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The Neoclassical Answer to Failure

In May 1979, Margaret Thatcher led the Conservative Party to victory in Britain's general election. Thatcher came to power with the intention of profoundly altering Britain, purging it of socialism and returning it to its Victorian golden age of individualist capitalism and free-market economics.

The next year, Ronald Reagan won the US presidency. These events heralded a shift to the right all over the Western world: further conservative victories were to follow in other countries, and where leftist parties won or retained power, they nevertheless moved to the right or formed coalitions with right-wing parties. Convinced that the welfare state had become so generous that it was robbing individuals of discipline and initiative, and believing that the growing intrusion of the state into the economy was hobbling private enterprise, conservative governments aimed to roll back the state and free the market.

This free-market ideology would eventually find its way into the corridors of the Western world's donor agencies, in particular the World Bank and the International Monetary Fund. To many observers, a new drummer was setting the beat of the world economy—a drummer that used its lending power to prod third-world governments to radically alter their development policies, reducing the role of the state in the economy and reemphasizing the market. It was, in this interpretation, the start of the neoclassical assault. Yet this assault resulted not from first-world pressure only; even before first-world governments turned to the right, neoclassical theory had begun influencing third-world policymakers because it seemed to offer practical solutions to the problems facing them.

The Neoclassical Tradition

Neoclassical economics dates back to the 1870s. At that time, mathematics was introduced into the study of economics, revolutionizing the discipline and breaking it away from its parent, classical political economy. This created a fissure between the economic and political components of political economy, giving birth to the new disciplines of economics and political science. As time went by, economists devised more and more mathematical equations to explain and predict economic behavior. Guiding neoclassical economists in their theorizing was a fundamental assumption: individuals behave as rational utility maximizers. Put another way, people are self-interested, they know best what they want, and they also know best how to get it. In the pursuit of their goals, people act rationally and efficiently.

From this assumption it follows that the most productive economy will be one in which individuals are allowed the greatest freedom to engage in activities or enter into contracts as they choose, and to reap the full benefits of their labors. Neoclassical theorists thus argue not only against government regulation, but also against taxation whose aim is to redistribute wealth. As argued by one of the doyens of neoclassical thought, Friedrich von Hayek, individualism ensured that more things would be tried; the greater the number of things being tried, the more innovation and progress there would be. But, he maintained, individuals would only incur the costs of trying something new if they knew they would reap the benefits of any success they had; people were not altruistic. Taxing the rich to feed the poor hindered the most affluent, reduced initiative and thus innovation, and so hurt all of society.[1]

This conclusion points to a central tenet of neoclassical economics that dates back to Adam Smith and beyond:[2] if individuals are left to pursue their narrow self-interests, society as a whole benefits, whereas if individuals are compelled to pursue collective interests, society as a whole suffers. For example, creating a business in order to generate wealth for oneself nevertheless creates jobs for others, whereas taxing that business in order to redistribute its profits will discourage the owner from expanding it further and creating any more jobs. Accepting this "doctrine of unintended consequences," neoclassical economists conclude that free-market economies enable individuals to pursue their self-interest to the benefit of society, whereas command economies stifle self-interest and initiative and thus slow society's progress. One cardinal rule follows from this: the less state, the better.

Interestingly, the forerunners of contemporary neoclassical theory

emerged at about the same time as John Maynard Keynes. Friedrich von Hayek and the Chicago school of economists were publishing their ideas at the same time that Keynes put out his *General Theory of Employment, Interest, and Money* in 1936. Yet so dominant was Keynes's thinking that neoclassical ideas remained confined to academic circles for a few more decades. It was only in the 1950s and 1960s that criticism of Keynes moved out of the margins of the academic community. Among the first critics to be given serious attention was Milton Friedman, who revived the quantity theory of money in the late 1950s, spurring considerable discussion in the academic literature over the next decade. In contrast to Keynes, who had argued that fiscal policy offered an effective means to manage capitalism's boom-and-bust cycles, Friedman contended that monetary policy was a more useful instrument. By tightening the money supply during bouts of high inflation, and loosening it during times of recession, governments could regulate aggregate demand and maintain economic growth. Money supply can be loosened by lowering interest rates, and tightened by raising them. When interest rates are high, people prefer to invest rather than spend their money, and the high cost of loans discourages people from buying on credit. Economic activity thus slows, less money chases after the same supply of goods, and prices rise more slowly or even fall. In times of recession, lower interest rates have the opposite effect: people withdraw money from savings and spend it; they even buy on credit because it is no longer expensive, and activity resumes. This, to Friedman, was a more effective means to deal with the boom-and-bust cycle than Keynes's proposed control of government purse strings.

Whereas Friedman assigned government a greater role in the economy than did traditional neoclassical theory, his was still an approach that implied a reduction in the size of the state. His proposal to remove many of the government's levers on fiscal policy went against much of the postwar Keynesian consensus, including such things as government investment and nationalization. As Friedman saw it, the task of the government was merely to create the right environment for businesses and individuals to maximize their potential. He argued that the government should concern itself merely with stabilizing monetary growth, which would "provide a monetary climate favorable to the effective operation of those basic forces of enterprise, ingenuity, invention, hard work, and thrift that are the true springs of economic growth."[3]

At first, Friedman's impact was modest. That changed in the 1970s, when stagflation hit the developed economies. As the decade progressed, first-world voters became more concerned with inflation than

with unemployment. The latter, a devil the postwar generation had feared, had led people to see in Keynesian economics a powerful exorcist. By the 1970s, however, the working classes had diminished as a proportion of the population in first-world countries, and the middle classes had emerged to become the prominent constituency. They feared unemployment less than the high inflation that was eating into their standards of living and raising their mortgage payments. The monetarist recipe of tightening the money supply in order to reduce inflation appealed to them. By this time there had emerged an even more radical economic theory, known as rational expectations, whose essential claim was that people had learned to anticipate government policies and thus could effectively derail government attempts to make adjustments in the economy. The proposed solution was even more extreme than monetarism's hands-off approach: a complete retreat of the state from economic life.[4]

Along with neoclassical economics there arose a separate but related school of thought in political theory: neoclassical liberalism. Its origins lay in the work of John Locke, and its forefathers included Adam Smith, Jeremy Bentham, John Stuart Mill, and Alexis de Tocqueville. Since World War II, political philosophers such as Robert Nozick[5] and Ayn Rand, along with economists such as Friedman and Hayek, had revived the ideas of classical liberalism that had long been confined to the history books.

Classical liberalism stressed individualism above all else, seeing individuals as the building blocks of society. It believed that the minimalist state produced not only a better economy, but a better society as well. Left with maximum freedom, people would not only realize their potential and pursue those things in life at which they were best, but also become more responsible and self-reliant. They would form the institutions, such as families, churches, and neighborhoods, that would then look after the young, elderly, and weak. Expanding the state not only deprived people of freedom, but by usurping many of the tasks performed by society—as, for instance, social agencies replaced families, churches, and community associations—it also robbed them of initiative and responsibility.

In the nineteenth century, classical liberalism gradually gave way to modern liberalism, which judged that society was riven by so many historical inequalities that only state intervention could level the playing field to give to all the same degree of freedom and opportunity to realize their potential. However, especially after the 1960s, classical liberalism went through a renaissance in the first world, resulting in neoclassical

liberalism. Although this school of thought did not have as direct an impact on third-world politics as did neoclassical economic literature, it did help to push the political agenda of the first world away from statism, profoundly influencing politicians such as Margaret Thatcher and Ronald Reagan. This in turn pushed the agendas of the donor agencies to the right, and prodded many third-world governments to reexamine their statist development practices. It was held that paring back the state would improve the operation of not only the economy but also the state itself. Reducing the state's resources would at the same time reduce opportunities for corruption; eliminating civil-service jobs would encourage educated people to create their own opportunities for enrichment in the private sector rather than look to the state for advancement. Making the state "leaner and meaner" would improve its operation while at the same time releasing resources into the private sector.

The Neoclassical Diagnosis of the Third World's Illness

By this time, critiques by neoclassical economists who focused their attention on the third world had begun to trickle in. Throughout the postwar period, dissenting voices were pointing to gaps or flaws in development theory, accumulating bits and pieces of evidence that could later be used in an all-out assault on statist development theory. Prominent among these critics was P. T. Bauer. Early in his career Bauer had studied Southeast Asian rubber farmers and West African traders. At the time, it was commonly assumed that third-world peoples, especially in rural areas, did not follow the rules of market rationality. They were believed to be backward, uneducated, and bound by cultural traditions that frowned on selfishness and individualism. This justified the state's playing the role as the economy's main entrepreneur, because there were too few private entrepreneurs to do the job. From the late 1940s, Bauer, following his studies, took direct aim at this logic. He had found that his subjects did in fact behave as rational utility–maximizing individuals, seizing new opportunities whenever they came their way.[6] T. W. Schultz supported Bauer, arguing that when peasant farmers invested little time and capital in their farms, it was not because their cultural values or backwardness led them to ignore the market, but rather that government policies deprived them of capital and kept returns on agriculture so low that it was neither possible nor worthwhile for them to become thrifty entrepreneurs.[7] Such arguments were later echoed by Harry G. Johnson,

who became convinced that "even the poorest producers are susceptible to price incentives" and doubted that the state could ever perform economic functions better than could the market.[8] By the late 1960s, neoclassical writers believed that there was enough evidence to show that peasants certainly responded to price incentives.[9]

This conclusion had profound implications. It questioned much of the logic of state marketing boards, and challenged the principle of skimming resources from agriculture to fuel industrial development. As time went by, more and more voices would contend that state intervention had distorted prices in such a way as to discourage production of potentially lucrative primary goods, thereby slowing growth. Bauer argued strongly that individuals, not the state, should provide the economy's entrepreneurship, and that too large a state stifled this entrepreneurship.

In the mid-1960s, a rash of literature emerged by such neoclassical economists as Jagdish Bhagwati, V. K. Ramaswami, H. G. Johnson, Bela Balassa, W. M. Corden, and Anne Krueger. Much of it appeared in the pages of the *Journal of Political Economy,* the publication of the Chicago school. This literature drew attention to the costs of protection and exchange overvaluation, and began to explore ways of measuring the welfare costs of these devices. Neoclassical writers also began to uphold the virtues of conventional economic theory, taking issue with the claims of structuralists and others that the peculiarities of the third world rendered traditional economics inapplicable.[10] This was the first intimation of what would become a sometimes vociferous claim that "development economics" was a waste of time because everything anyone needed to know was found in the conventional literature.[11]

In 1970 the Organization for Economic Cooperation and Development (OECD) published a study that did much to popularize neoclassical theory among development specialists.[12] This study looked at the trade regimes put in place in the postwar period by Argentina, Brazil, Mexico, India, Pakistan, the Philippines, and Taiwan, and concluded that in all these countries, import substitution industrialization had done more harm than good. In their analysis, the authors made a number of observations that would form a large part of the arsenal used in many neoclassical critiques of statism. To begin with, they pointed out that in trying to build new industries, ISI neglected the comparative advantages enjoyed by these economies. Given that these comparative advantages were often in agriculture, it was significant that industrialization had occurred at the expense of agricultural development. In large part this happened because currency overvaluation had discouraged exports, both

industrial and agricultural. All in all, ISI was seen to be a wasteful strategy: industry accounted for more investment than output, its capital-intensive nature created too few jobs, and it gobbled up foreign exchange in its need for imported inputs. ISI's bulky state administration created bottlenecks in the economy, further wasting resources through capacity underutilization, corruption, and sluggishness. The authors expressed the doubt common to all neoclassical theory that bureaucrats could gain access to the information needed to effectively administer the economy, and they disliked the fact that the controls used in ISI appeared to curb private initiative.

As if this were not enough, the study concluded that ISI, which was often justified as a strategy that would benefit a whole economy and not just preserve the wealth of a lucky few, was actually worsening income distribution. While profit earners benefited from protection, and skilled labor from currency overvaluation, farmers suffered and a large share of the urban population remained unemployed, forced to seek work in the marginal or informal sectors as bootblacks, peddlers, or prostitutes.

The proposed solution was for governments to shift from ISI to export industrialization, nurturing firms that could sell abroad rather than in the domestic market. For this purpose the study suggested promotional rather than protective policies to encourage industrialization—for example, subsidies over import restrictions. (As noted in later chapters, this preference for market-enhancing policies has now been accepted by most development theorists.) In line with its call for export industrialization, the study advocated more openness to foreign trade, less use of controls, more use of the "price mechanism," and currency devaluation. These recommendations would be repeated later, many times over, by other neoclassical theorists, but in hindsight the OECD study appears relatively moderate compared with some of the later volumes in the neoclassical library. It did not oppose public ownership, it accepted some role for price controls, it emphasized the state's role in building infrastructure and in human-capital formation, and it called for some degree of state activism in helping firms to capture export markets. Nor did the study repudiate ISI outright. It merely rejected its being used for too long.

Within a year the World Bank and the Inter-American Development Bank published a trade study, chaired by Bela Balassa, that strengthened the OECD study's findings.[13] This study assessed the impact of ISI's protectionism and currency overvaluation—or lack thereof, in some cases—on the economies of Brazil, Chile, Pakistan, Mexico, West Malaysia, the Philippines, and Norway. Its conclusions were damning to

ISI. Protection, it said, entailed high costs in static (allocative) efficiencies, limited the scope for the introduction of large-scale production methods, provided few inducements to improve productivity, slowed the production and exports of primary commodities, and hindered the expansion of manufactured exports. ISI was, in sum, a policy that wasted resources and did too little to stimulate increases in exports. By contrast, in the countries with less protective trade regimes, agriculture and exports grew rapidly, new primary exports were developed, and exports of manufactured goods increased. Once again, while granting that protection was legitimate over set periods, the study called for devaluation coupled with disinflationary policies, the replacement of quotas by tariffs, and the use of subsidies rather than protection for the promotion of new manufacturing industries. So while the Balassa report recognized that the state had a role to play in economic development, its principal thrust was a call to roll back the state and streamline its procedures.

Stronger—some might say dogmatic—expressions of neoclassical thought were to follow, as critics gained confidence and grew convinced that their findings had thoroughly discredited the old statist development schools. Deepak Lal composed a scathing indictment of what he called "development economics,"[14] saying there was no need to articulate an economics for development, as "development economists" had tried to do, because all the answers could be found in conventional economic theory. Lal then gave to neoclassical theory the memorable aphorism that market failure was always preferable to state failure. Meanwhile, P. T. Bauer pilloried dependency theorists and claimed that imperialism had done no harm to the colonies but had, if anything, improved them. He insisted that the first world was in no way responsible for the poverty of the third world, and that the market offered the best mechanism for a poor country to develop.[15]

In 1983 the National Bureau of Economic Research (NBER) issued a trade study that would become so influential that some would call it the core of the neoclassical critique of statism.[16] Like the OECD study, the NBER study dealt with trade regimes, reaching similar conclusions. From it emerged a focus on export-oriented industrialization, which it set against ISI. In the view of the study's authors, the latter was statist while the former, said to be practiced in the most successful of the East Asian newly industrialized countries, was market-oriented. Although few now dispute that export industrializers, particularly the East Asian NICs, have performed better than the import substituters, a great debate soon erupted over whether or not the export industrializers were free-market economies. Neoclassical theorists came to lean on the NBER

study's claims that these economies illustrated the virtues of the free market and liberal trade regimes, and they brandished the success of such countries as South Korea as a lesson for those such as India.

The NBER study focused on the various market distortions caused by government intervention in the course of ISI. It argued that labor-market regulations, restrictive trade regimes, credit rationing, and social-insurance tax systems all combined to raise the domestic cost of hiring labor relative to capital. Meanwhile, currency overvaluation, the favorable treatment of capital-goods imports, and credit rationing at subsidized interest rates drove down the prices of capital services. The end result, relatively cheap capital and relatively expensive labor, clearly favored capital-intensive production. Although there is nothing intrinsically wrong with capital-intensive production, it normally arises in high-wage economies. When it develops in low-wage economies, it excludes the mass of the population from the development process, because it creates relatively few jobs while eliminating traditional industries. The solution to this sort of problem appeared obvious: less distortion, which meant less government intervention in the economy. The trade regimes should be liberalized and there should be more "freedom" in the labor market.

The NBER study made another claim that drove to the heart of structuralist economics. Whereas structuralists had often argued that trade between first-world and third-world countries had worked to the detriment of the latter, and that intraregional trade offered more hope for development, the NBER study rejected this flatly. It argued that the gains from trade, including employment gains, would be maximized by trade with countries endowed with different characteristics. In other words, poor countries should trade with rich countries, not with other poor ones. Even if "collective self-reliance" had a nice ring to it, the study held that regional trade blocs in the third world would do little to benefit their member states. Given that postwar approaches to development were much influenced by trade pessimism, this argument, along with neoclassical claims that the terms of trade were not going against the third world, represented a remarkable attempt to refute that pessimism.

Throughout the 1950s and 1960s, other studies had challenged the conclusions of Raul Prebisch and Hans Singer,[17] who had maintained that over time the value of primary exports relative to finished imports would decline. Neoclassical writers, to bolster their arguments, claimed that, contrary to the trade pessimism that had underlain structuralism, the developing countries had actually grown rich by selling their pri-

mary goods to the developed world.[18] Neoclassical writers were also citing other problems associated with state intervention. These included financial repression (interest rates kept low by government regulation), which had been intended to encourage investment by making it cheap but in fact discouraged it by dissuading people from putting their savings in banks, where the returns were so low. Neoclassical writers also criticized rules that restricted foreign investment in order to, among other things, stem the outflow of profits or prevent the importation of inappropriate technology. Critics of such policies claimed that the problems of capital outflow or the sale of inappropriate products were not as serious as structuralist theorists feared.[19]

The New Political Economy

In addition to this economic literature, there arose a new current in the political theory of development that challenged the statist approach. This was the new political economy. Pioneered by Anne Krueger,[20] the new political economy took the neoclassical assumption that humans are rational utility maximizers and applied it to politics. (In this it bore close ties to rational-action or public-choice theory, which had become popular in US political science departments.)[21]

Krueger studied the effect of quotas on the behavior of firms. In any situation in which a government restricts the supply of a given good to a level that is below demand, the local price of that good will be bid up above the world price. The difference between the price paid by the importer (the world price) and the price the importer charges local buyers (the local price) is called economic rent. Because quotas create this windfall for importers, import licenses become hot commodities that are sought after for their own sake, not just because they offer access to needed inputs. Krueger found cases in which, with licenses being assigned to reflect firms' capacities, plant managers would invest to expand their plant even when they had idle capacity. (The problem with an idle plant is that, though it generates no income, its owners must continue paying mortgage and other bills on it.) This enabled them to obtain bigger import licenses, which they could then sell to other managers at a profit. However, in the process their productivity dropped even further, as an even larger share of plant capacity went unused. Plant managers also tried to obtain licenses through bribery, hiring the relatives of officials in return for licenses, and so forth; such rent-seeking behavior consumed resources that could have been better spent elsewhere in the economy.

Jagdish Bhagwati later expanded this to look at tariff evasion, tariff seeking, and revenue seeking.[22] These were all, he said, directly unproductive, profit-seeking activities made possible by government controls. They were profitable, but produced no goods or services, and thus wasted valuable resources. Capital-gains tax treatment, for example, led to the overbuilding of apartments or uneconomic oil exploration. The policy implications of this new political economy were clear: less government control. If some kind of protection were required, tariffs were better than quotas, because tariffs created no opportunities for rent. In this regard, neoclassical theorists distinguished between discretion and rules. Quotas and licenses were applied in a discretionary manner by bureaucrats or politicians, who could abuse their powers to favor themselves or their friends. Tariffs, on the other hand, were rules: they applied equally to everybody, and so could not create opportunities for rent seeking. Neoclassical theorists tended to favor rules over discretion whenever some form of state intervention was deemed necessary.[23]

The new political economy was further elaborated in the work of Robert Bates on sub-Saharan Africa.[24] In the course of his research he had found that governments in Africa seemed biased against the farm sector. Currency overvaluation and pricing policies kept prices on farm products low, thereby subsidizing the urban population's food bill. At the same time, overvaluation also kept the prices on imported industrial inputs low, while protectionism kept profits high, which made life good for industrialists. Marketing boards, in turn, skimmed off revenue from the primary sector to fuel urban development. All in all, Bates found that the cities were squeezing the rural sector in order to fuel their own growth, dampening the dynamism of what should have been the economy's engine of growth—agriculture. Import substitution industries were gobbling up foreign exchange and earning none in return, while agriculture, the sector of the economy that did garner foreign exchange, was contracting. The unattractive prices prompted many farmers to resort to subsistence production or to pack up altogether and move to the city, where life was much better.

Puzzled by the apparent irrationality of this self-defeating policy, Bates turned to interest-group analysis to try to find an answer. Interest-group analysis has a long history in the study of industrial polities. Bates relied on the theory of one of its most influential practitioners, Mancur Olson,[25] whose approach he blended with a form of class analysis to produce a provocative and influential hybrid.

Olson had argued that individuals are self-interested, and so will rarely try to pressure the government if the sought-after policy brings

them little benefit. A small group with a common interest will be more effective than a large one, because large groups are saddled with the problems of dispersed benefits and the free-rider effect. If a group has a million members, its weight of numbers may appear daunting; thus third-world farmers should be a force to be reckoned with. In fact, they seldom are. It is difficult for an individual to resist the temptation to stay at home tilling his or her plot while the million others go off to a demonstration to secure a policy that offers everyone an equal share of the gains. Of course, it is equally irresistible to all; the result is that very large groups often have a small number of activists doing all the work. When the work they have to do outstrips potential gains—after all, the gains are to trickle down equally to the million members—the rational incentive for action is lost. The opportunity cost is too high: the time and energy spent lobbying the government could be better spent on the farm. Consequently, in liberal democracies, interest-group politics often leads to undemocratic outcomes, because small groups work to secure desired policies while large groups remain largely ineffectual.

Bates believed that this explained what was happening in much of Africa. Even if development policies were counterproductive, they nonetheless served the interests of the urban elite of industrialists and skilled laborers. This class alliance, suggested Bates, underpinned the power of modern Africa's regimes, and no government could afford to antagonize it. Whereas peasant farmers are often a dispersed and disorganized lot—so many potatoes in a sack, as Marx once referred to them disparagingly—the urban constituency is tight-knit and dangerous. The working class, living in densely packed neighborhoods, can easily take to the streets and threaten stability if it feels it has been pushed too far. As for the industrialists, their wealth and personal connections make them a desirable support base. Interventionist policies that distort markets create administratively generated rents that can be used to curry their favor or build up networks of political clients.

Bates considered this urban bias a key factor in Africa's underdevelopment. It had to be overcome. African governments had to be prodded to realize their static comparative advantages, which for the most part lay in agriculture. As other neoclassical theorists had argued, raising the prices for peasant farmers' products would lead them to increase their output and would bring more foreign exchange into the country. Producer prices could be raised easily through currency devaluation. Soon after Bates published his work, "getting the prices right" became a guiding concern of the World Bank in Africa.

The new political economy reached the following conclusions.

Given that people behave in a self-interested manner, they will seek the available opportunities to maximize their gains. If those opportunities lie in the market, their self-interested behavior will create spinoff benefits for others—new jobs, products, and so forth. However, if those opportunities lie in a large and interventionist state, people will neglect the private sector and engage in activities that are detrimental to the welfare of society as a whole, such as corruption, rent seeking, and nepotism. The solution was obvious: reduce the size of the state and its role in the economy, so as to free up the market and make it attractive to entrepreneurs, and at the same time remove opportunities for corruption, rent seeking, and other economically harmful activities.

By the 1980s, a formidable corpus of literature had come together that hobbled Keynesian economics and reasserted the primacy of neoclassical theory over the statism of the postwar generation of development economists. The recommendations pointed in one direction: less government intervention, more freedom in the market, and the abandonment of ISI in favor of outward orientation.

By "outward orientation," neoclassical theorists specifically mean not only export-led growth but also a minimum of state control in this process. Other theorists, in particular the developmental-state theorists discussed in Chapter 6, talk of export-led growth that occurs behind a wall of state protection and sponsorship. Throughout this book, "outward orientation" will be taken to mean a development strategy that relies on export-led growth rather than domestic-led growth, and will not assume the neoclassical lack of control.

At any rate, underlying neoclassical theory was a sort of "trade optimism," that trade could be relied on for growth. Economic planning was not needed to alter the structure of production, agriculture should be left free to flourish, and trade with the first world was a boon, not a hindrance. If this was not a revolution of the scientific sort, it was nevertheless a rebellion that critically weakened the old orthodoxy.

Meanwhile, in the politics of the first world, the postwar Keynesian consensus was about to be shattered by the rise of conservative governments and the rightward shift of virtually the entire political spectrum.

From Theory to Practice

During the 1970s the public in many first-world countries had warmed to the neoclassical agenda. In part this arose from the apparent exhaustion and intellectual bankruptcy of the left. Well into the 1980s, when it

was growing increasingly obvious that the state could not expand forever, socialist parties in many developed countries were still calling for increased government activism and expenditure as a remedy for social and economic problems. All the while, the left was fragmenting between its traditional support base in the working class and the new, more individualistic "postmaterialist" voters of the baby-boom generation.[26] Related to this was the debilitating impact of postmodernism on leftist parties. Postmodernism, a current of thought that emerged in many disciplines, especially since the 1960s, rejected the modernist ambition of remaking and improving the world according to human design. Doubting that there is such a thing as progress, postmodern philosophers generally call for radical individual liberation that allows people to find their own truths in a world in which there is no objective reality. Postmodernist philosophers often gravitated to left-wing parties, to which they presented grave dilemmas. Their stress on individual autonomy, subjectivism, and relativism did not always sit well with the collective traditions of the left. Moreover, these values gave rise to calls for individual liberation, including gay liberation, that offended working-class supporters of the left, who were more inclined to be conservative on moral questions. The result was infighting on the left and erosion of its support base. The rise to political power of the right, with its neoclassical agenda, in large part resulted from the crumbling of the opposition.

Even before the election of Margaret Thatcher in 1979, administrations with neoclassical economic agendas had come to power elsewhere in the first world. In a number of third-world countries, governments had already begun experimenting with ingredients of the neoclassical recipe to deal with their own problems. The best-known case was Chile, where the 1973 coup d'état opened the country to a group of Chicago-educated monetarists who instituted a program of monetarist shock therapy even stronger than the International Monetary Fund had recommended.[27] But as early as the late 1950s, governments had begun using short-term adjustment programs to deal with balance-of-payments problems.

One could liken the early experiments with adjustment to the early experiments with ISI. Both were responses to circumstances that were not necessarily thought to be long-term, and neither was necessarily linked to an overarching and radically new vision of what development should entail. In the 1970s and 1980s these approaches would be formalized by theorists into long-term development programs. In the earlier period, the possibility of foreign borrowing lessened the need for major adjustment.[28]

The ascent of conservative governments in Europe and North

America in the 1980s injected neoclassical policy into the international financial bodies of these states, in particular the World Bank. Initially, the new conservative governments were responding to recession by raising interest rates. Falling commodity prices and dwindling export revenue in the third world made the debt crisis an inescapable reality. The World Bank, which in the 1970s, through its "basic needs" approach, had aimed to relieve the misery of the world's poorest citizens through grassroots development projects, suddenly shifted to a neoclassical approach in 1980. Instead of investing in specific projects, the Bank began providing loans to governments facing balance-of-payments difficulties on the condition that these governments agree to implement structural adjustment policies.

This rightward shift was intensified by the appointment of A. W. Clausen to the presidency of the World Bank in 1981, at which time the Bank began to incorporate the new political economy into its policy.[29] Meanwhile, the IMF, which by its nature advocated restrictive fiscal policies, gained influence during these years because more and more developing-country governments had to approach it for financing. In some cases the World Bank and especially the IMF virtually forced third-world countries into accepting neoclassical policies in return for funding. In the course of the 1980s, developing countries increasingly implemented neoclassical recipes for development.

The way in which neoclassical theory worked its way onto the agendas of third-world countries varied from case to case. For the early implementers, such as Chile, Côte d'Ivoire, Turkey, and Sri Lanka, which had all adopted neoclassical reforms by 1980, the new development policies were largely internally generated, although these governments quickly won friends in the IMF. First-world pressure to implement neoclassical development strategies had not yet reached its highest point, and the World Bank was still governed by its "basic needs" philosophy. After the turn to the right in the politics of leading first-world countries, which filtered down into lending institutions and donor agencies, pressure on third-world countries grew. Those most dependent on these same agencies and governments, namely those whose debts were great and whose economies were in the worst shape, found it almost impossible to resist the neoclassical development strategies that were thrust upon them. Notable among the most vulnerable were the majority of sub-Saharan African countries.

Nevertheless, the neoclassical recipe for development did not lack local advocates. Third-world academics had since the 1950s been making key contributions to the neoclassical critique. When Mexico shifted

to a neoclassical strategy in the 1980s, development planners agreed on the need for structural reform, and reformists were rising to power in the government.[30] Similarly, in Ghana, after Jerry Rawlings in 1983 seized power for the second time, there was a growing conviction that the country had no choice but to turn to the West, so dire had the economic situation become. The original reform program was in fact drafted by Ghanaian authorities, not foreign lenders.[31] And in India, Rajiv Gandhi began in the 1980s to surround his government with technocrats who favored a reform process. However, the full weight of structural adjustment began to be felt only after the ascent to power in 1991 of P. V. Narasimha Rao, who enjoyed the backing of new and modernizing elements in the Indian business community.[32]

In all of these cases, what seemed to tip the local balance in favor of reform was the gravity of the economic situation. Mexico's early flirtation with reform in the 1970s and early 1980s had failed to stem economic decline. India was nearly bankrupt when it moved into the severe phase of structural adjustment in 1991. And Ghana had arguably been in an even worse position when Rawlings, who originally articulated a radical stance, made an about-face and imposed an IMF-sponsored reform package.

Foreign backing made structural adjustment all the more attractive. In contrast, countries that resisted pressure to implement the proposed reforms found it increasingly difficult to obtain development assistance at the time they needed it most.

This neoclassical "assault" rolled on through the 1980s. In both policy and intellectual circles, opposition to the assault was weak, just as opposition to the initial wave of Keynesian intervention had been. Socialist thought, which by now constituted the main opposition to neoclassical theory in the field of development studies, was dealt a severe blow by the collapse of Soviet and Eastern European communism after 1989. Few Western socialists continued to advocate the Soviet model by the time the Eastern European revolutions rocked the world. Yet for as long as it existed, the Soviet model stood as a reminder that it was possible to build an economy on principles other than capitalist ones. Its collapse seemed to show that history's great experiment with socialism had in fact been what detractors such as Friedrich von Hayek had said it was all along: a dangerously romantic delusion.[33] It became fashionable to say that the sweep of liberal capitalism across the globe was now inevitable.[34] Those who held this conviction found further confirmation for their views in several of the formerly communist states of the Soviet bloc, in which the neoclassical advance seemed most rapid now that

communist objection had been swept aside. The Harvard neoclassical economist Jeffrey Sachs rocketed to center stage in the economic policymaking of several of these governments, notably in Poland and, for a time, in Russia. "Shock therapy" was embraced by the governments of several of these countries, signaling a complete rupture with past ways.

The political weakness and the theoretical schisms within the left prevented it from raising a coherent objection to the neoclassical advance. In this context the rightward shift in policy and the rollback of the state appeared beyond debate, at least in the first world. In the third world, if policymakers held concerns that differed from those of their first-world counterparts, they were often too weak politically to resist the pressure for change. Countries that had avoided the debt trap, such as those in East Asia, retained much autonomy; meanwhile, big economies such as Brazil's retained a certain amount of sheer economic might that gave them more leverage in negotiations with first-world agents. But a great many third-world countries could only tailor or soften the policies these agencies demanded as a condition for support,[35] and were seldom able to refuse outright the neoclassical recipe for development.

The Neoclassical Recipe for Development

In the third world, neoclassical theory has been embodied in structural adjustment. Essentially, structural adjustment seeks to make both the state and the market more efficient in such a way as to accelerate growth and eliminate waste. Structural adjustment embodies the goals of neoclassical theory: it places the market at center stage, assigns the state a secondary role in development, and puts its faith in the potential of unfettered individual initiative, creativity, and ingenuity.

Sensitive to the obstacles placed in the way of such individualism by an interventionist state, structural adjustment programs (SAPs) aim to remove perceived structural blockages to the efficient operation of markets. To this end, SAPs have usually included such elements as fiscal austerity and disinflationary policies, the privatization of state-owned enterprises, trade liberalization, currency devaluation, and the general deregulation of the economy, including financial and labor-market deregulation. SAPs also try to attract new private foreign investment in industry. All in all, SAPs seek to increase the powers and freedoms of entrepreneurs and investors, increase pecuniary incentives and competition, lower costs, restore macroeconomic stability, and make the

state leaner and reduce its presence in the economy. This represents a decisive shift away from the state and back toward the market in what has come to be seen as a market-state dichotomy.

Fiscal Austerity

Fiscal austerity has been an important component not only of structural adjustment, but of the government-retrenchment programs seen all over the first world in the 1980s and 1990s. Fiscal austerity, or "belt tightening" as it is sometimes known, refers to government reductions in spending.

The logic is straightforward: the more money the government spends, the more money it takes out of the economy. This money is removed directly, through taxes, or indirectly, by borrowing. When governments increase their borrowing, they compete with private borrowers, such as banks and corporate bond issuers, for scarce capital. The quickest way to attract lenders is to raise the interest rates paid to them. When interest rates go up, not only do businesses and consumers cut spending—because the cost of credit, by which so much spending is done, becomes too high—but people with money to spend are persuaded to put it in the bank, where returns are high, rather than spend it or invest in lower-yielding securities like stocks.

Furthermore, whereas government spending can be productive over the long term, for political and other reasons it often prompts inflation. Much government spending takes the form of short-term transfers, including salaries, welfare payments, subsidies, and grants. Salaries, in turn, are often increased regularly to retain the support of the civil service and the military, which are often important underpinnings of a third-world government. Although this money is pumped back into the economy, if it is spent rather than invested it contributes to inflation: when the amount of money in the economy is increased more rapidly than the economy's productive capacity, buyers bid up the prices of goods.

So the combined effects of excessive government spending are seen as follows. By withdrawing money from the economy, through taxes and borrowing, and by driving up interest rates, the government "crowds out" private investors. Businesses find it hard to attract savings, and so must restrict their investment. Economic activity therefore declines.

High inflation rates can further inhibit investment because they reduce business confidence and make profits unsure. When potential profits seem likely to be eroded by inflation, investment in new technology becomes unappealing. Investors are then more likely to prefer investments that promise high returns in the short run but may con-

tribute little to long-term development, such as property speculation and trade. Under such conditions, big investors often find it safer to export their money to havens where the value of their investments is less likely to be eaten into by inflation.

The solution to all of these problems appears simple. By reducing spending, governments enable interest-rate cuts. By capping pay raises and slashing budgets, they reduce inflation. Private investment thus becomes cheaper, and the environment for business more attractive. Economic activity should therefore resume.

In addition to lowering inflation and borrowing costs, and encouraging investment, fiscal austerity should achieve another goal: government spending cuts and caps on salaries and transfers should lead to a fall in real wages, which in turn should reduce overall consumption in the economy. This so-called demand compression should leave a surplus of unsold goods that will then be available for export. Ideally, more foreign exchange should flow into the economy as a result, stimulating economic growth and rectifying any imbalances in the current account (that part of a nation's balance of payments that covers income and trade flows).

Privatization

The idea behind privatization is self-evident. Any economic vision based on the virtues of a private market economy tends to frown on the state performing those functions that can be taken on by private companies. The severe abuses and inefficiencies often associated with public firms in the third world provide added impetus to privatization. It is also believed that the owners of a private firm have a greater interest in maintaining its efficiency and profitability than do public-sector managers, who operate more like civil servants and so might be given to such strategies as "empire building." In theory, privatization should raise money for cash-starved governments, enhance the normal operations of the market economy, and improve the efficiency and financial performance of the firms privatized. It is worth noting, however, that the argument for privatization has often been expressed more strongly by the political wing of the neoclassical school than by its economists.

Trade Liberalization, Currency Devaluation, and the Abolition of Marketing Boards

Trade liberalization refers to the effort to reduce hindrances to trade, thus maximizing the free flow of goods and services. At a general level, there are two types of trade liberalization. First there is the liberalization

of foreign trade by eliminating or reducing qualitative and quantitative restrictions on imports, especially quotas; streamlining taxes on imports; and devaluing overvalued currencies. Then there is the liberalization of domestic markets through the elimination of price controls and marketing boards. In addition, because it raises the price of export goods in local terms, devaluation has often been promoted as a means to give producers of export goods an incentive to increase production.

As a rule, ISI regimes limited imports of consumer goods but favored industrial producers when it came to the allocation of hard currency, whose price was kept down by overvaluation. This hard currency was then used to import the inputs and capital goods needed in the production process. When a currency is devalued, its purchasing power on international markets declines. Therefore, trade liberalization and currency devaluation doubly hurt firms that formerly relied on imported inputs to produce consumer goods for a protected market: their import costs jump just as imported consumer goods start entering the country, stiffening competition. These firms must find ways of lowering their costs, or else go out of business. Wasteful firms go under; efficient survivors then pick up the slack and thrive. In sum, trade liberalization and currency devaluation should stimulate an economy to realize its static comparative advantage. In other words, an economy should specialize in those industries in which it has the lowest opportunity costs, abandon those that are expensive for the economy to maintain, and rely on imports to fill the gap. This will ensure that the economy's resources are used with maximum efficiency.

In a third-world country, especially a less-developed one, much of the static comparative advantage lies in the agricultural sector. Devaluation boosts this sector by giving export-crop farmers a leap in income, because even if the world prices on their crops remain constant, the new exchange rate generates a greater amount of local currency. Their improved position should ordinarily encourage farmers to augment their output. This practice of "getting the price right" is a key concern of the new political economy. Given this school's belief that producer prices on primary goods were artificially distorted downward by an interventionist state, it follows that rolling back the state should, all other things being equal, lead to increased prices and thus output. Although domestic market liberalization is intended to improve the functioning of all domestic markets, in practice the concern of the new political economy has been to improve agricultural markets.

One way to liberalize domestic markets is to abolish marketing boards. This should introduce competition into local markets, thereby

increasing the bargaining power of farmers and enabling them to obtain better prices on their sales. If a marketing board is to remain, it can be pressured by donor agencies into paying farmers better prices. However, given the sometimes terrible abuses wrought by marketing boards in Africa, where prices designed to extract maximum revenues from producers were so low they simply drove producers out of the market, dismantling marketing boards altogether made sense.

Retrenchment and Deregulation

At a general level, government retrenchment and deregulation should free up the market and reduce the inhibitions on private entrepreneurs. Deregulation should enable the market to function more effectively, reducing price distortions and allowing them to find levels that encourage efficient resource allocation. Wages may drop, encouraging investors to hire more workers and use more appropriate labor-intensive technology. Bankers will find the business environment more conducive, and will expand their operations and make more credit available.

An added concern in most third-world countries is the battle against corruption, in which retrenchment is said to be a useful weapon. Paring back the state reduces channels to resource accumulation in the public sector. Opportunities for rent seeking diminish, there are fewer patronage appointments to be used to gain political influence, and there are fewer chances to use public firms or marketing boards to skim resources from the economy. Ambitious individuals will therefore turn to the private sector to seek upward mobility. Whereas in the 1970s in Côte d'Ivoire, people with university degrees most often entered the public service, by the 1980s most of them had been driven into business by the low salaries, unappealing promotion prospects, and generally unpromising environment of the public service.[36] Similarly, trade liberalization should allow highly skilled managers who formerly lobbied for quota shares to turn their attention to productive endeavors.[37]

Conclusion

Neoclassical advocates of structural adjustment recognized that there would be losers along with gainers, but contended that this was not necessarily bad, because the losers were gobbling up scarce resources in an inefficient manner. Their collapse would thus free up resources for more efficient producers. Losers would include large, protected industries

producing for the home market, and inefficient state firms. These would now have to compete with imports, lose state subsidies and protection, and pay more for imported inputs. Among the winners would be export industries, smaller firms, and farmers, especially export-crop farmers. They would benefit from currency devaluation, their goods becoming cheaper on export markets; they would gain more credit thanks to financial liberalization; and they would have fewer restrictions on their behavior.

By the 1990s very few holdouts remained against structural adjustment. Many experiments with structural adjustment were less than wholehearted. India approached it hesitantly at first, and in Zambia the government was forced to backpedal when riots broke out. But elsewhere shock therapy was and continues to be applied. Few if any other options presented themselves to governments facing economic stagnation and persistent balance-of-payments crises.

In the late 1980s the situation in the development debate was thus the mirror image of that which had prevailed in the late 1940s. Where neoclassical theory had once been a dissenting school, and Keynesianism and structural economics the orthodoxy, in both academic and policy circles, neoclassical theory was the new orthodoxy. Socialism was reeling, structuralism weak, and ISI discredited.

A great many third-world countries have implemented SAPs of one variety or another. As a result, most of the third world has become a laboratory for a huge experiment in neoclassical theory. The results are instructive. They shed a great deal of light on the strengths, but also the weaknesses, of neoclassical theory. Just as neoclassical critiques had trickled in steadily throughout the late 1940s and early 1950s, posing questions that orthodoxy could not answer or pointing to phenomena that orthodoxy had trouble explaining, so it goes today. Except that now the neostructuralists and new schools of statist theorists are asking the prickly questions.

Notes

1. See F. A. Hayek, *The Constitution of Liberty* (London: Routledge, 1990), pt. 1.

2. The "doctrine of unintended consequences" was originally expressed in the early eighteenth century by Bernard Mandeville in *The Fable of the Bees,* newly edited (New York: Capricorn, 1962).

3. Milton Friedman, "The Role of Monetary Policy," *American Economic Review* 58 (1968): 17.

4. Michael Carter and Rodney Maddock, *Rational Expectations: Macroeconomics for the 1980s?* (London: Macmillan, 1984).

5. See Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic, 1974).

6. P. T. Bauer, "Remembrance of Studies Past: Retracing the First Steps," in *Pioneers in Development,* edited by Gerald M. Meier and Dudley Seers (New York: Oxford University Press, for the World Bank, 1984).

7. T. W. Schultz, *Transforming Traditional Agriculture* (Chicago: University of Chicago Press, 1964).

8. Harry G. Johnson, *Money, Trade, and Economic Growth* (London: Allen and Unwin, 1964).

9. Ian M. D. Little, *Economic Development: Theory, Policy, and International Relations* (New York: Basic, 1982), p. 160.

10. Hla Myint, "Economic Theory and the Underdeveloped Countries," *Journal of Political Economy* 73 (1965): 477–491.

11. See, for example, Deepak Lal, *The Poverty of "Development Economics"* (London: Institute of Economic Affairs, 1983).

12. Ian Little, Tibor Scitovsky, and Maurice Scott, *Industry and Trade in Some Developing Countries: A Comparative Study* (London: Oxford University Press, 1970).

13. Bela Balassa et al., *The Structure of Protection in Developing Countries* (Baltimore: Johns Hopkins University Press, for the World Bank and Inter-American Development Bank, 1971).

14. Lal, *The Poverty of "Development Economics."*

15. P. T. Bauer, *Equality, the Third World and Economic Delusion* (Cambridge: Harvard University Press, 1981).

16. Anne O. Krueger et al., *Trade and Employment in Developing Countries* (Chicago: University of Chicago Press, for the National Bureau of Economic Research, 1983). A neat summary of the report can be found in Anne O. Krueger, "Trade Strategies and Employment in Developing Countries," *Finance and Development* 21,4 (June 1984): 23–26.

17. Little, *Economic Development,* p. 139.

18. Little, *Economic Development;* Hla Myint, "The Neo-Classical Resurgence in Development Economics: Its Strengths and Limitations," in *Pioneers in Development,* second series, edited by Gerald M. Meier (New York: Oxford University Press, for the World Bank, 1987).

19. Little, *Economic Development.*

20. See Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (June 1974): 291–303.

21. For a comprehensive critique of the rational-actor model, with particular reference to its application to politics, see Kristen Renwick Monroe, ed., *The Economic Approach to Politics: A Critical Reassessment of the Theory of Rational Action* (New York: HarperCollins, 1991).

22. Jagdish Bhagwati, "Directly Unproductive, Profit-Seeking (DUP) Activities," *Journal of Political Economy* 90 (1982): 988–1002.

23. I am indebted to Sudhanshu Handa for clarifying this distinction for me.

24. Robert H. Bates, *Markets and States in Tropical Africa* (Berkeley: University of California Press, 1981).

25. Mancur Olson, *The Logic of Collective Action* (Cambridge: Cambridge University Press, 1965).

26. Ronald Inglehart, *The Silent Revolution* (Princeton: Princeton University Press, 1977).

27. At one point the International Monetary Fund complained that the Chilean government was cutting too deep into its spending program. It has been said that this was one of the few times the IMF found itself prodding a third-world government to take a more interventionist role in the economy. See the Economist Intelligence Unit, *Chile to 1991* (London: Economist Publications, 1991), pp. 23–24.

28. Eliana Cardoso and Ann Helwege, *Latin America's Economy: Diversity, Trends, and Conflicts* (Cambridge: Massachusetts Institute of Technology Press, 1992), p. 99.

29. Despite the growing influence of neoclassical liberals in its ranks, the World Bank "never became a neo-liberal monolith, even in its most doctrinaire years." See Paul Mosley, Jane Harrigan, and John Toye, *Aid and Power*, 2 vols. (London: Routledge, 1991), p. 24.

30. Eduardo A. Gamarra, "Market-Oriented Reforms and Democratization in Latin America: Changes of the 1990s," in *Latin American Political Economy in the Age of Neoliberal Reform,* edited by William C. Smith, Carlos H. Acuña, and Eduardo A. Gamarra (New Brunswick, NJ: Transaction, 1994), p. 2; Nora Lustig, *Mexico: The Remaking of an Economy* (Washington, DC: Brookings Institution, 1992).

31. Jonathan H. Frimpong-Ansah, *The Vampire State in Africa: The Political Economy of Decline in Ghana* (Trenton, NJ: Africa World, 1992), p. 153.

32. Jørgen Dige Pedersen, "Explaining Economic Liberalization in India: State and Society Perspectives," *World Development* 28,2 (2000): 265–282.

33. Hayek's 1988 book, *The Fatal Conceit* (London: Routledge), in some ways the summation of a life's work, provided a powerful critique not only of socialist central planning, but of the very principle of state intervention in the economy.

34. Francis Fukuyama, *The End of History and the Last Man* (London: Hamish Hamilton, 1992).

35. Stephan Haggard and Steven Webb point out that while the IMF and World Bank have at times appeared to impose their will on borrowing governments, in many cases they have still failed to secure full adoption of the policies they recommended as a condition for support. See Stephan Haggard and Steven Webb, "What Do We Know About the Political Economy of Economic Policy Reform?" *World Bank Research Observer* 8 (1993): 157.

36. See John Rapley, *Ivoirien Capitalism: African Entrepreneurs in Côte d'Ivoire* (Boulder: Lynne Rienner, 1993).

37. Sebastian Edwards, "Trade Liberalization Reform in Latin America: Recent Experiences, Policy Issues, and Future Prospects," in *Latin America's Economic Future,* edited by Graham Bird and Ann Helwege (London: Academic Press, 1994), p. 17.