The Role of the State in Development: Re-examining Neo-Liberal Recommendations

https://www.e-ir.info/2012/04/26/the-role-of-the-state-in-development-re-examining-neo-liberal-recommendations/

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In order to give a comprehensive judgement about the validity of the current WTO recommendations for development in LEDCs, it is worth examining the history of development in those nations that have proven to 'climb up the ladder' successfully. This essay therefore analyses the history of Great Britain, the United States of America, Germany (Prussia), and Japan in that order. Throughout this analysis, it undoubtedly becomes clear that the level of state intervention in those cases have gone well beyond neoliberal recommendations of free trade. All four nations have actively created an entrepreneur-friendly environment through protectionism and infant industry promotion amongst other means. To derive a comprehensive conclusion on development policies for now-LEDCs, this essay is sub-divided into two sections: the first part points out the content of the current neoliberal discourse as embedded in the SAL-conditions of IMF and World Bank. The second part then investigates in the extent to which the now-developed countries mentioned above have used those policies. Considering the fact that the successful developers have not relied on mere market forces to any extent, the conclusion is that those policies are used by now-developed nations in order to 'kick away the ladder' for latecomers to climb up to the same level of development. The role of the state in LEDCs thus needs to be re-examined in order to construct more fruitful policy recommendations.

According to Robert Wade, the current neoliberal World Trade Organisation regime "actively prevent(s) developing countries from pursuing the kinds of industrial and technology policies adopted by (…) the older developed countries when they were developing" (Wade, 2003). He thus argues that the now more economically developed countries have not developed as a result of the same policies neoliberalism currently recommends to LEDCs. In order to analyse Wade's argument, the following section examines the content of neoliberal policies.

In the aftermath of the Bretton Woods era and the demise of the Keynesian orthodoxy, economists such as P.T. Bauer and Deepak Lal started to critique high development and heterodox theories Rosenstein-Rodan and Gunnar Myrdal (Cypher & Dietz, 2009) (Lal, 1985). Bauer rejected the argument of Myrdal that without government intervention states would be caught in a 'vicious cycle' of poverty (Bauer, 1984). In general, the argument was directed against the state and emphasised the forces of the market as a more efficient alternative to state-owned enterprises and infant industry promotion programmes (Chaudhry, 1993)[1]. One concern of neoliberals was, for example, that government intervention in channelling surplus from the primary sector to industry had kept revenues for agricultural products too low and thus distorted LEDC's comparative advantage in exporting those primary products (Rapley, 2007).

The neoliberal policy recommendations that evolved from those criticism are embodied in the so called 'structural adjustment programmes'. SAPs aim to deal with the failure of the state as presumed by Bauer, Dal and other neoliberals. Broadly speaking, they focus on fiscal austerity, privatisation, trade liberalisation, and deregulation to increase the 'freedom' of action for private entrepreneurs (Rapley, 2007). The logic behind all is firstly that government spending fosters high inflation; secondly that state-owned enterprises are less efficient than the private sector; thirdly that protectionism distorts free flow of goods and services; and finally that the government proves to be unable to allocate resources efficiently[2]. With the establishment of the New International Economic Order (NIEO) in the early 1980s, structural adjustment programmes were soon incorporated in the conditions of World Bank and IMF loans: "When a country borrows from the IMF, its government agrees to adjust its economic policies to overcome the problems that led it to seek financial aid from the international community" (IMF, 2011). In order to examine the validity of the current WTO-regime, the following part analyses the development of now-developed nations from a historical perspective and the extent to which the examined neoliberal policy recommendations have been applied in those cases.

The historical development of the now-MEDCs is examined in ascending order from when their development begun: Great Britain, United States, Germany (Prussia), and Japan. Starting with Great Britain, it becomes clear that protectionism, which lasted until the 1846 abolishment of the Corn Laws, has been key for the initial success of industrialisation. Though Britain entered the 'game' of industrialisation first, it still relied on protectionist policies until major industrial sectors were established. During the 16th Century, Henry the VII aimed to support the domestic processing of wool, which accounted for roughly half of English industry in that time, through taxing exports of raw wool (Chang, 2002). The British government itself thus promoted its infant industry through export taxes, which clearly disproves the current WTO-recommendations of free trade being key to development.

With colonisation and the Navigation Acts – the requirement that trade with Great Britain had to be carried out with British ships only – the government further actively created an environment that suited its local economy in the 17th Century. Though theories about the motivation of imperialism range from the Hobson-Lenin thesis[3] to the argument that colonies were important for raw material *supplies*, the truth probably lies somewhere in the middle (Schwartz, 2010). With the 1721 reform of the mercantile law through the first Prime Minister Robert Walpole, the British government introduced important policies to promote its manufacturing industry, i.e. the reduction of import tariffs on raw materials, the abolishment of export duties, and the rise of import duties on manufacturing goods (Chang, 2002). Great Britain thus used its colonies as *supplier* of raw materials for its manufacturing industry on the one hand, and as *export market* for manufacturing goods on the other. In 1820, Great Britain had as much as 45-55 per cent tariffs on manufactured imports (Bairoch, 1993). With the Corn Laws of 1815 it furthermore heavily protected agriculture. Due to the diverging interest between primary and secondary producers, the Corn Laws were abolished in 1846, which marked the final victory of free trade. Yet this step was undertaken at a stage in which British industry and British technological capacity was far ahead of its competitors. Until this was the case however, the development of its domestic economy equalled the modern form of import substitution industrialisation (ISI) and infant industry promotion. The case of Great Britain's development thus clearly disproves the current neoliberal policy recommendations.

Along with Britain, the United States, which is currently wrongly assumed to be the model type of political as well as economic liberalism, was in fact "the mother country and bastion of modern protectionism" (Bairoch, 1993). After independence, the United States issued high tariffs and taxes[4] under guidance of George Washington and Alexander Hamilton. It is however important to notice that there were diverging interests between the Northern and the Southern states: the South, where primary production was dominant, objected import taxes in order to lower prices for higher-quality manufactured goods from Britain. The North on the other hand, aiming to pursue industrialisation itself, expressed the need to raise import taxes. According to Chang, those tensions were the major reason next to the more commonly known issue of slavery that "finally culminated in the Civil War" of 1861 – 1865 (Chang, 2002). With victory of the Northern states and the New Tariff Act of 1862, the high tariff regime opposing British claims for free trade maintained.

In general, the United States performed most successfully during years of high protectionism. In the 1920s it had the highest tariffs on manufactured imports with 37% after Spain[5] (Bairoch, 1993). This policy clearly disproves the current neoliberal claim that developing countries should not rely on ISI strategies to initially 'push' industrialisation. It might be true – as the case of East Asia compared to Latin America has shown – that the level of protection and the industries that are protected need to be chosen carefully, because in Latin America some firms did not upgrade to the level of international competition when 'hidden' behind protective walls (Schwartz, 2010). The general conclusion that can be made however is that a developing country needs to elude the mere forces of the market when aiming to industrialise. As in the United States, other policies like investment in education and in research and development have significant 'spillover-effects' as well (Chang, 2002).

The 'spillover-effects' of state support of education become even clearer in Germany. Pioneering in high-class education through the Humboldt reforms of 1806 was only one important factor of active promotion through the Prussian state. As latecomer to development, the Prussian state felt threatened by its neighbours. Considering the predominance of political realism and the military threat of more developed nations, the Prussian elite felt the need to rationalise internally after being defeated in the Franco-Prussian War. Though Germany had not experienced a victory of the 'liberal' capitalist class[6], the Prussian aristocracy itself introduced the Stein-Hardenberg reforms that abolished serfdom to transform the agrarian system (Preuss, 1908). The case of Germany thus represents an important example of state intervention in development.

Though it is a widespread argument that protectionism was born in Germany with Friedrich List, it was instead much more important for successful industrialisation in the United States (Chang, 2002). Until Bismarck built a protective wall for iron and rye in 1879 after German unification to strengthen the ties between the political interests of the Prussian elite and the economic motives of German business (Berghahn, 1996), German industry was not effectively protected. In comparison to the USA, which additionally faced the natural barrier of high transportation costs, German tariffs were significantly lower with 8-12% in 1820 and 4-6 % in 1875 as opposed to 35-45 % and 40-50 % in the US (Bairoch, 1993). State support in contrast was rather in form of promoting infant industry through "monopoly grants, cheap supplies from royal factories (…)" and most importantly "the direct involvement of the state in key industries" (Chang, 2002). This occurred especially in the financial sector. State-owned banks actively channelled investment funds to certain infant industries. The German state under Bismarck furthermore pioneered in having the first social welfare system. This step was particularly motivated by the aim to deter subversive state enemies and demonstrates the importance of nationalism for late-developers.

The case of Germany thus clearly undermines the current recommendations of the neoliberal policy regime. Though its level of tariffs and taxes were not as high as in the United States, the Prussian and later German state actively promoted industry and thus fused political and economic interests. One reason why Germany firstly did not have high levels of protectionism is also because it would have provoked Russia, from where it imported certain products. When Germany became stronger after the unification in 1871, it introduced import tariffs on iron and rye, which gave German products an advantage over Russian imports and consequently indeed provoked Russia. Altogether German industrialisation was the result of active state intervention and the creation of an entrepreneur-friendly environment rather than 'passive' development through the operation of market forces.

Having analysed the history of three now-developed nations of the West, it is interesting that neither in the case of Japan laissez-faire policies have led to development. Japanese modernisation in East Asia shows significant similarities with German industrialisation as being led by an aristocratic elite. Aiming to adopt the "social structures analogous to which had allowed Western capitalism its stunning and technological therefore military superiority over the rest of the world" (Callinicos, 1989), the Japanese state intervened heavily to restructure its internal relations. It actively created a state bureaucracy through reforms. In order to form an effective new bureaucracy, an army of peasants replaced the aristocratic warrior-caste of the Samurai (Bendix, 1967).

Though Japan was not allowed to issue high rates of tariffs, as stated in the Unequal Treaties with Britain of 1858, the state actively promoted industrialisation through other means. Having mentioned the creation of a bureaucratic class, the state furthermore created state-owned enterprises in key industries such as "shipbuilding, mining, textiles (…) and military industries" (Chang, 2002). Though many of those industries were later privatised, they were still subject to significant state subsidies. Moreover the Japanese state focussed on the promotion of infrastructure (railways, telegraphs) and invested in education as shown by the establishment of the Ministry of Education in 1871.

With the end of the Unequal Treaties in 1911, the Japanese state promptly introduced protectionism. In 1913 the average rate on manufactured imports was 30 % and therefore increased by 25 % since 1875 (Bairoch, 1993). The example of Japan thus clearly undermines the policy recommendations by neoliberals similarly to the other cases examined above.

To conclude, state intervention in protectionism, infant industry promotion, the construction of infrastructure, the creation of educational opportunities – just to mention the most important factors – have played a significant role in the development of Great Britain, the United States, Germany, and Japan. Examining the history of development of the now-developed nations thus fully undermines the policy recommendations of neoliberalism. One could thus conclude that the conditions of IMF and World Bank SALs and the WTO regime confirm the assumption of Friedrich List that free trade policies aim to 'kick away the ladder' of late-comers to climb up to the same stage of development. As Kiren Chaudry points out, it is therefore necessary for us "to re-examine the conventional account of the role of the state in Third World economies" (Chaudhry, 1993). The importance of the state that represents the public interest needs to be understood. The market cannot provide certain public goods, such as infrastructure and education. This was already realised by classical economist Adam Smith. As we can derive from the case studies however, state intervention goes well beyond up to the point of active industry promotion, protectionism, and bureaucratisation. Considering the Gerschenkronian law this becomes logic for late developers. But even Great Britain, as the pioneer of the Industrial Revolution has shown high levels of protectionism and state intervention. The current neoliberal discourse embedded in the World Trade Organisation thus seems to be a tool of the developed world not to share the 'cake' of development.

List of Abbreviations

ISI – Import Substitution Industrialisation

EOI – Export-Oriented Industrialisation

LEDC – Less Economically Developed Country

MEDC – More Economically Developed Country

NIEO – New International Economic Order

R&D – Research and Development

SAL – Structural Adjustment Loans

SAP – Structural Adjustment Programmes

WTO – World Trade Organisation

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[1] See for example: Lal, D. (1985). *The Poverty of Development Economics.* Cambridge, MA: Harvard University Press.; Bauer, P. T. (1972). *Dissent on Development: Studies and Debates in Development Economics.* Cambridge, MA: Harvard University Press.; Bauer, P. T. (1984). Remembrance of Studies Past. In G. Meier, & D. S. (eds.), *Pioneers in Development* (S. 27 – 43). Oxford: Oxford University Press.

[2] Note that this is a broad generalisation due to the limited word count.

[3] The Hobson-Lenin argument claims that the motivation of imperialism was to export surplus capital to external markets. Lenin further called this 'the monopoly stage of capitalism' and forecasted – similarly to Marx himself – the demise of the capitalist mode of production. – (Beasley, W. G. 1987. *Japanese imperialism*, 1894-1945. Oxford: Oxford University Press, 1987) – (Hobson, J.A. 1938. *Imperialism: A Study*. Michigan: University of Michigan Press, 1938) – (Lenin, Vladimir. 1967. *Imperialism – the highest stage of capitalism*. New York: International Publishers, 1967)

[4] The table of Bairoch (1993) notes that the average tariffs on manufactured imports in 1820 was 35-45 %. Beginning with the liberal tariff act in 1789, the US started with a 5 % tariff on most of its imports. The avarage tariff rate from 1792 – 1812 was around 12,5 %, which then doubled due to the war with Britain (Chang, 2002).

[5] Tariffs in Spain were about 41%. Due to high transportation costs however, importing goods to the USA was already naturally of higher costs.

[6] After the ultimate failure of the attempted German revolution in 1848, the capitalist bourgeoisie and the leading Prussian aristocracy merged their interests. Political interests (military strength) were inevitably fused with the motive of economic power. The Prussian elite was clearly interested in having a strong economy.

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Date written: March 2012