

## Chapter \_\_. Theories Meet Facts

In this chapter the double-trust theory of economic development meets its alternatives and the facts. By comparing theories and aggregate data, we hope to show the greater plausibility of the double-trust theory over the alternatives.

### **Facts**

We begin with a broad description of world development in recent decades. Figure \_\_.1 depicts the percentage growth rate of income per capita for high incomes countries, and for low and middle-income countries, from 1980 to 2004. The two curves move in tight correlation, which shows that a world exists economy. For the first half of the period, the relatively rich countries grew faster, causing living standard to diverge. More recently, the relatively poor countries grew faster, causing living standard to converge.

Figure \_1.

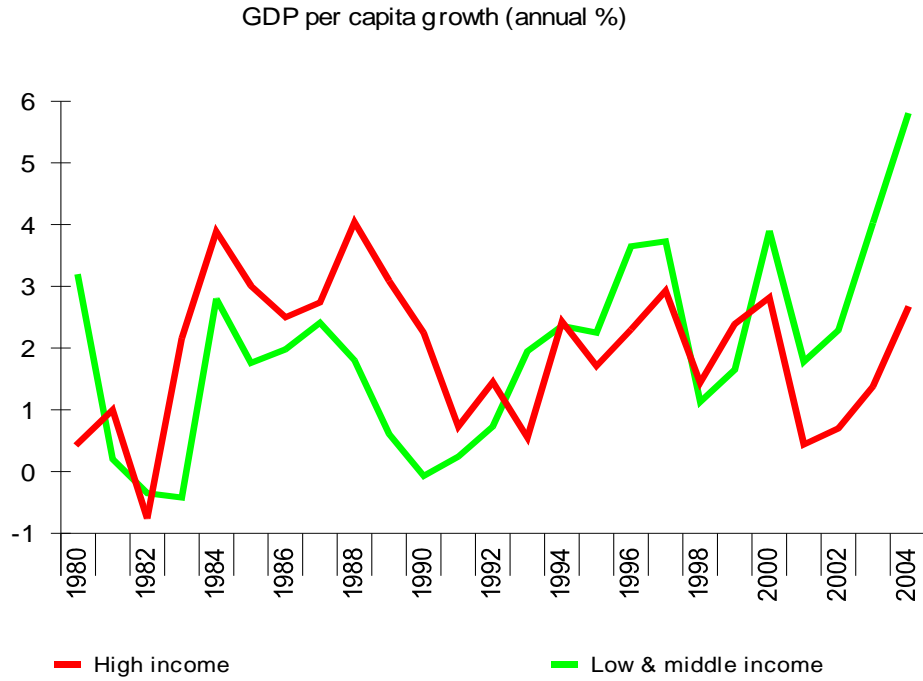


Figure \_2 reveals some of the countries in the high and low-income groups in the period 1993 to 2003. Low growth countries concentrated in Africa (but not Botswana) and Latin America (but not Chile), and high growth countries scattered around the world with more in East Asia.

Figure \_2. Accumulated Growth of Per Capita GDP in PerCent in Selected Countries from 1993 to 2003

Low Growth		High Growth	
Argentina	-3,5	Albania	122,3
Brazil	6,5	Botswana	38,1
Congo, Rep.of	-32,5	Chile	38,9
Cote D'Ivoir	-3,2	China	133,2
Ecuador	-2,6	Cyprus	45,2
Gabon	3,6	Finland	41,6
Honduras	-1,3	Hungary	36,4
Nicaragua	4,6	India	55,4
Niger	-4,2	Ireland	97,8
Papua New Guinea	0,5	Korea, Rep. of	54,4
Paraguay	-9,9	Malaysia	46,6
Sierra Leone	-21,6	Poland	50,3
Uganda	-11,8	Slovenia	45,1
Ukraine	-11,8	Taiwan	46,9
Zimbabwe	-20,7		

Source: Calculated from Penn World Tables 6.2 , 2006.

Next we consider some facts about growth rates in regions. (Keep in mind that individual countries defy the averages as suggested by Botswana and Chile in Figure .2.) Figure \_3 shows that sub-Saharan Africa enjoyed substantial increases in per capita income from 1965 until roughly 1970. After 1970, however, this region suffered 25 years of disastrous decline in income per capita. The decline appears to have reversed recently.

Figure \_3. Income Per Capita in Sub-Saharan Africa

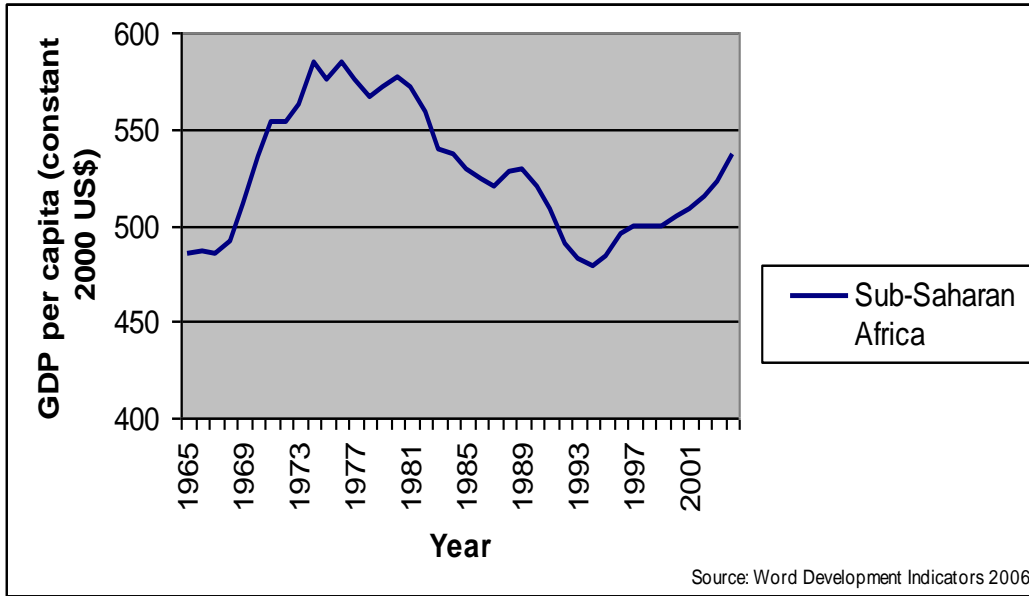


Figure \_4 depicts the pattern for Latin America. From 1965 until roughly 1980, this region enjoyed robust growth in income per capita. The 1980s, however, were a period decline or stagnation. In the 1990s, income per capita resumed its upward path.

Figure \_4. Income Per Capita in Latin America & Caribbean

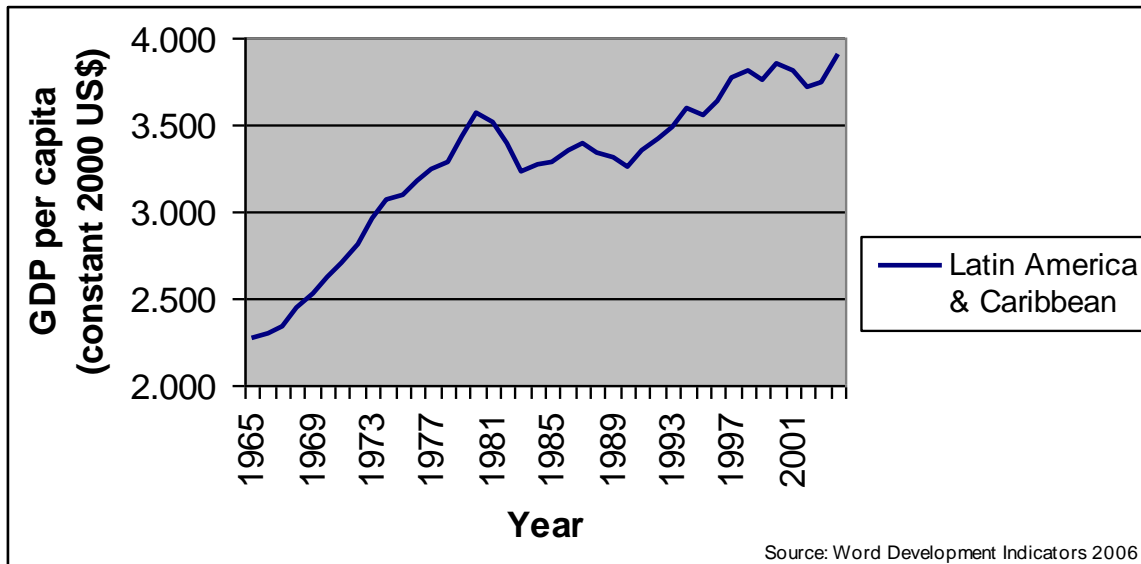
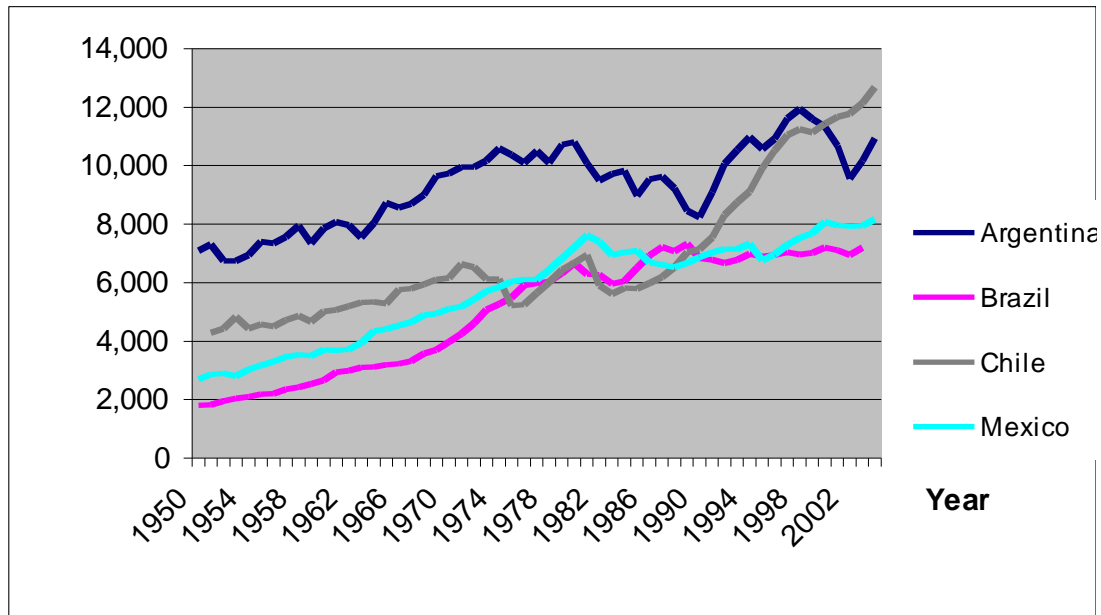


Figure 5 shows the growth of four of the larger Latin American countries. The downturn in the 1980s and recovery in the 1990s were steepest in Argentina. Note that Chile's growth accelerated after 1985 and remained high.

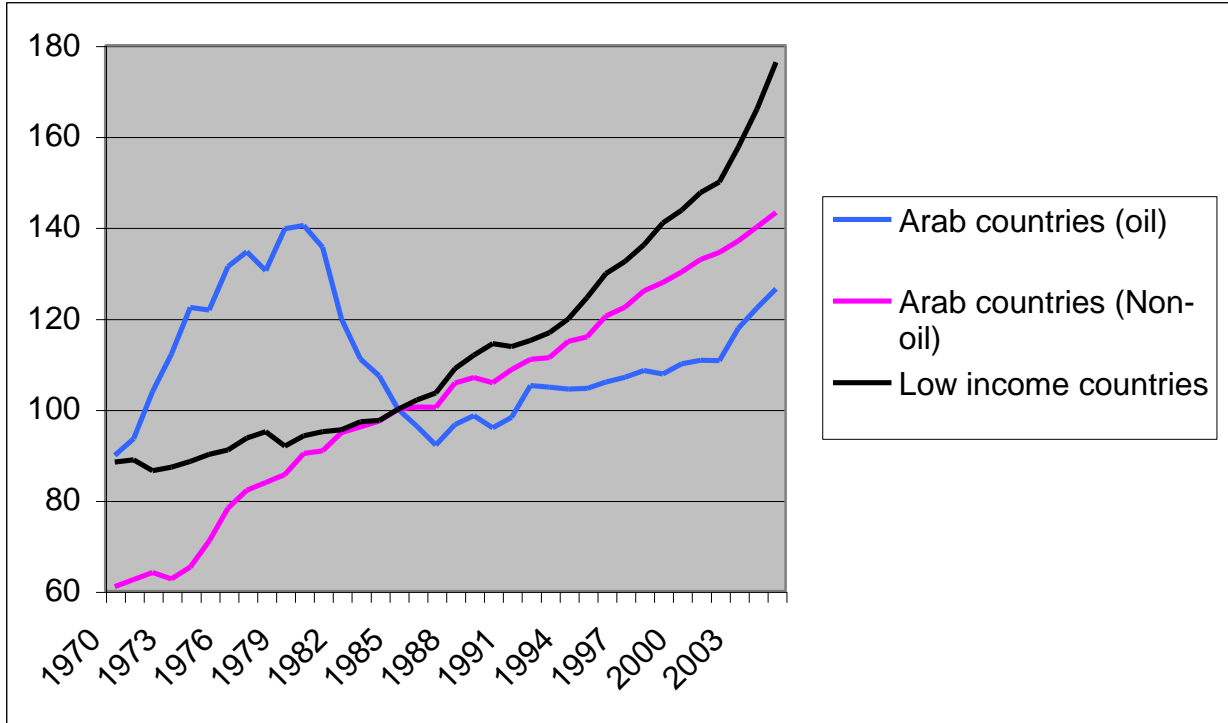
Figure 5. Income Per Capita in Four Latin American Countries



Arab countries can be broadly classified into oil and non-oil countries. In the 1970ies the region profited from the oil price rise. The Arab non-oil countries profited indirectly from large amounts of workers remittances. After the early 1980ies Arab growth rates declined and fell behind the rest of the developing world, especially if compared with countries in South and East Asia<sup>1</sup>. However since 1980 growth rates were not lower than in Latin America. Insofar Arab countries' growth patterns display some similarity with those of Latin America. Fig 7 shows that per capita income of the Arab non oil countries increased almost at a constant amount per year, growth rates declined below those of other low income countries.

Fig. 7 Growth in Arab Countries

<sup>1</sup> George T. Abed (2003) Unfulfilled Promise, Why the Middle East and North Africa region has lagged in growth and globalization, Finance and Development, Vol. 40, 1

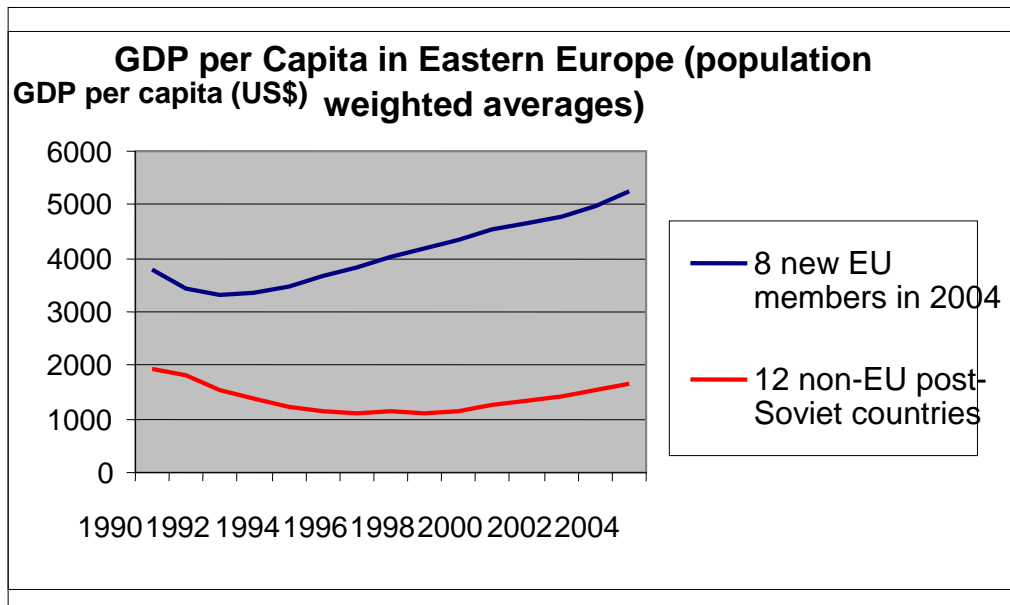


Source: Calculated from World Development Indicators 2007

Figure \_8 divides the countries of Eastern Europe into the 8 that became members of the European Union in 2004, and the 12 that did not join the EU. Both groups of countries experienced a decline in per capita income from 1990 to 1994, during the aftermath of communism’s collapse. The countries that joined the EU, however, recovered in the mid 1990s and grew steadily. By 1995 their income achieved to its former level before communism’s collapse, and then increased by 25% from 1994 to 2004. The 12 non-EU economies, however, remained stagnate during the second half of the 1990s. Only now are they regaining the level of income per capita achieved under communism. Note, however, that the general pattern in Figure \_5 is presumably correct, but precise comparison may be off because of Eastern Europe’s large underground economy. Also communism created a tradition of falsifying economic data. (It’s liking trying to compute industrial output in Italy based on corporate tax returns.<sup>2</sup>)

<sup>2</sup> Under communism, the performance of an industry as measured by its statistics affected the allocation of resources to it by the state. Consequently, industries had much stronger incentives

Figure 7. Income Per Capita in Eastern Europe



Now we turn to two especially important cases. Together, China and India have roughly 40% of the world's population. The remarkable economic performance of these two economies in recent years accounts for much of the world's progress in lifting people out of poverty. Figure 9 depicts income per capita for China. Until the mid-1980s, income per capita was low and stagnant. Subsequently China has enjoyed spectacular growth in income per capita without respite. China's performance in lifting so many people out of poverty in the last 20 years has no historical parallel. Figure 10 depicts income per capita for India. Until roughly 1980s, income per capita grew very slowly. After 1980, growth increased significantly and continued steadily at a fast pace. The results are remarkable historically, although less than China.

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to falsify reports than in most capitalism countries. Similarly, businesses have an incentive to misreport profits when they are taxed.

Source: Calculated from World Development Report 2007

Figure 7. Income Per Capita in China

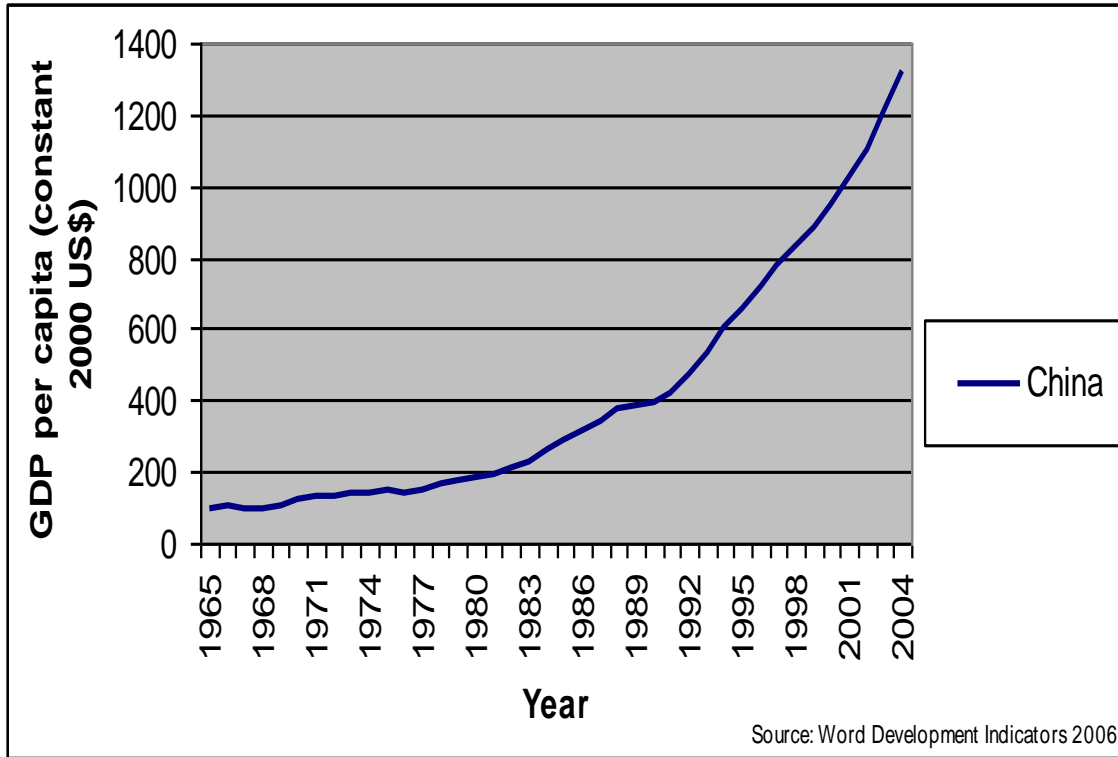
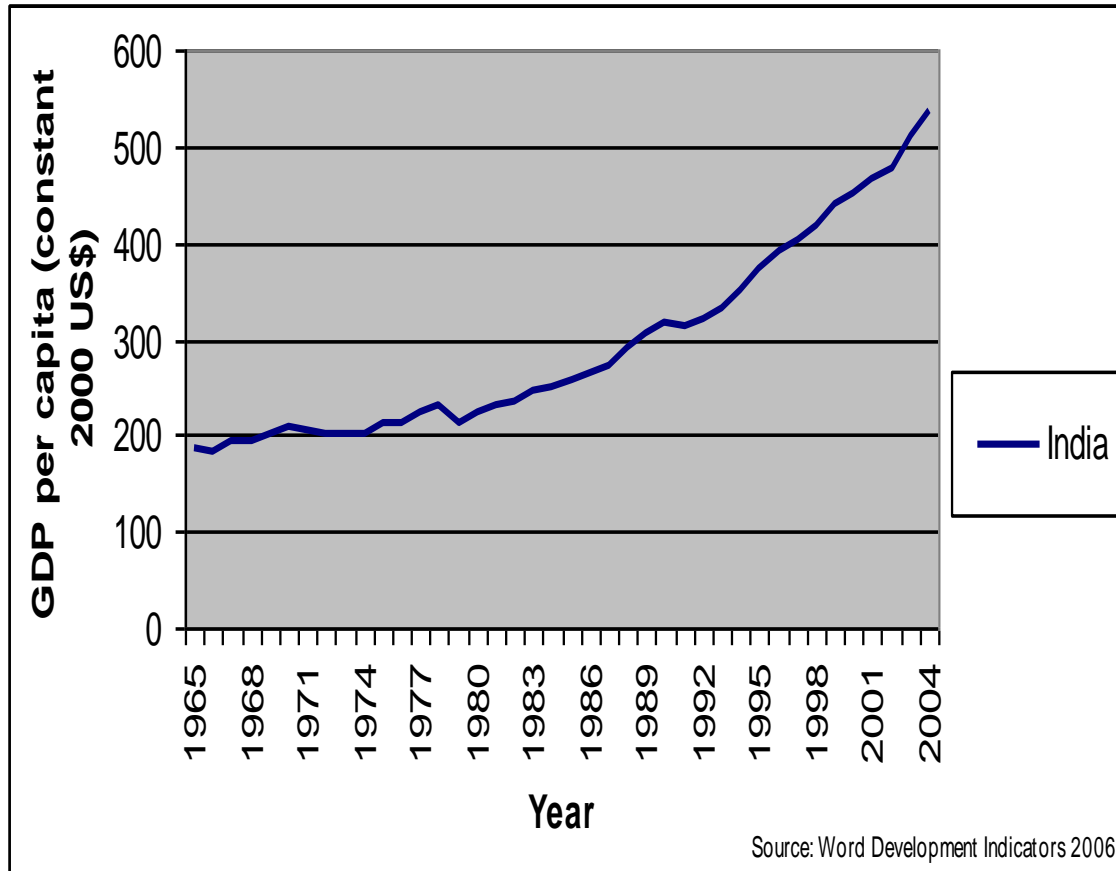




Figure \_8. Income Per Capita in India



## Theories

What theories can explain these facts? The theory of this book emphasizes law's role in facilitating entrepreneurship. We give central place to uniting capital and ideas through the law of property, contracts, and corporations. Effective private law requires both state and non-state institutions, including workable social norms. Having developed the double-trust theory throughout the book, now we explain three alternatives to it.

- *Neoclassical*: In neoclassical theory, growth depends on capital accumulation. World capital markets will spread capital evenly, causing per capita incomes to converge worldwide. This approach applies the

analysis of markets in microeconomic theory to development in a straightforward way, without referencing law or investor protection.

- *State-Led Growth*: According to this approach, markets can lead growth in rich countries, but the state must lead growth in poor countries. State-led growth applies the theory of market failure to economic development. The application complements socialist ideology. State leadership gives central place to planning, which requires public law, notably administrative law and regulations.
- *Washington Consensus*: In the 1980s two institutions in Washington, D.C., the World Bank and the International Monetary Fund, inverted the theory of state-led growth and produced a new consensus. According to this view, unfettered markets will succeed in poor countries. Unfettering markets requires privatizing, deregulating, liberalizing (free trade and free capital movements), and stabilizing (low inflation).

Figure 2.9 summarizes these alternative theories. The state-led growth approach dominated the history of development economics until roughly 1980. The Washington Consensus dominated in the 1990s. Subsequently, development theory has given much more attention to law and institutions. A new consensus recognizes the importance of law and institutions but not the particulars. Disagreement persists about which institutions are most important and why. Unlike the other three theories, the neoclassical theory permeates the thoughts of economists at all times and places because it applies the standard economic analysis of markets to growth.

Figure 2.9.

<b>Theory</b>	<b>Cause</b>	<b>Law</b>
neoclassical	accumulating capital	unreferenced
state-led growth	Planning	public law
Washington Consensus	unfettering markets	free-market policy
double-trust	uniting capital & ideas	private law

Now we confront each theory in turn against the facts.

***Neoclassical Approach: Accumulate or Innovate?***

According to neoclassical theory, capital accumulation causes growth, so world capital markets should spread capital evenly and per capita incomes should converge worldwide.<sup>3</sup> The facts contradict this prediction. Taking a long historical perspective, the income per capita ratio of the five richest countries to the five poorest countries grew from 6 :1 to 70:1 from 1820 to 1990. Looking at recent years, between 1980 and 2004 average per capita growth rates in high-income countries were 1.93 per cent per annum and 1.97 per cent per annum in low and middle-income countries.<sup>4</sup> If there is any indication for worldwide convergence, then it is only over the last 10 years (mainly caused by the high contributions of China and India), as revealed in Figure\_1.

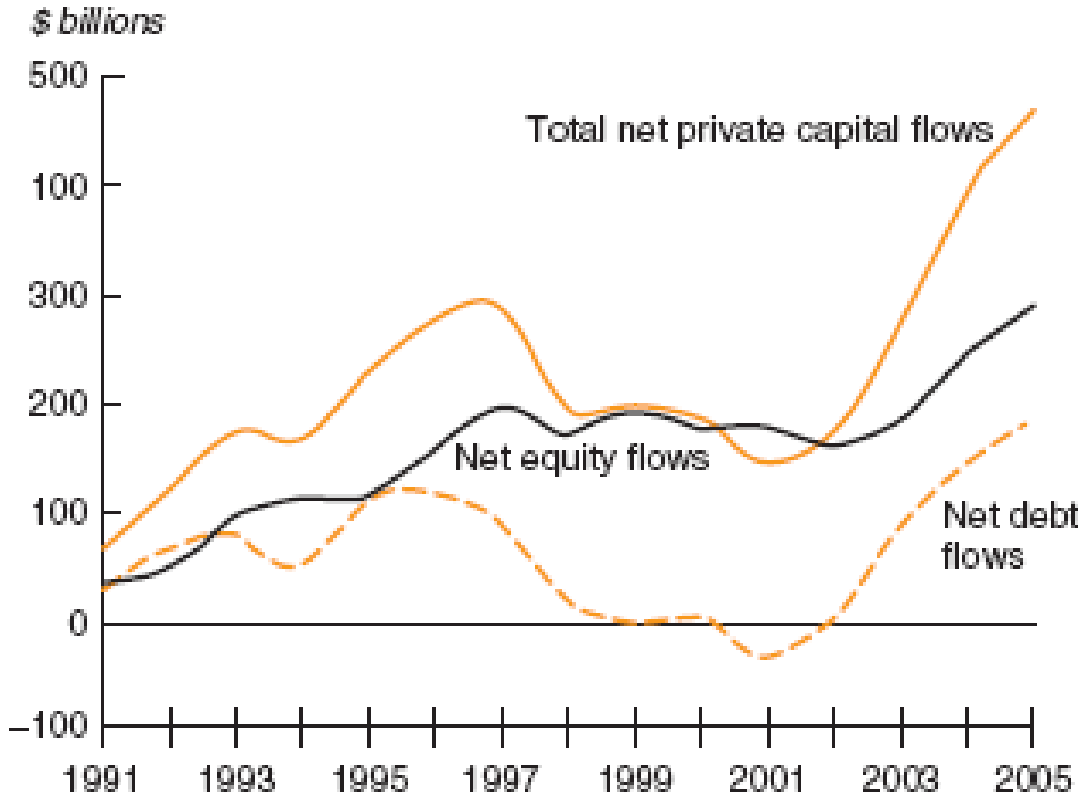
In neoclassical theory, convergence of per capita income that capital accumulates faster in poor countries than in rich countries. Relatively free movement of capital should cause it to flow from rich to poor countries. Restricted movement of capital might explain failure to converge. Thus neoclassical theory might be saved from contradiction with the facts provided that convergence occurs to the extent that capital markets are free. Figure \_10 depicts the net flow of private investment into developing countries. According to this figure, the value of equity (stock) and debt (bonds and bank loans) flowing into developing countries rose sevenfold between 1991 and 2007. Perhaps this sharp increase in capital flowing to poor countries in recent years explains recent convergence in income per capita found in Figure \_10.

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<sup>3</sup> In low-income countries the human and physical capital stock per worker is low, whereas in high income countries it is high. Consequently the marginal return to capital should be high in low income countries compared to high income countries. This should lead to an international transfer of capital until the marginal rates of return for capital in low income countries become equal with those in high income countries.

<sup>4</sup> W. Easterly and R. Levine: Its not Factor Accumulation: Stylised Facts and Growth Models

**Figure 10. Net Private Financial Flows (Debt and Equity) to Developing Countries (1991-2005) in billion US Dollars, from “”**



Source: World Bank Debtor Reporting System.

Source: Global Development Finance 2006

Before examining this possibility more carefully (and rejecting it), we note that Figure 10 disguises an important fact about foreign investment: It concentrates in a few developing countries. Foreign investors include insiders who control companies and outsiders who have no control. In developing nations, 23 countries received 78 per cent of all net investment in stock by insiders who were foreigners. Concentration is higher for foreign investors who

are outsiders, as we would expect.<sup>5</sup> More than 80 percent of all net investments in stock in developing countries by outsiders (net portfolio investment) went to five countries: China, India, Turkey, Brazil and South Africa<sup>6</sup>. Turning from stocks to bank loans, we find similar concentration.<sup>7</sup> Neoclassical theory does not explain why capital flows concentrate in some countries and not others.

The preceding figure focuses on *private* investment in developing countries. Even without private investment, a version of neoclassical theory could be true that relies on public investment. In the 20<sup>th</sup> century, communist countries closed themselves to world capital markets. To replace foreign capital, the Soviet Union forced people to save money, which resulted in extraordinary savings and investment in the 1930s and 1950s. According to neoclassical theory, investing in more machines, iron, coal, fuel, seeds, buildings, etc. show cause an increase in income per person. A nation also increases its production when more people work longer hours, and the Soviet Union forced people to work.<sup>8</sup> As predicted, the Soviet Union enjoyed high growth rates in the 1930s and 1950s. Neoclassical theory, however, predicts that sustained growth requires innovation, not just capital accumulation. After the 1950s, the Soviet Union's growth declined until it vanished, which might be due to the absence of innovation.

Capital accumulation may explain part of growth in developing countries, and innovation may explain the rest. How much does capital accumulation explain? For 60 non oil exporting countries between 1960 and 1992, Easterly and Levine found that capital accumulation caused about 40% of their increase in income per capita, and productivity increases caused about 60%. Recent empirical research shows that factor mobilization cannot explain most of the

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<sup>5</sup> Outsider investment in developing countries requires effective protection against insiders, which few developing countries have. Only the possibility of remarkable profits can overcome the fear that insiders will appropriate outside investments.

<sup>6</sup> World Bank, Global Development Finance (2006) Stat. Appendix.

<sup>7</sup> Insert citation.

<sup>8</sup> Besides forcing people to save, the Soviet Union also forced men and women to work. It especially forced farmers into factories and women out of the household. The Soviet Union thus mobilized capital and labor without relying on markets, but we focus on the former.

income differential across nations. Hall and Jones<sup>9</sup> showed that long run differences in per capita incomes depend on the “social infrastructure” of a society:

*Countries with corrupt government officials, severe impediments to trade, poor contract enforcement, and government interference in production will be unable to achieve levels of output per worker anywhere near the norms of western Europe, Northern America, and Eastern Asia.*<sup>10</sup>

Some more data supports the claim that capital accumulation does not cause most growth. “Capital productivity” refers to the amount of income obtained from a given amount of capital. The productivity of capital increases by using it more efficiently. For a country, capital productivity is measured by its national income divided by its capital stock. If the national income is 100 and the capital stock is 300, capital productivity is 1/3.

Instead of capital productivity, economists conventionally talk about its reciprocal, which is its inverse. In the above example the capital output ratio is 3. So we can say that a more efficient use of capital lowers the capital output ratio, or, equivalently, increases capital productivity.

Neoclassical theory predicts a definite pattern of change in the capital output ratio. A worker with more capital can produce more. As each worker obtains more capital to use, however, the increase in production slows (“decreasing returns”). This leads to an important proposition: If the capital stock per capita increases, then the capital productivity per capita must decrease. Equivalently, following the usual convention, if the capital stock per capita increases, the capital output ratio must also increase. Thus we would expect a low capital output ratio in poor countries with little capital per worker. And we would expect a high capital output ratio in rich countries with much capital per worker.

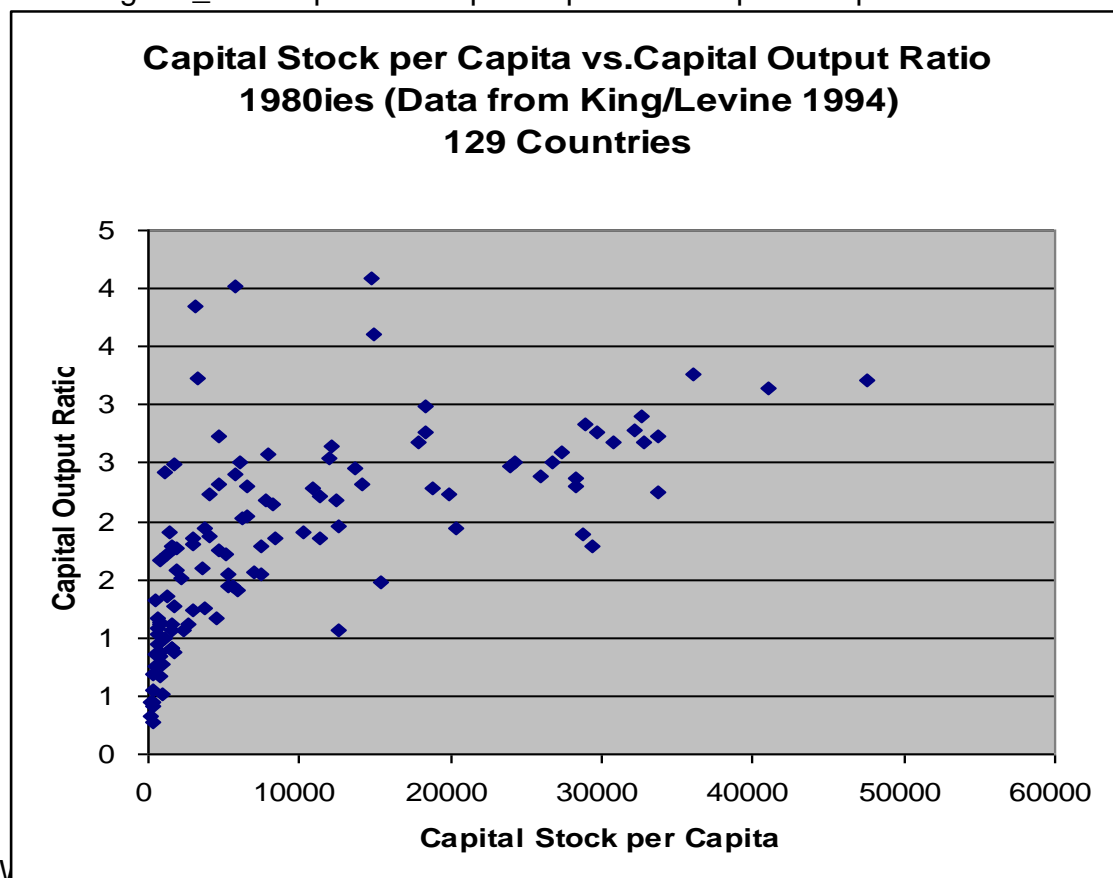
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<sup>9</sup> R. Hall and C. Jones (1999), Why Do Some Countries Produce So Much Output Per Worker Than Others? Quarterly Journal of Economics, 114,1, 83-116 See also Acemoglu Daron, Simon Johnson and James A. Robinson (2005), Institutions as the Fundamental Cause of Long-Run Growth, Handbook of Economic Growth (Philippe Aghion and Stephen Durlauf, eds., North Holland)

<sup>10</sup>R. Hall and C. Jones (1999), op. cit. p.4

We can test this proposition using data from different times and places. The vertical axis in Figure 11.11 indicates capital per worker for different countries. The horizontal axis indicates the capital output ratio. As explained, neoclassical theory predicts an upward sloping curve. The points in the scatter diagram, however, do not reveal such a relationship. Instead, they suggest no systematic relationship between the two variables. Countries whose capital per capita is small may have a higher or lower capital output ratio than countries whose capital per capita is high.

Figure 11.11. Capital Stock per Capital and Capital Output Ratio



The preceding figure is a snapshot of different countries at the same point. Now we turn to evidence on changes over time in a few countries. For any country, poor or rich, neoclassical theory predicts that an increase in capital per capita will correlate with an increase in income per capita. In the United Kingdom, capital per capita increased by 240% from 1960 to 1988, and real per

capita income increased by more than 80%. In Tunisia, capital per capita increased by around 70% between 1960 and 1988, and income per capita increased by about 40%. Thus capital accumulation correlated with income growth per capita in the U.K. and Tunisia as neoclassical theory predicts.<sup>11</sup>

In contrast, capital per capita increased by 300% in Algeria from 1960 to 1988, but income per capita did not increase. Similarly, capital per capita grew by more than one percent per year from 1980-1992 in Costa Rica, Ecuador, Peru, and Syria, but GDP per capita fell at over one percent per year.<sup>12</sup> In these countries, capital accumulation did not lead to income growth per capita, which contradicts neoclassical theory.

### ***State Led Growth: Great Awakening or Socialist Siesta?***

State led growth ranges from centrally economies planned to mixed economies. Central planning eliminates almost all markets in favor of government administration. Mixed economy gives the state ownership or tight regulation for heavy industry, utilities, banks, and insurance companies. State-led growth proceeds through plans, licenses, exchange rate controls, interest rate subsidies, price fixing and squeezing of agriculture.<sup>13</sup>

Two historical developments increased acceptance of these theories among third world leaders after the 1930s. First, the great depression and its crippling effect on the world economy after 1929 formed expectations more than the favorable development of international trade during the preceding century. Second, when Western countries suffered the severe economic slump in the 1930s, the Soviet Union achieved high growth with state forced industrialization and minimal international trade.

When development economics became a discipline in the 1940's and 50's, most of its prominent scholars taught that the state must lead the economy more in poor countries than in rich countries (See P. Krugman, 1994 and I.

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<sup>11</sup> All data are from King Levine 1994

<sup>12</sup> W. Easterly and R. Levine: Its not Factor Accumulation: Stylised Facts and Growth Models, 10.

<sup>13</sup> H.J. Bruton (1998) A Reconsideration of Import Substitution, JEL Vol. XXXVI, 903-936



Adelman, 1997 and 1999). Nobel Price winner Gunnar Myrdal (1957, 79) summarized the wisdom of the 1950s when he wrote:

*“The most important change in state policies in underdeveloped countries is the common understanding that they should each and all have a national economic development policy...Indeed it is also universally urged that each of them should have an overall, integrated national plan. All underdeveloped countries are now attempting to provide themselves with such a plan, except a few that have not yet been reached by the Great Awakening.”*<sup>14</sup>

Was state led growth the Great Awakening or the socialist siesta? State leadership advanced in many countries in the 1950 and 1960s, slowed, and then retreated in the 1980s and 1990s. To show the change, Figure 12 contrasts production of state owned enterprises as a percentage of national product in 1980 and 1999. When countries are grouped by income level in 1980, state owned enterprises accounted for a larger share of gross domestic income in poorer countries, consistent with Myrdal’s prescription.<sup>12</sup> By 1999, however, this percentage had fallen dramatically, as indicated by the second column of data. The fall was so great that percentage of production by state owned enterprises was lower in low-income countries than in other countries.

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<sup>14</sup> Myrdal, Gunnar. (1957) *Economic Theory and Underdeveloped Countries*. London: Duckworth.

Figure 12. Activity of State Owned Enterprises as a Percentage of Gross Domestic Product

<b>Countries (by income group)</b>	<b>1980</b>	<b>1999</b>	<b>Change</b>
Low Income Countries	15	2.5	-12.5
Lower Middle Income Countries	11	4	-7
Upper Middle Income Countries	10.5	4	-6.5
High Income Countries	6	4	-2

Source: Sheshinski, E. and L. F. Lopez-Calva (2003). "Privatization and Its Benefits: Theory and Evidence." *CESifo Economic Studies*. Estimations based on World Development Indicators, The World Bank.

The effects of state led growth in particular countries are complicated. The most aggressive form of state leadership was central planning. In the 1950s and 1960s, China adopted harsh central planning and India adopted moderate central planning. In the 1980s and 1990s, both countries abandoned central planning, which produced good or spectacular results.

In Soviet Russia, central planning produced growth in the 1930s and 1950s, and stagnated subsequently. Abandoning central planning in 1990 caused an immediate decline in production in Russia, as well as in all other eastern European countries. The formerly communist countries that eventually joined the European Union in 2004 turned the situation around quickly and achieved good results, but the other countries have had poor results. Latin American countries (except Cuba) did not adopt central planning, but they did adopt state leadership of the economy. State led growth produced goods results in most countries in the 1950s and 1960s, until it stalled in the 1970s. Its abandonment in the 1980s produced slower growth than in the 1950s and 1960s, at least until recently.

Argentina provides a harsh example of the path of state led growth. In 1870 after decade of relatively free trade, Argentina's per capita income was 33% higher than in Sweden and 82% of that in the USA. When Peron achieved

power in 1946, he imposed heavy export taxes on agriculture, subsidized industrial products that substituted for imports, and erected tariff barriers against industrial goods. (His political followers were especially industrial workers.) He wrecked Argentine agriculture while creating inefficient industries that could not compete in world markets. After his dethronement in 1955, the country continued with his industrial policy for another 18 years.<sup>15</sup> In the 1970s, growth flattened as indicated in Figure \_\_.5. The country responded by deregulation and divestment of state owned enterprises, and income per capita immediately declined. In 2004 Argentina's income per capita was 43% compared to Sweden and 33% compared to the US.<sup>16</sup>

The general pattern looks like this: State led growth was impressive in the initial stages in the 1950s, but in the 1970s failure became obvious. To explain this failure, we will consider the underlying economic theory and its flaws. Then we will turn to the question of why abandoning state leadership brought immediate gains in China and India, and immediate losses elsewhere.

State-led growth applies the theory of market failure to economic development. The most important market failure, according to this theory, results from increasing returns to the scale of production. With increasing returns to scale, a firm cannot turn profitable until it gets big. A famous passage in Adam Smith's Wealth of Nations explains increasing returns to the scale of production. :

*“One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head... [until the work is] divided into about eighteen distinct operations...ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day. But if they had all wrought separately and independently, and without any of them*

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<sup>15</sup> An interesting fact to note is that Peron's policies in Argentina and their consequences resemble the mercantilist in France who directed economic policy in the 18<sup>th</sup> century and whom Adam Smith criticized.

<sup>16</sup> Data for 1870 Data for 2004 F.A.M de La Balze (1995), Remaking the Argentine Economy, Council on Foreign Relations Press

A. Heston, R. Summers and B. Aten, Penn World Table Version 6.2, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, September 2006.

*having been educated to this peculiar business, they certainly could not each of them have made twenty, perhaps not one pin in a day...*"

As the pin factory expands from 1 to 18 workers, it divides labor more finely and becomes more efficient. In Smith's example, a firm that manufactures forty-eight thousand pins per day can drive any smaller competitor out of business.

Smith argued that the extent of the market determines the number of goods like pins that a firm can sell, which determines how finely labor is divided. If the extent of the market determines how finely labor is divided, and if a finer division of labor increases productivity, then only a few large firms can compete. This is a condition of natural oligopoly or natural monopoly.

This kind of reasoning led economists to conclude that developing countries must protect "infant industries" against competition until they achieve efficient scale. Premature exposure to international competition will wipe them out. Raul Prebisch (1950) advised poor countries to use tariffs to block imports and allow domestic industries to grow behind the tariff wall. This strategy is called "import substitution" because domestic production substitutes for imported goods. According to this view, import substitution can proceed until domestic industries reach an efficient scale where they can compete internationally, at which point international trade becomes viable for the developing countries. Without import substitution, according to this view, poor countries will export raw materials and remain chronically underdeveloped and dependent.<sup>17</sup>

This argument for temporary protection assumes that the world will buy enough of the good to support many firms operating at efficient scale. However, the minimum efficient scale might be so large that a few firms can supply all of the world's demand. This condition of natural monopoly or oligopoly leads to an even more pessimistic view about trade favors: Instead of temporary protection, industries in poor countries need permanent protection against international

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<sup>17</sup>Prebisch also thought that trends in world prices disfavor producers of raw materials. Specifically, demand for raw materials is inelastic, according to Prebisch, so an increase in supply from developing countries would cause a secular decline in the world prices of raw materials. In addition, random shocks in supply combined with price inelasticity causes large price fluctuations, which disrupt economies. ( R. Prebisch, 1950; H. W. Singer, 1950

competition. If technical characteristics of production favor natural monopoly or oligopoly, poor countries with small industries can never compete in international trade and they will harm themselves by trying to do so. According to this view, poor countries should opt out of the system of international trade. Contemporary hostility to “globalization” sometimes invokes this line of reasoning.

Besides increasing returns to scale, the other major market failure was thought to be positive spillovers of production activities. Thus an increase in the size of the pin factory would lower the cost of pins. A textile factory that buys pins would benefit from an expansion in the pin factory. Conversely, more demand from the textile industry helps the pin factory to expand. Firms and industries with positive spillovers like the pin manufacturer and the textile factory might need state planners to coordinate their expansion.

The school of “balanced growth,” associated with A.O. Hirschman and G. Myrdal, maintained that industries in developing countries produce external benefits for the industries from which they buy inputs or sell outputs. The external benefits are called “forward and backward linkages.” Since the private benefits of exchange are less than their social value in linked industries, free markets will exchange too little and the industries will not expand enough. To solve the problem, the state should subsidize industries so that they grow larger.<sup>18</sup>

Similarly, the school of “balanced growth,” which is associated with Rosenstein-Rodan, held that linkages among firms require all of them to get big at once. Development requires a “big push” where everything grows fast simultaneously. The big push, according to this theory, requires more capital than markets can supply. To instigate the big push, the state should create an investment board or planning board to direct investment into the modern sector.<sup>19</sup>

These theories have similarities to the concept of “primitive accumulation” developed by Marx (1867). The modern industrial sector, according to Marx,

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<sup>18</sup> See A.O. Hirschman, 1958 and G. Myrdal, 1957

<sup>19</sup> See Rosenstein-Rodan, 1943. Leibenstein (1957) took a similar view, when he asserted that before a self sustained industrial growth could occur, a state assisted “critical minimum effort” was necessary.

must achieve a minimum size before it can exist on its own. Capitalists financed the original accumulation of machines, buildings, railroads, etc., not by retaining profits from their own production, but by stealing wealth from the traditional sector. This alleged history of capitalism played an important role in debate over industrialization under communism in the Soviet Union. Much like the capitalists in Marx's theory, the Soviet state extracted resources from the traditional agricultural sector in order to finance the industrial sector in a primitive socialist accumulation.

The theoretical basis for transferring resources from the backward agricultural sector to the modern industrial sector was refined in the "dual economy" theory.<sup>20</sup> According to this theory, developing economies have two distinct sectors – modern and traditional. Production in the traditional sector allegedly does not decline when workers are removed from it. To be more precise, dual market theory holds that each worker in the traditional sector receives a subsistence wage that exceeds his marginal product.<sup>21</sup>

To illustrate, assume that a farmer employs his son to work the family's small plot of land in the traditional sector. According to dual market theory, the farm already has so many family members at work that the son's additional labor does not add much to the total product. For the son to survive, the father must pay him more his marginal product. Since the father pays the son more than he produces, the father would benefit from his son leaving the farm and finding alternative employment. Specifically, the father would enjoy a net gain if the son moved to the city, got a factory job, and supported himself.<sup>22</sup>

According to dual market theory, each worker who moves to the modern sector conveys a benefit on those who remain in the traditional sector. With free markets, the traditional sector is too large and the modern sector is too small. To avoid this problem, the state should tax the traditional sector and subsidize the

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<sup>20</sup> W. A. Lewis, 1954; J. C. H. Fei and G. Ranis, 1964, Jorgenson 19..., A. Sen 19...).

<sup>21</sup> In Chapter 3 we explained how competition leads to workers getting paid their marginal product. Dual market theory holds that this principle does not apply to agricultural labor markets, although it may apply to industrial labor markets.

<sup>22</sup> The same argument held, when a pre capitalist feudal landlord under the "noblesse oblige" rule guaranteed a subsistence income to his serf independent of the serf's marginal productivity of labor.

modern sector. By this policy, the relatively poor farmers subsidize the relatively rich city workers.

Politicians appreciate the advantages of this policy when country to city. In 1756 Quesnay wrote in Diderot's Encyclopedia:

*“Wrong promises have drawn people from the countryside into the cities, where the necessity to offer cheap labor led to political pressure on the price for wheat. ... (This has) has knocked down agriculture into a miserable state of subsistence.”*<sup>23</sup>

Similarly, Peron in Argentina impoverished agriculture and subsidized industry, which weakened the hacendado who opposed him politically and strengthened the urban workers who supported him politically. In Ghana during the reign of Kwame Nkrumah (1957-66), a similar policy transferred wealth and power from the cocoa farmers to the urban elites.<sup>24</sup>

In the 1980s most developing countries in all regions except East Asia discriminated against agriculture. A study of rice, wheat, and maize prices in almost 50 developing countries showed that these prices were heavily depressed against the world market price.<sup>25</sup> Export restrictions, multiple exchange, rates and regulatory price ceilings depressed agricultural prices. This way of thinking also affected investment projects by the World Bank.<sup>26</sup> Discrimination against agriculture has been reduced since the 1980s, but still persists. (Note that rich

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<sup>23</sup> F. Quesnay, Grains, 1757, Encyclopedie de Diderot et d'Alambert. (Own translation from French).

<sup>24</sup> Acemoglu Daron, Simon Johnson, James Robinson and Yunyong Thaicharoen (2003), Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth, Journal of Monetary Economics, volume 50, pp. 49-123

<sup>25</sup> Daphne S. Taylor, Truman P. Phillips, Food-Pricing Policy in Developing Countries: Further Evidence on Cereal Producer Prices, *American Journal of Agricultural Economics*, Vol. 73, No. 4 (Nov., 1991), pp. 1036-1043

<sup>26</sup> Dual market theory has caused organizations like the World Bank to assign higher costs to labor taken from the traditional sector and applied to modern investments. However, even if marginal productivity in agriculture is much below marginal productivity in modern industry, this does not imply that the social cost of labor is below the market wage rate. This holds especially, if migration from the traditional to the modern sector is endogenous and depends on wage differentials between the two sectors<sup>26</sup>. Development agencies disregarded this fact in cost benefit analyses until the middle of the 1980s. The shadow wage becomes close or equal to the market wage if they take this effect into account. See Sah, Raaj Kumar and Joseph E. Stiglitz. "The Social Cost of Labor and Project Evaluation: A General Approach." *Journal of Public Economics*, Vol. 28,(1985), pp. 135-163.

countries mostly stand this policy on its head: The city subsidizes the products of the countryside.)

Economists invoked increasing returns to scale and spillovers to justify more state leadership of the economy in poor countries than in rich countries. Most economists now believe that market failures have similar importance in poor and rich countries. Difference in their importance cannot sustain separate approaches to growth in poor countries and rich countries. Natural competition is the rule in economies of rich and poor countries, whereas natural monopoly is the exception to the rule. Adam's Smith's metaphor of the invisible hand characterizes the economy as a whole more accurately than his example of the pin factory. Adam Smith concluded against state growth, represented in his day by the philosophy of mercantilism, and so do we. As we explained in Chapter 2, the state should not lead economic growth in poor countries for the same reason that it should not lead it in rich countries: state employees lack the information and motivation.<sup>27</sup>

### ***The Washington Consensus: Freedom Before Law***

Stagnation in economies with state leadership discredited traditional development economics in the 1970s. Around 1980, a new approach became dominant, especially in the World Bank and the International Monetary Fund. Instead of state leadership, the "Washington Consensus" favored free markets, specifically privatization, deregulation, free trade, and free capital movements.<sup>28</sup>

The Washington Consensus affected economic policy in many countries, with variable results. When markets began replacing state leadership after 1980, China grew spectacularly, and Indian also had high growth, as the data shows in the beginning of this chapter. In central and eastern Europe, markets abruptly

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<sup>27</sup> ...every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. ...--Adam Smith, The Wealth of Nations, IV.2.9.

<sup>28</sup> J. Williamson, Democracy and the "Washington Consensus" (1993) World Development, 21, 8 (1993), 1329-36



replaced state leadership around 1990 when communism collapsed. By the mid 1990s, our data shows good growth in the central Europe nations that eventually joined the European Union in 2004, but not in the eastern European nations that did not join the E.U. After 1980 state leadership retreated in Latin America as prescribed by the Washington Consensus, and growth rates were low, as the data shows in the beginning of the chapter. In Africa, the disastrous economic decline between the mid 1970s and the mid 1990s did not have much to do with the Washington Consensus. Shifts between state and market leadership were overshadowed by more sinister events -- deteriorating administration, chaotic strife, and civil war.

Mixed results led many theorists to conclude that the Washington Consensus failed. A group of development theorists proposed a new policy agenda, called the Barcelona Consensus (2004).<sup>29</sup> They point to differences in institutions from one country to another as the primary factor in determining whether or not liberalization succeeds:

*... both basic economic reasoning and international experience suggest that institutional quality -such as respect for the rule of law and property rights- plus a market orientation with an appropriate balance between market and state, and attention to the distribution of income, are at the root of successful development strategies.*

*Moreover, the institutions that put these abstract principles into reality matter, and developing countries should work hard to improve their institutional environments. But effective institutional innovations are highly dependent on a country's history, culture and other specific circumstances.*

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<sup>29</sup> <http://ftp.mozilla.org/pub/mozilla.org/mozilla/nightly/latest/>

***Double-Trust Theory: Legalizing Economic Freedom***

Without law, people use economic freedom to take wealth from each other. The Washington Consensus got bad results where people used freedom to take wealth by exploiting weaknesses in institutions and norms. Liberalizing without law is no recipe for growth. With law, however, people use economic freedom to make wealth by innovating. The Washington Consensus got good results where institutions and norms directed the energies of people to make wealth. Liberalizing within law is a recipe for growth.

A brief passage from Adam Smith gets the balance right:

*“Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and tolerable administration of justice; all the rest being brought about by the natural course of things.”*<sup>30</sup>

Double-trust theory isolates the mechanism by which sustained growth comes from the “tolerable administration of justice.” Like the Barcelona Consensus, and unlike the Washington Consensus, double-trust theory stresses the effective protection of property, contracts, and investors.

These conditions apparently obtained in China and India after the 1980s. In central Europe, these conditions were implemented in those countries that joined the European Union, but not in the central European countries where people too often endured an intolerable administration of injustice. During the 1980s, African nations could not establish the peace on which the rest depends. In Latin America, moderate policies and muted tendencies make outcomes incomparable to central Europe, Africa, and China. Still, economic growth or stagnation in Latin American depended mainly on whether or not liberalization directed energies towards making wealth or taking it from the state. Next we look more closely at the institutional framework in these countries and regions to support entrepreneurs and innovation.

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<sup>30</sup> Adam Smith, Notebooks that formed the *Wealth of Nations* (1755), as found in the Modern Library Edition of the *Wealth of Nations* in the Editors Introduction, p. xlili.

### China: Growth-Protecting Authoritarianism

An economic miracle swept Japan in 1950, Taiwan and Korea in 1970, China in 1980, and Vietnam in 1995. In spite of the differences among these countries, they have striking institutional similarities compared to Europe and America -- suits are rare, rights are negotiable, institutional boundaries are permeable, reciprocity dominates contracts, and state administration is stronger than state law. Administrators substantially secure property, protect investors, and enforce contracts. The economic miracle in this region shows that strong, stable state administration can overcome weak state law and provide reliable economic expectations, as required for investment and economic growth.

We focus on how China does this. During the Cultural Revolution of the 1960s, China's communist party ardently destroyed the private economy, and then it learned from the ensuing disaster. Deep institutional reforms began in the late 1970s.<sup>31</sup> Instead of "capitalism," the communist party promotes a "socialist market economy," which is capitalism by another name.<sup>32</sup> The communist party, which stands behind the state bureaucracy and directs it, now views the private economy as the goose that lays golden eggs. A stable, reliable bureaucracy protects the private sector and resists the traumatic political enthusiasms of the recent past.

The form of protection for the private economy, however, is very different from Europe or America. The communist party is not committed to clear legal obligations, definite rights, limited state power, procedural justice, and other elements of the rule of state law. China has growth-protecting authoritarianism, not democracy. Legal reforms have occurred in almost all fields of civil, commercial, and regulatory law, but courts lack independence and enforcement

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<sup>31</sup> D. Rodrik, A. Subramanian, F Trebbi, Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development, *Journal of Economic Growth*, 2004, 9, 131-164.

<sup>32</sup> Some "foreign experts" were invited to meet China's Premier, Wen Jiabao, in 2005 in Beijing. Cooter asked the Premier a question about the stock phrase used by officials to describe China's economic system -- "socialist market economy." "What is the main difference," Cooter asked the Premier, "between a socialist market economy and a market economy that is not socialist?" Premier Wen, who earlier cited Adam Smith, replied, "The principles of the two systems are consistent. The difference is in the nation's history and traditions."

of court orders remains unreliable. By any standards and comparisons China has a weak state legal institutions, much weaker than India.

Why do party officials and state administrators protect the private sector instead of expropriating it? Governments at all levels – local, regional, and central –tax businesses and partly own them. The party, the central government, the regional and local authorities remain committed to growth because they profit from it. Remarkably, they restrain themselves and allow entrepreneurs to keep most of what they make, which keeps the economy growing.

### Indian Gradualism

After independence in 1947, the Indian state locked the economy out of the world market and developed import substituting industries. Heavy industry and banks were nationalized, but agriculture and consumer industries remained private. Five-year plans set priorities for loans and investments. Licensing laws regulated the establishment of new firms. Growth remained unimpressive. The “Hindu rate of growth” as Indians called it was around 1.5 per cent per capita.

India has liberalized its “mixed economy” since 1991. State monopolies were abolished in almost all sectors, state enterprises shrank or were privatized, and licensing requirements reduced. The state reduced its lending to sick industries and reformed tax collection. Import licenses and tariffs were gradually abolished, but restrictions were kept on international capital transfers. Unlike Russia, India never engaged in a sweeping big bang reform, but incremental reforms accumulate over a period of years. With liberalization, per capita growth rates increased markedly from to around 6 per cent in the new century.<sup>33</sup> Liberalization is largely welcomed and supported across political parties.

Economic distortions remain severe in India. The prices of electricity, gas and water are kept down for political reasons, so supplies are unreliable and shortages are frequent. Thus business routinely generates costly electricity from their own generators when the power grid browns out. Overprotection of workers

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<sup>33</sup> T.N. Srinivasan, *Eight Lectures on India's Economic Reforms* (2000) Oxford University Press

and tenants in the formal sector swells the informal sector. The sheer magnitude of the money value of overprotection makes liberalization difficult.

India's state legal institutions are stronger than in many other developing countries. Its universities provide a high level of legal training and its higher courts are independent of politics. Delays and corruption impede the courts, but they secure property, enforce contracts, and protect investors better than courts in other developing countries, including China. Strong courts make India's liberalization less dependent political policy and power. Thus the Indian Supreme Court promoted the privatization process in the Balco case.<sup>34</sup> By admitting public interest litigation it plays a pivotal role in curbing environmental degradation. Government in India is constitutionally and democratically constrained, which adds to the credibility of reforms protecting property and contracts.

#### Central Europe: Liberalization With Law

Eight central European countries that formerly belonged to the Soviet bloc became members of the European Union in 2004. To prepare for entry into the E.U., these countries had to incorporate democracy and constrained government into their laws. They also had to incorporate Europe's secondary laws, the "acquis communautaire." It comprises directives and regulations related to almost all economic transactions -- competition, consumer protection, safety, regulation of industries including banking and insurance, company law, corporate governance, and the protection of outside investors. Secondary laws must be transformed into national law, administered, enforced, and adjudicated before an accession country can become a full member of the European Union. The written has to be backed by effective institutions. Otherwise these countries would not have gained full membership in the E.U, including such advantages as large transfer payments from the European Commission to upgrade the infrastructure.

Under the supervision of the European commission, the central European countries adopted the rule of law in a very short time. As shown in Figure \_6,

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<sup>34</sup> Balco employees Union v. Union of India and others, Supreme Court of India, Indlaw Sc 181, December 10, 2002. The Supreme Court held that privatization and disinvestment by the government are not subject to judicial review except when unconstitutional, illegal or wholly arbitrary. It denied a preliminary injunction or stay in such cases.

these countries suffered a short economic slump, when the Soviet bloc broke down in 1990, but under the legal reforms from the E.U. they soon achieved high growth. This history shows that liberalization favored by the Washington Consensus works when law is effective.

### Russia and Eastern Europe: Liberalization Without Law

After central planning collapsed in 1990, Russia introduced a market economy in a big bang reform following the Washington Consensus. The result was the looting of state assets, violent conflicts over ownership and access to markets, and Mafia type enforcement of contracts -- in brief, "gangster capitalism." While a super rich oligarchy appropriated the nation's wealth, the country's real per capita GNP declined precipitously. Subsequently, President Putin established an autocratic state machine that restored some stability, and stability brought some economic growth. But in 2005 the country had not fully regain the per capita income level of 1990. Russia is an outstanding example where liberalization without law failed. Belarus and Ukraine experienced similar developments.<sup>35</sup>

### Sub-Saharan Africa: Institutional Collapse

During the first half of the 20<sup>th</sup> century, economic growth in Sub Saharan Africa was larger than in Asia. GNP per capita in the region exceeded Asia sample in 1950. After colonies gained political independence in the 1950s and early 1960s, growth accelerated. Given this history, several scholars have depicted Sub-Saharan Africa since 1970 as an unexpected tragedy.<sup>36</sup> They did not foresee that the region's economy would stop growing and start shrinking in the 1970s.<sup>37</sup>

Easterly and Levine (1997) relate the African tragedy to ethnic diversity and strife, and to the corruption of institutions. Collier (1999) found that a combination of ethnic diversity reduced growth in Africa by 3 per cent points

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<sup>35</sup> See World Bank, World Development Indicators 2007 GDP, per Capita Series

<sup>36</sup> W. Easterly, R. Levine (1997) Africa's Growth Tragedy, Quarterly Journal of Economics, 112, 1203-12050

<sup>37</sup> P. Collier and J.W. Gunning (1999), Why has Africa grown slowly? Journal of Economic Perspectives, 13,3,3-23

when combined with dictatorship, but ethnic diversity had no effect on growth in democratic states.<sup>38</sup> African dictatorship is typically rent seeking, not growth promoting. During the cold war unlawful, undemocratic and kleptocratic regimes in Africa like Mobutu Sese Seko in Kongo and Jonas Savimbi in Angola received foreign support from one side or the other in the Cold War, depending on whether they joined the Western or the Soviet camp. Military dictatorship became widespread during this period, destroying institutions and physical infrastructure as well as lives.

For Sub Saharan Africa there exists no consensus in the literature on the dominant role of institutions for growth but the majority of scholars adopts the institutional view on Africa's tragedy. One prominent scholar, J. Sachs (2003), argues that geography explains the Africa's economic disaster better than institutions, which is a hard case to make since geography remains the same when the economy goes up and down.<sup>39</sup> Sachs et al. also detects a special market failure in Sub Saharan Africa -- a low-level equilibrium trap -- that only a big push financed by foreign development aid can overcome.<sup>40</sup> Statistical analysis, however, suggests that development assistance has had no measurable effect on growth in the past.<sup>41</sup> Does anyone think *less* foreign aid will be wasted if there is a lot more of it?

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<sup>38</sup> P. Collier (1999) *The Political Economy of Ethnicity*, in *Proceedings of the Annual Bank Conference on Development Economics*, P. Pleskovic, J.E. Stiglitz, eds, World Bank, Washington D.C.

<sup>39</sup> Sachs, J., (2003), *Institutions don't rule: Direct effects of geography on per capita income* NBER. Africa is a sparsely populated continent, which makes transport costs comparatively high. This leads to lower levels of competition and to more regional and local monopoly power. African rainfall patterns increase the variance of agricultural income. In the absence of insurance markets this leads to high storages of wealth, which are lost for productive investment leading to a high variance high liquidity trap. School training is low, partly because of low life expectancy, which makes it less profitable. Extreme climate and widespread tropical diseases are seen as factors in their own right to cause low productivity. For a reply, see D. Rodrik, A. Subramanian, F Trebbi, *Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development*, *Journal of Economic Growth*, 2004, 9, 131-164

<sup>40</sup> J.D. Sachs, J. W. McArthur, G. Schmidt-Traub, M. Kruk, C. Bahadur, M. Faye, and G. McCord. 2004. "Ending Africa's Poverty Trap." *Brookings Papers on Economic Activity*, (1): 117-216.

<sup>41</sup> Cite Easterly.

Latin America: Liberalization With Stagnation

From the 1950s until the late 1970s most Latin American Countries followed a policy of state intervention and import substitution. If we compare per capita income in Latin America to the U.S., the ratio peaked for almost all Latin American countries between 1970 and 1980. Latin American countries had higher growth rates during the period of import substitution and state intervention from 1950 to 1980 than in the following period. After the debt crisis of 1980, most countries in Latin America follow the Washington Consensus and changed policies to favor export orientation, privatization, and market liberalization.<sup>42</sup> For the decade after 1980, per capita growth was less than one per cent per year in the region. (A noteworthy exception is Chile, a country with strong institutions and laws.<sup>43</sup>)

Why did growth stagnate in Latin America in 1980s after liberal reforms? We think that events in Latin America resembled a mild version of Russia. In Russia shock therapy created frenzies looting of the state and investor insecurity. Market liberalization without market institutions in Russia led to an economic collapse. In Latin America, liberalization was often abrupt and sweeping, with the aim of quickly removing all obstacles to free markets. Privatization directed the energies of many people into acquiring state assets and monopoly power. Market liberalization with weak market institutions in Latin America led to economic stagnation.

As in Russia, unfair privatization in Mexico generated new tycoons. Carlos Slim, who became the second richest man in the world after Bill Gates, bought a state owned monopoly named Telmex for 1.8 billion dollars after independent auditors estimated its value at 10 to 12 billion dollars. Having apparently acquired the company at 20% of its value, he was allowed to run it as a private monopoly.<sup>44</sup>

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<sup>42</sup> W. Easterly, *The White Man's Burden, Why the West's effort to help the rest have done so much ill and so little good* (2006), New York, 70

<sup>43</sup> *World Economy* 2005, 7

<sup>44</sup> *Handelsblatt*, 13 March 2007



Or consider the privatizing the Mexican banks. The banks financed their own privatization by lending money to the bank's buyers. Such a risky business would normally scare away the bank's depositors, but this did not happen because the state guaranteed the deposits. After becoming private, banks extended risky loans. When banks tried to collect non-performing debts, they were obstructed by impractical rules for debt collection, repossession of security on a loan, and bankruptcy. Lax regulation allowed them to roll over non-performing loans. Bank managers counted on a government bailout. After banking regulation was reformed in 1998, banks reversed themselves and became very cautious about lending to borrowers without the highest credit standing, so investment declined.<sup>45</sup> Similar stories can be told about Brazil in the 1990s following sweeping liberalization and privatization.<sup>46</sup>

In Latin America problems in the banking sector interacted with mistakes in macroeconomic policy to push economies into recessions. Unlike India and China, most Latin American countries completely liberalized international capital transfers, which is a particularly risky policy. Liberalization of capital movements and mistakes in managing the money supply apparently destabilized finance and aggravated investment problems.<sup>47</sup> Efficient small and middle enterprises were

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<sup>45</sup> W. Easterly, Op.cit. p.100

<sup>46</sup>E. Amann and W. Baer Neoliberalism and its Consequences in Brazil, (2002) J. Lat. Amer. Stud. 34, 945–959, 2002 Cambridge University Press 945. R. Hausmann, D. Rodrik, and A. Velasco (2007) Getting the Diagnosis Right, Finance and Development, 43, 1. E. A. Paus (2004) Productivity Growth in Latin America, The Limits of Neoliberal Reforms World Development, Vol.32, 3, 427-445 and E. Grilli (2005) Political Economy and Economic Development in Latin America in the Second Half of the 20th Century, Journal of Policy Modeling, 27,1, 1-31.

<sup>47</sup> Most countries in Latin America cannot borrow internationally in their own currency. Borrowing in dollars creates exchange rate risk. The liberalization of the capital account in Latin America thus increased the vulnerability of Latin American economies to exchange rate fluctuations. Also, most Latin American countries quickly face increasing interest rates as they borrow more money. So borrowing aggravated the business cycle instead of dampening it. See R. Hausmann, M. Gavin (1996) Securing Stability and Growth in a Shock Prone Region: The Policy, Challenge for Latin America, Inter-American Development Bank, Washington D.C.

forced to close because they could not get finance.<sup>48</sup> (These “mistakes” in policy may have an underlying political logic.<sup>49</sup>)

### **Arab Countries: Rentier Economies and Rent Seeking Societies**

The Arab world shares some features of institutional weakness with Latin America. When Arab countries introduced some liberal reforms in the 1980ies, they lacked the institutions of the market economy and liberalisation did not increase growth as private monopolies replaced public monopolies and access to finance remained politically constrained. As shown in Table \_\_.6 above, after 1980 growth of Arab countries fell behind.

The Arab human development report 2003<sup>50</sup> shows that Arab countries produce few goods which require high skills and advanced technology as an input. This is reflected in the composition of the domestic product as well as of exports. Both consist largely of agricultural products and raw materials, especially crude oil. Since 1980 non oil exports of Arab countries decreased steadily as percentage of world exports. Arab countries buy sophisticated expertise abroad but profit little from global economic integration. Production is concentrated in small and micro enterprises, which usually employ one or two workers and seldom employ more than 100 workers. This reflects an inability to solve corporate governance problems either by law or by relations. These enterprises use traditional modes of production and fail to generate, contain and exploit new knowledge. Large international companies often provide for developing countries the finance, organisation, skill and technology to produce for the world market. In Arab

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<sup>48</sup> J. Katz (2000), Structural Change and Labor Productivity Growth in Latin American Manufacturing Industries 1970–96, *World Development*, 28,9, 1583-1596. Katz finds that institutional factors explain much of the productivity changes in different sectors of Latin American industries.

<sup>49</sup> If political institutions are weak, macroeconomic instruments like the foreign exchange rate, the money base, or export and import duties, can be used to extract rents and stabilise the power of political factions. See Acemoglu Daron, Simon Johnson, James Robinson and Yunyong Thaicharoen (2003), Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth, *Journal of Monetary Economics*, volume 50, pp. 49-123.

<sup>50</sup> UNDP, Arab Human Development Report 2003, pp. 134

countries they limit themselves to “secondary activities with little effect on the creation of national skills or the adoption of technology.”<sup>51</sup> A particular feature of Arab countries, whose impact on growth is still debated is the tiny flow of knowledge import for the Arabian people from abroad. An often cited example of this shortcoming is the low number of translations into the Arab language. In a five years period during the 1980ies 4,4 books per one Million people were translated into Arabic, whereas the figure for Hungary was 519, for Israel 380 and for Spain 920<sup>52</sup>.

As in many other developing countries especially in Latin America, private monopolies dominate many markets. Bureaucrats and political cronies protect incumbents against competitors in exchange for rents. Access to power often generates more income by redistribution than productivity and leading business people are often also leading politicians or bureaucrats. Large incomes from crude oil production in some Arab countries and large incomes from foreign transfers support the tendency to a rentier economy as these incomes do not encourage reform.

The legal system suffers under several shortcomings<sup>53</sup>. Legal transplants from abroad often do not interact with the economy. They remain formalistic and abstract. Court delays are pervasive. Newly created exceptional courts negatively affect due process and procedural fairness, because their rulings are often final and not checked by courts of higher instance. This reduces the demand for courts as instruments for conflict resolution. Courts lack independence and political influence on courts is widespread. In many Arab countries there is strong interaction between the political and the judicial branch and compliant judges are awarded with political positions. Various Arab countries introduced the state of emergency over extended periods, by which the rule of law was even formally abolished. Rule of law indices are low, but not much lower than in Latin American countries.

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<sup>51</sup> Ibid. p. 136

<sup>52</sup> Ibid. p. 68

<sup>53</sup> Ibid. p. 152

The size of the government is too big and distorted in favour of the national government in many countries. In almost all countries political systems are authoritarian and bureaucracies are corrupt. The Middle East and North African (Mena) countries have the highest government employment of all developing regions, they have the highest central government employment but the lowest sub national government employment. The government wage bill as per cent of total wages is the highest of all regions in the world and only in this region the wage rate in the government is higher than the wage rate in the private sector.<sup>54</sup> Under government influence financial institutions channel savings into government projects and curb more productive private investment. Political instability and the Middle East conflict have also contributed to low growth in some countries.

The financial sector lags behind. Banks are state owned or state controlled. They remain fragmented and have few links with international capital markets. They finance the government rather than the private sector. Barriers to entry a market remain high, both internal barriers as well as import barriers. Like in Latin America manipulating foreign exchange rates is an instrument to redistribute wealth.

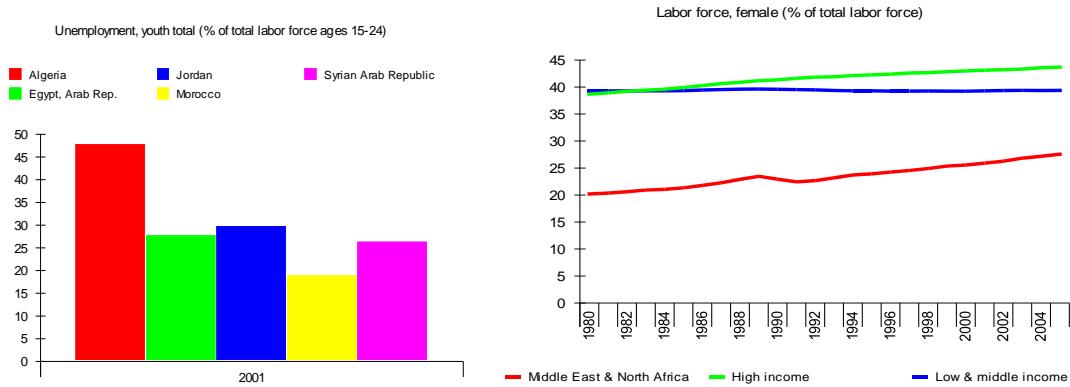
The monopolistic character in the society and the economy discriminates against women and young people. The social and legal position of women, their rate of literacy and their participation in the work force is one of the lowest in the world. Low growth led to extraordinary high unemployment rates, especially among the youth.

### Youth Unemployment and Female Labor Force Participation in Arab Countries

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<sup>54</sup> R. Beschel, the Impact of Large Governments on Development and Growth in the Mena Region, IMF Workshop Abu Dhabi, 2006

# Law and Economic Development



Source: World Development Indicators 2007

## Conclusion

Legalizing economic freedom requires effective protection of property, contracts, and investments. According to double-trust theory, legalizing economic freedom causes entrepreneurial innovation and growth. Effective protection of property and contracts by the state seems to be a precondition for becoming a rich country. Effective protection comes from social norms and state legal institutions, especially independent courts, as in central Europe. Effective protection can also come from a stable state administration that is committed to growth, as in East Asia.

Any theory of economic development focuses on a few causes of growth in most nations and relegates the rest to background. The background includes particular facts of history and culture. Particular causes are important in the economic history of any one country and not in another. Oil decisively changed the history of Dubai but not New Zealand. Unique events figure in the explanation of a country's development, but so do general causes. A satisfactory explanation combines generalizations and particularities.

If we focus on particulars, we can lose confidence in generalities. “I had three theories of child development,” said a parent, “but now I have three children and no theories.” Similarly, an economic historian might say, “I had three theories of economic development, but I studied three countries and now I have no theories.” Particularity without theory is description without explanation. A movement in the 1960s tried to develop a discipline of law and economic development without a foundation in economic theory. It produced a large volume of literature, then stopped abruptly and disappeared, with no lasting effect on scholarship or development policy.<sup>55</sup>

The institutional particularity that prompts growth varies widely by time and place. Institutions might be home grown or transplanted, formal or informal, judicial or bureaucratic.<sup>56</sup> We cannot say exactly what they will be. Whatever their particular forms, however, they must solve the double trust problem in order to produce sustained growth. We see no way to solve this problem except by security of property, contract, and investments, which is what we mean by effective law for growth.

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<sup>55</sup> See (D. M. Trubek, 1972; D. M. Trubek and M. Galanter, 1974. For critical perspective on its weak theory, see Trebilcock (2001). It was only with the writings of North<sup>55</sup>, Thomas, Weingast, Buchanan (1987 and 1988) and others that showed the historical importance of personal liberty and the protection of private property rights in economic development. D.C. North (1990) *Institutions, Institutional Change and Economic Performance*, Cambridge University Press 1990. D.C. North, D.C., (1989), ‘Institutions and economic growth: an historical introduction’. *World Development*, 17 (9), pp. 1319–32. and R.P Thomas (1973), *The Rise of the Western World*, Cambridge University Press. B:R. Weingast, Barry (1995) *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, *Journal of Law, Economics, and Organization*, 11 (1), 1-31.

<sup>56</sup> “The cross-national literature has been unable to establish a strong causal link between any particular design feature of institutions and economic growth. We know that growth happens when investors feel secure, but we have no idea what specific institutional blueprints will make them feel more secure in a given context. The literature gives us no hint as to what the right levers are. Institutional function does not uniquely determine institutional form.” See D. Rodrick (2006) *Goodbye Washington Consensus, Hello Washington Confusion? A Review of The World Bank’s “Economic Growth in the 1990s: Learning from a Decade of Reform*, *JEL*, XLIV 973-987, p.979

