19. Classical development economists of the mid-twentieth century

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INTRODUCTION

'I do not know', Alexis de Tocqueville says in *Democracy in America* (1876), 'if one can cite a single manufacturing and commercial nation – from the Tyrants to the Florentine and the English, – that has not also been free. Therefore a close tie and a necessary relation exists between those two things: freedom and industry.' Tocqueville expresses what could be called a development truism of half a thousand years from late Renaissance city-states to the Marshall Plan and the Havana Charter. Indeed, during the Enlightenment, civilization and democracy were understood, through the analysis of people like Montesquieu and Voltaire among many others, as products of a specific type of economic structure. When German economist Johan Jacob Meyen stated in 1770 that 'it is known that a primitive people does not improve their customs and institutions later to find useful industries, but the other way around', he expressed something which could be considered common sense at the time. We find the same idea – that civilization is created by industrialization or, to put it more specifically, by the presence of increasing returns activities – in the nineteenth century in thinkers across the whole political spectrum from Abraham Lincoln to Karl Marx. Industrialization 'draws all, even the most barbarian, nations into civilization', as Marx puts it. What might be called the historical development consensus saw, in other words, the aim of development in the creation of middle-income economies, with all the accompanying values and culture that in turn were perceived as highly conducive to further sustained development. However, as Figure 19.1 shows, the creation of middle-income economies has become a true rarity in the last three decades.

Apart from East Asia's much-praised experience and the enormous catching-up taking place in China and, to a lesser degree, in India, the rest of the developing world from Eastern Europe to Latin America and Africa is experiencing strong cognitive dissonance.

While many of these countries have seen significant growth in exports and in foreign capital inflows, their income levels have flatlined since 1980 and in most cases actually dropped in the 1990s. In fact, compared to highly developed countries, most developing countries were on a steady track towards catching up until the early 1980s; the subsequent decades show continuous and significant catching-up – and actual surging-ahead in the case of some countries such as Singapore – of East Asian economies (see also Wade 2008). The trends follow rather precisely the changes in development thinking from classical development economics up to the late 1970s to the Washington Consensus from the 1980s.

Moreover, as Figure 19.2 shows, in recent decades, most developing regions – again

* An early version of this chapter is Kattel et al. (2009).

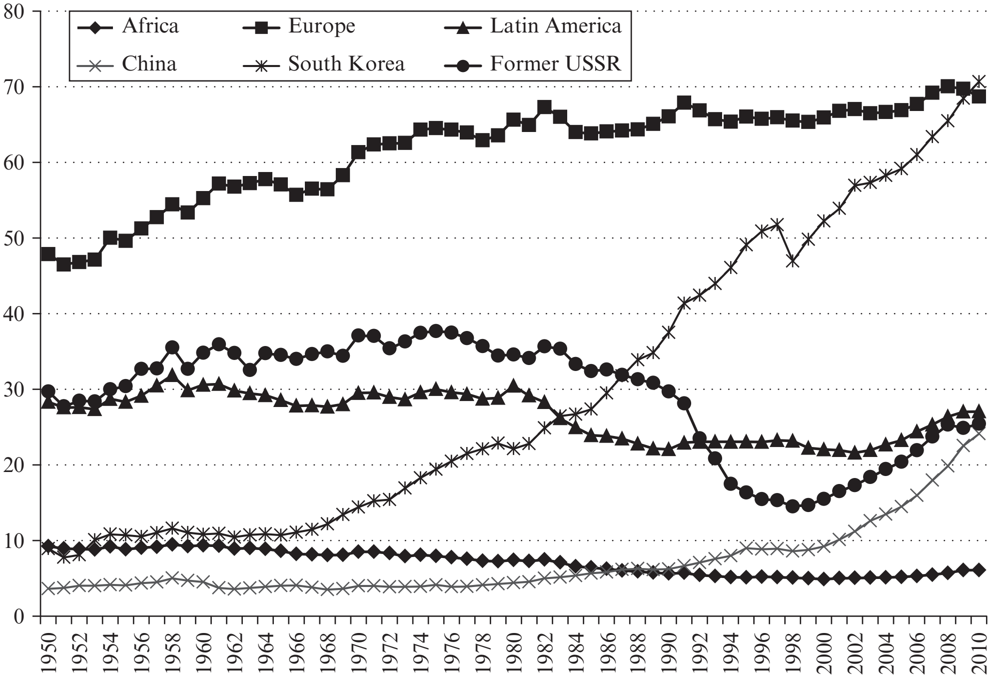


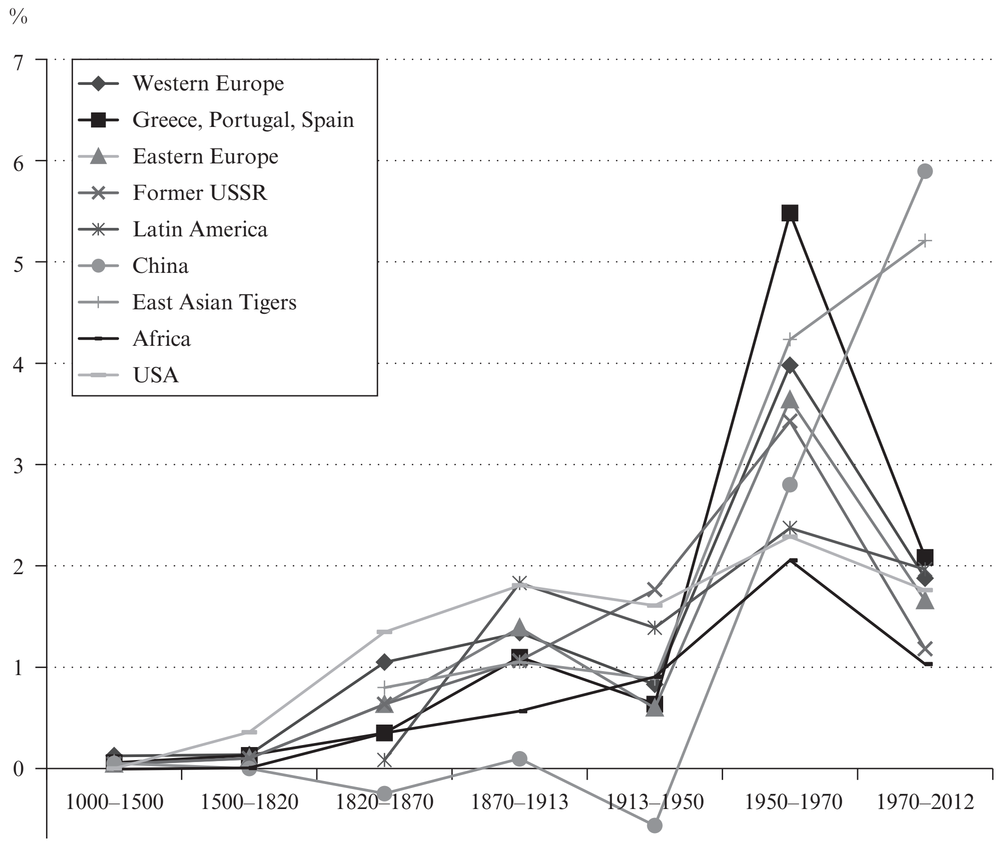
Figure 19.1 GDP per capita as a % of US GDP per capita, 1950-2010, regional simple averages, in 1990 GK$

with the exception of East Asia – experienced growth rates that go clearly against the more or less positive trend of the last 200 years from a long-term historical perspective. In other words, the world after the industrial revolution has not seen such a dismal development performance. The Washington Consensus in development mainstream seems to be a failure on an unprecedented scale.

Yet, surprisingly, the decades after 1980 have been called the best development decades in a generation (Rodrik 2007, 13–14; Skidelsky 2008).[1] While Amsden (2007, 2) argues, in contrast, that during these same decades, for most developing countries, 'Heaven slowly gave way to Hell', even the most ardent supporters of the Washington Consensus are forced to admit that there is something similar to the 'China price' in the development statistics of the poorer countries from 1980 onward. If one deducts China's and India's growth from the developing countries' data, there is not much as far as growth and development in the rest of the developing world is concerned. And neither China nor India can be counted as showcases of the neoliberal policies propagated by the Washington Consensus. We will return to this later.

As the World Bank itself admits, the rest of the developing countries, notably in Africa, Latin America and some of the former Soviet republics (in Central Asia, Moldova,

[1] To be precise, Rodrik and Skidelsky, similarly to many others, mean mostly poverty reduction in this context.



Source: Calculations based on the Conference Board Total Economy Database, http://www.conference-board.org/data/economydatabase/.

Figure 19.2 Growth rate of GDP per capita of selected world regions; regional average in selected periods between 1820 and 2001; annual average compound growth rate`

Ukraine), suffer from heavy doses of a cognitive dissonance between promised growth and the reality of standing still, if they are lucky, or dropping backwards to income levels of earlier decades: 'Whereas Latin America's income per head grew by 10 per cent in the entire 25 years from 1980 to 2005, it grew by 82 per cent in the 20 years from 1960 to 1980' (Amsden 2007, 6; also World Bank 2006).

Latin America diligently followed policy reform suggestions, yet failed to grow, as the World Bank also admits (World Bank 2006, 36–29); Eastern Europe and the former Soviet Union were equally willing to apply the policy reforms and again, according to the World Bank's calculations, the recession these countries saw in the 1990s and which many are still experiencing is worse than the Great Depression in the United States of America (USA) and World War II in Western Europe (in both cases, the countries affected recovered considerably quicker). In fact, for example, 'even if Ukraine managed to grow steadily at 5 per cent a year, starting in 2002, it would take until 2017 to regain its previous peak – implying a transformational recession of more than a quarter of a century at best' (World Bank 2006, 33). Indeed, also for most Eastern European countries, the recession was severe and lasted at least ten years (Reinert and Kattel 2007; Tiits et al. 2008).

Coupled with the change of techno-economic paradigm that completely changed the nature of industrialization (outsourcing) and essentially stripped many maturing and increasingly footloose industrial activities of significant (dynamic) scale economies, Washington Consensus policies emphasizing foreign direct investment (FDI)-led growth have created a truly toxic situation for many developing countries where the liability destruction initially was strong and quick but was followed by slow asset creation. Thus, 'the failure of the Consensus reform policies lies in the fact that they provided support for the "destruction" of inefficient domestic industry, but failed to provide support for the "creative" phase of "creative destruction" of a real transformation of the productive structure through higher investment and technological innovation' (Kregel 2008). We will return to this topic, as well. However, it seems rather obvious that the development community has unlearned how to create middle-income countries.

Yet, there is growing concern and evidence that the current form of globalization not only hurts developing countries that have followed the Washington Consensus policies, but is also harmful to the developed North. The flipside of the unlearning that has taken place in the development community seems to be that we are unlearning how to create middle-class jobs in the developed core countries. For all intents and purposes, non-existing growth in real wages in the USA and Germany over the first decade of this century has given ample reasons to start considering the impact of Washington Consensus trade policies on these countries, the most prominent examples being Samuelson's (2004) and Krugman's (2008) accounts. In 2004, Samuelson argued that continuing globalization and economic integration of world markets in its present form would do permanent harm to high-wage jobs in highly developed countries like the US. In early 2008, Krugman, another celebrity mainstream economist, argued that increased trade between US and developing countries was factually hurting US wages and middle-class jobs and thus increased income inequality. He went on to prove this not only with US data but also with elaborate modelling.

What Krugman does not realize, or at any rate does not say so explicitly, is that the problem lies not in the structure or policies of the US economy or even in the growing trade as such, but in the nature of specialization of developing-country exports. Specializing in lower-end production or services – also in sectors like information and communication technology (ICT) – virtually traps developing countries in low-wage jobs and, at the same time, lures the high-wage middle-class jobs away from the developed nations. Thus, while the global production grows, not all countries necessarily benefit from it. And, consequently, 'firms maximize global output but do not necessarily maximize national income' (Palley 2006, 16).

In this chapter we aim to show, first, how classical development economics, that of Ragnar Nurkse's (1907–1957) generation, epitomized the best development practices of the past 500 years and crafted them into what Krugman (1994) rightly calls high development theory. It is not a coincidence that the post-World War II era, when Nurkse and others ruled the development mainstream, is one of exceptionally good performance for many poor countries. Second, we argue that the alleged death of classical development economics and the subsequent rise of the Washington Consensus has to do not so much with increasing modelling in economics, a way of research purposely discarded by many classical development thinkers, as Krugman (1994) claims, but much more with misunderstanding the reasons for East Asia's success and Latin America's demise; we show that the root cause of this misunderstanding – which in fact goes back to 'misreading' key passages in Adam Smith – is the role of technology, or of increasing returns activities, and of finance, in development.

CLASSICAL DEVELOPMENT ECONOMICS

Pre-Smithian economics saw development as a goal created by increasing returns and innovations in manufacturing and not in agriculture, where stagnant productivity, diminishing returns and monoculture, as well as the absence of synergies, prevented growth.[2] There are a number of basic principles of development that can be observed in action from fifteenth-century Tudor England to the Marshall Plan. Despite all the theoretical and historical diversity that makes up this tradition of more than 500 years, one very simple formula sums it up rather effectively: a nation is better off with an inefficient industrial (increasing returns) sector than with none at all. Yet, part of this consensus is also the understanding that possessing an industrial sector, however inefficient, should be followed by increased trade in order to create competitive pressure for the industrial sector.

Classical development economics, while in itself a highly diverse group of economic and policy ideas as well as economists, is perhaps still the best-articulated and theoretically grounded expression of the above-described development consensus. And, as Krugman (1994) argues, the 'irony is that we can now see that high development theory made perfectly good sense after all'.

The group of economists commonly referred to as classical development economists, or pioneers of development or of high development theory, is typically seen to consist of four to six key thinkers: Paul Rosenstein-Rodan, Hans Singer, Arthur Lewis, Albert Hirschman, Gunnar Myrdal and Ragnar Nurkse.[3] While of this group, Nurkse's contribution is the strongest in terms of economic theory, Hirschman's accomplishments are perhaps the most far-reaching in terms of influencing mainstream social science and development.[4] Today, it is relatively typical to find accounts that juxtapose precisely these two thinkers as representing almost exactly opposing ideas about development, namely, balanced versus unbalanced growth. However, as Hirschman later acknowledged, the differences between him and Nurkse were minor at the end of the day, and, in large part,

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2 For detailed discussions, see Chapter 2 in this volume by S. Reinert on mercantilism, and Chapter 3 by E. Reinert and P. Rössner on cameralism.

3 There are a number of other thinkers who played key roles in early development theory and could be mentioned here as well, for instance Raul Prebisch and W.W. Rostow. A good collection of recollections by the key figures in this tradition is gathered in Meier and Seers (1984) (although this does not include Nurkse, as he had passed away by the time of this publication). On Latin American structuralism, see Cimoli and Porcile, Chapter 11 in this volume.

4 On Hirschman, see Alacevich, Chapter 24 in this volume.

they shared a very similar outlook (Hirschman 1984; see also Nurkse 2009, 329ff).[5] In what follows, we base our brief account mostly on Nurkse's ideas,[6] adding bits and pieces from the other pioneers, mostly from Rosenstein-Rodan and Hirschman.

The high development theory developed by Nurkse and others rests on two key ideas: (1) financing for development has to come to a large extent from the developing country itself ('Capital is made at home'; Nurkse 1953, 141); and (2) the key areas to be financed need to exhibit increasing returns in order to trigger dynamics of development or, as Myrdal (1957) argued, virtuous circles of growth.[7]

What makes Nurkse's contribution so important is the fact that he is the only thinker from this group to incorporate both key ideas into a coherent theory of development, and draw clear relationships between these notions.[8] Indeed, this is precisely the reason Nurkse favoured the balanced growth approach over the unbalanced one (the difference, simply put, being whether one industrializes in numerous areas or just a few key areas first): the former was deemed financially more stable than the latter by Nurkse (2009, 329ff).

According to Nurkse, the financing for development has to come mainly from within the country set on development, because financing of growth through either foreign investments or increased trade was largely a historically unique phenomenon confined to the nineteenth century and, more specifically, to the American (that is, United States) experience (see, e.g., Nurkse 2009, 249–250; 397–401). The 'new countries' within and without the British Empire were 'high income countries from the start: effective markets as well as efficient producers' (ibid. 330). Nurkse thought that it would be nearly impossible for any developing country to repeat such a successful trade- and foreign financing-based growth strategy because America was highly rich in resources, but at the same time populated by a workforce essentially on the same skill level as Britain (ibid. 255). This unique combination made the American experience non-replicable because, in any other circumstance, trade and foreign investment would engender a number of obstacles to development: first, large parts of such financing would seek to utilize poor countries' resources and eventually lock these countries into undiversified economies with a skewed social structure (Nurkse 2009, 246, 251, 255–256); and second, there is a clear danger that significant amounts of foreign financing would end up funding private consumption patterns emulating Western living standards and thus creating balance-of-payments problems (Nurkse 1953, 66–70).

To sum up, a growth strategy simply based on trade and foreign financing would leave the poor countries with negative financial flows and an undiversified production structure – just like the Washington Consensus-based policies have done – and this amounts to financial fragility or to a Ponzi financing position. The problem with such a

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[5] Alacevich (2011) offers a nuanced discussion of the differences between the two camps, and also comes to the conclusion that what these two strands of development theorists shared was significantly larger than what they disagreed upon.

[6] While Nurkse (2009) is a collection of his various main works, we refer to this publication as a whole. Further, the 2009 collection also includes Nurkse's 1953 book *Problems of Capital in Underdeveloped Countries*, but we will refer hereafter to the original 1953 edition as this is the best-known work by Nurkse.

[7] For Nurkse, key passages are Nurkse (1953, 19–25).

[8] Krugman (1994), for instances, discusses only the aspect of increasing returns and fails to note how this is related to financial issues.

strategy is that it relies on foreign financing to balance the current account, and this can take place only under very specific conditions:

> it is only possible to maintain a development strategy based on net imports financed by foreign capital inflows if the interest rates on the foreign borrowing are equal to the rate of increase of foreign borrowing. If interest rates are higher than the rate of increase of inflows . . . the policy will eventually and automatically become self-reversing as the current account becomes dominated by interest and profit remittances that exceed capital inflows. (Kregel 2004, 11)

This, arguably, is what has made various growth efforts in developing countries so difficult to sustain in the last few development decades: many growth strategies are simply based on a self-reversing logic, and this is indeed what Nurkse clearly foresaw.

Thus, according to Nurkse, any economic strategy that wants to be sustainable in the long term has to come up with another way of financing the development. What this means, however, is that such a development strategy has to work in a relatively confined environment in terms of capital and skills. Taking into account the financial constraints described above, it is in this context that Nurkse interprets Adam Smith's famous theorem about the size of the market being limited by the division of labour. For Nurkse (1953, 21–25), following Allyn Young's 1928 essay, this theorem indicates that the size of the market is limited by real wages that are, in turn, limited by productivity growth. For Nurkse (1953, 8, 14; 2009, 3–6), and very clearly for Hirschman (1984) and Rosenstein-Rodan (1984), productivity growth is determined by the presence of increasing returns in an economy. Thus, a viable development strategy should aim at establishing a number of increasing returns activities that would become each other's customers and generate the first virtuous circle of growth. The size of the market is limited by the number of increasing returns activities present at the particular market. This dynamics is the essence of Nurkse's balanced growth, but also of Rosenstein-Rodan's big push and, in the end, also of Hirschman's unbalanced growth, expressed in very similar wording:

> The expansion of the market can be realized only through a process of balanced growth, where people in different industries, working with more and better tools, become each other's customers. (Nurkse archives, Box 8; see also Nurkse 2009, 337–338)

> new producers will be each other's customers, and the complementarity of demand will reduce the risk of not finding a market. Risk reduction is in this sense a special case of external economies. (Rosenstein-Rodan 1984, 213)

Hirschman argues that such an interrelatedness – which he called backward and forward linkages – does not happen simultaneously, but rather in a sequential process of learning and development, and that in this process the role of public policy or development strategy in setting goals and advancing specific sectors is key.[9] Nurkse's most serious argument against this is that such unbalanced growth will very probably need to rely on foreign financing at some point, as Hirschman (1984, 103) also admits. As we have argued above, due to the specific nature of such foreign financing (extractive in its nature

[9] Hirschman discusses his relationship to Nurkse and Rosenstein-Rodan most explicitly in Hirschman (1984, esp. 96–97).

and easily engendering lock-in effects, plus financing the consumption of imported goods), Nurkse (2009, 247–253) was wary that such a strategy would lead to financial fragility. As we have argued above, this proved to be a highly far-sighted concern.

It is important to note that most subsequent accounts of big-push and balanced-growth theories only emphasize the idea of consorted investments, mostly missing the point that, first, these policy efforts should target increasing returns activities; and second, the reasoning behind this has to do with financial stability (see, e.g., Easterly 2008).

In order to create increasing returns activities, infant-industry protection may be necessary according to Nurkse and others, but it is also more important here to realize that the argument is less about protection but more about what is specifically targeted with the protective policies and how: infant creation is more important than infant protection (Nurkse 2009, 334; 1953, 104–105, 109). Indeed, perhaps the key idea behind targeting increasing returns activities is that the resulting virtuous circles of growth (productivity and wage growth) act as barriers of entry for competitors both in terms of private companies and also in terms of regions and countries (see also Reinert 1980; Gomory and Baumol 2004). The reason is evident in the very logic of balanced growth: virtuous circles of growth relay and create their own demand and financing (Nurkse 2009, 296). Thus, the driving idea behind Nurkse's balanced growth is not simply a set of reasons and/or policies for the creation of diversity in increasing returns activities, but moreover to show that both as a theoretical foundation and as a policy strategy, balanced growth is coherent and sustainable as it shows how long-term growth with financial stability can be achieved and maintained. In sum, Nurkse's balanced growth shows how middle-income nations can be created.

The quest to create middle-income economies as the main goal of development can also be stated differently: how to upgrade developing countries' economic structures with rising wages and without beggar-thy-neighbour types of policies, for instance in foreign exchange rates, labour markets, tax rates and so forth (see also Summers 2008). This, however, is largely the way in which competitiveness has come to be defined by international organizations such as the Organisation for Economic Co-operation and Development (OECD) and the European Union. Interestingly, however, this definition of competitiveness comes from a 1985 Reagan administration report, *Global Competition: The New Reality* by the President's Commission on Industrial Competitiveness (1985; see Scott and Lodge 1985 as background). Historically, however, this goes back further to the Bretton Woods agreements, in particular the one that established the International Monetary Fund (IMF), where under Article I.2 it states the aim of the IMF as follows: 'To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.' The key background publication for these ideas was the League of Nations publication from 1944 titled *International Currency Experience: Lessons of the Inter-war Period*, mainly written by Nurkse (see further, Urban 2009). This not only shows the breadth of Nurkse's influence, but also shows why his and his generation's development ideas are so relevant today: the strategy proposed by classical development economists is, first, based on a historically proven recipe of targeting increasing returns activities; and second, doing so under more or less financially stable conditions. It also shows, however, that following the path of balanced growth makes it clear that there is a need for global balancing rules as well. While the post-World War II era showed that this can indeed be done, the crisis starting in 2008 has taught that such global financial rules are in dire need again.

Krugman (1994) argues that the decline of high development theory has methodological reasons: 'so why didn't high development theory get expressed in formal models? Almost certainly for one basic reason: high development theory rested critically on the assumption of economies of scale, but nobody knew how to put these scale economies into formal models.' Krugman admits that Hirschman and Myrdal in particular were consciously against increasing modelling in economics. His own argument that modelling is inevitable in economics is based on two simplifying assumptions: first, science is based on models; and second, models need to be mathematical. While both assumptions are, to say the least, debatable (see, in particular, Drechsler (2004) for an excellent discussion), putting the blame on the doorstep of high development theory, Krugman, along with much of the economics profession, completely misses the other side of the story: how model-based economics interpreted post-World War II development stories. As we will argue below, because model-based economics assumed increasing returns and technology from development, it was left with tools Nurkse and others deemed counterproductive when used without targeting precisely the increasing returns activities, trade openness and foreign financing as the main engines of growth. As the saying goes, if all you have is a hammer, pretty soon all problems look like nails. This is precisely what happened. While high development theory argued for a context-specific approach and tailor-made policies – because economic activities, technology, knowledge and economies of scale change enormously in time and space – the new development consensus on the rise in the 1980s and in full sway to this day argues the opposite: all development problems are fundamentally alike, and thus, solving them should go by more or less the same policy prescriptions. The success of such an approach lies in the very nature of development: as Hirschman argues, all development presupposes some form of priority-setting through policy-making (Hirschman 1958). The Washington Consensus did away with exactly this assumption: since all development problems are assumed to be of the same nature, the solutions are bound to be the same as well, and this takes the burden of proof, so to say, away from domestic policy-making.

WASHINGTON FOLLIES

It has been more or less 30 years since the alleged death of classical development economics. The 'demise' was precipitated by the onslaught of 'The Age of Milton Friedman',[10] and by what about 20 years ago became more widely known as the Washington Consensus.[11] It can be argued that it was truly an intellectual 'counter-revolution', a term used both by the supporters and the critics (see Johnson 1971 and Klein 2007, respectively). The counter-revolution, whatever its ideological core or its public enemies may originally have

[10] Shleifer (2008); see Galbraith (2008) from the opposite perspective.
[11] The classic reference is Williamson (2002) summarizing 'what Washington means by policy reform', originally published in 1990; see also Williamson (2008).

been (be it development economics proper, Keynesianism or 'bastard Keynesianism'),[12] was at its core aimed at juxtaposing two seemingly different development traditions: East Asia's rise and Latin America's doom in the 1970s and 1980s. However, this was only possible by showing, first, that East Asia's rise was based on using policies based on classical Ricardian comparative advantage thinking and using exports as an 'engine of growth' (see, e.g., Balassa 1971; Rodrik 2006; World Bank 2008); and, second, that Latin America's problems had its roots in failed or at least mismanaged import substitution industrialization, closely related with the classical development economics (see, e.g., Bhagwati 1984; Rodrik 2007). In both cases, the counter-revolutionaries or their descendants got it wrong: exports were only a part of the success story in East Asia's rapid rise, and import substitution played only a relatively insignificant part in Latin America's fall.

East Asia's story was told as if feedback linkages and positive externalities emerging in these economies through state-led industrialization played only an exogenous role in development.[13] That is, technology and innovation were simply left out of the story, and a rather simplistic conclusion was drawn: export-led growth is what works in development countries. Latin America's problems, in turn, were seen through a double prism of inflation and rent-seeking, without however realizing that increasing foreign private lending in the 1970s also spurred the consumption engine into higher gear, which was bound to lead to the current account problems (through import consumption) and eventually towards long-lasting financial fragility that undermined industrialization efforts, and not the other way around (Kregel 2008). That is, the role of the post-Bretton Woods international financial architecture was ignored and, in fact, together with the newly learned 'lessons' from East Asia about export-led growth, it was precisely the accelerating financial liberalization that was seen as the main source of the much-needed capital for the export-led growth model.[14] Two plus two equals five: development needs foreign investments and exports, and both could be provided by a stable macroeconomic environment and liberalized markets. In sum, two misinterpretations ended up providing a new model for development that evolved into the Washington Consensus as a full-fledged ideology and set of policies.

Significantly, both misinterpretations marked a break with a long-standing development tradition reaching back to the Renaissance (see Reinert 2007 in detail) – that was, however, also supported by many if not most neoclassical economists at the time (an excellent summary is Evans and Alizadeh 1984) – namely, that infant industry protection is a necessary if not sufficient condition for industrialization and diversification. Also Williamson's (2002) original list of Washington Consensus policies included infant-industry protection, and 'a moderate general tariff (in the range of 10 per cent to 20 per cent, with little dispersion) [that] might be accepted as a mechanism to provide a bias toward diversifying the industrial base without threatening serious costs'. Neither made it into the Washington Consensus practices in the 1990s or into its augmented version of the 2000s.[15]

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12 For accounts from rather different perspectives, see Toye (1987) and Klein (2007).

13 Wade (2004) is an excellent overview.

14 Blecker (2000) provides an overview of export-led growth strategies.

15 A useful discussion of international agreements and industrial policy space is Rodrik (2007, 129–148). For the 'Augmented Washington Consensus', see Rodrik (2006).

With these misinterpretations, however, not only were real developments misunderstood, but it is equally important to note that comparing East Asian and Latin American development experiences yields key lessons about the success and failure of development strategies. More precisely, perhaps the key lesson is that there are different kinds of protectionism. If development history teaches us that infant-industry protection is a *conditio sine qua non*, then it is exactly the comparison of two very recent instances of this strategy that can teach us the reasons for success and failure. Indeed, based on these two historical experiences, we can create two 'ideal types' of protectionism. In Table 19.1, we try to distil from vast and diverse historical data and different contexts two such 'ideal types'.

Comparing the two, it is clear that key differences between these 'ideal types' rest precisely in the issues that especially Nurkse, but also other early development economists, thought fundamental to development. First is the idea that development needs specific economic activities that exhibit long-term potential in terms of learning curves, home-market expansion and exports. Such activities provide dynamic increasing returns that in turn create possibilities for continuous upgrading through educational, labour-market

Table 19.1 Ideal types of protectionism compared

East Asian	Latin American
Temporary protection of new industries/ products for the world market	Permanent protection of mature industries/ products for the home market (often very small)
Very steep learning curves compared to the rest of the world	Learning that lags behind the rest of the world
Based on a dynamic Schumpeterian view of the world – market-driven 'creative destruction'	Based on a more static view of the world – planned economy
Domestic competition maintained	Little domestic competition
Core technology locally controlled	Core technology generally imported from abroad/assembly of imported parts/ 'superficial' Industrialization
Massive investment in education/industrial policy created a huge demand for education. Supply of educated people matched demand from Industry.	Less emphasis on education/type of industries created did not lead to huge (East Asian) demand for education. Investment in education therefore tends to feed emigration
Meritocracy- capital, jobs and privileges distributed according to qualifications	*Nepotism* in the distribution of capital, jobs and privileges
Equality of land distribution (Korea)	Mixed record on land distribution
Even income distribution increased home market for advanced industrial goods	Uneven income distribution restricted scale of home market and decreased competitiveness of local Industry
Profits created through dynamic 'Schumpeterian' rent-seeking	Profits created through static rent-seeking
Intense cooperation between producers and local suppliers	Confrontation between producers and local suppliers
Regulation of technology transfer oriented towards maximizing knowledge transferred	Regulation of technology transfer oriented towards avoiding 'traps'

and other policies. This is what East Asian countries did; Latin American countries failed to target windows of opportunities in different activities, and a need for competitive pressure was underestimated. Second is the failure to create dynamic economies of scale, which led to financial fragility relatively easily, in particular when foreign capital inflows and lending became prevalent elements in the development strategy, as happened in Latin America in the 1980s.

These lessons, however, were almost completely missed by the Washington Consensus.[16] Moreover, what is historically significant is the fact that the classical development economists were largely made the culprits of Latin America's problems. This is all the more puzzling when one reads the original works of these authors and looks at the subsequent history; it becomes clear, as we have shown above, that their theories predicted both East Asia's rise (understanding the key role of technology and diversity) and Latin America's doom (understanding financial fragility built into foreign-financing-led growth strategies). Interestingly, Williamson's article on the Washington Consensus ends with doubt and a premonition along similar lines of thought:

> A striking fact about the list of policies on which Washington does have a collective view is that they all stem from classical mainstream economic theory, at least if one is allowed to count Keynes as a classic by now. None of the ideas spawned by the development literature – such as the big push, balanced or unbalanced growth, surplus labor, or even the two-gap model – plays any essential role in motivating the Washington consensus . . . This raises the question as to whether Washington is correct in its implicit dismissal of the development literature as a diversion from the harsh realities of the dismal science. Or is the Washington consensus, or my interpretation of it, missing something? (Williamson 2002)

As we have seen in Figures 19.1 and 19.2, Washington Consensus policies not only failed to deliver growth and development to most developing countries, but following such policies even seems to have been almost a blueprint for falling back rather than catching up. It is ironic, however, but also deeply significant, that in its core the Washington Consensus goes back to a misreading of Adam Smith. We use here the term 'misreading' in a rather specific way. This term was coined in the late 1960s by Harold Bloom and denotes a process where authors creatively appropriate phrases and ideas from other authors, in their writing process, and mould them into something new, or at any rate something different. Bloom (1997, 5), writing about theory of poetry, writes 'Poetic history . . . is . . . indistinguishable from poetic influence, since strong poets make that history by misreading one another, so as to clear imaginative space for themselves.' A misreading does not thus connote a negative meaning. Generalizing it into a hermeneutical principle, we can argue that a misreading is the way most theoretical works are read and written. We argue that the history of economic thought has one such key passage, namely Smith's above-mentioned theorem about the size of the market and the division of labour. The impor-

[16] It is interesting that China's development strategies over the last few decades exhibit the results of this skewed learning process in the international development mainstream: while in the 1980s China seemed to be on the path towards the East Asian type of capitalism, where a mix of competitive markets and technology targeting is a key element, China then, reflecting the rise of the Washington Consensus in the 1990s, switched to an export-led growth strategy that, however, also exhibits certain elements of the Latin American type of development: nepotism and static rent-seeking in the policy environment, and uneven income distribution. For an intriguing study of Chinese capitalism, see Huang (2008).

tance of the theorem can be easily understood from the famous example Smith himself uses, namely, that of 'the trade of the pin-maker'. According to Smith (1976 [1776], 1.1.3), this particular occupation has gone through a transformation from a one-man business into at least 18 distinct operations performed by different individuals, causing productivity per employee to increase from one pin a day to 4800 pins a day. Such productivity explosions that follow innovations depend, as Smith rightly argued, on extensive trade and, as Smith also admitted, rapid technological development. While most researchers in economics and in related fields agree with the broad-brush description given by Smith, there are strongly varying misreadings about what causes and stimulates such innovations in the private sector. There are essentially two opposing schools of thought. On the one hand, there are scholars in the Schumpeterian/evolutionary/institutionalist[17] tradition who argue that innovations and economic growth in general take place because of knowledge and skill agglomeration and continuous upgrading and technological change, which are engendered by highly embedded policy-making of increasing coordination, dialogue and cooperation managed by a highly capable state and administration.[18] On the other hand, there are scholars in neoclassical and public-choice traditions who argue that the main driver behind innovations and growth are trade and competition: the former using the comparative advantage of nations to bring more, better and cheaper goods to consumers (higher efficiency); the latter creating pressures for companies to incessantly innovate and outcompete the competitors, and to push prices downwards in the process (higher efficiency, again).[19] While the differences in details are, of course, greater than described here, it is important to see that both traditions can be traced back to Adam Smith's (1976 [1776]) theorem that the division of labour is limited by the size of the market. The difference is how one understands the theorem: the former school takes it to mean that the division of labour is key (creation of knowledge and technological diversity, and the producer with his capabilities, are the main policy goals), the latter school thinks the size of the market is key (the extent of trade and competition, and lower prices for consumers, are the main policy goals).

If, instead of accepting Adam Smith as an icon of free trade and laissez-faire under any circumstances, one reads what he says about economic development at an early stage, one will find that he is very much in line with classical development economics, where industrialization is the key recommendation. In his early work, *The Theory of Moral Sentiments*, Adam Smith (1810 [1759]) argued passionately for 'the great system of government', which is helped by adding new manufactures. Interestingly, Smith argued that new manufactures are to be promoted neither to help suppliers nor to help consumers, but in order to improve this 'great system of government'.

In fact, it is possible to argue that Adam Smith was also a misunderstood mercantilist, someone who firmly supported the mercantilist policies of the past, but then argued that they were no longer necessary for England. He praises the Navigation Acts protecting English manufacturing and shipping against Holland, arguing that 'they are as wise . . .

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17 See contributions in this volume by Nelson (Chapter 18) and Lundvall (Chapter 31).

18 On the role of the state and institutions in economic growth, see for example Evans and Rauch (1999), Wade (2004) and Amsden (1989).

19 The most recent summary of such arguments is Rodrik (2007). For public choice, see most recently Buchanan and Yoon (2008).

as if they had all been dictated by the most deliberate wisdom' and holding them to be 'perhaps the wisest of all the commercial regulations of England' (Smith 1976 [1776]: I, 486–487). All in all, Smith described a development that had become successfully self-sustained, a kind of snowballing effect, originating in the wise protectionist measures of the past. Only once did Smith (1976, [1776] 477) use the term 'invisible hand' in the *Wealth of Nations*: when it sustained the key import substitution goal of mercantilist policies, when the consumer preferred domestic industry to foreign industry. This is when 'the market' had taken over the role previously played by protective measures, and national manufacturing no longer needed such protection. If one cared to look, Adam Smith also argued for tariff protection at an early stage as a mandatory passage point to development, as did Friedrich List. Studying economic policy without discussing the context is one of the destructive vices of economic practice.

The key is not which side one chooses, however, but to see that both approaches are not simply complementary to each other, but rather should be seen as following each other in a step-by-step development. This, indeed, is perhaps the greatest legacy of early development economists and Ragnar Nurkse: having synthesized these two broad theoretical schools into a coherent theoretical framework that proved highly successful once applied in real life.

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