocketing the difference between the price at which he imports the good and the much higher domestic price at which he can sell it because of the quota restrictions. With competition by "rent seekers" for these quota rents, in the limit they will spend in aggregate an amount equal to the total rent to be derived, in the form of resources of time, and money -- waiting in queues, lobbying, bribery, etc. Thus in addition to the loss consumers suffer from the raising of the price of the good, there will be a deadweight loss equal to the whole of the quota rents -- as if the equivalent resources had been dumped into the sea!

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increasingly in doubt as planners have often shown a lack of foresight which would have swiftly bankrupted a private agent. But the assumption that the State -- whether democratic or authoritarian -- is a committee of benevolent Platonic Guardians has been more tenacious.

A more clear-headed appraisal of the motives of the State arose with the resurrection of the ideas of the classical economists associated with the Scottish Enlightenment -- particularly David Hume and Adam Smith -- combining politics and economics (in the so-called "new" political economy). Though there are some Platonic Guardian states or elements of it within most, many states are better viewed as being self-interested, even predatory. It is this realization which has led to the search for a policy package subserving the interests of the prey rather than the predator. A predatory state is interested above all discretionary resources and hence will seek to maximize its revenues. The interests of the prey are to provide only enough revenues to finance the essential public goodse. How the differing ends are to be reconciled remains controversial.

There is more agreement on how the past dirigisme of the Second and Third World can be reversed. Above all, it is essential to establish macro-economic balance, ideally through a monetary constitution which prohibits any future levying of the inflation tax. The other components of the policy package include, first, the conversion of import quotas into tariff equivalents, and then a gradual movement towards a low uniform tariff, which is ultimately reduced as close to zero as possible. Second, the removal of price controls and all forms of industrial licensing. Third the liberalization and rationalization of domestic capital markets -- with the removal of interest rate ceilings and centrally planned direction of credit. Fourth, the removal of exchange controls and the maintenance of realistic exchange rates. Fifth, the privatization of state enterprises, not merely on grounds of efficiency, but on those of political economy: to remove the State from areas where it has no role and to allow it to concentrate on the things only it can do.

As it is unlikely that all these reforms can be undertaken simultaneously, lively but inconclusive debate continues about the appropriate sequencing of these reforms.

V. The Political Economy of Reform

One lesson from past experience is, however, of importance. In the reform process time may be of the essence. This is linked to the question of why self-interested predatory states, who have benefitted from their past dirigisme, should suddenly want to liberalize and serve the general weal. Here the parallel with the liberalization of the mercantilist "ancien regimes" in the late 18th and 19th centuries is instructive.

One unintended consequence of past mercantilism and contemporary neo-mercantilism is that, while both were motivated by the desire to establish "order" and thence "nations" by expanding the scope of government control, after a certain stage increased dirigisme bred disorder. As economic controls become onerous, people attempt to escape them through various forms of avoidance and evasion. This has a devastating effect on the state's fiscal base. The first sign of an impending crisis is fiscal, with the accompanying unMarxian "withering away of the State". It is to regain control over what seem to have become ungovernable economies that economic liberalization is undertaken, to restore the fiscal base and government control. Once this crisis of the State seems to be manageable, there is no further incentive for the predatory State to continue with liberalization.

This suggests that a "crisis" provides an opportunity for liberalizers -- but it maybe of short duration. A big bang may therefore be desirable to smash the equilibrium of rent-seeking interest groups who have a stake in maintaining the past system of dirigisme. To stiffen the government's spine in this unenviable task, sweetners which ease its fiscal problems, in the form of soft loans or grants from multilateral and bilateral foreign governments may be desirable. Beyond that the role of foreign assistance seems limited.

VI. New Horizons

(a) Good Governance

But it is still an open question whether once a market economy is established, it can be maintained against the unavoidable political pressures for its subversion. The sad fate of many constitutions shows how fragile a corset they are in constraining a predatory state. A political culture which internalizes the classical liberal virtues maybe a better bulwark. Questions concerning the appropriate institutions which help to create and foster the requisite character and culture have therefore, come to the fore of the current debates on development.

As it is human to think that one's own "habits of the heart" are ideal, it is not surprising that the West is now seeking to promote Western democracy in the Third World; as the means of ensuring the good governance now generally recognized to be a prerequisite for economic development. Whatever the moral virtues of democracy, the historical evidence does not support any necessary connection between this form of government and the promotion of prospe

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This classical liberal view of civil association, with the State as the custodian of laws which do not seek to impose any preferred pattern of ends (including abstractions such as the general welfare, or fundamental rights), but which merely facilitate individuals to pursue their own ends, has been challenged by a rival conception of society as an enterprise association. The State is now seen as the manager of an enterprise seeking to use the law for its own substantive purposes, and in particular for the legislation of morality. As the British philosopher, Michael Oakeshott has shown, both conceptions of the State have deep roots in Western thought, going back to ancient Greece in one case and the Judaeo-Christian tradition in the other.

It is important to note that, socialism is the major secular embodiment of society viewed as an enterprise association: with its desire to use the State's power to equalize people. The demise of the socialist economies does not mean this socialist impulse is dead, least of all in the First World. It continues to infect the design of an appropriate social safety net to protect the "poor". In combination with democratic politics it remains a continuing threat to the sustainability of a market order, and to the classical liberal view of civil society.

(b) Welfare States for the Third World?

It is not surprising, therefore, that with the seeming victory of the market over the plan, the dirigiste bands have consolidated under the banner of "adjustment with a human face". They now seek to create Western style welfare states in the Third and Second worlds.

But the Western welfare state is itself in trouble because of the dynamic costs associated with its inevitable enlargement in majoritarian democracies. Under factional pressures, politicians bid for votes by offering transfers of income to some sections of the populace at the expense of others. With the inevitable "universalization" of benefits, the welfare state comes to be captured by the middle classes with a tendency for net transfers of income from both the rich and the poor to the middle income groups. The same tendency is observed in those developing countries (Uruguay, Costa Rica, Sri Lanka, Jamaica) which, under the factional pressures of majoritarian democracy, created and expanded their welfare states. These were financed by taxing the rents from their major primary products. With the expansion of revenues during upturns in the primary product price cycle, political pressures led to their commitment to entitlements which could not be repudiated when revenues fell during the downturn. The ensuing increase in the tax burden on the productive primary product sector -- to close the fiscal gap -- led to a retardation of its growth and productivity, and in some cases to the "killing of the goose that laid the golden egg".

Similar fiscal pressures have also attended the universalization of benefits in Western economies. With political entitlements (mainly pensions and health care) whose fiscal burden is governed more by demography than the conjunctural state of the economy, the growing tax burden creates well-known distortions that discourage productivity and growth. The reform of the welfare state is therefore at the forefront of public policy debates in the First World, just when many are seeking to establish or expand them in the Third!

Nevertheless, ways to deal with the poverty caused by the inevitable vagaries of life, over the life cycle of some individuals, and of the persistent poverty of those of nature's victims who are incapable of earning a living, have been recognized by many classical liberals to be part of the State's functions. No ideal means are available to achieve this end.

institution through public subsidy, which historically has been -- and in some cases continues to be -- an enemy of the market. But there may be a case for using more secular NGO's in servicing the poor.

(c) Culture and Development

No form of government or agency for promoting good government can thus be taken as granted to be ideal. Ultimately, these forms are likely to be less important than the existing habits of a people (including those which might evolve with modernization and industrialization). But these relate to questions of character and culture. It is by no means self-evident, as the previous discussion has emphasized that, Western democracy necessarily promotes a culture which is market-friendly. Its uneasy tension between the rival notions of the State seen as a civil or enterprise association, can lead to a form of decadence in private habits -- which some have identified as a feature of many contemporary Western societies. With the substitution of public for private benevolence, the transfer state saps the latter -- the highest private moral virtue for classical liberals. While every turn towards making the State an enterprise association saps those lower level "vigorous virtues" -- productivity, thrift, and self-reliance -- which classical liberals see as underpinning the market and thence the promotion of "opulence".

But once the religious roots of the Western impulse towards creating a state as an enterprise association are recognized, it is evident that there are other non-Semitic religions, which have never sought to legislate morality. Hinduism and Confusianism for instance are ways of life (cultures rather than religions), without the centralized institutions of the various Christian or Islamic churches, seeking to capture the State to serve their own substantive ends. They can, as they have, provide the cultural sustenance for prom

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