second edition

UNDERSTANDING DEVELOPMENT

Theory and Practice in the Third World

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Development Theory in the Postwar Period

EARLY IN THE SUMMER OF 1944, ALLIED TROOP COLUMNS ROLLED EASTWARD through France. Berlin lay on the horizon. World War II had entered its final phase and Allied victory was just a matter of time.

Having begun to ponder the possible shape of the postwar world, the Allied leaders held a conference to discuss the structure they would give to the world economy. This meeting took place at a hotel in Bretton Woods, New Hampshire. It began within a month of D-Day and lasted three weeks. The absence of the USSR signaled the imminent split of the world economy into two blocs, the Western capitalist one, and the Eastern state-socialist one. The Bretton Woods conference would provide the blueprint for the postwar capitalist economy.

The intellectual shadow of the leading economic thinker of the age, John Maynard Keynes, loomed large over the conference, and Keynes made important contributions to its proceedings. Chief among the concerns of the participants was the desire to create a favorable international trading environment. They wanted to put behind them the conditions that had worsened the Depression. Monetary instability and lack of credit had inhibited trade among nations and led governments to adopt protectionist policies when they could not pay for their imports. To this end the Bretton Woods conference gave rise to the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development, which became known as the World Bank. In 1947 the Bretton Woods system, as it came to be known, was rounded out by the General Agreement on Tariffs and Trade (GATT). All were designed to create as stable and freely flowing an international trading environment as possible.

GATT was a treaty organization that aimed over time to reduce tariffs, or taxes on imports, thereby lowering the barriers to trade among member states. The IMF was set up to provide short-term loans to governments facing balance-of-payments difficulties, the problem a government encounters when more money leaves its economy through imports, capital flows, and spending abroad than enters it. In the past, governments had dealt with this problem by taking measures to reduce their imports, but this brought retaliation from the countries whose exports they were blocking. The IMF was to lend governments the money they needed to cover their balance-of-payments deficits, so that governments would no longer resort to the sort of tactics that set off protectionist spirals, reducing trade. Member governments would pay into the IMF and then draw on its deposits when necessary. The IMF later extended credit beyond its members' resources. However, in cases in which governments repeatedly ran balance-of-payments deficits, the IMF was allowed to demand, as the price for further loans, government reforms to rectify structural problems in the economy—in effect, the IMF was to be the world economy's conservative and parsimonious banker, slapping the wrists of governments that had been careless with their checkbooks. The World Bank was created to invest money in the reconstruction of war-ravaged Europe. When it had completed this task, it turned its attention to the development of the third world.

Finally, to ensure that goods flowed freely across borders, the world needed a universal medium of exchange, a currency all participants in the economy would accept. Because the World Bank did not have the power to issue currency, the U.S. dollar filled the role by default. By U.S. law, every thirty-five dollars any individual or government accumulated could be exchanged for one ounce of gold, from U.S. gold reserves held at Fort Knox. In effect, this made the dollar as good as gold, and virtually all governments, including those in the Soviet bloc, were willing to accept U.S. dollars for payment.

The Bretton Woods conference failed to take Keynes's advice to create an international trade organization, which would have enjoyed more power than did GATT to enforce the compliance of member states, and would also have been able to stabilize commodity prices. No institution could discipline any government into improving its trade practices. As a treaty organization, GATT could only rule when member governments were entitled to retaliate against other governments; it could not end protectionism, though it could discourage it and give it some order. Importantly, GATT did not deal with nontariff barriers such as quotas. As tariff barriers fell, governments began using nontariff barriers to block trade, which undermined GATT. Keynes had also recommended that the IMF be able to pressure balance-of-payments surplus countries into opening up to trade. Instead, the IMF could only pressure those countries to which it made loans, namely, deficit countries. Pressure on surplus countries would have benefited the world economy by expanding trade, whereas pressure on deficit countries to curtail their spending slows the world economy.[1]

The Impact of Keynes in the First World

The Bretton Woods conference was concerned primarily with establishing a favorable international environment for economic growth, but Keynes's influence was evident in another way: his thinking had come to exercise a profound impact on a generation of political leaders. Keynes's recipe for economic development was accepted not only for the international system but for domestic economies as well. His vision of a smoothly running capitalist economy involved a much greater role for the state than had been tolerated in classical and neoclassical models of development, which had been more concerned with the free market.

Classical political economy, whose key contributors included Thomas Malthus, David Ricardo, and J. B. Say, and whose most lasting expression is found in Adam Smith's *Wealth of Nations,* stressed the role of the free market and individual liberty in economic success. Individuals, unfettered by state interference, would use their ingenuity to the greatest extent. Division and specialization of labor would allow resources to be used in the most efficient and productive manner possible. If all individuals pursued their narrow self-interests, all of society would benefit inadvertently. State interventions to relieve poverty would inhibit initiative, and would stifle investment because they would rely on increased taxes. Therefore, the prescribed role for the state in the economy was a minimal one. Smith identified only three functions for the state to perform: defense of national sovereignty, the protection of citizens' rights against violation by one another, and the provision of public or collective goods. Public or collective goods are those that society needs but the market will not normally provide because the gains are so widely dispersed. An example is traffic signals: almost everyone depends on them, but no individual will bear their cost. The state fills the gap by exacting a small payment from everyone in order to cover the cost of installing traffic signals wherever they are deemed necessary.

The other important feature of classical political economy was its conception of citizens' rights, which it was the state's task to defend. Classical political economy, along with classical and neoclassical liberalism, conceived of individual rights in negative terms. Citizens enjoyed certain liberties from coercion, such as freedom to practice religion, trade, and economic enterprise, and these could not be violated by either the state or other individuals. Citizens did not, however, possess positive rights, that is, rights *to* something, whether it be employment, housing, education, or the like. This conception of rights emerged only with the development of modern liberalism, and has always been rejected by neoclassical thinkers. To the latter, freedom has always meant simply freedom from physical restrictions imposed by another person or by the state. The price of this negative freedom is inequality: because people have different aptitudes, endowments, and inheritances, some will prosper and others will not. Neoclassical thinkers, along with their classical forebears, have always insisted that it is not the state's task to redistribute resources to equalize society. They contend that, in fact, the least well-off in society benefit more from this inequality—because it speeds up economic progress, which in turn benefits them—than they do from an egalitarian society that inhibits economic progress.

At any rate, classical political economy saw the capitalist system as a complex and delicate mechanism that could easily break down once the state started meddling with it. Left to itself, the free market was seen to be self-regulating: even when it appeared to have broken down, it was still functioning and would repair itself naturally. Hence the term "laissez-faire capitalism," which means precisely a capitalism that is left alone. For example, in an economic depression there is a slowdown of economic activity and widespread unemployment. The economy appears to have stopped functioning. But classical political economy, and the neoclassical economics this tradition spawned in the late nineteenth century, sees a silver lining to the gray cloud. With so many people unemployed, there are more people competing for fewer jobs; they must offer to work for less than their competitors. Thus, labor prices drop, and employers respond by hiring more workers. More workers with more money to spend translates into increased demand for goods and services, which in turn causes producers to expand their activity, which compels them to hire more workers, and so forth.

Keynes had no problem with the market economy. He liked the machine, but judged it to be in need of improvement if it was to operate well. In particular, Keynes took issue with the conventional economic assumption that during a downturn, labor prices drop, causing employers to hire more workers and thereby mop up unemployment. The Depression led Keynes to believe that high unemployment could persist indefinitely. He advocated the use of fiscal policy—government spending—to deal with recession. This was an instrument that virtually all governments were then loath to use. (Even Roosevelt's New Deal eschewed deficit spending, which Keynes favored.) By building roads and dams, for example, a government could create jobs, which in turn would create more demand for goods and services, which would cause factories to increase their output and then to take on more workers, and so on in an upward spiral. Once good times returned, the government could prevent the economy from overheating by taking money back out of it. In short, Keynes's prescription for improving the capitalist economy was for governments to save in good times, spend in bad.

Keynes was not the first to advise governments to spend their way out of recessions. However, his innovation was to call on governments to *borrow,* if necessary, to pump money into the economy.[2] The loans would be repaid later from the earnings generated by a newly robust economy. Neoclassical theorists worried that such public spending would worsen inflation, as more money would chase fewer goods. But Keynes argued that this expansionary fiscal shock would not cause inflation because increased investment would occur along with increased demand. It all heralded the advent of managed capitalism; this revolution in economic policymaking overthrew the doctrine of laissez-faire capitalism that the Depression had discredited.

In the late 1940s, governments in Western Europe and North America started taking Keynes's advice. By then, the USSR had begun to consolidate its hold on Eastern Europe by establishing puppet regimes in the six countries it had liberated from Nazi rule (East Germany, Poland, Romania, Bulgaria, Hungary, and Czechoslovakia). This solidified the iron curtain that Winston Churchill said had fallen across Europe, dividing it in two. It was becoming obvious that the new Soviet bloc was not going to join the economic order prescribed at Bretton Woods. The dust was slowly settling in Western Europe, though, even if the future looked uncertain immediately after the war, especially with communist parties threatening to take power in Italy, France, and Greece. Capitalism only firmly reestablished its hold on Western Europe when the United States instituted the Marshall Plan, whereby it injected billions of dollars into the reconstruction of Western Europe's ravaged infrastructure. At the same time, liberal democratic parties committed to a more equitable social order came to power in Western Europe.

What emerged in the politics of Western Europe, and indeed in virtually all the developed capitalist countries, has come to be known as the postwar Keynesian consensus. Not only did this innovation safeguard capitalism, it also won the support of the Western world's working classes. Western governments made full employment a top priority, along with improved social benefits such as public education, housing, and health care. Postwar capitalism was to be both redistributive and managed. Western governments, through nationalization of declining or important private companies, regulation of the economy, public spending, and other means, involved themselves far more deeply in the management of their economies than ever before. In its new version, capitalism was to be not only more efficient, but indeed more humane. It was a recipe for social peace like none seen before: investors would grow richer—Keynes himself had grown rich on the stock market—but so too would workers, and poverty would become a thing of the past. Scholars proclaimed that correct economic management would prevent there ever being another Depression, and that the high growth rates that followed in the 1950s were a permanent feature.[3] All of this was possible because the ingredient missing from earlier capitalism—an appropriate interventionist role by the state—was now in place.

The Emergence of the Third World

This was the political and intellectual climate into which the third world was born at the end of World War II. The industrial world had polarized between capitalism and Soviet communism, while a new form of statist liberalism had taken hold in the capitalist West.

The term "third world" originally denoted those countries that were neither advanced capitalist (the first world) nor communist (the second world). In practice, "third world" came to refer to all developing countries, including those that called themselves communist.

A number of features characterize third-world countries. First, by comparison with the advanced capitalist economies of Western Europe and North America, their per capita incomes are low. This poverty translates into shorter life expectancies, higher rates of infant mortality, and lower levels of educational attainment. Typically, a high proportion of the population is engaged in agriculture. The secondary, or manufacturing, sector occupies a relatively less important place in the economy than it does in the first world, and exports come mainly from the primary sector (the cultivation or extraction of natural resources, as in farming or mining). Such a characterization, of course, fails to capture the great variety within the world. Some rich countries, such as Canada, are relatively underindustrialized, relying on primary exports for their wealth. Some poor countries have made remarkable strides in improving health and education. Yet as a rule, there is a correlation between national income and a country's ability to improve the social indicators of its citizenry. With the exception of the few countries endowed by nature with an abundance of natural resources, there is also a correlation between industrialization and growing national income. There are factors other than economic that are common to third-world countries, including a tendency to high population-growth rates. However, perhaps the most important common thread is the political one: virtually every third-world country began its modern history as a colony of one of the former imperial powers of Europe or Asia (Britain, France, Belgium, Germany, Spain, Portugal, the Netherlands, and the Ottoman Empire).[4]

Most of Latin America threw off Spanish or Portuguese rule in the early nineteenth century. However, it was not until the twentieth century that the bulk of the third world in Asia, Africa, and the Caribbean would win its independence. As the Ottoman Empire crumbled in the late nineteenth and early twentieth centuries, giving way at its core to modern Turkey, some subject peoples constituted themselves as states, although the Arab territories in the Middle East were rapidly recolonized by Britain and France. The bold venture of Mustafa Kemal, who took on the name Atatürk (father of Turkey) in leading the creation of the independent republic of Turkey, inspired nationalist thinkers in the colonies of Africa and Asia.

The two world wars further altered the relationship between colonizer and colonized. Japanese conquests of European colonies early in World War II punctured any myths about white superiority, while soldiers recruited in the colonies to assist the Allied war effort felt they had earned their peoples the status of equals. Drained of military and police resources by the war, colonial regimes found it difficult to maintain or reimpose control over peoples who had grown tired of colonial rule. A number of colonies effectively obtained their independence during World War II when they were vacated by the Axis powers (Italy or Japan; Germany, the third Axis power, had already lost its overseas colonies in World War I). Occasionally, as in Indochina and Indonesia, former colonial masters tried to reverse this situation, but failed.

When in 1947 the British government granted the Indian subcontinent its independence, giving birth to modern India and Pakistan, the floodgates opened. Independence followed in short order for most of the other colonial territories of South and Southeast Asia. Africa came next. North of the Sahara, bloody struggles brought independence to Morocco and Tunisia; south of the Sahara, Ghana ushered in the postcolonial era peacefully in 1957. The Portuguese held out for two more decades, and it was not until 1990 that South Africa gave up its hold on Namibia. But apart from these holdouts, and a few small colonies scattered around the globe, the curtain had been drawn on colonial rule within twenty years of India's declaration of independence.[5]

Thus, very much of the world had, in the early postwar period, shaken off the bonds of colonialism. Most of this new world was poor. The rulers of the newly independent countries therefore had two overriding priorities: development and independence.

In practice, the two were often seen to go together. The generation that had led the third world to independence usually equated development with industrialization. Although some nationalist leaders glorified rural utopias, as did India's Mahatma Gandhi, many more took the opposite view. Most of Africa and Asia was rural and poor, and blame for this state of affairs was placed squarely on imperialism. Third-world nationalists argued that by using the colonies as sources of raw materials and markets for finished goods, and by establishing intra-imperial free-trade blocs that prevented colonial administrations from using protective barriers to nurture industrial development, the imperial countries had actually impoverished the third world in order to enrich the first. Where shoots of industrialization had begun to sprout, as in precolonial India, the imperialists rolled it back by swamping the colonial markets with the cheap manufactures of their factories. Thus, claimed third-world nationalists, the first world's entry into the industrial age had been made possible by its appropriation of the third world's resources; independence would be illusory if the colonial economic structure was not overthrown along with the colonial masters. Looking to the first world, third-world leaders saw that industry was the key to modernity and wealth. The ability to produce finished goods, and not rely on the imports of their old masters, would signify the complete rupture of the ties that had bound third-world economies for so long.

Latin America seemed to point the way forward. Even though Latin American countries had become independent in the nineteenth century, the structure of the continent's economies remained largely colonial for much of the century despite bursts of prosperity. South American agriculture had by and large become dominated by big, typically inefficient plantations, and virtual serfdom continued in several countries. The colonial pattern of exporting primary goods in return for finished products deepened throughout the nineteenth century. British merchant houses took the place of those of the Spanish and Portuguese. What emerged to replace colonialism was an agrarian economy closely tied to Europe, and a political order dominated by authoritarian *caudillos,* or strongmen, who ruled in alliance with the agrarian elites.

The ground slowly started to shift as, late in the century, small numbers of private industrialists began to appear, often calling upon governments to change policy direction and nurture their development.[6] They made little political impact over the following four decades, but their importance emerged. When change came, and governments enacted ambitious industrial-development policies, there were capitalists at hand ready and eager to take advantage of these new policies.

And change came. During the 1930s Depression, the fall in first-world demand caused world prices on Latin America's exports to collapse. This was followed by the wartime loss of European markets and supplies. Revenue from exports of primary goods plummeted. The resulting lack of foreign exchange restricted opportunities for importing manufactured goods. If local demand was to be satisfied, it would have to be done internally. Latin America found itself confronted with the necessity of industrialization.

The Depression and wartime experiences prompted a sort of "trade pessimism" among Latin America's economic analysts. The world market suddenly appeared volatile, certainly not the type of horse to which one would want to hitch the cart of a national economy. Greater independence from the first world seemed now a distinct virtue. To secure this goal, Latin American governments decided to build up their industrial bases and trade more among themselves. By creating large state firms and encouraging private firms to produce substitutes for goods previously imported, governments sought to shelter themselves from the vicissitudes of the global economy. This strategy came to be known as import substitution.

Latin America's first wave of import substitution, during the Depression, had been a reaction to the sudden changes in the world economy. The second wave sought to anticipate further shocks, and began in 1939 when Chile created the Corporación de Fomento de la Producción to foster industrial development. By this time, Mexico had nationalized its foreign-owned railways and oil companies. Such actions provided the blueprint for an industrial strategy that would be applied throughout Latin America after World War II.

I Development Theory After Keynes

During the 1940s, Keynesianism began finding its way into the work of development theorists. Economists in the third world read the *General Theory* with great interest. Many obtained their training in first-world universities, where Keynesianism had become prominent by the late 1940s. Meanwhile, the apparent successes of Soviet central planning in the 1930s, when Soviet industry had surged ahead at a time when Western capitalism seemed in decay, as well as the prestige the Soviet system earned with its victorious effort in World War II, led many Western academics to develop an interest in statism. Under such influences, new currents of thought emerged from third-world academies that lent further support to the principle of an expanded state role in the economy.

Shortly after the war, two economists, Raul Prebisch and Hans Singer, published separately the results of their studies of first world–third world trade. Though working independently of one another, they reached similar conclusions. Their recommendations, which would dominate development thinking for years to come, became known as the Prebisch-Singer thesis. In a nutshell, the thesis was that over time, third-world countries would have to export more of their primary commodities just to maintain their levels of imports from the first world. If they wanted to increase their imports, they would have to increase their exports even more. They called this syndrome the declining terms of trade.[7]

As an economy industrializes, capital tends to concentrate. Small firms either expand or fall by the wayside. With fewer firms competing for customers, possibilities for either open or implied collusion emerge. Firms feel less competitive pressure to lower prices, and profit margins rise. Traditional producers of primary products, on the other hand, usually operate in very competitive markets, and must keep their prices and profit margins low.

Put simply, Prebisch and Singer argued that prices in more technically advanced economies rose more quickly than those in more backward ones. Differences in income elasticities of demand strengthened this effect. Demand for finished goods rises with income: as people get richer they buy more televisions, stereos, and childrens' toys. Demand for primary goods varies less with income: no matter how rich they get, people will buy only so much coffee. Ragnar Nurkse added to this by arguing that the search for substitutes among industrial producers could actually reduce demand for third-world primary exports.[8] He used the example of chicle, an ingredient in chewing gum that was imported from Latin America. The discovery of a synthetic substitute meant that chewing gum producers would need less chicle. In the long run the prices of first-world goods were expected to rise relative to those for third-world goods. First-world populations would grow wealthy, with unions securing a share of the growing pie for their members. The third-world countries, while possibly still moving forward, would nevertheless fall further behind the front-runners.

The implications were obvious. If things continued the way they had been going, third-world countries would sink deeper into poverty. To import even a fixed amount of finished goods, they would need to export more and more primary goods. They would end up running to stand still. The requirements of increased primary production would in turn gobble up a growing share of the nation's resources, reducing what was left for development. There was only one way to break free of this syndrome: alter the structure of the economy's production. Third-world economies had to rely more on industry for their wealth, and less on the primary sector.

However, many economists believed that this would never happen if things were left to the free market. For instance, P. N. Rosenstein-Rodan said a "big push" in infrastructure investment and planning was needed to stimulate industrialization, but that the resources for this lay beyond the reach of the private sector.[9] Nurkse also believed that markets in the third world were too small to attract private investment. He proposed a balanced pattern of public investment in several different industries as a way to kickstart an economy by creating the demand that would draw in private investors.[10]

Because these economists spoke of the structural obstacles blocking the third world's path to development, they became known as the structuralists. Structuralism, which came to dominate development economics for the next couple of decades, found its intellectual center in Chile. Raul Prebisch went to Chile in 1950 to direct the UN's newly created Economic Commission for Latin America (ECLA). He then recruited Celso Furtado, Aníbal Pinto, Osvaldo Sunkel, and Dudley Seers, all of whom went on to publish important contributions to structuralist theory. The structuralists judged that the only way third-world countries could remove the obstacles from their path was through concerted state action. States had to push industrialization along, and third-world countries had to reduce their dependence on trade with the first world and increase trade among themselves. Support for structuralist theory came from outside its camp when in 1954 W. A. Lewis published a paper on labor and development.[11] Lewis argued that in a third-world economy, the wage rate was set at a constant level as determined by minimum levels of existence in traditional family farming.

This ensured a virtually unlimited supply of cheap labor, which was an advantageous factor in industrial development. With state support, this cheap labor supply could be harnessed to build up a nation's industry.

In the course of the 1950s Latin American governments began to implement the advice of ECLA. The belief that industrialization would remedy underdevelopment spread throughout not only Latin America but most of the third world.[12] This optimism was mirrored in the emergence of the American modernization school, which looked forward to the third world's entry into the modern, and Western, world.

Modernization Theory

Modernization theory sprang from what has been called the behavioral revolution, a shift in U.S. social scientific thought that began in the late 1940s and continued through the 1960s. Before World War II, for example, U.S. political scientists had devoted themselves to the study of constitutions and institutions. However, the rise of totalitarianism in Hitler's Germany and Stalin's USSR battered their faith in constitutions (both countries having started out with model constitutions). Whereas political philosophy had always concerned itself with questions of human behavior and how best to organize society, the behavioralists inaugurated a revolution by trying to replace philosophy with science. They were interested not in society as it should be, but simply as it was. They set out to observe, compare, and classify human behavior in the hope of making general inferences about it.

Modernization theory sought to identify the conditions that had given rise to development in the first world, and specify where and why these were lacking in the third world. Modernization theorists, depending on their focus, reached varying conclusions. To some, the problem of the third world was a mere shortage of capital; development required a rise in the savings rate.[13] To others, it was a question of value systems: third-world peoples lacked the cultural values, such as the profit motive, that would make them entrepreneurial. In this case development required Westernizing elites, or some kind of education in capitalist values.[14] Yet whether from a sociological, political, or economic standpoint, modernization theorists generally concurred on one important point: underdevelopment was an initial state. The West had progressed beyond it, but other countries lagged behind. However, the West could help speed up the process of development in the third world, for instance by sharing its capital and know-how, to bring these countries into the modern age of capitalism and liberal democracy.[15]

Reflecting the optimism and idealism of their time, behavioralism in general and modernization theory in particular eventually ran into problems. Chief among these was that the scientific method they tried to apply to the study of human behavior and society was not of the highest quality, being closer to nineteenth-century positivism than to contemporary scientific theory. Whereas philosophers of science were then writing about the extent to which opinions, biases, and judgments influenced scientific research, the behavioralists, in their quest for value-free science, were not always sufficiently sensitive to the biases they carried. Modernization theory was a prime example. It reflected not only the age's optimism and idealism, but also its anticommunism. W. W. Rostow called his book *The Stages of Economic Growth* a noncommunist manifesto. Because they assumed that all societies progressed in linear fashion along the same path toward development, from which fascism and communism were aberrations, modernization theorists could not easily accept that the third world might differ fundamentally from the first.

Modernization theory resembled structuralism in its emphasis on physical-capital formation, but differed somewhat in its more benign view of first-world capitalism and imperialism and the role they played in third-world development. Modernization theorists looked to Westernizing elites, trained in the secular, bureaucratic, and entrepreneurial values of the first world, to lead their countries into the modern age. At first the differences between structuralism and modernization theory were not so great—after all, both Prebisch and Lewis favored foreign investment. But as time went by, a more radical second generation of structuralism emerged that reacted angrily against modernization theory. This was dependency theory.

Modernization theory grew out of a time in which many academics spoke about the end of ideology. The idea was that the postwar period had given rise to a grand consensus. It was supposed that everyone agreed that market economies, harnessed to an interventionist state, were the wave of the future, that left and right had met up and become one. By the 1960s, however, whatever consensus did exist had begun to fray in academic circles. The radical left had resurfaced, and argued that market economies created certain injustices that no amount of state tinkering could rectify. Whereas modernization theory espoused the market, radical theorists repudiated it. The left-right divide was back. In development studies, it was dependency theory that carried the torch.

Dependency Theory

Although it had roots in Indian nationalist thought from the turn of the century, dependency theory first came to light in *The Political Economy of Growth,* written by Paul Baran in the 1950s.[16] However, a decade would pass before dependency literature would begin to proliferate. Whereas modernization theorists saw the first world as guiding third-world development through aid, investment, and example, Baran argued that the first world actually hindered the emergence from poverty of the third world. The Westernizing elites

in whom modernization theorists placed their faith would not lead their countries out of backwardness. Rather, argued Baran, they were fifth columnists who conspired to keep their homelands poor. Though it appeared illogical, this strategy was shrewd: it impoverished most of the population, but enriched the few who applied it.

Baran suggested that third-world bourgeoisies ruled in alliance with traditional landed elites, spending their profits on ostentation rather than on the investment that would accelerate growth. Imperialism had not exported capitalism to the third world; rather, it had drained the colonies of the resources that could have been used for investment, and had killed off local capitalism through competition. Imperialism had, in effect, cut short the natural process of capitalist development that Marx had identified. André Gunder Frank later sharpened Baran's analysis,[17] stressing that development and underdevelopment were, in effect, two sides of the same coin. By siphoning surplus away from the third world, the first world had enriched itself. By keeping the third world underdeveloped, the ruling bourgeoisies of the first world ensured a ready market for their finished goods and a cheap supply of raw materials for their factories.

Dependency theory took as axiomatic the view that the dominant class in any developed capitalist society was the bourgeoisie, or capitalist class, and thus that the foreign policies of first-world countries would be concerned primarily with the promotion and protection of capitalist interests. The capitalist states of the first world were able to thwart the development of the third world by striking alliances with the dominant classes of the third world, the dependent bourgeoisies. This latter class was essentially a rural oligarchy, though it often had interests in the modern sector in trade and services. It benefited from its dependence by earning its revenue on the export market and spending its profits on imported luxury goods. A national industrialization strategy would threaten the well-being of the members of the dependent bourgeoisie, because it would entail heavy taxes on their income to fuel savings, and protective barriers that would block their access to cherished luxury goods. Keeping its country backward thus preserved the wealth and privileged position of a third-world ruling class. At the same time that Frank was developing his theory, Samir Amin, working thousands of miles away, was reaching similar conclusions in his study of the economy of Côte d'Ivoire.[18] There he discovered a "planter bourgeoisie" that evinced little interest in development and was content to be a parasite living off the avails of foreign capital. Côte d'Ivoire was too small to contain Amin, who quickly generalized his theory into an explanation for the underdevelopment of West Africa[19] and eventually the entire third world.[20]

Early versions of dependency theory were inclined to claim that third-world countries would remain locked into "classical dependence," producing primary goods and importing finished goods. They did not foresee the change in the structure of production called for by the structuralists, namely industrial development. However, time belied this pessimism. Industrial development did take place in many third-world countries that had been labeled dependent. Some, such as Brazil and Argentina, developed sizable industrial bases.

Nevertheless, the later generation of dependency theorists maintained that this development would not free third-world countries from their dependence. They argued that industrialization in the third world, which in any event reached only a handful of countries, did not emerge from the development of these countries but from that of the first world. First-world companies seeking access to protected third-world markets, or to their cheap labor, would export capital-intensive assembly plants, but none of their research and development capacity. Thus, third-world industry would be based on second-generation production technology and would be owned by foreigners who processed imported inputs and created few jobs or linkages to other producers in the economy. Capitalism would not spread far beyond these firms, and the need for imported inputs would drive up the country's import bill. The drain of foreign-currency reserves would be worsened as foreign companies sent their profits back home. This would compel the host country to export more primary goods to earn foreign currency. The health of the economy would thus continue to rest on exports of primary goods to first-world countries, while the lack of job creation would leave most of a dependent country's population seeing few of the fruits of growth. In sum, whatever economic development took place would bring little social development, and would still be determined by the development of another economy.

Over time, many writers contributed to the dependency debate,[21] adding nuances and variations, but the broad thrust of all dependency theorists remained the same: as long as third-world economies were linked to the first world, they could never break free of their dependence and poverty. What they needed were autonomous national-development strategies. They had to sever their ties to the world economy and become more self-sufficient. Dependency theorists did not expect any third-world bourgeoisie to launch such a strategy. It was more likely that a dependent bourgeoisie would resist national development on the grounds that its well-being depended on foreign capital, whose firms it serviced or in which it owned minority shares. This assumption, as well as the belief that walls would have to be erected to insulate a national economy from the world economy, led dependency theorists to place their faith in the state as the motor for development. The state alone could crush the domination of the parasitic local bourgeoisie and stand up to the might of foreign capital, so as to engineer a development strategy that was in the national interest rather than in the interest of a single class.

In the end, dependency theory proved to be of less practical import than structuralism. Its recipe for development was applied briefly in Chile under Salvador Allende and in Jamaica under Michael Manley. Structuralism, on the other hand, influenced policymakers all over the third world. However, it is of great significance that dependency theory became popular on the left at the same time that neoclassical theory reappeared on the right. Chapter 3 will show that when changes in the world economy seemed to demand new approaches, neoclassical theorists would appear to offer them. The left, on the other hand, would end up calling for more statism.

Statism in the Third World

With statist theories such as Keynesianism and structuralism ascendant, the quarter century that followed World War II witnessed a degree of state intervention in economies all over the world on a scale hitherto unseen. In the first world, intervention took the form of generous welfare legislation, nationalization of private industries, and immense public programs. In the third world it took the form of legislation to nurture emerging industries and to create public ones where the private sector had failed to do so.

In addition to the weight of theoretical opinion there were practical factors that made statist development strategies appealing to third-world governments. Colonialism left behind immature capitalist classes. Where capitalists existed, their numbers were usually limited, and they most often confined their activities to trade and services, in no small part because colonial administrations had hindered their involvement in large-scale activities in the productive sector.[22] Even if a new regime favored its bourgeoisie—which many did not, having linked capitalism with imperialism—it could not rely solely on the private sector to rapidly push the economy into the industrial age. When countries sought to industrialize rapidly, but lacked bourgeoisies upon whom to devolve the task, the obvious agent for this transformation was the state. In Africa there was an added imperative to statism in development strategies. Arguably, most of Africa's independence movements had been led by modern petty bourgeoisies, made up of teachers and civil servants, who had vested interests in the state and few if any in the private sector. To these people, the state seemed a natural instrument for social change.

Furthermore, in South Asia and Africa policymakers confronted limited industrial bases. Early industrializers such as Britain had developed their industrial firms gradually from small ateliers and cottage industries to the immense factories of the modern day. Over a period of more than a century, entrepreneurs had been able to gradually amass the capital necessary for the creation of larger and larger production units. By the time countries in Africa became independent, the costs of establishing a new industrial venture were estimated, in relative terms, to be 250 times what they had been for an entrepreneur in the early days of the Industrial Revolution.[23] Faced with such circumstances, development planners had various options. One was to cut the national economy off from the world economy and try to take it through its own process of indigenous development, a model known as autarky. A second option was to attract those with the necessary capital, namely foreign companies, to build up the industrial sector. A third was to use the state to accumulate the necessary resources. Through taxation, borrowing, or control of the marketing of primary products, the state in many third-world countries could mobilize capital far beyond the reach of even the wealthiest of its citizens.

The first option, autarky, has historically been more popular in theory than in practice, and in practice has seldom proved feasible. In this century the chief experiments in autarky have been in Albania in the later years of the Hoxha regime (1945–1985), and in Cambodia under the Khmer Rouge (1975–1979). Neither made autarky attractive, with Cambodia's bold attempt degenerating into a tragedy from which the country took years to emerge. Autarky seems to offer the most promise when practiced on a small scale. For example, Anabaptist (Hutterite, Mennonite, Amish) farm communities in North America succeed in building self-reliance and fostering strong networks of social support. However, even these communities depend for their economic well-being on the sale of their farm produce and other commodities to the outside world. In today's world, in which steamships and airplanes crisscross the globe laden with cargo, autarky is a rare species. When Bhutan opened its border and built a road to India in 1959, the world's last truly autarkic national economy entered the history books.

Today the logic of comparative advantage makes foreign trade an essential component in rapid economic growth. In economic theory, a country enjoys a comparative advantage over another in the production of a good if it can produce it at a lower opportunity cost, that is, if it has to forgo less of other goods to produce it. For example, a given country could invest heavily to develop its own rubber industry, but for a fraction of the investment could produce enough cocoa to buy the rubber from a country that can produce it more inexpensively. It will then have resources left over for investment elsewhere in the economy. Thus, rather than try to satisfy all its own needs, an economy will prosper more if it specializes in the production of a few goods in which it enjoys a comparative advantage, and relies on imports to satisfy the remainder of its needs. This can even apply to food production. Alarm bells often sound when it is said that a given country cannot feed itself, but if food can be imported more cheaply than it can be produced locally, and if the imports are coming from a friendly country

unlikely to cut food supplies for strategic reasons, then food self-sufficiency may be a costly goal.

Instead of autarky, most third-world governments opted for development strategies that blended the other two approaches and exploited comparative advantages. They sought to build up industry by mobilizing foreign and state investment, finding the revenue they needed for state investment through the sale of traditional exports. The strategy they adopted is known as import substitution industrialization (ISI).

Import Substitution Industrialization

The logic underlying ISI is simple. Let us assume that a given country is exporting primary goods in order to import finished goods. It wants to begin producing those finished goods itself. It can do this by restricting imports of the goods in question by way of tariffs—taxes on imported goods—or of nontariff barriers such as quotas, content regulations, and quality controls. Quotas limit how much of a given good can be brought into the country. Content regulations and quality controls impose qualitative restrictions on the goods being imported. For example, a content regulation might demand that 50 percent of the given product be locally produced; a quality control can create a list of requirements that local producers are able to meet but that importers have a more difficult time satisfying. Such restrictions raise the prices of imported goods to local consumers, either by adding a surcharge to the world price, as tariffs do, or by reducing supply and thereby causing buyers to bid up the price, as nontariff barriers do. Either way, local investors who could not normally compete with foreign suppliers find the market suddenly benign. Provided they can get hold of the start-up capital, they can import the production machinery and begin to produce the good locally.

Because the domestic market is relatively small, producers will operate at lower volumes than does the foreign competition. This means they will not be able to take advantage of economies of scale, which is the basic economic principle that as volume of output increases, unit production costs decrease. For example, it will take one person more time to build a car in a garage than it will take a thousand people to build a thousand cars in a factory, because of the time involved in switching tasks, not to mention the time needed to build up all the specializations involved. In a factory, each individual performs one simple task repetitively, so that efficiency is maximized. This production technique was masterminded by Henry Ford; the ability to produce large volumes of goods cheaply underlay the U.S. industrial triumph of the twentieth century.[24] Because third-world producers operating in an ISI regime cannot exploit economies of scale, the prices on their goods will be higher than those on the world market. Nevertheless, provided these prices remain below the administratively inflated prices of imports, any venture can turn a profit.

Governments can go further to guarantee profits. They can establish licensing schemes that limit the number of firms allowed to produce a given product or import a needed input. Some governments even allowed only one firm to produce a given product, in effect giving it a legal monopoly that, in combination with import restrictions, provides an almost watertight guarantee of profits. Many third-world governments went further still to encourage investment, offering firms access to foreign exchange at concessionary rates by overvaluing their currencies, thus allowing local firms to import inputs at artificially reduced prices.

A simple example illustrates how currency overvaluation keeps foreign imports artificially cheap. Assume the market rate for a given currency to be two to one—that is, for every two units of local currency one could buy one unit of hard currency, which is a currency, most often the U.S. dollar, that can be used for international transactions. A government could overvalue its currency by offering to exchange it at its central bank at a rate of one to one. As a result, local buyers can obtain twice the amount of hard currency for the same price. In local terms, this halves the cost of imports. Given that currency overvaluation aims to benefit local industry, will the reduced cost of imports mean that, even taking trade barriers into account, imported consumer goods will now be cheaper than local ones and will drive local producers out of business? The answer is, usually, no. Unlike local currency, which can be printed, foreign exchange is a scarce commodity; it must be obtained through sales. When its price is set so low, local demand will go up, so much so that not enough is available to go around. The government then has to ration foreign exchange, and will tend to favor local industries rather than local importers of finished goods. Of course, the government can also choose to favor its friends in the allocation of foreign exchange, and herein lies one of the abuses of currency overvaluation, as neoclassical critics were soon to discover.

With prices kept high, and costs low, the attractions to invest are enough to persuade even the most conservative of investors. If a local entrepreneur cannot find the money to set up a venture, a foreign firm probably will. Import barriers may have closed off an export market to a foreign firm, but by setting up a branch plant it can sneak in under the wire and realize even greater profits than it had been earning when it was selling goods shipped from its home plant. When a foreign firm creates a branch plant under this arrangement, or when it licenses a local firm to use its technology to produce its product, it will typically allow the branch plant/licensee to produce only for the domestic market, and not for export. This prevents

the branch plant/licensee from ever competing with the parent company in export markets and thereby eroding any of its sales.

Governments can further accelerate the industrialization process by offering firms subsidies and cheap credit. In a developing country, the way a government obtains the capital for subsidies or cheap loans is often by skimming off the revenue from the sale of its primary exports. By taxing primary exporters, and by establishing marketing boards that pay local producers less than the world price for their goods, and then pocketing the difference once they sell the product on the world market, governments have been able to realize far greater savings than the private sector might have. Several countries have used this strategy of rural-urban transfer to build up their savings pool.

Conclusion

The appeal of ISI spread rapidly throughout the third world. The strategy went on to become one of the twentieth century's boldest and most widespread economic experiments. Holes eventually appeared in the fabric of ISI, but in the early days this development strategy promised many gains. The third world, it seemed, was about to come of age.

Notes

1. H. W. Singer and Sumit Roy, *Economic Progress and Prospects in the Third World* (Aldershot, England: Edward Elgar, 1993).
2. Mark Blaug, *Economic Theory in Retrospect,* 3d ed. (Cambridge: Cambridge University Press, 1978), pp. 684–686.
3. See, for example, Andrew Shonfield, *Modern Capitalism* (London: Oxford University Press, 1965), especially chapter 4. The optimism of Keynesian economists is captured in a quotation from Michael Stewart, who once wrote, "The days of uncontrollable mass unemployment in advanced industrial countries are over." See Michael Stewart, quoted in Derek W. Urwin, *Western Europe Since 1945,* 4th ed. (London: Longman, 1989), p. 152.
4. Not all former colonies are third-world countries, however, nor are all former imperial countries necessarily in the first world. These subtle but important distinctions are often overlooked.
5. A few of these, especially in the Caribbean, remain colonies or overseas territories to this day.
6. On this subject see Markos J. Mamalakis, *The Growth and Structure of the Chilean Economy* (New Haven and London: Yale University Press, 1976), chapter 8; Henry W. Kirsch, *Industrial Development in a Traditional Society* (Gainesville: University Presses of Florida, 1977), chapter 7; Werner Baer, *Industrialization and Economic Development in Peru* (Homewood, Ill.: Richard D. Irwin, 1965); Rosemary

Thorp and Geoffrey Bertram, *Peru 1890–1977: Growth and Policy in an Open Economy* (New York: Columbia University Press, 1978).

7. See R. Prebisch, *The Economic Development of Latin America and Its Principal Problems* (New York: United Nations, 1950), and H. W. Singer, "The Distribution of Gains Between Investing and Borrowing Countries," *American Economic Review* 2 (1950).

8. See Ragnar Nurkse, "Balanced and Unbalanced Growth," in *Equilibrium and Growth in the World Economy,* edited by Gottfried Haberler and Robert M. Stern (Cambridge, Mass.: Harvard University Press, 1961). Nurkse actually developed his theory in the 1950s.

9. P. N. Rosenstein-Rodan, "Problems of Industrialization of Eastern and South-Eastern Europe," *Economic Journal* 53 (June-September 1943).

10. Nurkse, "Balanced and Unbalanced Growth," p. 247.

11. W. A. Lewis, "Economic Development with Unlimited Supply of Labour," *Manchester School of Social and Economic Studies* 22, no. 2 (1954).

12. Magnus Blomström and Björn Hettne, *Development Theory in Transition* (London: Zed Books, 1984), p. 42.

13. W. W. Rostow, *The Stages of Economic Growth* (Cambridge: Cambridge University Press, 1966).

14. David E. Apter, *The Politics of Modernization* (Chicago: University of Chicago Press, 1965); Myron Weiner, ed., *Modernization: The Dynamics of Growth* (New York: Basic Books, 1966).

15. See Apter, *Politics of Modernization*, and G. A. Almond and G. B. Powell, *Comparative Politics: A Developmental Approach* (Boston: Little Brown, 1965).

16. Paul Baran, *The Political Economy of Growth* (New York: Monthly Review Press, 1957).

17. See André Gunder Frank, *Capitalism and Underdevelopment* (New York: Monthly Review Press, 1967).

18. Samir Amin, *Le développement du capitalisme en Côte d'Ivoire* (Paris: Editions de Minuit, 1967).

19. Samir Amin, *Neo-Colonialism in West Africa* (Harmondsworth, England: Penguin, 1973).

20. Samir Amin, *Unequal Development* (New York: Monthly Review Press, 1976).

21. A good survey of the dependency debate, along with criticisms, can be found in Blomström and Hettne, *Development Theory in Transition.*

22. E. A. Brett, "State Power and Economic Inefficiency: Explaining Political Failure in Africa," paper presented to the Political Science Association Conference, Manchester, England, 1985.

23. Paul Bairoch, *Révolution industrielle et sous-développement* (Paris: SEDES, 1964), p. 198.

24. In the late twentieth century, however, this production technology was challenged by the Japanese concept of total quality management. Invented by an American, the process seeks to reincorporate the worker in the decisionmaking process, with workers verifying the quality of products each step of the way. Although this slows down production, it lowers prices by eliminating waste.

2

State-Led Development in Practice

THE POPULARITY OF IMPORT SUBSTITUTION INDUSTRIALIZATION BEGAN TO SPREAD throughout the third world after World War I, gaining speed after World War II. Although not all countries implemented the strategy, most at least experimented with some version of it. Early results were generally positive as countries benefited from the booming world economy. However, by the late 1960s and the 1970s, as the world economy slowed, the failings of ISI started coming to light. Radical theorists then blamed the persistent poverty of the third world on its dependent relationship to the world economy, and called for third-world countries to sever these ties. However, where such breaks were made and countries experimented with socialist development strategies, the results were scarcely any better. Statist development theories, it seemed, were not all they had been held out to be.

I ISI: The Early Decades

Events, rather than theory, drove the early experiments with ISI, with nationalism playing a strong supporting role. Economic changes forced governments to find ways to reduce their import bills, while the desire to roll back the influence of former colonial masters, or the threatening weight of the great powers, led governments to seek greater economic independence.

Some of the first moves into ISI took place in the Middle East. World War I interrupted these countries' imports and highlighted their dependence on foreign manufactured goods. However, serious action to remedy this situation was hampered by the limited autonomy allowed colonial regimes. (At the end of World War I, Britain and France had stepped in to fill the void left in the Middle East by the collapse of the Ottoman Empire.) During the 1920s, however, while maintaining their tight grip on most of North Africa, Britain and France allowed their Middle Eastern possessions greater