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AFTER NEOLIBERALISM, WHAT?[1]

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After more than two decades of application of neoliberal economic policies in the developing world, we are in a position to pass unequivocal judgment on their record. The picture is not pretty.

Consider economic growth first. In Latin America, only three countries have grown faster during the 1990s than in the 1950-80 period. And one of these three was Argentina, a country whose hopes of economic salvation through financial integration with the world economy now lie in ruins. Among the former socialist economies, real output still stands below 1990 levels in all but four of them. And poverty rates remain higher than in 1990 even in Poland, unquestionably the most successful of the East European countries. In sub-Saharan Africa, results remain very disappointing, and far worse than those obtained prior to the late 1970s.

Moreover, this record on growth has been accompanied by worsening income inequalities in most of the countries that have adopted the Washington Consensus agenda. Frequent and painful financial crises have ravaged Mexico, East Asia, Brazil, Russia, Argentina, and Turkey.

The few instances of success have taken place in countries that have marched to their own drummers and are hardly poster children for neoliberalism. Such is the case of China, Vietnam, India—three important countries which have violated virtually all the rules in the neoliberal guidebook even while moving in a more market-oriented direction.

Since this failure is obvious to all, one consequence has been the transformation of the original policy reform agenda into a broader "augmented Washington Consensus" entailing heavy-duty institutional reform (see Table 1). Its proponents now argue that the Washington Consensus needs to be complemented by "governance" reforms and by country "ownership." In this view of the world, the failure of the original Washington Consensus is due to an inadequate application of an otherwise sound set of principles.

The trouble with the Augmented Washington Consensus is that it is an impossibly broad, undifferentiated agenda of institutional reform. It is too insensitive to local context and needs. It does not correspond to the empirical reality of how development really takes place. It describes what "advanced" economies look like, rather than proscribing a practical, feasible path of getting there. In short, the Augmented Washington Consensus is infeasible, inappropriate, and irrelevant.

The challenge for the critics of the Washington Consensus is this: they need to provide an alternative set of policy guidelines for promoting development, without falling into the trap of having to promote yet another impractical blueprint that is supposed to be right for all countries at all times.

<u>What not to reject</u>

As a first step in constructing this agenda, let's be clear at the outset about what this is not an alternative to:

<u>Mainstream economics.</u> Critics of neoliberalism should not oppose mainstream economics—only its misuse. Economic analysis lays out many sound principles that are universal in the sense that any sensible development program has to take them on board. I have in mind things such as:

- providing <u>property rights</u> and the <u>rule of law</u> (so that investors--both current and prospective--can expect to retain the return to their investments);

[1] This is an edited version of remarks made at a conference on Alternatives to Neoliberalism, in Washington, D.C., May 23, 2002. I thank Jim Weaver for his invitation and for his encouragement to put these remarks on paper.

- recognizing the importance of private incentives and aligning them with social costs and benefits (so that productive efficiency can be achieved);
- managing financial and macroeconomic policies with due regard to debt sustainability, prudential principles, and sound money (so that inflation, macroeconomic volatility, financial crises and other pathologies can be avoided)

These are universal principles of good economic management, but--and this is the key point--they do not map into unique institutional arrangements or policy prescriptions. The principle that property rights should be protected implies very little about what is the best way to do this under a society's existing institutional preconditions. It certainly does not imply that a system of private property rights and Anglo-American corporate governance is the right approach for all countries at all times. Look at the tremendous amount of investment and entrepreneurial activity that China has managed to elicit through a hybrid system of property rights and a legal regime that is as far from the Anglo-American system that one can imagine. The Chinese institutional innovations—the household responsibility system, the township and village enterprises, and the two-track pricing regime—were obviously successful in providing effective property rights despite the absence of even private property rights.

Similarly, the principle that private incentives should be aligned with social costs and benefits hardly results in unconditional support for policies of trade liberalization, deregulation, and privatization that are the cornerstones of the Washington Consensus. As every well-trained economist knows, under real-world conditions of incomplete information, externalities, and scale economies (not to mention administrative and political-economy constraints), economic models generate policy guidance that is highly context-specific and often heterodox (by the standards of the Washington Consensus). The easiest exercise in the world for a graduate student in economics is to write down a model in which trade restrictions or capital controls are welfare enhancing.

Finally, debt sustainability, fiscal prudence, and sound money are also obviously compatible with diverse institutional arrangements. The current obsession with independent central banks, flexible exchange rates, and inflation targeting is nothing other than a fad.

All of this is to say that the economics of the seminar room is very different from the economics as practiced by the World Bank or the IMF. Or to put it in my preferred form: Neoliberalism is to neoclassical economics as astrology is to astronomy. In both cases, it takes a lot of blind faith to go from one to the other.

Economic growth. The alternative should not be against economic growth. In fact, it should be adamantly in favor of economic growth. Growth need not always generate adequate poverty reduction, and it can have adverse effects on environmental sustainability. But problems of poverty and the environment are much easier to handle in the context of robust economic activity than under stagnation.

The main strike against neoliberalism is not that it has produced growth at the cost of greater poverty, heightened inequality, and environmental degradation, but that it has actually failed to deliver the economic growth that the world needs to be better equipped to deal with these other challenges.

Globalization. Finally, I don't think we should be against globalization per se. Poor countries need markets and technology, which they can access only through close contact with the world economy. The problem is not with globalization, but with the skewed agenda that

governs it at present.

When I talk about a "skewed agenda," I have in mind things that go beyond the traditional complaint about asymmetries in market access. What we have at present is an agenda that excessively privileges liberalization in trade and financial markets, while completely disregarding the much larger gains to be had from liberalizing trade in labor services—the one thing that developing nations have actually plenty to sell. It is an agenda that ignores the developing countries' legitimate needs to have the policy "space" and autonomy within which they can develop their own strategies. And it is an agenda that equates a so-called "development round" almost fully with liberalization in agriculture, even though the primary beneficiaries from this agenda are the advanced countries themselves, and many poor, food-importing countries are likely to lose out. We should not reject globalization; we should correct its agenda.

What does the empirical record show? The second step in constructing the alternative agenda is to be clear about the empirical record. The alternative has to be grounded not in faith or in myths, but in reality. I summarize the record on growth and its determinants in the form of 4 propositions.

1. Transitions to high economic growth are typically sparked by a relatively narrow range of policy changes and institutional reforms. Here are some of the key examples: South Korea and Taiwan since early 1960s; Mauritius since early 1970s; Brazil, Mexico, Turkey others before 1980; China since 1978; India since the early 1980s; Chile since mid-1980s. In none of these cases, do we have the ambitious reforms recommended by the Augmented Washington Consensus playing an important role at the outset or as a prerequisite.

2. The policy changes that initiate these growth transitions typically combine elements of orthodoxy with unconventional institutional innovations. East Asia combined extensive industrial orientation with "outward orientation." China combined the household responsibility system and TVEs with (partial) liberalization. Mauritius carved out an EPZ for its export oriented activities rather than liberalize across the board. Chile combined capital controls with otherwise quite orthodox economic arrangements.

3. Institutional innovations do not travel well. What works in one setting often does not work well in another. Two-track reform worked extremely well in China's rural sector, but failed miserably when Gorbachev tried it in the Soviet Union. Import substitution worked well in Brazil and Mexico, but not in Argentina. The EPZ worked well in Mauritius, but has not produced anything approaching the same results in most other countries that created it. Gradualism worked well in India, but not in Ukraine.

4. Sustaining economic growth is a challenge in itself, and cannot be taken for granted. Historically, few countries maintain high growth once embarked upon it. China, South Korea, and a few others in the last few decades are the exceptions rather than the rule. Most of the countries that registered high growth under import-substitution policies eventually stagnated. There were no fewer than 15 countries in sub-Saharan Africa that grew at rates exceeding 2.5% per annum prior to 1973. Most of these economies eventually collapsed, as they were unable to handle the shocks that they were buffeted with in the late 1970s. This points to the central importance of invigorating and renewing institutions during an economy's high growth phase, so

as to be able to manage shocks and other sources of adversity.

Two crucial elements of a growth program

This brief overview of the empirical record suggests a growth program with two elements: (i) an investment strategy in the short-run to kick start growth; and (ii) an institution building strategy in the medium and longer run to give the economy resilience in the face of volatility and adverse shocks.

An investment strategy

The key here is to get domestic entrepreneurs excited about investing in the home economy. Encouraging foreign investment or liberalizing everything and then waiting for things to happen will not work. An effective investment strategy needs to do two things:[2]

- Encourage investments in non-traditional areas (carrot);
- Weed out projects/investments that fail (stick).

To see why public intervention is required, and why it needs to have both of these prongs, consider the problem of economic transformation that every poor country faces. Learning what a country is (or can be) good at producing is a key challenge of economic development. Neither economic theory nor management science is of much help in helping entrepreneurs (or the state) choose appropriate investments among the full range of modern-sector activities, of which there could be tens of thousands, once one moves beyond broad categories such as "labor-intensive products" or "natural-resource based products." Yet making the right investment decisions is key to future growth, as it determines the pattern of specialization. In these circumstances, there is great social value to discovering, for example, that cut flowers, or soccer balls, or computer software can be produced at low cost, because this knowledge can orient the investments of other entrepreneurs. But the initial entrepreneur who makes the "discovery" can capture only a small part of the social value that this knowledge generates as other entrepreneurs can quickly emulate such discoveries. Consequently, entrepreneurship of this type—learning what can be produced—will typically be undersupplied, and economic transformation delayed.

This perspective differs from the standard view in an important way. In the neoclassical model, it is presumed that the production functions all extant goods are common knowledge. This is not a good assumption for developing countries. Much technology is "tacit," meaning that it cannot be easily codified into blueprints that allow easy application. Moreover, even when the production techniques used in the advanced countries are transparent to outsiders, their transfer to new economic and institutional environments typically require adaptations with uncertain degrees of success.

The intellectual property regime in the advanced countries protects innovators through the issuance of temporary monopolies, i.e., patents. But the investor in the developing country who figures out that an *existing* good can be produced profitably at home and sets up a model for others to emulate does not normally get such protection, even though the social returns can be very high. Laissez-faire cannot be the optimal solution under these circumstances, just as it is not in the case of R&D in new products. Optimal government policy consists instead of a two pronged strategy: (i) to encourage investment and entrepreneurship in the modern sector ex ante, but, equally important, (ii) to rationalize production and weed out poor performers ex post. Industrial policy has to combine the carrot and the stick.

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[2] This account draws heavily on Ricardo Hausmann and Dani Rodrik, "Economic Development as Self-Discovery," NBER Working Paper No. 8952, May 2002.

The specifics of how this can be achieved is likely to differ considerably from country to country, depending on administrative capability, the prevailing incentive regime, the flexibility of the fiscal system, the degree of sophistication of the financial sector, and the underlying political economy. Time-bound subsidy schemes, public venture funds, and export subsidization are some of the ways in which this approach can be implemented, but there are many others. No single instrument will work everywhere. Even with East Asia, there were important differences in the way promotion was practiced. (Korea relied heavily on credit subsidies, while Taiwan relied mainly on tax incentives.) Governments without adequate capacity to exercise leadership over their private sectors are likely to mess things up rather than do better. But there are examples to suggest that the job can be done.

This way of looking at things helps us understand why, for example, the provision of rents by governments (through trade protection, temporary monopolies, subsidized credits, and tax incentives) often goes hand in hand with industrial growth and diversification. These rents are needed to stimulate the cost discovery process. Detailed accounts documenting these rents in South Korea and Taiwan (see for example the work of Alice Amsden, Robert Wade, and Peter Evans) are otherwise impossible to square with the conventional understanding of what constitutes desirable economic policies. At the same time, this framework highlights how rents can backfire if governments do not complement them with policies that rationalize industries and discipline firms that end up with high costs. What stands out in many discussions of East Asia is how governments in the region were unusually good at supplying the requisite discipline. The Korean and Taiwanese governments were typically quick to shelve their plans for supporting particular firms or industries when new information suggested that productivity would lag. Japan used a similar combination of state promotion/protection followed by rationalization in several industries.

Consider on the other hand Latin America during its import-substituting industrialization (ISI) period. Latin American ISI produced many successful firms, but also an industrial structure that was too diversified—too many low productivity firms alongside the high performers. Discipline was to come to Latin America in the 1990s in the form of trade openness, and many of the low-productivity firms were eventually driven out. Countries such as Argentina, Brazil, and Chile deepened their specialization in capital-intensive, natural resource based industries, while others like Mexico and the smaller Central American countries increased their focus on assembly industries servicing the U.S. market. But openness and institutional reform were not enough to spark a significant new wave of entrepreneurship and investment in non-traditional activities.

A crude, but useful characterization of the policy environments in East Asia and Latin America, as viewed from the perspective of the framework laid out here, would be as follows. East Asian governments provided their firms during the 1960s and 1970s with both promotion (the carrot) and discipline (the stick). Against this benchmark, Latin American industrial performance has fallen short because of varying shortcomings. Under ISI, Latin America was marked by plenty of promotion, but too little discipline. In the 1990s, Latin America has considerable discipline (provided through competitive markets and open trade), but too little promotion.

A strategy of institution building

Markets are not self-creating, self-regulating, self-stabilizing, or self-legitimizing. Economic growth requires more than getting a temporary boost in investment and

entrepreneurship. It also requires effort to build four types of institutions required to maintain the momentum of growth and build resilience to shocks:

- Market creating institutions (property rights and contract enforcement)
- Market regulating institutions (to deal with externalities, scale economies, informational incompleteness)
- Market stabilizing institutions (for monetary and fiscal management)
- Market legitimizing institutions (social protection and insurance; redistributive policies; institutions of conflict management, social partnerships)

Building and solidifying these institutions take time. Using an initial period of growth to experiment and innovate on these fronts can pay high dividends later on.

As suggested earlier, the "functions" that high-quality institutions perform (providing property rights, aligning incentives, and so on) map into multiple institutional forms. This is shown schematically in Figures 1-3. The first column in each of the figures refers to the objectives to be attained: productive efficiency, macroeconomic and financial stability, distributive justice, and poverty alleviation. The next column lists the relevant concepts from economic analysis. For example, property rights and the rule of law are necessary to achieve productive efficiency; debt sustainability and sound money are required for macroeconomic stability; and so on. The third column illustrates some of the institutional choices that have to be made. These choices are not pinned down by economic analysis (although economic analysis can be tremendously useful in illuminating the tradeoffs to be made). What type of legal regime should a country adopt—common law, civil law, or a hybrid? What is the right balance between decentralized market competition and public intervention? Which types of financial institutions/corporate governance are most appropriate for mobilizing domestic savings? Should fiscal policy be rule-bound, and if so what are the appropriate rules? What is the appropriate size of the public economy? What is the appropriate regulatory apparatus for the financial system? How progressive should the tax system be? How should labor markets be organized?

Institutional arrangements have a large element of specificity. Discovering what "works" locally requires experimentation. Reforms that succeed in one setting may perform poorly or fail completely in other settings. As I argued earlier, such specificity helps explain why successful countries—China, India, South Korea, and Taiwan among others—have almost always combined unorthodox elements with orthodox policies. It could also account for why important institutional differences persist among the advanced countries of North America, Western Europe, and Japan—in such areas as the role of the public sector, the nature of the legal systems, corporate governance, financial markets, labor markets, and social insurance mechanisms.

In addition, since policy makers always operate in second-best environments, optimal reform trajectories—even in apparently straightforward cases such as price reform—cannot be designed without due regard to prevailing conditions and without weighting the consequences for multiple distorted margins.

Here is a thought experiment to elucidate the point. Imagine a Western economist had been invited in 1978 to give advice on reform strategy to the Chinese leadership. How would she formulate her advice, in light of what we "know" today? Being a sensible economist, she would presumably know that the place to start would be agriculture, as the vast majority of the Chinese population lives in the countryside. Liberalization of crop prices would be number one item on the agenda. Cognizant that price incentives make little difference when farm incomes accrue to communes, she would immediately add that privatization of land must accompany price liberalization. Reminded that the obligatory delivery of crops to the state at controlled prices is

an important implicit source of taxation, she would then add that tax reform is also required to make up for the loss in fiscal revenues. But another problem then arises: if the state cannot deliver food crops to urban areas at below-market prices, will urban workers not demand higher wages? Yes, that requires some reforms too. State enterprises need to be corporatized so they can set their wages and make hiring and firing decisions freely. (Privatization would be even better of course.) But if state enterprises now have autonomy, will they not act as monopolies? Well, anti-trust regulation, or trade liberalization as a short cut, can take care of that problem. Who will provide finance to state enterprises as they try to restructure? Clearly, financial market reform is needed as well. What about the workers who get laid off from the state enterprises? Yes, that's why safety nets are an important component of any structural adjustment program. And so on.

These recommendations replicate the standard list of items on the Washington Consensus, and their logic is impeccable. But the recipients of such advice would be excused if they reached the conclusion that this reform business is too hard to accomplish in one's own lifetime. Luckily, actual experience with successful reform provides a different lesson: an ambitious agenda of complementary institutional reforms is *not* needed to kick-start growth. As we know with hindsight, the Chinese reformers were able to take imaginative shortcuts that sidestepped the complementarities that might have otherwise ruined a partial and gradual approach. Dual-track price reform and the introduction of the household responsibility system enhanced agricultural production incentives at the margin without requiring ownership reform, undercutting fiscal revenues, and upsetting the social balance in urban areas. This may not have been an ideal reform by textbook standards, but it worked.

While economic analysis can help in making institutional choices, there is also a very large role for public deliberation and collective choice. In fact, we can think of participatory democracy as a meta-institution that selects among the “menu” of possible institutional arrangements in each one of these areas.

Summing up

As the Chinese case demonstrates, transitions to high economic growth are rarely sparked by blueprints imported from abroad. Opening up the economy to trade and capital flows and adopting “best-practice” institutions are hardly ever key factors at the outset. The initiating reforms instead tend to be a combination of unconventional institutional innovations with some of the elements drawn from the orthodox recipe. Adequate human resources, public infrastructure, macroeconomic stability, and social peace are all key enabling elements of a growth strategy. But the strategy has to go beyond that and kindle the animal spirits of domestic investors. These combinations tend to be country-specific, requiring local knowledge and experimentation for successful implementation. They are targeted at domestic investors and tailored to domestic institutional realities.

Designing such a growth strategy is both harder and easier than implementing typical integration policies. It is harder because the binding constraints on growth are usually country specific and do not respond well to standardized recipes. But it is easier because once those constraints are targeted, relatively simple policy changes can yield enormous economic payoffs and start a virtuous cycle of growth and additional reform.

Implication for global institutions

In this alternative view, a development-friendly international economic regime is one that does much more than enhance poor countries' access to markets in the advanced industrial

countries and promulgate codes, standards, and "best practices." It is one that enables poor countries to experiment with institutional arrangements and leaves room for them to devise their own, possibly divergent solutions to the developmental bottlenecks that they face. It is one that evaluates the demands of institutional reform not from the perspective of integration ("what do countries need to do to integrate?") but from the perspective of development ("what do countries need to do achieve broad-based, equitable economic growth?"). In this vision, international economic arrangements would serve no longer as instruments for the harmonization of economic policies and practices across countries in pursuit of the maximization of trade and investment flows, but as arrangements that manage the interface between different national practices and institutions.

In effect, we need to return to a "thin" model of globalization—with less focus on international disciplines and harmonization—and give up pursuing a "thick" version that suffocates developing countries. The GATT approach of "shallow integration" has proved much more hospitable to development prospects than the WTO model of "deep integration." And within a "thin" model of globalization, attention needs to shift to relaxing restrictions on labor mobility. This is an area where the gains are larger for both global efficiency and for poor countries than is the case with everything else on the current negotiating agenda taken together.[3]

Concluding comments

The new, refurbished Washington Consensus is not a helpful guide to promoting development in poor countries. Its message that "best practice" institutions + openness to trade and capital flows economic growth is likely to disappoint once again. I have provided an alternative approach here, which focuses on experimentation--both in the institutional and productive sphere--as an important driver of economic development. The key is to realize that neither technology nor good institutions can be acquired without significant domestic adaptations. Those adaptations in turn require a pro-active role for the state and civil society, and collaborative strategies that foster entrepreneurship and institution building. What the world needs right now is less consensus and more experimentation. The role of external agencies, in turn, should be to enhance the capacity of national democracies to undertake such innovations, not to constrain them. The needs of the developing world are better served within a "thin" set of rules for global economic governance (as opposed to a "thick" set of rules aimed at maximizing trade and investment flows).

To return to my title: After neoliberalism what? Certainly not another slogan or blueprint. The approach I have outlined here is grounded in hard-headed economic principles and informed by the empirical record, but it leaves room for the institutional imagination and participatory politics to devise development strategies that respond to and are appropriate to local needs. It may lack the appeal of ready-made solutions, but at least it has a chance of working.

[3] For more discussion, see Dani Rodrik, "Feasible Globalizations," May 2002 (http://ksghome.harvard.edu/~.drodrik.academic.ksg/Feasible.pdf).

Table 1: The Washington Consensus is dead; long live the new Washington Consensus!

Original Washington Consensus	"Augmented" Washington Consensus
	the previous 10 items, plus:
1. Fiscal discipline 2. Reorientation of public expenditures 3. Tax reform 4. Financial liberalization 5. Unified and competitive exchange rates 6. Trade liberalization 7. Openness to DFI 8. Privatization 9. Deregulation 10. Secure Property Rights	11. Corporate governance 12. Anti-corruption 13. Flexible labor markets 14. WTO agreements 15. Financial codes and standards 16. "Prudent" capital-account opening 17. Non-intermediate exchange rate regimes 18. Independent central banks/inflation targeting 19. Social safety nets 20. Targeted poverty reduction

Figure 1

OBJECTIVE	UNIVERSAL PRINCIPLES	INSTITUTIONAL ARRANGEMENTS
Productive efficiency (static and dynamic)	Property rights: Ensure potential and current investors can retain the returns to their investments Incentives: Align producer incentives with social costs and benefits. Rule of law: Provide a transparent, stable and predictable set of rules.	What type of property rights? Private, public, cooperative? What type of legal regime? Common law? Civil law? Adopt or innovate? What is the right balance between decentralized market competition and public intervention? Which types of financial institutions/corporate governance are most appropriate for mobilizing domestic savings? Is there a public role to stimulate technology absorption and generation? (e.g. IPR "protection")

Figure 2

OBJECTIVE	**UNIVERSAL PRINCIPLES**	**INSTITUTIONAL ARRANGEMENTS**
Macroeconomic and Financial Stability	Sound money: Do not generate liquidity beyond the increase in nominal money demand at reasonable inflation. Fiscal sustainability: Ensure public debt remains "reasonable" and stable in relation to national aggregates. Prudential regulation: Prevent financial system from taking excessive risk.	How independent should the central bank be? What is the appropriate exchange rate regime? (dollarization, currency board, adjustable peg, controlled float, pure float) Should fiscal policy be rule-bound, and if so what are the appropriate rules? Size of the public economy. What is the appropriate regulatory apparatus for the financial system? What is the appropriate regulatory treatment of capital account transactions?

Figure 3

OBJECTIVE	**UNIVERSAL PRINCIPLES**	**INSTITUTIONAL ARRANGEMENTS**
Distributive justice and poverty alleviation	Targeting: Redistributive programs should be targeted as closely as possible to the intended beneficiaries. Incentive compatibility: Redistributive programs should minimize incentive distortions.	Progressivity of the tax system Appropriate points of interventions: educational system? Access to health? Access to credit? Labor markets? Tax system? Social funds. Redistribution of endowments? (land reform, endowments-at birth) Organization of labor markets: decentralized or institutionalized? Modes of service delivery: NGOs, participatory arrangements, etc.