Development Policy in the Twenty-first Century

Beyond the post–Washington consensus

Edited by

Ben Fine, Costas Lapavitsas and Jonathan Pincus

Routledge Studies in Development Economics

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Development Policy in the Twenty-first Century

In the 1980s development policy and debate was dominated by the neo-liberal *Washington consensus*, heavily promoted in theory and practice by the World Bank and the IMF. Under mounting criticism of the Washington institutions, the mid-1990s witnessed a shift in stance of the World Bank to embrace what has become known as the *post-Washington consensus*. This book constitutes a critical assessment of the new position by comparison both with the old consensus and, more importantly, in the context of the broader development studies literature.

The old consensus set an agenda of market versus state and, in the ideological climate determined by Ronald Reagan and Margaret Thatcher, leaned exclusively on the side of the market. The new consensus, pioneered by the World Bank's then Chief Economist, Joseph Stiglitz, has claimed to be more state and people friendly, although the policy shifts have, in the view of the editors, been negligible. Across the issues addressed – finance, industry, privatisation, education and agriculture – the book argues that the attempt by the new consensus to broaden the scope and analytical content of development studies is a failure because it employs the same reductionist analytical framework as its neo-liberal predecessor.

Development Policy in the Twenty-first Century is unique in its depth and assesses the postures of the new consensus topic by topic, while posing strong alternatives. It will improve and stimulate the reader's understanding of this very important subject and is highly recommended to advanced students and professionals studying, or otherwise involved with, development economics, studies and policy.

Ben Fine is Professor of Economics, **Costas Lapavitsas** is Senior Lecturer in Economics and **Jonathan Pincus** is Lecturer in Economics. All three editors are based at the School of Oriental and African Studies (SOAS), University of London.

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Preface

For much of the 1980s and 1990s, the Washington consensus dominated development theory and policy. The term, coined in the late 1980s, denoted a series of measures that were presumed to lead developing countries to greater wealth and prosperity. The suggested measures were a natural outgrowth of the neo-liberal policy framework that already held sway in the developed world: fiscal and monetary austerity, elimination of government subsidies, moderate taxation, freeing of interest rates, lowering of exchange rates, liberalisation of foreign trade, privatisation, deregulation and encouragement of foreign direct investment. Free-market economics, with a strong US flavour, would take care of the problems of developing countries.

Two factors facilitated the global ascendancy of the Washington consensus. The first was the final demise of the development ideology and practice of the 1950s and 1960s. Import substitution, five-year plans, government ownership and control of strategic industries, regulation of the labour market and state controls over the flows of saving and investment seemed less effective at delivering growth in the 1970s and 1980s. This battery of policies – which drew inspiration, directly or indirectly, from the success of Soviet industrialisation in the inter-war years – had lost prestige and influence by the mid-1980s. The advancing crisis of the Eastern bloc, moreover, meant that resources for developing countries in Africa, Asia, the Middle East and Latin America were not going to come from 'actually existing socialist countries'. The final collapse of the bloc, especially that of the Soviet Union, appeared to signal the complete triumph of capitalism and the free market. Washington was the undisputed political, economic and ideological centre of the world.

The second factor was active advocacy of the prescriptive recommendations of the Washington consensus by the international Washington organisations, above all the IMF and the World Bank. By the late 1980s, the fundamental ideas of the consensus had become 'orthodox economics' for the thousands of economists employed by, and otherwise attached to, these organisations. What other view of the world could be 'rational', or should be taken seriously? Here was the cream of Western (mostly USA-trained) academe developing theory and formulating policy in full command of all economic knowledge that was worth knowing. To oppose the Washington consensus, as plenty did, both in theory and in practice, was to demonstrate plain ignorance or, worse, obtuseness. And in any case, if the effortless intellectual superiority of Western-trained economists were not enough to persuade developing countries to wear the hair shirt, a simple lever was available to force them to do so: conditionality. Loans by both the IMF and the World Bank came to be dependent on adopting policies consistent with the consensus. The debt crisis of the 1980s had severely limited the room of developing countries to manoeuvre in negotiations with international organisations. Pressure to comply was applied in the hundreds of polite and brutal ways so familiar to international bureaucrats.

The 1990s, however, have not been kind to the Washington consensus. Fiscal and monetary conservatism might be claimed to have achieved greater price stability in some developing countries, but that was just about the only possible success of consensus-inspired policies. Growth outcomes were deeply disappointing and, to add insult to injury, typically below the levels of the derided 1950s and 1960s. Poverty reduction made little headway, according to the calculations of the World Bank itself. Vast swathes of humanity have continued to survive on the equivalent of a dollar a day, or less. Worse, the elimination of restrictions on domestic finance and on international capital flows resulted in huge global crises but did not succeed in enhancing volume and efficiency of productive investment. Last but not least, the transformation of Eastern bloc countries into capitalist market economies on the basis of the prescriptions of the Washington consensus can only be described as an abject failure.

Until 1997, the only part of the world that appeared to have escaped from the blight afflicting developing countries was East and South East Asia, including China. For much of the 1970s, 1980s and 1990s, growth rates across the region approached double figures. However, here was an evident paradox: development success appeared to rest on conditions that contradicted several of the prescriptions at the heart of the Washington consensus. True, the states of the region were typically conservative in the fiscal sphere, but they also tightly controlled domestic finance, imposed restrictions on imports, often discouraged foreign direct investment, controlled international capital flows, regulated several domestic markets and owned significant parts of the national productive capacity. That is not to say that they did not participate in the world market – they did and avidly so, but on terms which they manipulated in their favour. The Asian tigers seemed to create their own comparative advantage in the world market.

Thus, the intellectual and policy pre-eminence of the Washington consensus was short-lived. Already by the second half of the 1990s, dissatisfaction with its dry certainties emerged even within the privileged circles of Washington. The failure of the consensus occurred at a time when information-theoretic and transactions-costs-theoretic analyses have become prominent within economic theory. This has important implications for the gradually emerging successor to the old consensus. It is now widely accepted among the neo-classical economists who populate universities and international organisations that, though markets are by far the most efficient social mechanisms for allocating resources and maximising social welfare, information asymmetries among market participants and inescapable transactions costs decisively limit market efficiency. Put differently, cost and information externalities result in market failure. Now, in itself, the recognition of market failure as a result of externalities is neither particularly radical nor particularly novel. Still, the conclusion that economists presently draw from it represents a sharp rupture within mainstream theory, namely that institutions are pivotal to the efficient functioning of markets.

Institutions (such as the government and the various branches of the civil service), and non-market factors more generally, are now thought to play a prime role in facilitating information flows and in lessening transactions costs. They make the difference between well-functioning markets and markets prone to disequilibrium. They could allow the private returns from economic activity to approximate more closely the social returns, which might be different as a result of externalities. Institutions could even create markets where none would have emerged spontaneously. It is now hard to come across an economist who does not pay at least lip service to the importance of institutions; though precious few of them have any notion of how to construct the various institutions that are supposed to be so vital to the efficient functioning of markets. Perhaps the most bizarre aspect of the rediscovery of institutions by the orthodoxy is that economic theory has remained characteristically blind to the fact that the market is itself an institution. It is still an article of faith among economists that commodity exchange is an inherent part of the interaction among human beings in a state of nature. The social conditions that make possible the emergence of the institution of generalised market exchange, such as class structure and access to the means of production, remain a closed book for the mainstream.

Be that as it may, market failure and institutions played no significant role in the Washington consensus. The emergent post-Washington consensus inevitably based itself on them. The new consensus, if such it can be called, is still an inchoate current of thought, possessing none of the prescriptive – and profoundly misleading – sharpness of the Washington consensus. However, acknowledgement of the importance of institutions in economic activity has led the mainstream to recognise that social factors are decisive for success in development. Once institutions are discovered, it is natural to enquire into the social junctures within which they operate, the articulation of interests they express and their interaction with each other. Development thus emerges as a complex social process that involves more than growth of per capita income or increases in consumption. It entails changes in the distribution of property rights over resources, alterations in the patterns of work, increasing urbanisation, as well as transformation of the family's productive and reproductive activities. In short, development represents profound social change and has to be analysed as such.

It is imperative to stress that the gradually forming post-Washington consensus remains deeply conservative in fiscal and monetary matters; it does not in principle oppose liberalisation and deregulation, and it is broadly in favour of free trade and privatisation. The difference from the previous consensus lies perhaps in the following two elements. The first is advocacy of a 'milder' opening of the economy to the dictates of the market, drawing upon the analysis of market failure. Room is left for interventionist policy by the state, in so far as such policies deal with market imperfections, thus improving the performance of the market system as a whole. However, the areas and the limits of these interventions are not clearly specified. In the same vein, institutions are proclaimed vital for development success, particularly those relating to the financial sector, which is especially prone to market failure. Specific policy recommendations to developing countries on how to build the required institutions are not forthcoming. Note that these institutions in the sphere of finance alone could range from an exchange commission, which does little more than set and police clear rules of market participation, to a ministry of finance, which could intervene in the allocation of credits and in determination of interest rates. The demarcation lines among acceptable and non-acceptable activities by the institutions, which are presumably necessary for development success, are far from clear. Inevitably, the policy prescriptions of the new consensus are more vague and less explicit than those of the old.

The second element is an emphasis on the non-economic 'glue' that holds society together. The concept of social capital is of critical importance in this connection. This rather badly thought out notion is now used by social scientists as an envelope term for a vast array of social relations: membership of clubs, undertaking of communal activities, partaking of information networks, participation in civic organisations, fostering of ethnic rivalries and so on. Indeed, any social relation that does not directly fall within the purview of the market and the economy is included in social capital. In a broad and general way, social capital is thought to influence the development path of a country – not enough of it (or plenty but of bad quality, as, for instance, in crime-ridden countries) could jeopardise development prospects. It is apparent that, in this connection too, there are no clear policy prescriptions readily available to the post-Washington consensus, other than very long-term ones.

Nevertheless, the post-Washington consensus represents a welcome advance for social scientists concerned with development. The emphasis on market failure and the rediscovery of social relations, even in the unsatisfactory form of social capital, are far removed from the dogmatism and intellectual poverty of the Washington consensus. After a long period of treating development as a technical problem of growth in macro-economic aggregates, which could be tackled by the freeing of markets, social science seems to have awakened to the realisation that development is a process of profound social transformation. To analyse such social transformation, political economy is necessary, rather than plain economics. The post-Washington consensus implicitly recognises this, since it engages in political economy of institutions and seeks to employ the concept of social capital. However, the version of political economy deployed by the emerging consensus is lifeless and unconvincing. Information asymmetries and transactions costs are inadequate theoretical principles on which to base analysis of the process of development. The concept of social class is also necessary, as are those of generation of economic surplus, its division among classes and its utilisation for consumption and investment. More broadly, the concept of social reproduction is vital in analysis of the social relations to be found at the workplace, in agriculture, in the schools, within the family, in state organisations and between state institutions and enterprises. Development is reproduction of society on a different level and in a 'modern' way, implying radical transformations in all these social relations.

Put differently, development is a social process that calls for an analytical approach that would have been familiar to classical political economists, as well as their chief critic, Marx. After all, classical political economy emerged precisely on the cusp of transformation of Western Europe from an agrarian society into modern industrial capitalism. For Marxist political economy, in particular, issues such as the role of institutions, social relations, the methods of state intervention and the non-economic underpinnings of markets were never absent from its analytical framework. Furthermore, these issues are evidently contingent on historical events. By this token, development theory needs to recognise the specificity of the historical experience of each individual country. History, from this perspective, is not treated as simple accumulation of chance events, a register of accidental shocks or mere 'path dependency'. History is also a record of interaction among the various social classes, with all their inevitable conflicts, alliances and temporary truces. The development direction that a country is likely to follow depends on the balance of forces among its social classes, and that is an outcome of its history. The post-Washington consensus offers no analysis of this kind, but at least it promotes recognition of the importance of the social and historical context of development. Thus, it opens room for the required political economy of development.

This book is a collection of papers first presented at a recent seminar series on the post-Washington Consensus held at the School of Oriental and African Studies (SOAS) of the University of London. As Europe's leading centre for the study of Asia and Africa, SOAS is home to a diverse group of researchers specialising in the history, society and culture of the developing world. The Economics Department, which sponsored the post-Washington consensus series, is unique in the UK, and perhaps the world, in its emphasis on the importance of the specific historical and social context of individual countries to the development process. Nearly every member of staff is fluent in at least one African or Asian language, and all have extensive research experience in their regions of expertise. Members of the department, both students and staff, thus share an approach to the political economy of development based on a common appreciation of the embeddedness of social phenomena within the historically specific conditions of real people and places.

The nine chapters of the book tackle various aspects of the emerging post-Washington consensus and reflect the concern to build and criticise theory on the basis of strong empirical foundations. Ben Fine's introduction to the volume traces the intellectual roots of the post-Washington consensus and assesses its likely impact on development studies. One of the most disturbing features of the new consensus is that, although it attempts to broaden the theoretical agenda of development economics, it does so within the same narrow, reductionist framework of its neo-liberal predecessor. The result is therefore not a more heterodox economics, but rather a more aggressive *neo-classical* economics that now possesses the self-confidence (if not the analytical tools) to take its colonising mission to the other social sciences. Aybar and Lapavitsas reach similar conclusions in their chapter on financial system design: although the asymmetric information paradigm adds some subtlety to the dominant neo-classical approach to financial systems, it remains unwilling, and perhaps unable, to address the specific historical and structural factors that shape the relationship between finance and industrial development in individual countries. Cramer and Bayliss's analysis of the evolution of the World Bank's privatisation policy from the 1980s to the present raises parallel concerns. Neither the old nor the new consensus can provide a convincing theoretical justification for the 'blanket' approach pursued by the Bank: privatisation should not be treated as a synonym for increased efficiency and competitiveness. The authors argue instead for a case-specific approach that views privatisation as one policy tool among many within the broader context of the social, economic and political dimensions of industrial policy.

Industrial policy is also the subject of Chapters 4 and 5. Sonali Deraniyagala examines the relevant literature and searches in vain for significant differences between the Washington and post-Washington policy prescriptions. However, a consistent source of cognitive dissonance for orthodox theorists has been the countries of East and South East Asia: first as examples of successful state intervention in trade and industrial policy; and second, after 1997, as a graphic illustration of the hazards of financial-sector liberalisation. Dic Lo surveys the terrain and concludes that despite the fanfare surrounding the post-Washington consensus, the Washington institutions still adhere to a superficial view of economic institutions in the region based largely on a textbook notion of what constitutes the 'natural path' of development.

The assumption in the literature of the Washington institutions that liberalisation of one form or another is the natural cure for dysfunctional institutions reappears in Mushtaq Khan's chapter on the political economy of corruption. Khan points out that liberalisation is not only an insufficient response to endemic corruption but in some cases may actually exacerbate the problem depending on the distribution of political and class power. Mainstream approaches, both old and new, have failed because they seek uniform solutions to what is in fact a range of separate problems faced by specific countries.

For some, the World Bank's adoption of 'social capital' as a necessary complement to physical and human capital signalled a new willingness on the part of the Washington institutions to take the social and political dimensions of development seriously. Ben Fine is not convinced. In his chapter on 'The social capital of the World Bank' he argues that this incursion of orthodox economics into the realm of social theory is an offensive, rather than defensive, move. As long as the orthodoxy is unwilling to revisit its core assumptions, the incorporation of the social will not yield a more progressive analytical or policy agenda.

Similarly, in their chapter on the World Bank's approach to education, Fine and Rose examine the implications of what they term the Bank's 'obsessive attachment to human capital theory'. The obsession has grown more compulsive under Stiglitz's tutelage owing to the real or imagined linkages between his economics of information and investment in education. The main appeal of human capital theory – like the concept of social capital – is that it allows orthodox economics to handle complex social phenomena using the familiar tools of micro-economics. However, as Fine and Rose explain, these metaphors quickly become overloaded, and eventually collapse under the weight of their own contradictions. For human capital theory the moment of absurdity arrives when education systems, abstracted from their specific social and historical contexts, are called upon to explain social and economic phenomena ranging from savings behaviour to fertility rates.

The final chapter of the book turns from economic theory to the implications of theory for the World Bank as a public-sector lending institution. Pincus reviews the evolution of the World Bank's approach to rural development, and finds that change is easier to effect in the virtual world of development rhetoric than in the concrete world of lending operations.

It is a sombre, although perhaps apt, note on which to conclude that, whatever its development theory and rhetoric, the post-Washington consensus remains remarkably remote as far as policy stances in Africa, Eastern Europe and elsewhere are concerned. The dissonance between policy rhetoric and practice has already been felt within the World Bank with the resignations of Joseph Stiglitz, Chief Economist at the World Bank and pioneer of the post-Washington consensus, and Ravi Kanbur, lead author of the figurehead 2000 *World Development Report on Poverty*. This draws a postscript commentary to Chapter 1.

Ben Fine
Costas Lapavitsas
Jonathan Pincus
SOAS, November 2000

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