The State, Democracy & Markets

Global Perspectives and Learnings for India

Dr. Rajiv B. Lall, Distinguished Fellow, Artha Global

October 2023

artha.global

ARTHA GLOBAL

Table of Contents

About Artha Global 4
About Rajiv Lall 5
Synopsis 6
Foreword and Acknowledgements 7
Introduction: History Did Not End 8
Structure of the Monograph 10
1. Reflections on Pax Americana: The Golden Age of Democratic Capitalism 12
The Initial Spread of Capitalism: State as Handmaiden 12
The Rise of a New Liberal Order 14
The March of Democracy 15
The Mixed Record of Pax Americana 18
2. Markets Are Not Enough: Sub-Saharan Africa and the Washington Consensus 21
Encounters with Marxist-Beninism 21
The French Heart of Africa 22
Travels in Central Africa 24
3. Aligning to Markets: The Latin American and Southeast Asian Low Road 28
Latin America's Failed Developmental State 29
Southeast Asia's Fading Developmental State 32
The Singapore Exception 34
4. Harnessing Markets: The Northeast Asian High Road 36
Creating a National Innovation System 37
Korean Catch-Up 40
Taiwan's Transformation 44
5. Chinese State Capitalism 48
A Familiar Obsession: Breaking into Export Markets 48
The Entrepreneurial State 50
National Champions: Evolution of the Strategic State 52
A New Technocratic Elite 53
Infrastructure Binge 58
Development Banking in the Middle Kingdom 59
Multiple Roads: Chinese Models of State Support 60
6. Challenges to the Asian Developmental State 63
The Rising Cost of Incubating Technology 63
Coping with financialization 65
7. State Capacity and Economic Transformation: Lessons from the Developing Country Experience 69
Meritocratic Bureaucracy 71
Contrasting Northeast Asia with Other Emerging Markets 73
The Hard State: Engaged Yet Autonomous 77

Mechanisms for Social Compensation and Focus on Equitable Growth 80
Conclusions 82
8. Democracy and Free Markets: Uncomfortable Bedfellows 83
Historical Sequencing: Markets Before Democracy 83
The Theory of Democracy's Social Drivers 87
Democracy and the Transformation Challenge of Developing Countries 90
9. The Crisis of Democratic Capitalism 93
The Bretton Woods Framework and the Rise and Retreat of Globalization 94
Technology and Social Dislocation 98
Financialization and Economic Disruption 99
Inequality and the Decline of Meritocracy 101
10. State Capacity and Economic Fault Lines: The Experience of Mature Democracies 104
The Anglo-American Neo-Liberal Model 104
Northern Europe's Coordinated Market Economy Model 106
Southern Europe's Social Democratic Model 109
Japan's Corporatist Model 111
Lessons from the Experience of Mature Democracies 118
11. Learnings for India 119
State Capacity: Taxonomy of Success 119
State Engagement with Markets 119
Commitment to Markets, Aggressive Export Promotion 120
State Engagement for Market Legitimacy:
Social Investment, Protections and Redistribution 121
12. Indian State Capacity: Broad Characteristics 122
Strong and Weak: the Paradoxical State 122
Becoming Softer: The State's Declining Autonomy 123
The Rising Public-Private Trust Deficit: Confrontational, not Consultative 125
Surprisingly Small and Under-resourced, with Unproductive Spending 125
Concluding Observations and Priorities for the Future 128
Bibliography 130

ARTHA GLOBAL

About Artha Global

Artha Global is a policy organisation that supports global partners to design, implement, and institutionalise practices that promote prosperity and resilience, with a primary focus on the developing world. We provide actionable research, support policy implementation and work to institutionalise change.

Over the next few decades, the developing world will negotiate overlapping transitions: from rural to urban, farm to factory, informal to formal, brown to green, analog to digital. We help governments manage these transitions, and the inevitable dislocations they cause, in order to secure long-term prosperity and social stability for citizens.

We believe that the multiple challenges of the 21st century require new thinking that cuts across the traditional boundaries of geography, disciplines and interests. Therefore, we leverage our global network of experts to help craft new development agendas, create consensus and build broad coalitions across governments, business, academia, philanthropy and civil society.

Artha's research is housed in six centres: **Emerging Cities, Access to Justice, Technology and Innovation, Rapid Insights, Public Health, and Inclusive Growth.**

Disclaimer & Terms of Use

The analysis in this paper is based on research by Artha Global. The copyright of this paper is the sole and exclusive property of Artha Global. You may use the contents only for non-commercial and personal use, provided Artha Global retains all copyright and other proprietary rights contained therein and due acknowledgement is given to Artha Global for usage of any content. You shall not, however, reproduce, distribute, redistribute, modify, transmit, reuse, paper, or use such contents for public or commercial purposes without Artha Global's written permission. Copyright: © Artha Global 2023.

Suggested Citation

Lall, Rajiv. (2023). “The State, Democracy and Markets: Global Perspectives and Learnings for India” Working Paper. Mumbai: Artha Global

About Rajiv Lall

Rajiv B. Lall PhD, Distinguished Fellow, Artha Global, has over close to four decades of experience in academia, international public policy, investment banking, private equity and corporate and retail banking. His expertise spans infrastructure and climate finance, sustainable investing, microfinance, capital markets, international trade, and macroeconomic policy issues across Southeast Asia, China, Africa, the U.S. and India.

He was Executive Chairman of IDFC Ltd., Founder CEO of IDFC Bank, Chairman of IDFC First Bank, and has served in various positions, at the World Bank, the Asian Development Bank, Morgan Stanley, and Warburg Pincus. He has made pioneering contributions to the development of India's impact investing and microfinance industries and is Founding Partner at Mondiale Impact, an initiative to support boards to confront the challenges of governance for impact.

He is currently based at Singapore Management University, where he is a Professorial Research Fellow serving on the Management Committee of the Singapore Green Finance Centre and focusing on research/training relating to climate finance and climate aligned board governance.

Synopsis

The State, Democracy and Markets: Lessons for India from the Global Experience is a monograph by Rajiv B. Lall, Distinguished Fellow, Artha Global and former Chairman, IDFC Limited. It provides a critical analysis of the relationship between free markets and democracy and examines the role of the state from an historical perspective. It challenges the neoconservative view that free markets unencumbered by state intervention are the basic recipe for economic development and that liberal democracy and free markets are intertwined and mutually reinforcing companions.

Rajiv posits that while free markets are necessary for generating prosperity, they are not sufficient for delivering transformative economic development. Drawing in part on his rich working experience in Sub-Saharan Africa, China, and East and South-East Asia, he makes the case that late developers cannot rely just on free markets to catch up. For transformational development the state has a pivotal role to play in nurturing market development and building indigenous technological capability.

He explains that the interaction between markets and democracy is fraught with tension and conflict, and using the experience of the U.S. in particular, he points out how capitalistic excess can destabilise democratic polities. Markets, by their very nature, are amoral mechanisms designed for efficiency. They operate on the principles of supply and demand, with little inherent regard for notions of equality or social justice. In contrast, democracy is deeply rooted in the idea of popular sovereignty. It emerges from a collective yearning for representation, voice, and participation in decision-making processes. Comparing the Anglo-American experience with high income European democracies, Rajiv suggests that the single most important determinant of success in managing the inherent tension between free markets and democracy, is state capacity.

Tracing the implications for India, Rajiv argues that for a democracy where the median voter is still poor, ensuring that the state has the capacity not only to complement and regulate, but also to legitimise markets, is the need of the hour. He posits that for India to achieve its goal of becoming a high income country, the state must also learn how to build an 'indigenous innovation system' that helps develop domestic industry. He argues that strengthening state capacity in its multiple dimensions is probably the most important reform priority for keeping India on a path of sustained economic growth with social stability.

Foreword and Acknowledgements

This monograph is the product of background research for a more ambitious book on India's evolving model of democratic capitalism. The completion of that book kept getting delayed mostly for reasons of personal health. But also, truth be told, because the manuscript became unwieldy. I felt that an assessment of democracy and markets in India would be more useful through a comparative lens – one that allowed the reader to place the Indian experience in a global context. Developing a comparative perspective became all the more important given that the present moment is one of much soul searching with regards to the Western model of democratic capitalism, and the many inviolable orthodoxies about the role of the state. The interaction between markets and democracy is being re-examined by scholars and commentators even in the U.S. As a result, the material on the 'varieties of capitalism', and alternative models of state engagement in democratic and non-democratic polities began to accumulate. This monograph is the result.

I hope that the global evidence that is synthesised here provides a useful perspective on the powers and limitations of markets, the challenges of managing the interface between markets and democracy, and the important role of the state in enabling transformational economic change. India is not the focus of this monograph; I draw lessons from the global experience that I believe are of vital importance for India in its quest for economic transformation, as a democracy where the median voter is still very poor.

Much of the work for this monograph was done in the relative isolation of a pandemic-stricken world. Perhaps as a consequence, I did not get as much of an opportunity as I would have liked to discuss and debate my ideas and arguments with friends and colleagues. I am much indebted to Francis Fukuyama, to whom I was recently introduced, but have never had a chance to meet. I learned a great deal from his magisterial work, *Political Order and Political Decay*, about the history of state development around the world. Thanks to Dave Fernandez for pulling me in to Singapore Management University and forcing me to teach a course on markets and state capacity. I am grateful to Artha Global for supporting me in this endeavour; to Reuben Abraham, Niranjan Rajadhyaksha, and Pritika Hingorani for taking on the publication of this work, to Vibhav Mariwala for his astute editorial suggestions, and to Aryan Singh for fact checking my work. Finally, I must thank the Rockefeller Foundation for the privilege of a residency at the Villa Serbelloni, whose tranquil setting has provided the environment that I needed to finish this monograph, and make material progress towards finishing my book.

I alone am responsible for any inaccuracies or deficiencies that might have escaped attention.

Dr Rajiv B. Lall, PhD

Bellagio, Italy

October 20, 2023

Introduction: History Did Not End

In a celebrated 1989 essay and subsequent book, Francis Fukuyama, a noted political scientist at Stanford University, posited the 'End of History.' His argument was that while there may be many competing forms of social and political organisation, none could claim to be superior, more effective, or more durable than liberal democracy. Fukuyama's essay came in the wake of the fall of the Berlin Wall and the remarkably widespread embrace of democratic forms of government towards the last quarter of the twentieth century. He went further, arguing that liberal democracies work better and are more sustainable if accompanied by free markets. In the context of the late 1980s Fukuyama meant for the 'End of History' to signal the end of ideological contestation with respect to the best way of organising a polity and economy. The pairing of political and economic freedom was an obviously appealing idea at a moment when most of the world had come to terms with the idea of *Pax Americana*. People had come to accept the avuncular and reassuring Ronald Reagan as the photogenic leader of the Free World, and the Nike swoosh, as the optimistic symbol for the benefits of globalisation and the free movement of goods, services, capital and people across national borders. The 'End of History' became a popular metaphor for the end of intellectual debate about what is the best form of political and economic organisation for a nation state: Democratic Capitalism was the widely acclaimed victor and the toast of the so-called Washington Consensus.

Fukuyama made the case for a Hegelian dialectic, an historical determinism. Democracy with capitalism was posited to be the eventual, albeit inexorable, end state for any nation: an evolutionary inevitability for any country subject to the forces of economic modernisation. As nations get integrated into the modern global economy, rising levels of prosperity trigger social mobilisation, creating a new middle-class that then pushes for its voice to be heard through the democratisation of the political process. This explains the believer's conviction that all nations, including Russia and China, that have turned to some form of market based economic organisation would eventually succumb to democratisation. The only threat to the idea of Democratic Capitalism in the 20th century came from Marxism-Leninism. With the collapse of the Soviet Union in 1989, there remained no "historically significant" nation to provide a competing ideology of political and economic organisation of society. In that sense we had arrived at the End of History.

This world view was very quickly appropriated by the neo-conservatives[1] of the American intelligentsia who were the most influential in shaping the agenda of the Washington Consensus. The neo-conservatives, from whom Fukuyama later distanced himself, made the End of History narrative all about freedom, rooting it in a libertarian conception of the world. In this world view the right to freedom is held up as the most important right of all. Viewed through this prism, capitalism and democracy are fundamentally compatible. The former is all about a free market, and the latter is all about freedom of the individual. While on the face of it, this argument is intellectually and emotionally appealing, in reality the link between markets and democracy is much more complex than what the libertarians would have us believe. As we shall see, the

[1] There is a lot of confusion about labels. Neo-conservative thinking on economics is also referred to as 'neo-liberalism' amongst economists. The term liberal in economics overlaps with the term conservative in politics. A conservative politician is likely to espouse neo-liberal views on the economy. Neo-liberal in our usage is the same as neo-libertarian.

democratic impulse has much more to do with a yearning for voice, recognition and justice, than with a simple-minded notion of freedom. And this means that there is a real tension between free markets and democratic politics that must be managed in order for the two to co-exist. This is a reality that is all too evident in India.

Moreover, since Fukuyama's essay first appeared the world has changed very dramatically such that such certitude has given way to a modicum of doubt about the incontestable primacy of democratic forms of government or about the magic of Anglo-Saxon capitalism.[2] Just when it was looking as if *Pax Americana* and its neo-libertarian orthodoxy would extend its domination into the 21st century four trends have since given us ample cause to question that complacent assumption.

First, there is a growing realisation that the tool kit of the neo-classical economist is too limited to bring about sustained development and transformational change. Even though the gap in market orientation between the developed economies and those in Sub-Saharan Africa and Latin America has narrowed, the gap in GDP per capita has continued to widen.

Second, growing inequality, the rising concentration of wealth, and declining living standards have fueled a sense of injustice amongst the middle-classes of Western democracies, opening up and expanding a rift between them and their own traditional political, business and intellectual elite. The great achievement of the West post-WWII was the creation of a prosperous middle-class that became the bulwark of support for centrist politics. Of course, there was healthy competition between Democrats and Republicans, between parties to the Left and Right of the political centre in all liberal democracies. But the extremes on either side of the spectrum were confined to the periphery of the mainstream discourse.

Since the 2008 financial crisis this political status quo has changed. As the sheen of globalisation wore off, right-wing political parties played to the insecurity and alienation of disappointed middle-class voters. The politics of identity, namely religion, race, nationality, have thrust populist politicians into positions of power. There is recognition that the oldest democracies and advanced economies, Italy, France, Britain and even the U.S.,may be vulnerable to decay and perhaps even backtracking from the cherished ideals of liberal democracy.

Third, even as the debate about the crisis of liberal democracy and western style capitalism gains momentum, Xi Jinping's China, exploiting a potent combination of state capitalism and shrill nationalism, has emerged in people's imagination as a possible alternative model to the Western model. For years outside observers have been predicting the unravelling of the Chinese model of state capitalism and authoritarian rule. This has not happened. And in a post-Covid world we can expect China to become more assertive as it seeks to counter the finger pointing and chorus of China bashers in the West.

Fourth, it has become painfully apparent that electoral democracy by itself is not sufficient to ensure freedom and justice to citizens, even if accompanied with market reforms and some measure of rising prosperity (Zakaria, 2003). As we have seen from the experience of several

[2] This world view calls for a minimalist non-intrusive state. Hence the importance of deregulation and privatisation, in addition to trade liberalisation.

countries such as Egypt, Nigeria, Turkey, Poland, Hungary, Sri Lanka and Myanmar, to name a few, in the absence of empowered and well-functioning institutions to provide the necessary checks and balances to uphold the "rule of law", elections can degenerate into a mere contest for asserting hegemonic control. However, building a well-functioning institutional foundation for liberal democracy is a non-trivial task that requires consensus and a shared vision across stakeholders about the nation itself. If even in India, the world's largest democracy, the strength of seemingly established institutions and their ability to accommodate a deepening divide between competing notions of the nation is being tested, what is the future for the likes of Iraq, Afghanistan and Libya?

The U.S. has been remarkably naïve about the difficulty of state building in geographies with such complex histories. In the absence of domestic consensus about the very basics of their polities, a large number of Third Wave democracies,[3] many of which are nation states that came into being quite arbitrarily in the aftermath of the collapse of empires and of wars recent and not so recent, will likely go the way of the Sudan or the Balkans; that is fragment geographically as they succumb to internal conflict between ethnically, religiously and racially diverse populations. In this context, the question arises: what is the relevance and feasibility of democracy in nation states that are in many respects artificial? If the institutional pre-requisites for a well-functioning liberal democracy are too onerous for a lot of young nation states, what is an alternative that they might turn to?

Finally, with growing uncertainties about U.S.'s leadership of the post-War framework governing both international trade, commerce, and international security arrangements, doubts are rising about the future of the existing global order. China's growing assertiveness only accentuates these concerns. All of this to say that, as Fukuyama will himself admit, the 'End of History,' in the sense that he meant it at the time of writing the essay, is hardly upon us. Instead of the demise of ideological debate, we are in fact entering a new era of contestation about fundamental ideas, about the attributes of a successful and sustainable polity and economy in the 21st century.

Structure of the Monograph

My goal in this monograph is multifold. One, it is to examine the interface between the state and markets across various parts of the world, and by drawing in part on my own experiences working in Africa, China, and East and South-East Asia, I highlight the limits to what free markets by themselves can achieve and explore the role of the state in delivering transformational economic change; Two it is to analyse the Anglo-European and Western European experience in managing the inherent tension between capitalism and democracy; and three, I aim to draw broad lessons for India. To be clear at the outset, I am one of those who believes, both as a normative matter and as a pragmatic one, that India has no choice but to pursue a democratic path. It is also my belief that market-based economic policy provides the best prospect for India to succeed in its quest to deliver sustained economic growth. I believe that we have much that we can learn from the rest of

[3] The Third Wave of democratisation refers to countries that democratised after 1980. This includes parts of Latin America in the 1980s, Asia including Philippines, South Korea, and Taiwan, from 1986 to 1988, and lastly post collapse of the Warsaw Pact, Eastern Europe and Sub-Saharan Africa.

the world as we chart our path economic prosperity as a democracy where the median voter is still very poor.

This monograph is structured as follows: I start with reflections on the historical spread of capitalism and democracy on the influential advocacy of the Washington Consensus about the power of economic and political freedom. I make the case that the world has changed in fundamental ways since the break-up of the Soviet Union in 1989 and that there is no room for ideological triumphalism in contemporary global discourse. Next, drawing partly on my first hand experiences in varous emerging markets, I highlight the limits of what free market policies by themselves have achieved across Africa, Latin America, and South-East Asia. I compare this experience with the role that the state has played in the economic transformation of South Korea, Taiwan, Singapore, and China. I then turn to an examination of the tension between markets and democracy and trace the drivers of the ongoing challenges facing Western models of democratic capitalism. Based on a comparative analysis of the Anglo-American and Western European models I examine the importance of state capacity in addressing the inherent tension between free markets and democratic polities. I conclude by outlining important lessons for India.

The broad argument is that for a democracy where the median voter is still poor, ensuring that the state has the capacity to complement, nurture, regulate, and legitimise markets is the need of the hour. Strengthening state capacity in its multiple dimensions is probably the most important reform priority for keeping India on a path of sustained economic growth with social stability.

1. Reflections on Pax Americana: The Golden Age of Democratic Capitalism

A lot of ink has been dispensed on the meta issues of Democracy and Capitalism. From defining, measuring, and explaining what drives democratisation and the spread of capitalism, and the impact these trends have had on the world, the literature is broad, rich and illuminating. This book will rely on the Schumpeterian definition of democracy.[4] As Huntington so eloquently explains, normative definitions of the term rely on the source of political power in a democracy (as in the 'will of the people') or the purpose of a state (as in the pursuit of the 'common good') (Huntington, 1993). These are subject to debate and disagreement. Cross-country comparisons can usefully be drawn using a procedure-based definition of democracy. For the purposes of this book, we define any country where those occupying the highest executive offices of the nation are appointed through competitive and periodically held elections with extensive suffrage[5] as a democracy. This criterion obviously falls short of the much higher bar that would justify a country being labelled a liberal democracy, but it does have the advantage of being binary.

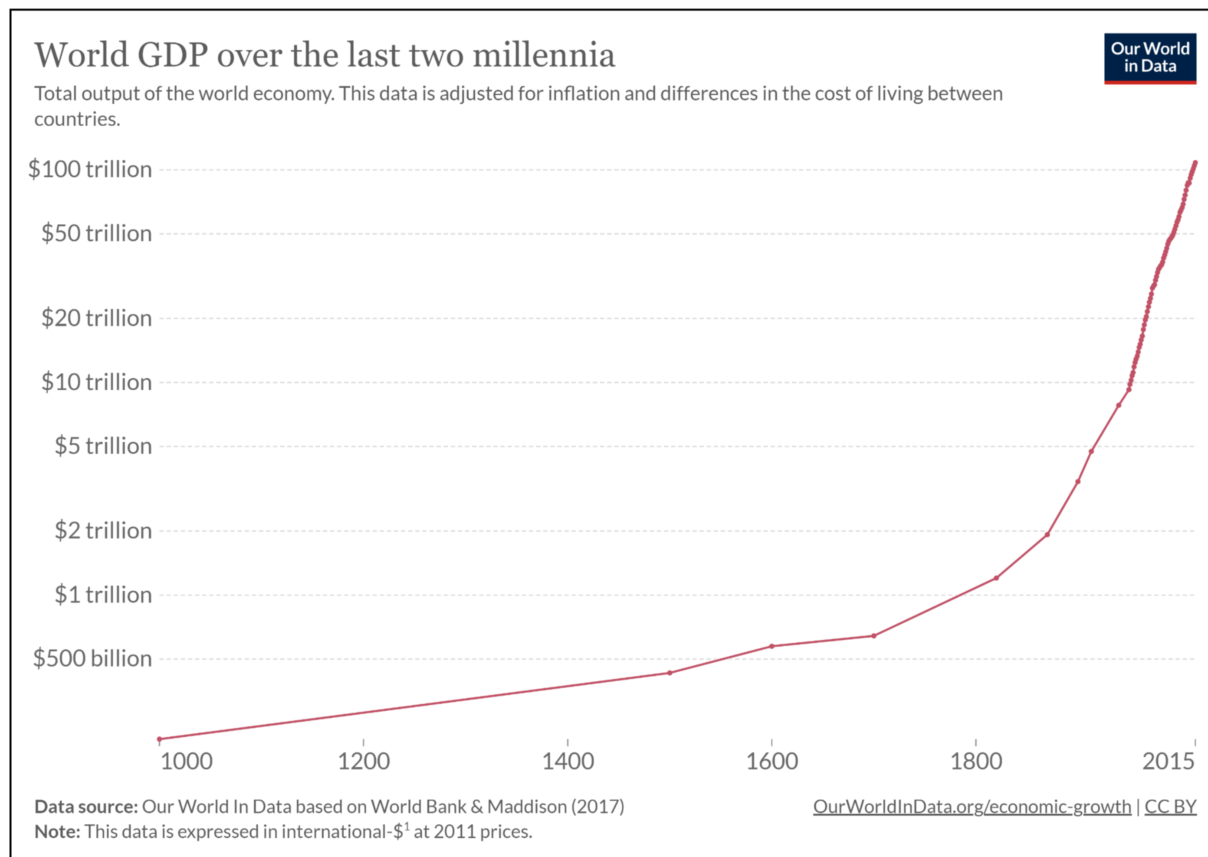
Similarly, capitalism can mean different things to different people. But it has two features that most would agree are essential to its essence: the salience of private ownership of the means of production, and the ability of private agents to make decisions freely on the deployment of capital and other factors of production (land and labour) based on prices determined by market forces. Obviously, the extent of private ownership and degree of restrictions applying to the free functioning of markets varies greatly across countries making it difficult to divide countries into clearly binary categories of 'capitalist' versus 'non-capitalist' (Fraser Institute, 2019; Heritage Foundation, 2019).

The Initial Spread of Capitalism: State as Handmaiden

Angus Maddison (2004), in his book, *The World Economy*, divides the capitalist epoch into five phases of development: the early phase from 1820 to 1870; the 'old liberal order' from 1870-1913; the period of the two World Wars from 1913-1950; the 'Golden Era' from 1950-1973; and the 'neo-liberal' era from 1973 onwards (Maddison, 2001). The rationale for this phasing has to do with the markedly different rates of growth in average world GDP per capita across each of these periods, as you will see in Figure 1 below. As it happens, each phase also reflects changing attitudes towards the role of the state in economic activity.

[4] In Schumpeter's view, democracy is a system where the governing elite competes for the vote of the citizenry, not a system where the will of the people directly determines policy.
[5] Specifically, we take 50 percent or more of the adult population as the cut off.

Figure 1: The growth of world GDP since 1000 CE, logarithmic scale



Prior to 1820, the world was living in a Malthusian equilibrium. Between 1000 and 1820, growth in world real GDP barely kept ahead of the rise in population. The Netherlands enjoyed the highest per capita income and had the largest merchant shipping fleet in the 18th century. This was a period of contestation, often military, between European powers, for hegemony over international commerce. It was a 'beggar thy neighbour' world of mercantilist competition (Maddison, 2001; Lloyd, 1833; Smith, 1776). This was hardly a world of what Adam Smith would call 'perfect competition'; the state played a very active role through trade protection and military intervention to secure competitive advantage.

The late 18th century is usually heralded as the start of the Industrial Revolution, with mechanisation in agriculture freeing up labour to be used in manufacturing. Britain took early advantage of the technological advances taking place at the time, particularly in cotton manufacturing. Exploiting its Indian colony as a ready source of raw cotton and as a captive market for its finished product, Britain became a global powerhouse for the manufacture of cotton textiles. More broadly, using the reach of its expanding shipping fleet, and aggressively enforcing restrictive trading arrangements through the ports under its control using the Navigation Acts (Maddison, 2001), Britain transformed itself into an international hub for the manufactured re-export of raw materials shipped from its Colonies. GDP per capita in Britain soared, and by the end of the 18th century, it had surpassed that in the Netherlands.

By the time of the Napoleonic Wars, Spain, Portugal and the Netherlands were spent powers. The French invasion of Spain and Portugal sealed their fate. But by then France was financially already stretched, with ambitious military campaigns on multiple fronts. War also hampered industrial and commercial activity across the rest of Europe, including in Germany. Britain's victory over France established Britain's status as the leading global power in 1820. From then until 1913, Britain greatly expanded its global role through acquisition of other overseas territories and influence over the design of international rules governing trade and commerce, including through the preferential trade arrangements forced upon its colonies. Technological advances in transport, notably the introduction of steam power and the use of iron and steel allowed Britain to modernise its shipping fleet ahead and play a leading role in developing and financing rail transportation around the world. Breakthroughs in communications technology helped Britain internationalise its banking industry and its capital markets, making it the world's dominant financial power.

Maddison's first two phases of the capitalist epoch spanning 1820-1913 can justifiably be labelled Pax Britannica. Throughout this period of capitalist advancement, the state played a key role in ensuring the success of the victors in global economic competition. But even domestically at this time, notably in France and Prussia, the state provided active support for the push towards industrialisation. So in the initial expansion of capitalism, the state played a vital role of handmaiden.

The Rise of a New Liberal Order

The old liberal order collapsed with the advent of WWI. The inter-war years (1919-1939) were devastating for the global economy: the share of trade in global GDP shrank, international capital flows dried up, and Western Europe lost most of its foreign assets. The Second Industrial Revolution encompassing great advances in road transportation and electricity generation in the early years of the 20th century was driven by the U.S., which by 1913, had surpassed Britain as the world leader in innovation. It, however, took WWII for a new stable international order to emerge for the rules of free trade to be institutionalised globally.

Although subject to the stresses of the Cold War, this order was anchored in the rules of the United Nations Charter for international security related issues, and was progressively dominated by the United States and its influence over the Bretton Woods Institutions, the Organisation for Economic Cooperation and Development (OECD), General Agreement on Tariffs and Trade (GATT) and then its successor organisation the World Trade Organisation (WTO), on all matters pertaining to global commerce. Unlike the old pre-WWI order, this had the advantage of being rule based and having all the Western economies working collaboratively in competition with the Soviet Union, instead of being in mercantilist competition between themselves.

Since 1945, membership of the IMF has expanded from 45 to 190 nations; only 6 nations of the 193 recognised by the UN are not members of the Fund as of 2023. Of the 190 member countries, 165 have accepted obligations of Article VIII of the IMF which enjoins them not to impose any

restrictions on the current account of the balance of payments – a rough proxy for the breadth of acceptance of the post-war international economic order and the market-based principles on which it rests. A similar trend is evident from the Fraser Institute's 2019 Economic Freedom of the World Index, according to which a total of 153 countries had an 'economic freedom' score of 5 or higher on a scale of 0 to 10 in 2018. As per the Heritage Foundation's 2023 Index of Economic Freedom, 148 countries scored 50 or higher on a scale of 0 to 100. Maddison's work provides convincing empirical evidence of the impact of capitalism on prosperity.[6] His analysis extends to the end of the 20th century. Extending the analysis to 2015[7] does not change his conclusion: capitalism has brought about unprecedented prosperity to the world. From 1820 to 2015 the world grew at an average real rate of 1.87 percent a year, almost ten-fold that of the growth rate between 1500 and 1820 (World Bank and Maddison, 2017). Moreover, since the beginning of what Maddison calls the capitalist epoch, the period since 1950 has been the best period for global growth possibly in recorded history.

While the degree of market orientation the role of the state varies widely across this sample of countries, the big picture reality is that since WWII, as a growing number of countries moved to market based economic systems, world GDP grew at an average annual rate of 3.91 percent, which was more than double of the average growth rate of 1.79 percent between 1820 and 1950 (World Bank and Maddison, 2017). From the early 1950s to 2021, world GDP per capita has grown 350 percent in real terms, global trade expanded 400-fold (Federico and Tena-Junguito, 2017)[8], cross-border capital flows multiplied almost 20-fold (Obstfeld and Taylor, 2004; IMF, 2020)[9], life expectancy has risen from 46.5 years to 71 years, and poverty has declined from 52.4 percent to an historical low of 8.6 percent (OECD, 2021).[10] It is over this period that neo-classical libertarian ideas about the virtues of minimalist state intervention in domestic and cross-border economic activity gained traction. The work of the likes of Freidrich Hayek and Milton Friedman emerged as a powerful counter to the communist and socialist movements that were ascendant in the early and mid-twentieth century.

The March of Democracy

What Maddison did for phases of capitalism, Huntington attempted for phases of democratisation. In his work, *The Third Wave of Democratisation*, Huntington divides the world's engagement with democratic forms of government into three phases. He dates the first wave of democratisation from 1828 to 1926, the second from 1943 to 1962 and the third wave from 1974 onwards. His choice of starting date for the first wave was the year the U.S. expanded suffrage to cover more than 50 percent of white males. In so doing, Huntington reinforced the perception that looms large in the popular imagination that the U.S. has been the global pioneer in ushering in the age of modern democracy. The reality is that the U.S. did not adopt universal suffrage until as late as

[6] Of course he is hardly the one, but he is amongst the most objective.
[7] The last year for which consistent time series data are available in the Our World in Data database.
[8] Specifically, global exports grew 400-fold from 1950 to 2014
[9] From 1952 to 2012
[10] Share of population below $1.90 a day

1964, when the voting right was finally extended to include African Americans across all states. Subsequent research has made it easier to categorise the trajectory of democratisation around the world more accurately.[11]

Taking a leaf out of Maddison's sweeping analysis of the progress of capitalism, we divide the 'march of democracy' into three waves or surges, interrupted by a period of reversal between the second and third waves. *The First Wave* spans a period of over 13 decades from the ratification of the American Constitution in 1789 to Japan's election of the National Diet under Emperor Taisho in 1925. This First Wave started with gradual evolution of proto-democracies becoming more democratic in character mostly through a calibrated expansion of the voting franchise. This was the period of the three Reform Bills in the English Parliament steered by William Gladstone of the Liberal Party and Benjamin Disraeli of the Tories in 1832, and then in 1867 and 1884 respectively. In the U.S., property qualifications for white males to vote were abolished starting in 1792 under Thomas Jefferson. The franchise was then extended to include all adult white males in 1822 under the Jackson presidency. Following the Civil War and the abolition of slavery, the Fifteenth Amendment to the Constitution in 1870 sought to prevent states from denying the right to vote on the 'race, colour or previous condition of servitude', although its implementation was frustrated in the South through the use of 'Jim Crow' laws designed to prevent African Americans from voting on other grounds. Outside the Anglo-Saxon world, cognisant of the times immediately after unification in 1871, Germany created the Reichstag, an elected Assembly, to temper the authority of the Imperial unelected government. In 1876 France became the first country to extend the franchise to all adult males before the election to the lower house of the Third Republic's National Assembly.[12]

Starting in 1893, this wave began to pick up pace. In that year, following France's lead towards mass participation in elections, New Zealand became the first self- governing polity in the world to move to universal suffrage by extending voting rights to women. Thereafter, up until 1925, democratisation gained rapid momentum as a large number of additional countries became electoral democracies with mass, if not universal suffrage. For example, Denmark (1902), Norway (1906), the Netherlands (1918), Britain (1919), the U.S (1920) and Canada (1921) all extended their franchise to include women over this period. Germany, Argentina (1920), Austria (1921), Poland, Czechoslovakia and the Baltics (1919-23), and Japan (1925) were amongst those countries that embraced national elections with voting open to all adult males (V-Dem, 2023).

Between 1925 and 1945, the world saw a substantial reversal of the momentum towards democracy. Over these years, in part because of the Great Depression of 1929 and then the onset of WWII, many countries reverted to non-democratic forms of government. By 1945, the number of autocracies in the world had crept back up to a peak of 137 previously reached in the immediate aftermath of WWI, following the disintegration of the Austro-Hungarian and Ottoman Empire.

[11] See V-Dem dataset

[12] V-Dem has Australia and New Zealand getting there earlier with an electoral democracy score of more than 0.5 in 1856 and 1865 respectively

Since the end of WWII, the world once again saw a sustained resurgence of democracy in what can be characterised as the Second Wave of democratisation from 1945 to 1973. The Second Wave was led by the defeated Axis Powers – Germany, Italy and Japan, which saw electoral democracy restored with active encouragement from the U.S. in the immediate aftermath of the War. Next, this wave of resurgence enveloped a number of additional Latin American countries, notably Costa Rica and Chile, that elected governments through competitive elections with no significant previous flirtation with the democratic idea. Others, such as Brazil and Argentina re-engaged with the democratic idea with the dislocations of the two Wars and the Great Depression behind them. A third cluster of countries comprising new nations, former British colonies in particular, starting life in the wake of de-colonisation also caught this wave. Barbados, Botswana, India, Sri Lanka, Malta, Mauritius and Trinidad and Tobago, for example, have been fairly stable democracies ever since. This second surge exhausted itself by the end of the 1960s by which time the decolonisation process had substantially played out.

Finally, the Third Wave of democratisation started its surge in 1974. This surge has been the strongest and has seen an incredibly diverse group of nations turn to more participatory governance structures, at the very least in the form of national level elections with mass participation. The Third Wave started with the political transformation of the last autocratic regimes in Europe. As Portugal (1974), Spain (1975) and Greece (1975) finally rediscovered their previous engagement with democracy, the wave spread back to their respective former Iberian and Lusophone colonies in the Americas. Some of these were newcomers to the democratic fold such as Ecuador (1980), Colombia (1974), Bolivia (1985), and Mexico (1995). But for others -- such as Peru (1964 and 1981), Argentina (1920, 1964, 1984), and Brazil (1948, 1987)-- it was the resumption of an intermittent, even cyclical, relationship with democratic governance.

The wave enveloped Asia in the 1980s. Several East Asian countries from the Philippines to South Korea emerged from under the shadow of authoritarian regimes. Then came the collapse of the Soviet Union in 1989, and the Third Wave picked up further momentum as countries of the former Eastern Bloc reclaimed their democratic status. It did not take much time for the effects of the end of the Cold War to reverberate across the rest of the world. Many African and Central American autocracies that previously enjoyed Soviet support collapsed, giving way to new democratic regimes through the 1990s.

The momentum of democratisation carried over into the 21st century with a number of small overseas colonies and territories finally separated from the colonial mothership embracing democracy. The most recent surge in democratisation came in the Middle East, with Tunisia adopting a new constitution. But the 'Arab Spring', which looked like it might spread to other parts of the region including Egypt, Libya and Syria, has failed to catch on.

The Mixed Record of Pax Americana

Since 1945, therefore, not only has most of the world turned to market based economic policies, but it has also seen an unprecedented spread of the impulse to democratise. The former has contributed to the remarkable growth in global prosperity, world GDP increased tenfold between 1950 and 2015 (World Bank and Maddison, 2017), while the latter has driven the number of democracies[13] in the world from only 25 in 1950 to 90 in 2022 (Lührmann et al, 2018). In 2011, for the first time in history there were more democracies in the world than autocracies. By 2018 more than 4.1 billion people, or about 56 percent of the world population, lived in nations where leaders in the highest executive positions were chosen through elections with universal suffrage (Gorokhovskaia et al, 2023).

Regardless of what you might think of the American "neo-conservatives", or "neo-liberals' or whatever label you might to ascribe to them, it is impossible to not be impressed by the rise in global prosperity that the embrace of some or the other form of free market economic policies has generated. Nor is it possible to ignore the widespread appeal of the democratic idea over the 20th century. The evidence of these trends is so compelling that one might be inclined to understand, if not forgive, the ideological certitude of the neocons. The period 1945 to 2015 has certainly been the best period in history for Democratic Capitalism[14] -- a period that may appropriately be called *Pax Americana*.

On the face of it the record of *Pax Americana*[15] has been impressive indeed. That said, we must be careful in what lessons we draw from the experience of this period. As we noted earlier, the overall trends for which the neocons take credit mask several issues. We focus on two that we believe are especially important: the limitations to the neo- classical economic toolkit; and the growing tension between capitalism and democracy. It is noteworthy that of all the countries that have taken to market based economic policies since 1950, only those in Western Europe and East Asia have made material progress in terms of catching up with North America and other industrialised countries. Since 1990, India too has made some progress in closing the gap, but it lags far behind East Asia.

Although the gap in terms of market orientation between Sub-Saharan Africa[16] and the more developed economies of the world have declined over the past three decades, the gap between the two in terms of real GDP per capita has widened. Despite adopting the neo-conservative economic policies, Sub-Saharan Africa fell further behind the rest of the world during the age of *Pax* Americana (see Figure 2). Similarly, both Latin America and Eastern Europe[17] have both fallen further behind the West even after they turned to market oriented reforms in the 1980s and 1990s respectively.

---

[13] Liberal and electoral democracies (as opposed to electoral and closed autocracies)

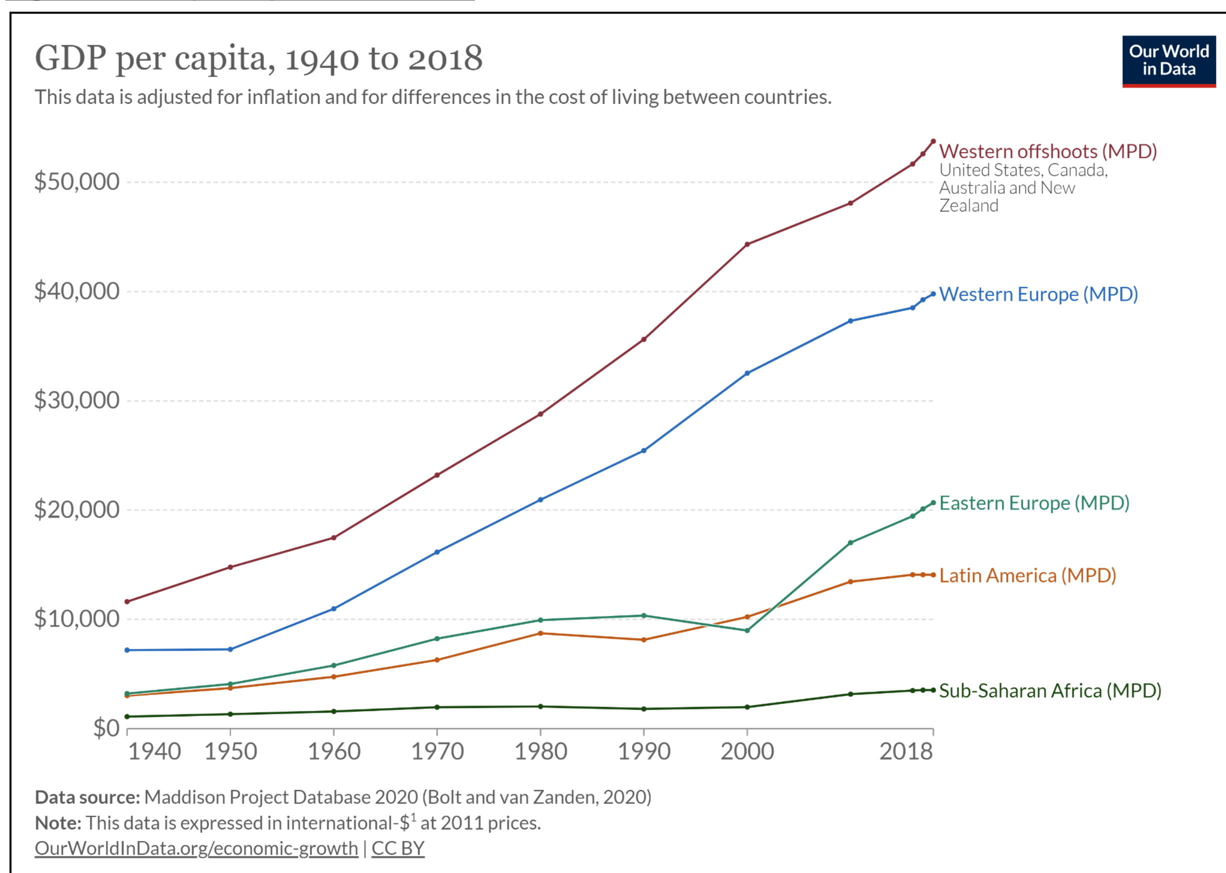
[14] As researchers like Steven Pinker remind us: "humanity has never had it better".

[15] Modelled after *Pax Romana* and *Pax Britannica*, this term refers to the period of relative peace brought about by the global dominance of the United States after World War II

[16] Africa excluding Libya, Morocco, Algeria, Tunisia, Djibuti and Egypt.

[17] Albania, Bulgaria, Romania, Poland, Czech and Slovak Republics, Hungary and the countries comprising ex-Yugoslavia.

Figure 2: GDP per capita, 1940-2018



What explains this phenomenon? As per neoclassical growth theory, unless total factor productivity (TFP)[18] grows at a consistently elevated pace through constant innovation, higher income countries with ageing populations must eventually slow down, allowing poorer countries to 'catch-up' with their more developed counterparts. The evidence suggests that the pace of growth for developed countries has indeed slowed down because of declining growth rates of their labour force, and also because of decelerating TFP rates. However, 'catch-up' has happened only for a cluster of Asian countries. The rest have fallen further behind. If one controls for differences in such factors as savings rates, fertility and rule of law, for example, differences in the growth performance across countries can indeed be explained by differences in degrees of market orientation as captured in metrics such as size of government and extent of trade liberalisation and deregulation. In other words, all else being equal, differences in growth performance across countries can be explained by their relative commitment to economic freedom.[19] The problem with this argument is that 'everything else' must be held equal and in real life of course, it never is equal. The truth is that the tool kit of neo-classical economics is not enough to bring about sustained development and transformational change.

---

[18] Defined by Solow in *A Contribution to the Theory of Economic Growth*, 1956. Refers to the efficiency with which inputs (capital and labor) are used in the production process.
[19] See, for example, the Fraser Institute's *Economic Freedom of the World 1975-1995*.

Second, within countries, the pursuit of market-oriented policies has resulted in growing inequality. The debate about growth versus inequality is old in the context of developing countries. In the development economics literature Simon Kuznets (1955, 1963) famously posited the theory that growing inequality was inevitable in the initial stages of development. But he predicted that past a certain threshold of GDP per capita, however, most countries would see a decline in levels of inequality. Although the share of the global population living in absolute poverty has declined substantially over *Pax Americana*, inequality, as measured using the Gini Coefficient, has indeed grown in almost all developing countries of the world. Contrary to the predictions of the Kuznets' Curve, there has been a significant deterioration in income distribution, even in developed countries. Moreover, as argued by Thomas Piketty, the rise in inequality is even more acute if one considers the distribution of wealth, considered distinct from income. The insecurity, fear and anger stemming from a deep sense of betrayal amongst the middle-class of the West is real, it cannot be wished away. The sense is growing that free markets and globalisation, despite the elaborate framework for welfare support that has been set up in Western liberal democracies, are no longer working to serve the needs and aspirations of their middle-classes. This has aroused rising anti-immigration sentiment, mobilised support for populist leaders of both the Left and the Right and triggered much introspection about the future of the Western model (Rajan and Zingales, 1998).

In sum, as impressive as global achievements have been under *Pax Americana*, there are several uncertainties and concerns that have arisen. In what follows, there are two questions, of the many we enumerated in the section above on the 'End of History' that I shall particularly focus on: If adoption of the neo-classical toolkit is not enough to bring about sustainable and transformational change, then what is? Second, what are the implications of the unequal spread of prosperity both across and within countries that have come to be associated with capitalism? [20]

[20] The other questions are no less important but are beyond the scope of this book.

ARTHA GLOBAL

2. Markets Are Not Enough: Sub-Saharan Africa and the Washington Consensus

The 1980s were a watershed decade for global capitalism. By the time I arrived at the World Bank in the second half of the 1980s, the evidence for the transformational power of market oriented economic policies was pretty compelling. Being a French- speaker I was offered an opportunity to join the West and Central Africa Department of the Bank. Until then I was familiar only with Asia and was very excited about the opportunity to discover Sub-Saharan Africa for myself. And so I became one of those deployed to spread the gospel of the Washington Consensus into Franco-phone Africa. What I learned is the obvious: that a market-enabling policy and regulatory framework by itself is insufficient for delivering economic development.

Encounters with Marxist-Beninism

One of my first "missions," as official World Bank trips are called, was to Cotonou, the capital of Benin in West Africa. I was part of a small team of experts from the World Bank and the IMF advising on the design of that country's first Structural Adjustment Loan (SAL). This type of lending was very much the fashion at the time. It involved balance of payments support but subject to conditions imposed by the Bank;it became the principal tool for propagating the canon of neo-classical economic policy to that part of the world. Benin was reeling from an economic crisis precipitated by the failed policies of "Marxist-Beninism," a local variant of Marxist-Leninism, under the authoritarian control of Camarade General Mathieu Kerekou.[21]. We had a long meeting with the tormented General in a vast, deserted hall of the gently decaying Presidential Palace, a 1960s modernist structure designed by a French architect for a more optimistic time. Our articulate "mission chief", a self-assured Belgian, a quintessential IMF technocrat in a deep blue YSL suit complete with pocket kerchief, shared our team's sombre diagnosis of the country's economic situation: the country's trade and macro-economic policy framework o had to be fixed and was suffering from a severe case of fiscal profligacy and non-competitiveness. The Big Man sitting in a throne like seat on an elevated platform at a suitably respect-worthy height above the team of visiting technocrats gave us a patient hearing and concluded our discussion with the simple plea: *"Camarade experts, il faut nous aidez"* (my consultant comrades, you must help us).

And of course, we were there with just the right medical kit. Our suggestion was broadly that he adopt various measures to curtail government spending including through phasing out of energy subsidies, contracting the bloated civil service, and the sale and/or closure of loss-making public-sector enterprises. The team also recommended restructuring and privatising the country's banking system which had by then collapsed. And of course, that the government eliminates those dreaded "price distortions" by simplifying and redesigning the structure of industrial tariffs, as part of a broader initiative to improve "incentives" for the private sector.[22] Normally the package would

---

[21] "*Camarade*" was the honorific commonly used in government at the time
[22] Another key word for economists

also have included a devaluation of the currency, but in the case of Benin, and indeed for much of Central and West Africa, that critical tool was not available because these countries were part of the Franc Zone, a legacy of French colonial rule. Benin was, and still is, part of a group of eight franco-phone West African nations that share a common central bank, a common monetary policy and a common currency, the West African CFA Franc, whose value was pegged to the French Franc. With monetary policy not available as a tool for macroeconomic stabilisation, the burden of "adjustment' had to fall on fiscal policy which therefore implied a very severe contraction in spending to induce a decline in real domestic wages that was needed to make the economy more competitive and restore equilibrium to the balance of payments.

The economic theory behind such a structural adjustment program was pretty text- book and not very hard to understand. But what I found perplexing was how both the World Bank and the Fund at the time seemed to ignore the institutional and social context in which these policy recommendations were being prescribed, which will be discussed later. In the case of Benin, the bitter medicine of orthodox economic policy did stabilise the economy but triggered, by the World Bank's own admission, severe social dislocation that led to the downfall of the Kerekou government. In its Project Completion Report (1992) for Benin's first SAL, the Bank acknowledged that it:

> *"could not of course foresee that mounting political and social crisis would initially impede program implementation and culminate in the end of the regime", but notes that "however unintended it was, SAL I played an important part in this transformation…by empowering key segments of the population who would settle for nothing less than a complete change of regime."*

So as a young World Bank economist I had not only helped a struggling country improve its "incentive structure" I was also party to a socio-political upheaval! It took another ten years before Benin's GDP per capita improved. After 15 years of stagnation, ten under the Marxist-Leninist regime and 5 after the structural adjustment program of 1991, per capita real GDP in Benin has grown at an average rate of 2.2 percent a year since 1992. This is not bad, but it is less than half the growth that India delivered over the same period. More importantly, from such data as are available, it is not clear that Benin saw any meaningful reduction in the proportion of the population living in extreme poverty over the past three decades. In 2015, almost half of Benin's population lived below the poverty line.[23]

The French Heart of Africa

In 1991, the World Bank released a particularly impressive World Development Report prepared by a distinguished team of economists. Titled '*The Challenge of Development*', it made a strong, empirically grounded case for what had by then become the standard tool kit for the tribe of World Bank and IMF economists.[24] Macroeconomic stability through fiscal discipline and

---

[23] Under $1.90 a day as defined by the World Bank.
[24] Lawrence Summers was the World Bank's Chief Economist at the time

exchange rate depreciation to correct for "over-valuation"; trade liberalisation to ensure competition; and assorted reforms to unleash the private sector. Although this opus did recognise the importance of the catalytic role of government, it stuck to a largely libertarian line on the role of the state: restrict it to the distribution of public goods, including the provision of an effective regulatory and legal system, and intervene only in the event of "market failure". This was the tool kit for the soldiers of development in the Golden Era for neoclassical economics. So we soldiered on.

I travelled through the heart of Francophone central Africa, advising governments on trade and tax policy reform. My most interesting assignment was to persuade the six member countries, Cameroon, Congo Brazzaville, Gabon, Central African Republic (CAR), Chad and Equatorial Guinea, to come together around a program to simplify and restructure their industrial tariffs and indirect tax policy regimes. All these countries were essentially commodity exporters and their fortunes were very much tied to the ebb and flow of oil prices, with limited wealth redistribution. The CAR did not have oil; it had diamonds, ivory and uranium. Equatorial Guinea, the only non-francophone country in the group, found oil later. The five belong to UDEAC[25] now called the CEMAC or Central African Economic and Monetary Union. The origins of regional cooperation in central Africa lie in the colonial construction of French Equatorial Africa.

Brazzaville was a small, relatively neat town on the northern bank of the Congo River, across from the sprawling mess that is Kinshasa, the capital of the Democratic Republic of Congo, that lies to its south. One could see Kinshasa from my hotel, and watch Zaire T.V. which would start and end its daily broadcast with Mobutu, in his trade-mark leopard skin cap and dark glass, exhorting the nation to rise with *éclat* like the sun! In contrast, Sassou Nguessou who was then, and still remains, the President of Congo-Brazzaville, was more sophisticated and low key. One indicator of the sophistication of the regime in Brazzaville was the fact it was, at that time, a Marxist Leninist state with close relations with the Soviet Union until its collapse in 1991 and yet an integral part of the central African CFA zone with strong links to the French; they were not non-aligned, but were aligned to both camps. Elf Aquitaine, the French state oil company remained a significant stakeholder in the Congolese oil industry right from when the first oil rig went into production in 1972.

It was interesting, despite sharing a common currency, how little the six member nations of UDEAC had to do with each other. The customs union was pretty much dysfunctional, with the movement of goods and people between member countries restricted by all manner of *ad hoc* trade and non-trade barriers. The regional central bank did function. With the exchange rate fixed against the French franc and backed formally by the Banque de France and the French Treasury, there was a functioning institutional mechanism for managing macro-economic policy across the region.

The headquarters of the regional central bank were in Yaoundé, Cameroon. German entrepreneur settlers made their way up from Douala on the coast to Yaoundé in the interior highlands during the 'scramble for Africa in the 1880s. With characteristic efficiency they did a good job of creating

[25] The Customs Union and Economic Union of Central Africa.

a well-functioning plantation economy in the territory that they controlled. Following their defeat in WWI the German colonial territory of *Kameroun* was divided between the British and French into British Cameroon and French Cameroon, which was absorbed into French Equatorial Africa.. It was only after Nigerian independence in 1960 that the southern Christian portion of British Cameroon opted, following a plebiscite, to merge with the newly independent, predominantly Christian, Federal Republic of Cameroon. The northern, predominantly Muslim, portion of British Cameroon got absorbed into Nigeria. Christians and animists make up more than three-quarters of post-independence Cameroon. The main fault line today is between the Anglophone west and Francophone east of the country. Yet the country has been remarkably stable with Paul Biya, who succeeded Ahidjo as the second President of the Republic in 1984, still in power having survived a coup attempt and several flawed elections held since.

Travels in Central Africa

The UDEAC Secretariat was in Bangui, the capital of the Central African Republic (CAR), formerly known as Oubangui Chari. It was housed in an expansive but dilapidated campus that betrayed the yawning gap between the rhetoric and reality of regional cooperation between the member states of the Union. At the time General Kolingba was the President of CAR. And not too far from the hotel I used to frequent was the prison where his predecessor, the self-proclaimed 'Emperor Bokassa' was serving out his sentence for the brutal murder of children that refused to buy the expensive school uniforms that he had mandated they must wear.[26] Oubangui Chari became the independent Republic of Central Africa or CAR in 1960. By 1966 Bokassa had usurped power in the country's first coup. He himself was displaced in a second coup by General Kolingba in 1981. This pattern of coup and counter-coup was not surprising given the fluid history of the region that never consolidated into a homogenous state. The northern parts of the territory were controlled by various competing groups, mostly Muslim warlords, remnants from better organised kingdoms of the past that thrived because of their centuries' old involvement in the trans-Saharan trade, especially the slave trade with the Arabs. The rain forest set the geographical limits to how far south they could extend their control.[27] Similarly, south of the rainforest line, control alternated between different groups of Bantu speakers that had migrated northwards over the millennia. Making their way up the Oubangui river, the French first established a presence in Bangui. Next, they secured their southern flank by persuading the Belgians to accept the Oubangui and Congo rivers as the northern and western borders of their Congo Free State. They secured the western front through a diplomatic agreement with the Germans with respect to the eastern borders of Kameroun, the territory they had laid claim to. Then the French fought their way up, pushing Muslim warlords way back north, to claim Oubangui Chari and what is now Chad for themselves.

[26] He was found not guilty of the other charge of cannibalism and was eventually freed in 1993 as part of a general amnesty for prisoners.

[27] Historically this line became the religious divide in the countries of West and Central Africa. Thus the populations in the North – above the rain forest line -- of Nigeria, CAR, Chad, Sudan, for example, are all Muslim and those in the South are Christian. The former were converted through the encounter with the Arab trade route, and the latter from their encounter with European missionaries.

Oubangui Chari and Chad were left to private French concessionaires to manage – tea, coffee, and cotton and then diamonds and gold mining concessions became quite important in the former. The latter mainly provided access only to raw cotton and labour that was shipped to the more productive South.

The French engagement with Chad was particularly perfunctory.[28] By the late 1980s, Chad had been through a turbulent period of civil war waged broadly between Libyan supported northerners and southerners supported by the French. On a visit to war ravaged N'djamena, I was invited to a meeting to discuss the Government's efforts to raise fiscal revenue. The Ministry of Finance, housed in a building scarred with damage from mortar shells, was embattled in a physical and metaphorical sense. Our counterpart explained how with very limited administrative capacity the country relied primarily on customs duties for revenues.[29] However, even these were threatened because of extortion and smuggling by armed bandits that were active along the country's northern desert borders. The international donor community was pressing Chad to outsource the management of their Customs services to SGS, the Swiss company. SGS was already operating in CAR at the time; it reminded me of how the British had taken over the operation of Qing China's Customs operations during the Opium War. It was hard to think about using trade and tariff policy to tweak private sector incentives in these conditions! I shared this perspective with senior colleagues at the Bank. This was not a message, however, that the intellectual leadership of the World Bank were willing to embrace in the early 1990s.

It took two years of intensive work with colleagues and well-meaning government officials spread across six countries to come up with a coherent program for the simplification and rationalisation of the trade and tax regime of the customs union. Opposition to the reform program had to be overcome not only from local vested interests, but also powerful business interests in France; members of the Paris based Conseils Nationale du Patronat (French Employers Association) were confused and amused in equal measure to be negotiating/debating with a French speaking Indian about the phasing out tax exemptions accorded to their businesses in Central Africa. It took another year of intense lobbying at the political level in the region as well in Paris before we succeeded in getting the six Heads of State to convene in Libreville, Gabon to sign a Protocol of Understanding.

The signing was a big event hosted by Omar El Haj Bongo, the President of Gabon. Endowed with generous petroleum reserves, controlled in large part by Elf Aquitaine, the French state-owned oil company,[30] Gabon is the wealthiest of the six nations that comprised UDEAC and it has been remarkably stable as a one-party state under Bongo who had taken over as President upon his predecessor's death in 1967. After the official signing ceremony, President Bongo and the First Lady, his considerably younger second wife, who happened also to be the daughter of Sassou Nguesso, the charismatic president of the Republic of Congo, hosted an elegant dinner party for

---

[28] Having subdued the local warlords in hard fought battles, Fort Lamy, as N'Djamena was then called, languished as an outpost for a military garrison until 1920 when Chad finally got its own status as one of the five colonies forming part of AEF.

[29] Since then, Chad has discovered oil, which is now the main source of the government's revenue.

[30] Since merged in to Total Energies

the visiting dignitaries. The hosts arrived in their olive-green Rolls Royce to welcome guests. Toasts were raised to the future of regional cooperation and economic reform.

Gabon enjoyed the dubious distinction of having the highest per capita consumption of champagne in the world. The champagne that was served was a gift from Teodoro Obiang Nguema, the President of Equatorial Guinea. Knowing his host's tastes he had taken the trouble to bring with him several cases of the special pink stuff in his private jet. Equatorial Guinea was the only non-Francophone member of the group and had only joined UDEAC in 1984. Having gained independence from Spain in 1968, Francisco Macias Nguema, turned the newly formed republic into a one-party state and became President for Life in 1972. As a result of the capriciousness of his autocratic rule, he left what was a reasonably prosperous plantation economy in ruins[31], until his nephew the young Teodoro deposed him in 1979.

It took another two years after that colourful evening before the reforms were actually implemented alongside a devaluation of the CFA Franc in 1994. By then much of the African continent had turned to market economics and macroeconomic discipline. 37 of 45 countries comprising Sub-Saharan Africa were under Structural Adjustment Programs of some kind. All these programs basically prescribed the same formula: macroeconomic stabilisation through fiscal discipline and exchange rate adjustment,which mostly meant cutting government expenditure and devaluation, where possible; trade liberalisation: cut tariffs and reduce non-trade barriers; reduce price distortions induced by government interference in markets, which meant deregulation or dismantling of subsidies and various price support schemes; and last but not least, strengthening the 'rule of law'; this typically meant getting some lawyer to draft an Investment Code and propose simplification of procedures for setting up a new company, preferably through a 'one-stop window'). But while the neocons were busy declaring victory and were already engaged in the mother of all battles, the transformation of the ex-Soviet bloc, I was left scratching my head.

In retrospect, it is amazing that this initiative got as far as it did. Now almost two decades since that period of economic reform, what progress have these countries made? Gabon, Cameroon and Congo, Brazzaville continue to languish in a low-level equilibrium or in a state of turmoil. They remain oil rich, managed by what Acemoglu and Robinson (2012), amongst others[32] have described as extractive regimes, with civil conflict and electoral manipulations.[33]

Chad and Equatorial Guinea have joined the club of oil producing nations, which has led to a bonanza for the elite in both countries, but the benefit of these developments for the general public has been unclear. In Chad, the construction of the oil pipeline, so vital to the exploitation of

[31] By the mid-1970s very few public services were functioning. Schools and churches were shut down as the regime pursued a devastating campaign of indigenisation. Fortunately, discovery of oil reserves came to the rescue in 1996.
[32] Notably, Paul Collier
[33] Congo-Brazzaville went through a period of civil conflict when Sassou Nguessou refused to abide by the verdict of the first multi-party elections that the country was pressured by the international community to hold in 1992. Sassou Nguessou was able to reassert control in 1997 with military assistance from the Angolans, and has since consolidated his hold on power by managing the referenda to bring about suitable constitutional changes to legitimise term extensions and allegedly manipulating the election process to ensure continuity of tenure. Paul Biya remains in charge in Cameroon but has been grappling with armed conflict relating to the Anglophone crisis since 2016. In Gabon, Omar Bongo's son was deposed in a coup earlier in 2023.

this land-locked country's oil reserves, was completed in 2003 but the World Bank withdrew its support over a dispute pertaining to the diversion of oil receipts for non- development purposes. The fate of CAR has been altogether more troubling. The country has descended into repeated civil conflict and violence between different ethnic and religious groups vying for power.

Taking a look at Sub-Saharan Africa as a whole, it must be said that in the two decades since the SAPs were rolled out across the continent, the share of the population below the poverty line on average has declined from 58.5 percent in 1990 to an estimated 47.5 percent in 2010. But as we saw in the case of the Central and West African nations that I worked on, there has been no 'breakthrough' of the type seen in East Asia and India over a similar time frame. Africa remains as dependent on natural resource exports as before. No Sub-Saharan African country has been able to internalise technological capability to make their way up the value-added chain and secure their journey on a path to sustainable prosperity.

My personal experience with Africa left a deep impression on my mind. It convinced me of the limitations of any technocratic effort, particularly one led by external parties like the external donor community, to address basic issues in state building. Market economics alone can hardly be a lasting solution for countries that have weak state capacity, or worse, dysfunctional or conflict ravaged states.

3. Aligning to Markets: The Latin American and Southeast Asian Low Road

What of the post-War performance of other developing regions of the world? What role has the state played in the case of late developers in Latin America and Southeast Asia? To shed light on why this is the case, let us turn briefly to consider the Latin American and Southeast Asian experience with industrial policy.

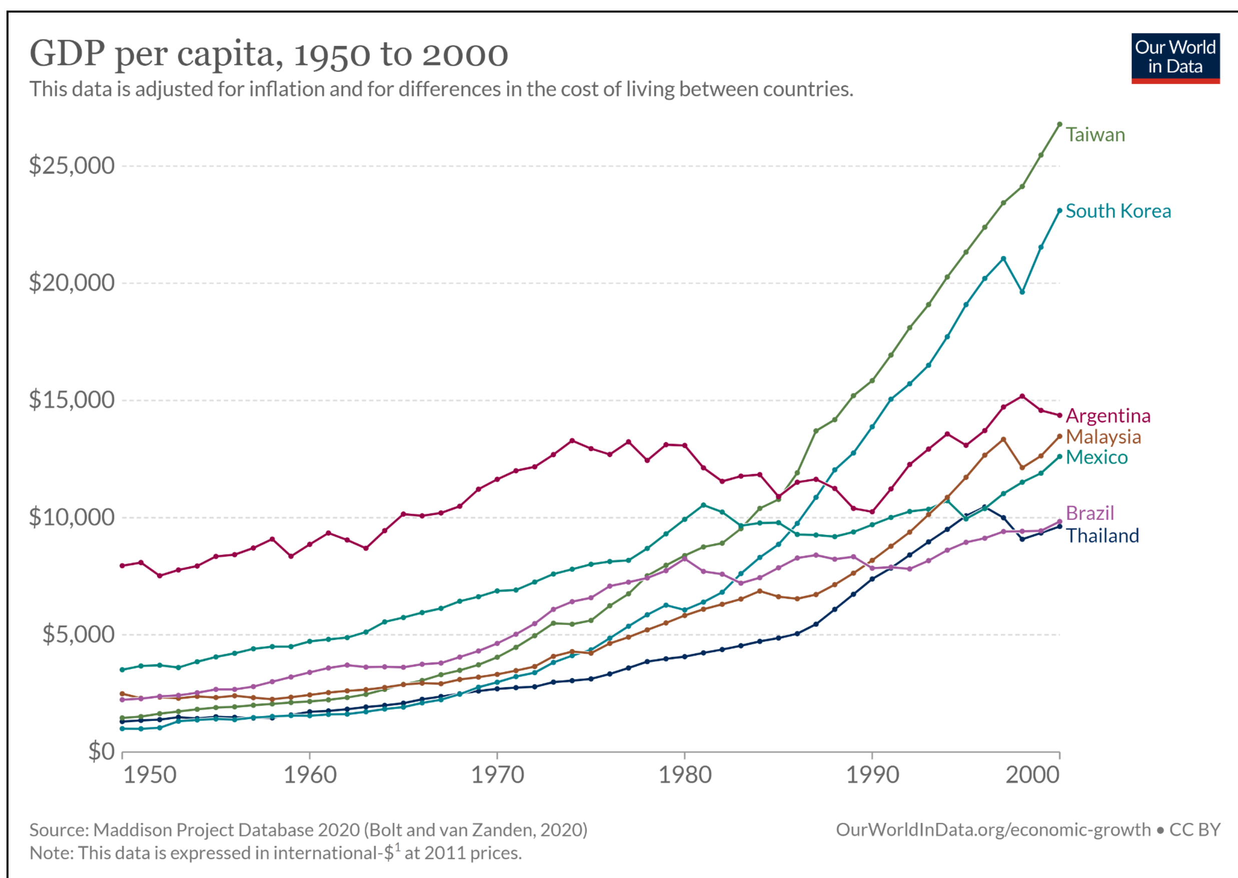
During the 1950s and 1960s, the Argentinian economist, Raul Prebisch was a particularly influential voice in development circles. His views, associated with the so-called 'structuralist school', on the importance of import substitution to develop industrial capability resonated with developing countries around the world, including of course, India. In the case of Latin America, which was considerably more prosperous than Asia at the end of WWII, much of the wealth had been created on the back of agriculture and commodities. There was nevertheless a recognition of their vulnerability to terms of trade shocks and hence for the need to develop industrial capability. In Mexico, immediately after the War, the presidency of Miguel Aleman made industrialisation the main focus of its economic plan (Amsden, 2001). Brazil's basic industries were the focus of the Target Plan – *Programa de Metas* -- in the late 1950s. Chile embarked on industrial promotion starting in the early 1960s. and Argentina attempted support for domestic industry under the Peronist regime in the 1940s.

In Asia, with the end of the colonial era, there was an understandably strong desire for leaders in the developing world to strive for economic independence. None had well developed market economies. We have already discussed the historical compunctions that drove Northeast Asian countries to strive for industrial catch up in the years after WWII. A nationalist sentiment was equally an important driver for the industrial ambition of Southeast Asian nations. The leadership in Singapore has always been driven by an existential threat and the island's precarious position vis- à-vis its much larger neighbour; it is the epitome of a market consistent, but state-led economic model. And Vietnam, having emerged victorious from the with the U.S. is the latest to tackle the challenge of economic transformation with active state engagement.

In Thailand, Malaysia and Indonesia in particular, there was also the need to develop manufacturing capability outside the ethnic Chinese emigre community that propelled the state to take a leading role in industry. In Malaysia, the Pioneer Industry Ordinance of 1958 was the first articulation of the industrial policy ambitions of the government. In Indonesia, Sukarno and then Suharto charted a path to state led industrialisation. In Thailand, the one country that has not been colonised by the West, the military regime that took over in 1960 set up the Board of Investment to support the growth of domestic manufacturing. The institutional infrastructure used for industrial policy has been similar in countries that have attempted it. As in Northeast Asia, Planning and/or industry ministries took the lead and were supported by government owned development banks in Latin America and Southeast Asia as well. Over the years, Brazilian Development Bank (BNDES) in Brazil developed a very large balance sheet and played a very active role in providing long term financing for capital intensive industrial development. Nacional Financiera (Nafin) in Mexico, Industrial Finance Corp. of Thailand (IFCT) in Thailand, specialised sector specific development finance institutions (DFIs) in Malaysia, state owned banks in

Singapore and Vietnam have all played a similarly important role. All these countries succeeded in building technological capability to different degrees, but none so far have been able to replicate the experience of the Northeast Asian states. In 1950, GDP per capita of the Southeast Asians was about the same as in Korea and Taiwan, and theirs was about a third on average of their Latin American counterparts. By 1973, the Southeast Asians had fallen to about half of the GDP per capita of the North East Asians, who had in turn mostly caught up with Latin America. And by 1995, SE had almost caught up with Latin America, and the North East Asians had raced way ahead of all of them (Figure 3).

Figure 3: GDP Per Capita, 1950-2000



Latin America's Failed Developmental State

The popular narrative about post-War Latin American economic performance, especially for the region's larger economies, Brazil, Mexico, and Argentina, is like the familiar story about India: that of a development state gone wrong. The argument is that, unlike the East Asian countries, none of these countries were committed to a 'market consistent' industrial policy. Instead, import substitution became victim to 'rent seeking' by vested interests, leading to a highly distorted

incentive framework and low levels of competitiveness and productivity. As we know from our experience in India, there is truth to this narrative.

There can be little doubt that state activism in economic policy did not lead to desired outcomes in Latin America. Import substitution in these countries was driven by government investment in state owned industries and consumption demand from a large domestic market. The Latin American version of the reciprocal control system was not as effective as the North-East Asian version; these countries were less focused on enforcing the discipline of export promotion. As a result, the foreign exchange requirements for their import substitution strategy were met with earning from exports of primary products and overseas borrowing. For a while this delivered reasonable growth rates, as seen in Brazil and Mexico in the 1960s. However when the terms of trade turned against primary exports, these countries became heavily dependent on foreign debt capital to fund their growing external imbalances. Argentina never even tried to develop its version of the reciprocal control mechanism. And its efforts at development banking very soon went awry with a corrupt Peronist regime playing clientelist politics.

Following the second oil price shock and the contractionary U.S. monetary policy of the Volcker years, the rise in the debt servicing cost soon became unsustainable, triggering the debt crisis and the 'lost decade' of the 1980s. Latin American countries spent the bulk of the 1980s experimenting with what were called 'heterodox' programs for macroeconomic stabilisation. These involved a combination of currency devaluation to address the deterioration in the terms of trade, price controls and income policy to restrain price and wage increases, and central bank financing of fiscal deficits to protect growth. These efforts ended up in failure, with Brazil's Cruzado Plan of 1986 being the most spectacular example.

Most of Latin America slipped into a vicious cycle of devaluation and inflation. By the late 1980s inflation was running at over 70 percent per annum in Mexico, 450 percent in Argentina and a mind boggling 1000 percent in Brazil! Foreign debt remained unsustainable, leaving little choice but for these countries to turn to the IMF. The standard medicine administered by the Fund entailed severe, and very unpopular, austerity. The region had to live through a painful decline in real incomes, severe cutbacks in infrastructure spending, and a material deterioration in income distribution. But the IMF stabilisation programs did break the back of hyper-inflation and restored the economies to a period of decent real GDP growth in the 1990s. This sealed the conversion of Latin American policy makers to neoclassical orthodoxy to the delight of a new generation of Chicago trained local technocrats that had been waiting for their day in the sun. It was a curious sight to have Carlos Menem, the flamboyant leader of the populist Peronist Party of Argentina, recount at the Annual Meetings of the World Bank and IMF in 1998, how Argentina had successfully pursued stabilisation policies and structural reforms working side by side with the IMF (Pop-Eleches, 2008). Fujimori of Peru, Cardoso of Brazil, amongst other leaders from Latin America, also sang from the same sheet of music. However, even as victory was being declared, the new generation of technocratic reformers were also eagerly embracing the other two staples of the Washington Consensus: financial deregulation and liberalisation of capital accounts. While these measures temporarily made foreign capital more accessible, they also made Latin American

economies much more vulnerable to the volatility of cross border capital flows. Sure enough, by the early 2000s they all found themselves once again in crisis mode.

What has been the impact on Latin America of moving from the failed structuralist policy tool kit to the neo-liberal one? Broadly speaking, they have each, in differing degrees, taken to what may be called the 'low road' or the easy path. They have transferred control of large swathes of their respective manufacturing sectors to foreign investors, including multinationals. Mexico's automobile sector is a good example. Operating from its *maquiladoras* the auto majors have integrated Mexico into their geographically unbundled supply chain designed to serve the North American market. In turn, Mexico has become a vital centre for the manufacture of automobile parts and components. Nonetheless, with this approach, Mexico has become dependent on foreign investors' willingness to transfer know-how or invest in local R&D to develop its own technological capability. Since foreign investors are typically reluctant to do either, Mexico's own international competitive advantage now rests on its ability to keep the cost of its labour attractive enough for this kind of lower-end manufacturing activity to continue.

Chile has adopted a similar strategy. Like Mexico, Chile has also welcomed FDI into domestic industry, hoping that spillover effects would help develop its own technological capabilities. Meanwhile, it has been sensible and expedient for Chile to exploit its good climate and abundant land resources to develop export niches in high value agricultural produce. Argentina drifted along an extreme version of this trajectory. Between 1980 and 1995, a period during which the share of higher skill manufacturing sectors like electrical and non- electrical machinery, for example, was expanding smartly in Korea and Taiwan, the contribution of these sectors to Argentine GDP shrank. In fact, more generally, Argentina experienced pretty marked de-industrialisation over this period, with industry's share in GDP declining from 29.5 percent to just about 21 percent. In the absence of any state support for industrial innovation or manufacturing export promotion, the country's landowning business elite have found it easier to revert to the comfort zone of agricultural and commodity exports, rather than try to break into high-tech industry (Amsden, 2001).

Of all Latin American countries, Brazil developed the deepest and most diversified manufacturing capability during the 1960s and 70s. It was even able to break into aircraft manufacturing. The country did not invest behind continuing industrial diversification in pursuit of developing a dynamic comparative advantage in technology intensive manufacturing. While commodity prices were riding high in the 1990s, Brazil had the opportunity to seriously upgrade its infrastructure, improve the quality of its higher technical education system and strengthen its national R&D capability; it seems to have squandered that chance because of the new technocratic elite's discomfort with activist industrial policy. As the global technology frontier kept moving further out, Brazil found the cost and risk of 'making' at home higher than 'buying' know-how from abroad through licensing agreements or by inviting foreign capital. As a result, Brazil, like India, finds itself struggling in the middle ground: unable either to compete in low-end manufacturing or to build indigenous capability to keep up with the fast-moving global technology frontier. Meanwhile, it has ceded control over a larger share of domestic manufacturing capacity to foreigners more interested in exploiting its large domestic market than in integrating Brazil into a global supply

chain or transferring advanced technological know-how to their minority Brazilian partners. Over the past three decades, Brazil has fallen back to a dependence on primary exports, and having also opened the door to international capital flows, its fortunes have become more vulnerable to the commodity price cycle and the ebb and flow of foreign capital.

In sum, Latin America's development states were mismanaged and ran into severe macro-economic difficulty, forcing countries across the region to embrace orthodox macroeconomic stabilisation policies in the 1990s. This did deliver the region from the curse of hyper-inflation. But the standard prescriptions for structural reform that were adopted in parallel with stabilisation failed to deliver on the promise of economic transformation. Much of Latin America is no doubt better off economically than it was in the 1990s. However, the region has fallen way behind Northeast Asia in technological capability despite a significant rise in foreign ownership of domestic industry. In the process, the region has become more vulnerable to the volatility of cross-border capital flows and ironically also more dependent on traditional commodity and agriculture-based exports.

Southeast Asia's Fading Developmental State

Whereas Latin America gave up on the development state, the Southeast Asians, barring the Filipinos, who were always an outlier in the region, and arguably the Indonesians, still hold onto the idea of more active state engagement in economic policy. In this respect, the region probably lies somewhere between Latin America and Northeast Asia.

Thailand has never had an expansive economic bureaucracy. Its relatively small BoI led the state's engagement in industrial policy. BoI traditionally attracted the best and the brightest of talent and commanded high respect and prestige. Its ranks, as we have seen in the case of Korea and Taiwan's economic bureaucracies, were dominated by engineers. There was always tension between the engineering and macro-economic perspectives within Thailand, with the latter typically espoused by a tribe of foreign trained economists who were eventually co-opted by the bureaucracy. Despite its small size, BoI provided assistance to the vast majority of manufacturing projects whether public, private or joint ventures at least up until the Asian Financial Crisis (AFC) of 1997. These efforts helped Thailand become a regional hub for global auto manufacturers who have invested heavily in integrating the country into its global supply chain. However, even though almost a quarter of Thailand's exports are still in higher technology industry segments, the reality is that technology spillover benefits for the Thai economy remain limited. All auto assembly operations and the manufacture of 'Tier I' parts and components are largely controlled by foreign investors. The truly domestic auto-manufacturing ecosystem remains restricted to a bunch of small local suppliers that feed the lower tech portions of the supply chain.

Malaysia's industrial policy goals have not lacked ambition. Unlike Thailand, the Malaysian have not made great use of a 'reciprocal control mechanism' requiring private companies to meet export targets and performance standards in exchange for special privileges. They have instead relied on state-led conglomerates in chemical and heavy industries to try and develop domestic

technological capability. But this strategy has not been particularly successful. Of all ASEAN members, Malaysia is the only one that tried to design and manufacture its own indigenous automobile. Proton, one of two state-owned automobile manufacturers, was promoted by one of the largest state-owned conglomerate groups. Proton did start exporting cars to the U.K. in the 1980s, but was not able to retain its competitive edge. The company struggled to remain profitable and eventually a significant stake was sold to Geely from China in 2017. Malaysia has also made more extensive use than Thailand of sector-focused development finance institutions that have played an active role in directing credit towards the development of local manufacturing capability. In addition, the country has channelled some of its oil wealth into sovereign funds of various kinds such as Khazana and PNB, to make capital available for investments seen to be of strategic national importance. This approach, however, has not been particularly successful in accelerating the country's industrial transformation. Much of the dynamism of Malaysia's manufacturing sector comes from the efforts of the ethnic Chinese and Indian business communities who have helped Malaysia break into middle tech industry segments such as computers, IT equipment and electrical machinery in partnership with foreign investors. That momentum was rudely disrupted by the AFC of 1997. But the country began to lose its focus on industrial policy when the state machinery got increasingly distracted by the pursuit of the socio-political goal of extending Bhumiputra ownership control over commercial activity rather than systematically building the economy's dynamic comparative advantage. After Mahathir Mohammad's departure, this political agenda gradually became conflated with the interests of UMNO party members and their acolytes rather than those of the wider Malay community. By the time Najib took over as Prime Minister, corruption blurred the lines between community and private enrichment. Meanwhile, the Malaysian economic bureaucracy seems to have lost the sense of national purpose that it once possessed. As a result, the Malaysian development state is treading water, and in terms of technological capability the country seems mired in a low equilibrium trap – the so-called middle-income trap.

Indonesia is in many respects a story that is like Malaysia when it comes to the role and evolution of the development state. It has also used state-owned enterprises, outside the government-controlled oil sector, as the main vehicle for industrial policy. These state owned enterprises (SOEs) have been concentrated in agricultural processing and heavy industry – notably steel, and have been supported with credit from state owned banks. The most technologically ambitious foray of the Indonesians has been in the aircraft industry. Indonesia is the only Southeast Asian country with complex aircraft manufacturing capability. Two companies, Dirgantara Indonesia, a state controlled joint venture with Korean Aerospace, and RAI a private company – manufacture a variety of small aircraft and helicopters for mostly local airlines. But the industry has been struggling because of shortage of skilled labour and a supporting ecosystem of suppliers. Unlike Korea and Taiwan, Indonesia has failed to make significant investment in higher technical education nor has it been systematic in nurturing a national innovation system. The economic bureaucracy's autonomy had begun to erode in the face of an increasingly corrupt Suharto regime. The 1997 AFC then delivered a sharp blow that was a major setback for the Indonesian developmental state. Since the fall of the Suharto regime, and in parallel with the country's democratisation process, the state bureaucracy has been radically decentralised and has

been subject to several reform efforts. Progress in terms of professionalisation has been slow with senior levels of the central bureaucracy much less focused than before on industrial policy. The reality is that the country's commodity wealth provides it with a comfortable cushion that makes the more ambitious goal of technological self-reliance a lower priority. The signs are that Indonesia is defaulting to the comfort zone of the 'low road' to economic development – one that relies on a combination of natural resource based and labour cost based comparative advantage.

The Singapore Exception

Amongst the late industrializers in Southeast Asia, Singapore is a noteworthy outlier that is worth examining. It is true that because of its small size, Singapore's challenge has been very different from the rest of Asia. It would be unwise to dismiss its experience as irrelevant for the rest of us. A bit like Taiwan, Singapore faced an existential threat from the moment it was born. As the British departed the region in 1963, precisely in view of its small size, the island opted to remain part of the Malayan Federation. But because of the fear of domination by a predominantly Chinese population, the Malays forced Singapore to exit the Federation in 1965. This tumultuous birth and the precariousness of Singapore's position imparted a sense of political and economic urgency that was, similar to what we saw in the case of Korea and Taiwan, a critical driving force for the development state. Lee Kuan Yew's association with anticolonial activism in England at a time when socialist ideas were at a peak left a deep impression on him about the importance of social policy and the role of state-led industrialisation. His own technocratic background and his reading of Chinese history anchored his belief in the stewardship function of a meritocratic elite. The Political Action Party was built on the basis of this principle with candidates for leadership roles in the party selected for their academic excellence (Vogel, 1991, p. 76).

Singapore's industrialisation strategy was led by the Economic Development Board (EDB) that survives, albeit in a role that has evolved, even today. In view of the limited domestic entrepreneurial talent and the lack of a market, the goal was to attract high quality multinationals to locate in Singapore. Singapore was the first in the region to build an export oriented industrial park – Jurong Park became operational in 1961, investing quickly and heavily in parallel to raise educational standards in the island nation. The state also nurtured several state- controlled enterprises in key sectors managed directly by the economic bureaucracy, but subject to commercial discipline. A form of technocratic entrepreneurialism was born, which one Singapore politician described as "capitalism with socialist characteristics''. With the PAP firmly in control under the charismatic leadership of Prime Minister Lee, "politics disappeared, and Singapore became a bureaucratic state." (Heng-chee, as cited in Vogel, 1991, p. 77) In the early years, Singapore did create a few national champions in heavy industry, steel, petrochemicals, in its bid to build a deeper domestic manufacturing capability. Over time, with a rapidly moving global technology frontier, it focused increasingly on capturing the spillover effects of FDI as effectively as possible. In the late 1970s it phased out subsidies for labour intensive manufacturing and set up

the National Wage Council, the Skill Development Fund and the Productivity and Standards Board to link wage growth to productivity improvement. In parallel, the Government spent heavily to develop transport and telecommunications infrastructure of the highest standard and to improve the quality and technical education of the local workforce. It then actively wooed global companies in higher tech sectors to locate in Singapore, while not insisting on ownership control or even joint venture partnership with local companies. It thus created a coveted hub for locating international businesses, which in turn attracted top quality talent and expertise from around the world. As the networking effects of this strategy gained momentum, it helped create high quality jobs in Singapore, allowing locals to enjoy higher wages in higher value-added industry segments.

The Singaporean developmental state is very much alive and has adapted itself to address the challenges of a post-industrial future. The government continues to guide and nurture the development of the country's dynamic comparative advantage. In this quest, it enjoys the strategic advantage of having accumulated very substantial foreign exchange surpluses. The funds managed by Temasek and GIC can be deployed not just to deliver a suitable financial return for Singapore, but also, a bit like the Chinese, to strategically acquire IP through international acquisitions. Whether it was the launch of the casino industry or the F1 racing circuit, Singapore is continually re-inventing itself. The bet that is still playing out, Singapore as a centre for quality higher education, R&D, innovation, and venture capital.[34]

[34] Singapore's strategic positioning has many similarities with Israel which has also, through state-business collaboration, positioned itself as a global R&D hub.

4. Harnessing Markets: The Northeast Asian High Road

The Japanese post-war economic model was fashioned on a theory of dynamic comparative advantage that posited that a country's export capabilities would evolve over time from primary to consumer and then to capital goods exports. The strategy called for the acquisition and internalisation of technological capability assisted by a government-led industrial policy. As the country worked its way up the curve of technological capability its comparative advantage would move to progressively higher value-added exports, leaving the less sophisticated exports to be pursued to lesser sophisticated economies in a "flying geese" pattern of regional economic growth. Indeed, South Korea and Taiwan followed in Japan's wake, and all saw dramatically rising levels of economic prosperity as they too pursued their immensely successful strategies of export-oriented manufacturing-led growth. What took these countries a little over two decades to deliver in terms of advancement in per capita GDP and export prowess in the world markets, took the U.S and the U.K. more than a century.

A debate has dragged on between neo-liberal/neo-con economists on the one hand and institutionalists on the other about what factors best explain the extraordinary post-War economic performance of East Asian economies. The neo-liberals claim that other than ensuring macro-economic stability, activist government policy had at best a marginal impact on the success of these economies.[35] Some neo-liberals reluctantly concede that to the extent that government intervention did matter, it was only to address market failure or to neutralise the pernicious consequences of price distortions. In an important report on the East Asian Miracle, the World Bank tried to glean lessons from the success of these economies.[36] Thanks in part to the contributions of Nobel Laureate Joseph Stiglitz who was one of the authors of that seminal report, the World Bank did take note of the constructive role that the government played in making the Miracle happen.

In addition to paying mandatory respect to the virtue of "macroeconomic stability", trade liberalisation and the "elimination of price distortions" the importance of investments in primary and secondary education were noted. But more significantly, the report conceded that "the institutional context in which policies are implemented is as important to their success or failure as the policies themselves." In a separate paper, Stiglitz (1996) points out that in East Asia the government was able to play a vital role as a catalyst. The government complemented the market, not substituted for it. It never became the engine of growth but was always an effective facilitator. Other institutionalists, including Rodrik, Subramanian and Trebbi (2002), go further and argue that the quality of institutions is key for economic growth . Whatever their ideological predilections, it would be hard for anyone to refute that governments in East Asia used industrial policy to play an

[35] This view is based on statistical analyses (Krugman, 1994 and Young, 1995 for example) that find that the bulk of the 'miracle' is explained simply by higher capital and labour inputs and the acquisition of technology. After taking these into account there is no meaningful unexplained 'residual' that could be assigned to miracle government policies in a standard Solow neoclassical growth model.

[36] This report examines the experience of a wider range of countries that include Hong Kong and the economies of Souteast Asia. In fact the depth and nature of state engagement in industrial policy in these other countries is quite different from North East Asia. I will consider their case later.

active role in economic management. In fact, the role of industrial policy in these countries went far beyond the minimalist state recommended by the neocons.

Creating a National Innovation System

As Amsden (2001) has shown, the distinctive feature about industrial policy in these countries was a system of reciprocity, whereby domestic enterprises were given access to special benefits in exchange for delivering measurable results, notably in terms, for example, of export targets and domestic content requirements.[37] The package of special benefits mostly included selective duty exemptions and drawbacks on imported intermediate inputs for manufacturing, and selective protection, subsidies and tax rebates for targeted sectors. In addition, development banks and/or government controlled commercial banks were used to provide targeted access to concessional long-term credit. The goal of the economic bureaucracy was to deploy a 'reciprocal control mechanism' using conditional, performance-linked government support to help domestic enterprises overcome obstacles to technology absorption.

The key to catch-up lies in technology. The First Wave of Industrialisation that placed Britain in a leadership position in the 18th century was powered by invention. The Second Wave that allowed the U.S and Germany to catch up and then overtake Britain was powered more by proprietary innovation or the ability to successfully harness technology for commercial use than the ability to necessarily invent new technologies.[38] Late industrializers trying to catch- up in the 20th century were trying to compete in a world where technologies for basic and intermediate manufacturing were already fully commercialised in other countries. (Amsden, 2001). Contrary to what models of neo-classical growth theory assume, technology transfer does not happen by simply purchasing capital goods or licence agreements. Information transfer is not the same as the transfer of knowledge. Production, project execution and innovation are capabilities that remain proprietary to the incumbent. These skills cannot be purchased by an aspiring competitor, they must be learned. As international competition intensifies, incumbents become more reluctant to share their know-how, creating an imperfect market for knowledge. And as the global technological frontier itself keeps moving outward with time, barriers to learning tend to become *de facto* barriers to entry for potential newcomers. It is not unreasonable, therefore, to expect that the "later a country industrialises the harder it is for it to catch-up." (Amsden, 2001)

Under these circumstances manufacturing at international prices, i.e., under a free trade regime, is not profitable for newcomers even in labour intensive activities in which they are theoretically expected to enjoy a comparative advantage. The Northeast Asian latecomers found that manufacturing activity in export processing zones, despite access to duty free imported inputs and sensible exchange rate policies, was not internationally competitive except in the most labour-intensive industry segments such as apparel. Even in the case of textiles, for example, Korean firms in the post-War years were not able to compete with the Japanese despite the

---

[37] Amsden is the most eloquent of the inductive institutionalists, eschewing sociological/anthropological explanations for the Miracle, but relying rather on finding common threads emerging from rigorous case studies.
[38] The steam engine is an example of an invention; the production-line is an innovation. The former gave Britain control over sea transportation and the latter was the trigger for America's large-scale manufacturing boom.

latter's much higher wage levels because of very low per-worker productivity. To make their exporters competitive in the face of these entry barriers, late-industrializers offered duty drawbacks on import inputs embodied in exports. This helped exporters compete internationally in labour-intensive sectors but did not lead to dynamic diversification of domestic capability.

The late industrializers of Northeast Asia understood that exploiting a comparative advantage rooted in just the lower wage cost of labour would not be sufficient. In order to develop a sustainable competitive edge, they needed to keep moving up the value-added chain of dynamic comparative advantage in the so- called 'flying geese' pattern. This meant acquiring the ability to continually drive improvements in labour productivity to keep per unit costs of production below the competition, even in the face of rising real domestic wages. To achieve this, they needed first to master the skill of integrating technology embodied in imported capital goods and technology licence agreements into shop-floor processes for manufacturing at scale. Japan, Korea and Taiwan certainly developed this capability. They got there by offering more targeted support for industry using a principle of reciprocity enforced with discipline. Thus subsidies, the right to sell in selectively tariff-protected domestic markets, duty rebates on deemed imports of intermediate inputs, and access to concessional credit were all offered to domestic firms, but only in exchange for delivery on measurable performance outcomes such as export targets, local content requirements, target debt-equity ratios etc.

The Northeast Asians did not stop here. They pushed further to internalise purchased technological knowhow to enable indigenous production of previously imported capital goods. As industries started moving up the value-added chain, the performance standards deployed as part of industrial policy's 'reciprocal control mechanism' shifted to R&D. So, for instance, special benefits were granted to firms in exchange for meeting targets for employment of technical staff or share of new more technology intensive products in total sales. The focus of state engagement was on creating a *national innovation system* and an export culture with the explicit goal of developing an advanced indigenous industrial capability. This is what Amsden has aptly termed the 'high road' to prosperity – the path to independent techno-industrial capability.

To get a fuller appreciation of the role of the state in delivering economic transformation we should note that while the 'reciprocal control mechanism' was core to the state's initiative, it was not the only initiative. The state contributed in two other important respects: by developing and continually upgrading high quality physical infrastructure, especially the energy, transportation and communications infrastructure; and by investing heavily in education at all levels, but especially in developing managerial and technical/engineering capability.

The Japanese government made consistent use of their control over postal savings to fund infrastructure investments through the Fiscal Investment Loan Program (FILP). That Japan has world class physical infrastructure can hardly be in doubt. If anything, with "bridges to nowhere", Japan has been accused of over investing in infrastructure. With lower levels of domestic savings, the Korean government did not hesitate to take on debt to finance infrastructure spending. Between 1964 and 1971, the share of transportation, communications, electricity, gas, and water in GDP grew 100 percent and the share of public debt to GDP went from 6.57 to 11.27 percent

(IMF, 2023). During these years the public sector consolidated fiscal deficit was on average 3 to 4 percent of GDP. Similarly, in support of the 'big push' to heavy industry, the Korean government ran large fiscal deficits, with a disproportionately large share of the spending directed towards infrastructure development. Taiwan calibrated its investments and paced its public infrastructure development with economic growth and the related expansion of the government's revenue base. It focused on essential road and agricultural infrastructure in the 1950s and 1960. It then turned to highway development, railways, ports, and nuclear power in the 1970s, as part of its plan for Ten Major Development Projects. After completing these projects in 1979, the Taiwanese government took on another twelve infrastructure projects of national importance and launched another fourteen in 1985. In the case of all three countries the provision of facilitating infrastructure became a progressively more important tool for supporting industrial transformation, as their reliance on more intrusive tools declined with 'liberalisation'.

Given rising complexity and technological advancement, it should be intuitively evident that to succeed later stage industrializers need to invest more heavily in educating their labour force than their historical predecessors. Over time, industry has become generally more demanding of managerial, technical and shop floor skills. The ability to assimilate new technologies into production processes that often span supply chains straddling different geographies has become vital to success in high-end manufacturing over time. The availability of salaried managers, engineers and more technically adept shop-floor managers has become key for manufacturing at scale as production technologies have become more sophisticated and product quality standards have become more demanding.

Northeast Asian countries invested heavily in primary, secondary and post-secondary technical and engineering education. Over the past 40 years, Taiwan on average allocated more than 15 percent of government spending to education (Taiwan Ministry of Finance). Public education from primary to junior secondary levels became compulsory in 1968 and Taiwan enjoys some of the best test scores in the world, well above the OECD average, especially in maths and science. More than 45 percent of the country's population between 25 and 64 years old are college graduates. As a result, the work force has delivered a steady supply of skilled labour for higher-tech manufacturing, but it has also produced the requisite number of engineers and managers to allow smaller family-owned companies to build the capability to master modern industrial product and process design to manufacture for the world markets at scale.

This is the story of companies like Acer in high-end electronics, and Leadwell in NMC machine-tools. Korea demonstrated levels of educational attainment higher than expected for its level of GDP per capita as early as the mid-1960s. (Amsden, 1992, p. 217) Between 1965 and the late 1970s, the share of students enrolled in secondary education as a percentage of population in that age group more than doubled from 29 percent to almost 70 percent, and the share of students enrolled in college also grew dramatically. Samsung would not be where it is today in telecommunications without access to high quality domestic engineering and professional management. Japan invested in education a couple of decades or so before Taiwan and Korea, and was able immediately following the War to help the *zaibatsu* pivot from an entrepreneur centric management culture to one more reliant on a class of salaried managers and engineers.

Korean Catch-Up

I first visited Korea in search of investment opportunities on behalf of a private equity firm in the aftermath of the Asian Financial Crisis of 1997-98. The crisis had badly damaged the Korean banking system and the IMF had to put together a $60 billion bail-out package, the first for any OECD member since the early post-War interventions in southern Europe. What was striking was the sense of bruised national pride that one encountered and a general resistance to foreign ownership. The Korean government stepped in to create a new government-owned bank that was made the repository for the bulk of the banking system's bad assets. In so doing it prevented large swathes of the country's banking system from falling into the hands of foreign strategic investors. Following the crisis, foreign ownership of Korea's banking system did increase substantially; some banks recapitalised by raising equity from a range of institutional investors in a manner that kept management control with the Koreans.

Now imagine the situation in Korea after the War. The country had been under Japanese colonial rule for more than five decades. Korea was used by the Japanese primarily as a source for agricultural produce. No Koreans were allowed to participate in the colony's governance. The Japanese occupiers deprived the Korean peasantry of any ownership rights to land, formal title to which was conferred upon the local landlord class. The Japanese left a country in turmoil, with a restive and impoverished peasantry pitted against landowners. And soon thereafter the country was dragged into the dynamics of the Cold War that had a communist supported North fighting against an American supported South. The Korean War ended in 1953 with the country artificially bifurcated at the 38th Parallel; Seoul is only minutes' drive south from the Demilitarised Zone (DMZ). The South Korea that emerged was in shambles, with Korea's GDP per capita was lower than India's at the time. Its capital stock had been largely destroyed and the male population seriously depleted. To gain popular grass roots support in their battle against the North during the Occupation, the Americans pushed through draconian land reforms re-distributing land back to the tiller. This did wonders for restoring some balance to the hitherto highly unequal distribution of income. By then, the Americans also transferred power to the non-Communist KDP, a party drawn from the old elite, many of whom had collaborated with the Japanese. Syngman Rhee's First Republic did a poor job of restoring economic and political stability. The Korean military, the other legacy left behind by the Americans, finally stepped in with a coup in 1961 led by Park Chung Hee. Park quickly took control and put in place a highly centralised bureaucracy. It was in this context that Korean industrial policy was born.

Korea set up its own Economic Planning Board (EPB) and the Ministry of Trade and Industry (MTI) took on a role like that of Japan's MITI and its Enterprise Bureau relying on the same five pillars as the bulwark of its industrial policy. MTI established the Korean Institute of Science and Technology (KIST) to manage access to foreign technology, and for commercial intelligence on export markets it set up the Korea Overseas Trade Association (KOTRA). To allocate concessional capital to target industries MTI worked closely with the Korean Development Bank (KDB) and with the commercial banks which, in the case of Korea, were all nationalised following the military

coup and remained under government control until the mid-1980s. Korea's economic bureaucracy was more centralised and controlling than Japan's post-War MITI. Korea's EPB, for example, handed down much more detailed directives to industry than the indicative plans of Japan's EPA in the 1950s. Korea's plans for industry were more akin to pre-War Japan's sector specific control laws.

EPB and MTI started their multi-faceted and continually evolving engagement with industrial policy in earnest in the early 1960s. The first five-year plans pursued a directional change from light to heavy industry. During this period the MTI instigated imports substitution in cement, fertilisers, and synthetic fibres. The government led the way to launch the country's first large shipyard and built the nation's first integrated iron and steel mill using Japanese technology. This is how state owned POSCO was born and was nurtured to become by the mid-1980s "arguably the world's most efficient producer of steel" (World Bank, 1987). Also, with the Heavy and Chemicals Industry Development Plan of 1973, EPB and MTI led Korea's 'big push' into heavy machinery manufacturing and oil refining. In 1974, they orchestrated the country's entry into automobiles and electronics with the Eight Year Electronics Industry Development Plan, the Automobile Industry Plan, and a complementary plan for the promotion of auto-parts. And in 1982 they set the stage for the Korean industry's push into high-end electronics with the Long-Term Semiconductor Industry Promotion Plan.

Korea being smaller than Japan, and with access to a much more modest domestic market, the government focused on setting granular export targets for the companies that they chose to support. In fact, the heart of the government's 'reciprocal control mechanism'[39] was government support in exchange for meeting export targets. Such was the obsession with exports that MTI used to share export volume data daily with the Blue House -- President's Office. This export culture driven by continual exhortation from the top down helped push Korea's export to GDP ratio from 5 percent in the early 1960s to over 35 percent by the mid-1980s.

The export support measures included, but were not limited to, duty rebates and exemptions on imported inputs, tax relief of various kinds, as well as direct and indirect subsidies. During the 1960s, although the average legal import duty was about 60 percent, local firms enjoyed rebates or exemptions on more than three-quarters of the total value of imports. As a result, the estimated effective tariff, net of rebates and exemptions, was a relatively modest 14 percent. During the 'big push' years, the effective tariff rose quite substantially as the government sought to develop locally manufactured machinery to substitute for intermediate and capital-intensive imported inputs. And throughout this period the government made targeted use of non-tariff barriers (NTBs) in support of industrial policy. By the late 1990s, however, Korea's import substitution policies had run their course. Partly in response to pressure from trading partners, particularly the U.S., the average level of legal import duties declined to under 10 percent by the early 2000s and the use of NTBs was substantially reduced (Lee et al, 2022).

Arguably, the most important support for exports was access to concessional credit. Korea was a capital short economy with relatively low levels of domestic savings and high real interest rates in

[39] This is a term popularised by Amsden (2001)

the 1960s and 70s. In such a context, allocation of subsidised financing from KDB and nationalised domestic banks and privileged access to lower cost overseas borrowing was a huge benefit that was conferred to target industries and companies. It is hard to quantify the extent of total government support for exports, but it is estimated that this could have been the equivalent of about 5 percent of GDP during the 1960s and 70s (Amsden, 1992).

As noted earlier, a notable aspect of Korean industrial policy was their determination to keep foreign ownership, particularly Japanese ownership of industry, to a minimum. Park Chung Hee's speeches are full of references to 'self-sufficiency', a national objective with broad-based emotional appeal. Thus, Korean businesses were not only expected to deliver on ambitious export targets, but also on stiff local content requirements intended to build broader domestic capability and a local 'innovation system'. To facilitate the latter, the government provided active support for the acquisition of foreign technology, through licensing agreements, rather than through FDI. Moreover, the government invested heavily in a network of research institutes to help local businesses assimilate foreign technology, learn to reverse engineer, and then to develop their own design capability. KIST and KIET (Korean Institute of Engineering Technology) were deployed for this purpose until the *chaebol* developed enough financial muscle to pursue R&D on their own. The resulting transformation of Korean industry was dramatic. Over the decade of the 1970s, the share of heavy industry in manufacturing went from 40 to 56 percent and its share in exports tripled. And throughout the share of FDI in GDP remained below a modest 0.5 percent (Amsden, 1992, p. 77).

As was the case in Japan, Korea focused initially on support to the country's textile weaving and spinning industry. The goal then was to ensure that Korean firms caught up with Japan whose cotton textile manufacturers were more cost-efficient despite paying higher wages. The Koreans were able to break through in the textiles sector only with the advent of synthetic fibre. The Korean government had nurtured the development of the chemical fibre industry early and then nudged local firms to start weaving mixed fabrics using imported cotton and locally manufactured synthetic yarn in exchange for heavily subsidised access to upgraded technology. This became hugely successful in driving the country's export performance and helped Korea surpass Japan in the global market for textile exports. By the late-1960s, textiles accounted for almost 25 percent of GDP and about 33 percent of the country's exports (Park, 1997).[40] However, this initial success could not be parlayed into other higher value-added export sectors. Korea's hugely profitable textiles exporters lacked the necessary engineering capability to pivot successfully to other manufactures. Diversification into more capital-intensive manufacturing was achieved in the 1970s by companies such as Hyundai that were early beneficiaries of government efforts to support the development of heavy industries.

Like their Japanese counterparts, Korean industrial policy too had a distinctly corporatist flavour -- it systematically favoured large over small firms.[41] MTI worked hard to nurture the *chaebol*, business groups that had grown in breadth and depth during the later years of Japanese colonial

[40] Korean Federation of Textile Industry, 1976

[41] As in Japan, small firms did less on the export front, but formed part of the domestic supply chain of the conglomerates.

rule by exploiting opportunities to feed the Japanese economy's war effort. The founder of the Hyundai Group, for example, made his initial fortune in the pre-War construction business. He then cut his teeth in cement production during the early post-War period before the company was picked by MTI for its manufacturing experience as one of three 'national champions' to spearhead the country's push into the automobile industry in the early 1970s. The goal set by MTI was for these firms to achieve 90 percent local content by the end of the decade and achieve target levels of exports to ASEAN and other selected markets. MTI kept Hyundai and the other two, Kia and GM Korea, on a tight performance- linked leash, intervening, as they did in 1980, to rationalise the industry if things did not go to plan. By the mid-1980s, Hyundai had established itself as a serious new contender in the U.S. car market. And as it earned the confidence of the government, the Hyundai Group was encouraged to build on its heavy engineering capability to also enter shipbuilding for which it received generous, but time bound support. By the 1990s Hyundai Heavy Industries was the largest shipbuilder in the country, ahead of Samsung and Daewoo, and Korea had displaced Japan to become the largest shipbuilder in the world (Amsden, 1992). Korean shipbuilders did phenomenally well during the commodities boom of the early years of the millennium. But they would not have been able to take advantage of this boom were it not for the agile interventions of the government that used government banks such as the KDB to help industry participants survive through the lean 1980s. Daewoo, which had become especially burdened with debt, had to be bailed out in the late 1980s and then again in the wake of the Asian financial crisis in the late 1990s (Amsden, 1992).

The trajectory of the Korean electronics industry is similarly instructive.[42] The Korean government grasped the importance of semiconductors early and identified it as one of the first sectors into which FDI was specifically invited in the 1960s from the likes of Fairchild and Motorola. Over the next decade, the government invested heavily in building the domestic ecosystem to help local firms develop their own capabilities in the sector. KIET was tasked with catalysing semiconductor R&D in the country. It also imported foreign technologies and disseminated them to local firms through technical assistance programs. It helped local firms negotiate technology transfer agreements and even procured skills and talent for them from Silicon Valley. Then after launching the Long- Term Semiconductor Industry Promotion Plan in 1982, the government went all out to encourage a select number of well capitalised *chaebol*, notably Samsung and Goldstar, to make large investments in high-end chip manufacturing in exchange for boosting their telecom profits through selective and targeted protection. This had the desired effect and by the late 1980s, the *chaebol* had acquired significant capability in advanced semiconductors. Samsung emerged as the market leader, shipping over a million one megabit DRAMs a month to American computer makers keen to reduce their dependence on Japanese suppliers. Korea is now the world's second largest manufacturer of semiconductors with more than a 16 percent share of the overall global market and a close to 60 percent share in memory chips.

What should be evident from the foregoing is that the state bureaucracy played a critical role in the transformation of the Korean economy. In fact, every major structural shift during the 1960s,70s and 80s in Korea was driven by the state's activist industrial policy.

[42] I draw largely on Robert Wade, 1990 for this segment.

Taiwan's Transformation

Taiwan's post-War predicament was no less dramatic than that of Korea's. As the War ended, the Republic of China, under the official control of the Kuomintang (KMT), was handed administrative control over the island by the United Nations Relief and Rehabilitation Administration in October 1945. At the time, the KMT were fighting a civil war against Mao's Communists. By late 1948 when it became evident that the Communists would prevail, Chang Kai Shek masterminded the retreat of the Nationalists to Taiwan. Over the course of more than a year, by some estimates over two million troops and civilian refugees, a 100 million tons of gold bullion, antiquities, the entire Air Force and naval vessels then at the disposal of the ROC were moved to Taiwan. It is said that 50-60 flights a day were deployed to move fuel, munitions, and soldiers from the mainland to the island of Taiwan. These were the conditions under which the Nationalists set up their new administration. Chang Kai-shek and the bureaucratic machinery of state that the Nationalists created was determined to place the humiliation of their defeat behind them.

The 'dynamic duo' of Taiwan's economic bureaucracy overseeing the country's industrial policy were the Economic and Planning Development Board (EPDB) and the Industrial Development Bureau (IDB). The former set broad macroeconomic targets that were indicative in nature, but more importantly, it served as a key advisor to Cabinet outside the ordinary machinery of government. The IDB, much like the Enterprise Board of MITI in Japan, carried responsibility for managing Taiwan's version of the 'reciprocal control mechanism', which comprised the familiar array of policy instruments including selective import protection, tax and duty rebates, and subsidies. The most popular instrument in Taiwan's industrial policy tool-kit was rebates on duties payable on imported inputs (Wade, 1990, p. 119).[43] The country moved from a regime of generally high tariff and non-tariff barriers on imports in the 1950s to progressively lower levels of protection. Over the 1970s and 80s, Taiwan's tariffs and NTBs were applied broadly in a cascading structure whereby the upstream intermediate and capital goods sectors targeted as part industrial policy over the 1970s and 80s were the most protected. By the 1990s, as in Korea and Japan, the Taiwanese trade regime was 'liberalised', and IDB reliance on tariffs and NTBs was much reduced.

Compared to the Japanese and Korean cases, the Taiwanese experience with industrial policy had several distinctive features. Taiwan made greater use of duty-free export processing zones (EPZs) for developing their export capability than either Japan or Korea. Three EPZs were set up in the second half of the 1960s: two in Kaohsiung and one in Taichung. The Hsinchu Science and Industry Park that was set up a decade later was not a traditional EPZ, focused as it was on creating agglomeration economies for a network of high-tech companies collaborating with ESRO. The EPZs together accounted for about 8 percent of Taiwanese exports during the 1970s and early

[43] By some estimates, incentives for exports, delivered primarily in the form of rebates on, exceeded 10 percent of the gross value of exports in the 1970s. Wade, pp 119

1980s.[44] Thereafter their contribution declined as Taiwan developed more sophisticated and globally competitive domestic industrial capability.

Taiwan did not have any large domestic firms comparable to the *zaibatsu* and the *chaebol*. At the end of the War, the government took over firms that the Japanese had abandoned. Consequently, in the early years, state owned enterprises played a much more prominent role in the industrial transformation of the country. In many instances the government led by investing in joint ventures with muscular international partners and brought several domestic firms to invest alongside. Such JVs were then used to facilitate technology transfers to the domestic firms in the consortium. This is how Taiwan's entry into the synthetic fibre industry was orchestrated. The Taiwanese government started a joint venture with an American firm for rayon manufacture. This JV then floated another one with a Japanese company for the manufacture of nylon fibre. Domestic firms entered the industry thereafter and by the mid-1970s there were more than twenty local manufacturers of size. Another model used was that of state-owned joint ventures in upstream sectors acting as the anchor for the development of smaller domestic players in down-stream activities. This is how the Taiwanese plastics and machine tools industries developed. The government owned China Petroleum Corporation's joint venture for polyethylene manufacture helped downstream PVC firms such as Nanya Plastics of the Formosa Group become significant international players. Similarly, government owned China Steel helped Taiwan's machine tool industry find its feet. Over time, except in strategic sectors, the government transferred management control over to private domestic players.

Much more than either Japan or Korea, Taiwanese exports were dominated by smaller firms (Wade, 1990).[45] Taiwan made most effective use of state-owned R&D platforms to help such firms break into export markets. The flagship for this approach was the Industrial Technology Research Institute (ITRI) set up in 1973 with several institutes operating under its umbrella focused on civilian technologies in various sectors including electronics, machinery, and chemical engineering amongst others. These institutes were mandated to develop sectoral R&D capability, incubate technologies, and facilitate their diffusion amongst domestic firms. A similar research platform was created for military technologies and worked in close association with select state owned manufacturing enterprises. The Hsinchu Science-based Industry Park was set up in 1980 to incubate smaller high-tech companies by offering them government investment of up to 49 percent and an opportunity to collaborate with co-located ITRI research laboratories.

The Electronics and Services Research Organisation (ESRO) created as part of Information and Electronics Industry Development Plan 1980-89, played an especially important role in the launch of the country's semiconductor and advanced electronics sectors. It incubated new technologies and then found domestic firms to absorb them. It trained micro-electronics engineers, and helped local firms gain access to key technologies and even talent. ESRO played a key role in creating Taiwan Semiconductors Manufacturing Corporation (TSMC), which established the country as an important international player for the manufacture of large capacity (VLSI) chips. Similarly, firms

[44] In comparison Korea had two export processing zones whose contribution to exports was under 3 percent of the country's total in 1985. See World Bank, PRS, 1992.
[45] In the mid-1980s, more than two-thirds of exports were from companies with less than 300 employees.

like Acer would not have been successful without early support from ESRO. ESRO gave the PCs and peripherals industry a big boost by incubating and then sharing key technologies with domestic firms and by helping build local design capability. Other than R&D, government agencies also helped smaller firms with quality control and with export marketing. Taiwan's Bureau of Commodity Inspection developed a network of sector specific public testing facilities such as the Taiwan Electrical Testing Center and the Plastics Development Center for this purpose that were widely used by Taiwanese exporters to ensure that minimum quality standards were met for export markets. And the China Trade Development Council (CETRA) helped reduce Taiwanese firms' heavy reliance on Japanese trading companies for distribution and marketing.

Taiwan also made effective use of non-government task forces to rally support from various government agencies and nudge domestic firms to adopt certain technologies and penetrate promising sectors early in the game. The Science and Technology Advisory group was able to mobilise different instruments of support to drive the agenda of embedding industrial automation across a range of factories across a range of sectors. This group got the Mechanical Industries Research Laboratories under the ITRI umbrella to focus their R&D on building domestic capability in designing numerically controlled machine tools. The task force prevailed on the IDB to provide fiscal support and selective protection from imports to nurture local NMC machine tools manufacturing capacity. And it deployed various government funds earmarked for innovation or strategic interventions to help local companies defray the initial cost of automating their manufacturing processes. It was in substantial part thanks to support from the task force that the Taiwanese auto component companies were able to embed themselves in the global supply chain. The country's success in developing capability in technology intensive contract manufacturing can be traced back to the work of the task force.

Compared to the Koreans and the Japanese, Taiwan's economic bureaucracy was less centralised and also less directive of industry. This is because the relationship between government and business was different. In Taiwan the mainland Chinese elite that controlled the government were seen as outsiders, having arrived on the island only after the War. The bureaucracy was able to exercise less authority over, and was more suspicious of, local business leaders. Hence the greater reliance on government owned firms to lead industrial transformation. Taiwan was also more open to FDI, especially from the U.S., than either Korea or Japan. The more widespread presence of joint ventures with foreign firms across the industrial landscape is also why Taiwanese economic bureaucracy made use of tax incentives and rebates, rather than directives and 'reciprocal control laws', to nudge decisions of domestic industry. As a result, Taiwanese industry, which is also characterised by smaller average firm-size, is more integrated into the global supply chains of high-tech and high skill industries than either Korea and Japan, both of whom have sought to build their own international supply chains. Foxconn, the very successful Original Equipment Manufacturing (OEM)[46] giant, with contract manufacturing operations all over the world, is a good example of the superior technology-intensive industrial capability that has emerged in Taiwan with help from various initiatives of the state. It is also a good example of the internalisation of

[46] OEM is defined as a company whose products are typically used as non-branded-intermediate inputs in the manufacture of branded finished goods by another company.

Taiwanese industry, which has made excellent use of links with mainland China to drive its penetration into cross-border supply chains.

Finally, coming to the use of concessional credit as a complement to industrial policy, the Taiwanese government has been even more controlling of financial flows than either the Japanese or the Koreans. While Taiwan did not create a development bank quite like JDB or KDB, it made extensive use of government control over the banking system to allocate scarce credit – especially long term credit – to target sectors on preferential and concessional basis. In fact, whereas the banks were never government owned in Japan, and whereas the Koreans had substantially denationalised their banks by 1983, government owned and controlled banks still accounted for 95 percent of the assets of the Taiwanese banking system as late as the mid- 1980s. Interest rates remained substantially regulated and access to foreign banks was still severely restricted. During the 1950s and 60s, the Taiwanese banks were given sectoral credit allocation targets as well as more granular instructions from the economic bureaucracy. Over later years even as the banks were gradually given greater flexibility on credit allocation, the government turned to greater use of special purpose funds – such as the Strategic Industry Fund and the Loan Guarantee Fund -- from budgetary allocations to make concessional funding available to target sectors (Wade, 1990). In other words, Taiwan was much more controlling than either Korea or Japan in its financial system.

5. Chinese State Capitalism

By far the most significant event in the global economy in the 20th century was the decision in 1978 of the Third Plenum of the Chinese Communist Party's Central Committee to abandon collectivised agriculture, a decision that had profound consequences for the lives of over 800 million farmers. In a few short years thereafter, China was able to significantly increase agricultural productivity allowing surplus labour from the farm sector to be deployed in so-called "township and village enterprises" (TVEs). These dynamic small companies powered the first phase of China's boom in low cost export-led manufacturing. China opened the floodgates to Foreign Direct Investment (FDI) from Hong Kong in the early years; and then from the rest of the world. Hong Kong entrepreneurs brought capital, technology, and networks that helped China acquire its initial foothold in the international markets.

I could not have imagined a more radical shift of focus, but it was my good fortune to move from the Africa Department of the World Bank to the China Department. My first ever trip to China was in early 1992, not too long after the Tiananmen Square incident. By then, hopes of any political liberalisation in the wake of the student protests that had been triggered by the death of the detained pro-reform Hu Yaobang General Secretary of the Communist Party in 1989 had pretty much vanished. Deng Xiao Ping was firmly in control and was focused on an economic agenda. The World Bank had offices in the Diaoyutai State Guest House complex, which was generally meant to host state guests. The World Bank Resident Mission was in a distinguished building dating back to 1959, amid beautifully landscaped gardens, complete with a lake and wispy willow trees straight out of a Chinese scroll painting. It was quite a privilege to work in such surroundings and closely, although always on their terms, with our official counterparts, *cái zhèng bù zhǎng* (Minister of Finance), whose main offices were only a few minutes away. The Chinese made very effective use of World Bank expertise in the early years. Later, when they had gotten what they needed from the Bank, the latter's Resident Mission was relegated to a suitably drab office building in Beijing's business district at the other end of town.

A Familiar Obsession: Breaking into Export Markets

In 1992, after about a dozen years of reform experimentation radical changes were already materialising across the country. Over the decade of the 1980s, while Latin America was struggling with its debt crisis, and Sub-Saharan Africa was struggling with similar problems, China's exports tripled, and the share of manufacturing in their exports almost doubled to 80 percent. By way of comparison, the share of manufacturing in India's exports in 2021 was just under 70 percent, and in Brazil's exports was still 25 percent (World Bank, 2023). Like Korea, Taiwan and Japan before them, China had pursued a focused strategy to achieve this goal. In this process, the Chinese government had gone from being a rigid, centralised, state planner to one that played an invaluable role of 'hand-maiden' to an economy becoming progressively market based.

How did they do this? China's foreign trade and investment reforms over the 1980s and 1990s offer an extraordinary case study. Let me share a few specific examples (World Bank, 1994).[47] Until the early 1980s, the Chinese foreign trade system was essentially based on a planning mechanism that controlled all imports and exports. A small number of centrally administered foreign trade corporations (FTCs)[48] were responsible for importing key raw materials in short supply, and for ensuring that enough foreign exchange was generated through planned exports to pay for these imports. Since China had artificially low fixed prices for a range of key domestic raw materials at the time, and its exchange rate was not market determined, FTCs would incur losses in domestic currency for their services. These losses were subsidised by the government. Starting in 1984 the foreign trade system was decentralised, and it gradually became more a 'guidance' plan than a 'command' plan. Provincial subsidiaries of national FTCs were allowed to become independent financial and operating bodies and provincial governments were allowed to set up their own FTCs. All trade still had to be channelled through FTCs most of which were running financial losses. In 1988 FTCs were subject to what was called the system of 'foreign trade contracting'.[49] This system had the effect of mobilising the state machinery, from the central down to provincial level, to make sure that exports grew at a significant clip. It encouraged FTCs to morph themselves into becoming proactive providers of export support services, including marketing, quality control, export promotion, access to export credit, to help the growing number of domestic companies, especially the small size TVEs we alluded to earlier, access international markets. At their peak, fiscal subsidies to FTCs amounted to about 2 percent of GDP (World Bank, 1994, p. 26). As domestic prices were decontrolled and the exchange rate became market determined, these subsidies were phased out, and most FTCs themselves became redundant and disappeared. Meanwhile, China's merchandise exports exploded from 10 percent of GDP in 1980 to more than 30 percent of GDP in 2000 (Fouquin and Hugot, 2016). By then, most of China's exports were deemed to be compliant with international trade regulations and China gained entry into the WTO in 2001.

Second, when Deng Xiao Ping embarked on his Spring Winds tour in 1992, he provided powerful support for market reforms being pursued in China's coastal provinces. One such was the Special Economic Zones (SEZ) and Open Cities. Deng made the deliberate choice to pursue a policy of geographically concentrated growth.[50] By encouraging Guangdong, Fujian, and other coastal provinces to create 'growth-poles', and exploiting economies of agglomeration in special economic zones that offered attractive tax regimes and freedom from regulatory restrictions in place

[47] This section draws on the World Bank report, 'China - Foreign Trade Reform', of which I was principal author.

[48] FTCs were state-owned corporations that had exclusive rights to conduct foreign trade activities. They often acted as middlemen, connecting domestic enterprises to global markets; they bought local products to sell overseas and imported foreign goods to sell in China, and were crucial for China's early years of international trade. They also benefited greatly from Special Economic Zones (SEZs), which involved preferential policies such as tax breaks and relaxed regulation. Over time, municipalities and provinces were also allowed to set up FTCs, leading to their proliferation across the country.

[49] Every province and national level FTC signed a contract with the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) that fixed the amount of domestic currency subsidy they would receive from the central government to cover losses on export sales in exchange for foreign exchange they were expected to remit to the central government.

[50] This meant that had to tolerate growing regional inequality. Later they pursued the strategy of spreading growth from the 'dragon's head', the mouth of the Yangtse on coast to the interior, along the length of the river towards its headwaters.

elsewhere in the country, Deng triggered a cascade of FDI into the country. Although there was undoubtedly some abuse of the SEZ regimes from tax arbitrageurs, the zones became a vital conduit for diffusion of technological know-how, market intelligence, and access to international capital and networks. SEZs were used as experimental laboratories to test schemes and reform initiatives before they 'crossed the bridge' to be introduced to the rest of the economy. By 1984, in addition to the five SEZs, (Shenzhen, Zhuhai, Xiamen, Shantou and Hainan), 14 coastal cities had been designated 'open cities' and several economic and technological development zones (EDTZs) had been created along the southern and eastern seaboard of the country. By 1990, SEZs and Open Cities accounted for two-thirds of Chinese exports and absorbed the bulk of the FDI pouring into the country. Shenzhen, which was a small town of some 600,000 people in 1980, today has a population of 17 million and is viewed as Asia's Silicon Valley. Shenzhen would never have happened were it not for an active strategy of land aggregation and leasing, infrastructure build-out, and marketing, spearheaded first by the provincial government of Guangdong and then by the municipality of Shenzhen itself. Pudong, the special zone outside Shanghai, had similarly humble beginnings. It is today the site of China's premier financial hub.

The Entrepreneurial State

There are other equally important dimensions to the complex nature of state-business interactions in China. One key feature that a lot of outsiders do not grasp about China is the extraordinary degree of decentralised decision making. China is a unitary country, but the degree of decision-making autonomy enjoyed by provincial and municipal governments is remarkable. In all my years of regular travel to China, I was struck by the dynamism of government leadership at the municipal level. Local level leaders were always uniformly enthusiastic about meeting foreigners, whether it was in the mega cities of Shanghai or Guangzhou, or smaller ones like Dalian or Tianjin.[51]. In the early 1990s, all meetings were of course intermediated by an official interpreter and attended by a Communist Party representative as well as a government assigned 'chaperone'. But this changed over time, with meetings becoming much more open. One thing that did not change was the official banquet, the length and number of courses of which signalled the importance that the hosts attached to their guests.[52] The mayor's office typically worked very long days that were mostly taken up in meetings with, and problem solving for, companies, industry representatives already operating, or looking to operate, in their jurisdiction. I have not seen this level of government engagement with industry elsewhere -- not even in Korea and Japan, both of which, as we saw before, are known for their corporatist industrial policies.

That said, this behaviour was markedly different from the comportment of senior level officials in central government ministries who typically came across as more cerebral. Local level officials were almost always keen to enumerate and show- off the growth record of their respective jurisdictions. The numbers on *touzi*, or investment, were particularly important in any introductory remarks. It was as if the entire state machinery had been aligned from top to bottom on making

[51] Small being a relative term given that we are talking about China, given its size and scale

[52] I gather that more recently, since Xi Jin Ping's anti-corruption drive, official banquets has been severely curtailed.

capital accumulation happen. The roots of this phenomenon lie in a key principle of the economic reform process initiated in 1978 at the 11th Congress of Communist Party: administrative decentralisation. It was called *'fan-chuan jiangli'* or 'devolving powers to yield benefits'.[53] Its impact was far reaching.

By way of illustration, China did not have a centralised tax administration, nor did it have the institutional capacity to manage a centralised monetary policy in the early 1990s. Although the central government determined who was to be taxed and how much, collection was left to provincial administrations. This gave *de facto* control over tax policy to the latter. Central government received tax revenues subject to complex 'revenue sharing contracts' with provincial governments, who in turn had similar contracting arrangements with lower levels of government down to the county and municipal levels. This gave huge discretion to lower levels of government. In the early years of reform, county authorities used their limited resources to invest in and nurture TVEs. These were local enterprises that created valuable jobs for workers displaced from farming as it became more productive following de-collectivisation. With FTCs connecting these enterprises to export markets and to investors from Hong Kong, TVEs led the first wave of export market penetration in low-cost manufacturing.

Just as tax collection was decentralised to the county level, so was the allocation of bank credit. Bank credit was dispensed from one of the 15,000 settlement accounts of the People's Bank of China (PBOC) to local level branches of public sector banks supposedly as per centrally fixed 'credit plan'. But after the 1978 reform drive, the local branches of PBOC were highly vulnerable to the 'two mothers-in-law' syndrome: they were easily swayed by local authorities to extend more credit than authorised by the central office of the PBOC. These practices bred a culture of discretionary deal cutting between local government officials and companies operating in their jurisdiction. Local administrators enjoyed huge power to grant tax relief and incentives and credit access not authorised by the centre to favoured enterprises.

Combined with political incentives that seemed to reward growth performance with promotion within the Party, this dynamic drove the 'investment hunger' and capital accumulation that in turn delivered extraordinary GDP growth until well into the 2000s. But this process was not good for macroeconomic stability. Rising inflationary pressure allowed Zhu Rong Ji, Vice Premier in charge of the economy in the critical years of 1990s to push very significant reforms through the 3rd Plenum of the 14th Congress of Community Party in the summer of 1993 that allowed for macro-economic policy to be effectively managed by the central government while leaving local level autonomy on other aspects of economic decision making intact. It was only after 1993 that China got a central tax administration, and that the central government was first able to make decisions on credit creation without influence from local level leaders.

Notwithstanding this essential rebalancing, the culture of local level autonomy remains alive. Based on more recent research, Chang-Tai Hsieh of the Chicago Booth School and colleagues come to conclusions from their research on China's local governments that match my own experience. They argue that although China scores low on any of the traditional metrics of 'economic freedom'

[53] See '*China - Macroeconomic Policy in a Decentralised Economy*' of which I was principal author.

and 'rule of law' that are supposedly important for robust market development, it has nevertheless succeeded in delivering consistently high growth because of the dynamism and administrative capacity of local government officials motivated not only by prospects for political recognition but also by the benefits accruing to them from 'side deals' to facilitate and problem solve for private and quasi-private enterprises (Hsieh et. al, 2019). In fact they argue that cronyism is a foundational pillar for Chinese capitalism. What keeps it from degenerating into a dysfunctional, extractive rent seeking, is that thousands of local governments are competing fiercely with each other to ensure the business success of their respective cronies. The paradoxical result is what you would expect in a market economy: survival of the fittest (Hsieh and Song, 2015). Chery Ltd., backed by Wuhu city from Anhui Province, is amongst the top ten automobile manufacturers in the country. It is promoted by a scrappy promoter who benefitted from a great deal of help from the Wuhu local governments in gaining access to technology, capital, land, and special privileges.

Between 1990 and 2005 the share of private companies, defined as companies in which the controlling share is with non-state owners, in industrial production grew from 50 to 70 percent (State Statistical Bureau, People's Republic of China, 1990; 2005). A large share of these private companies have in fact enjoyed patronage of entrepreneurial government authorities at various levels. Also, many new state-controlled companies were also created between 1997 and 2005, mostly with patronage from entrepreneurial local government officials. And there is compelling evidence that these companies have made a meaningful contribution to GDP growth (Hsieh and Song, 2015). That said, entrepreneurial state engagement has its limitations. More than two decades after Zhu Rongji's re-centralisation reforms were rolled out to restore control over macroeconomic management, Xi Jin Ping is arguably trying once again to reign in the administrative autonomy of lower levels of government through his anti-corruption campaign. China's ranking in the World Bank's Ease of Doing Business Index has improved dramatically as a result. Ironically, this may well turn out to be at the cost of some of the Chinese economy's growth momentum. There is recognition that China's model for state engagement in the economy needs to evolve to a higher level of sophistication from entrepreneurial efforts of local officials to facilitate private and quasi-private business.

National Champions: Evolution of the Strategic State

When the Asian Financial Crisis hit in 1997, a large number of SOEs could not service their debt. With deteriorating asset quality, bank balance sheets were impaired. China took advantage of this turn of events to pursue deep reform of its SOEs. Over the next ten years, more than 80 percent of SOEs were either closed or privatised in the sense that majority ownership shifted to private hands including private strategic investors, institutional or financial investors, or fragmented retail shareholders.[54] Of those that remained under majority state control, about half were restructured and 'corporatised', which meant that they were no longer subject to the obligations and constraints applicable to traditional SOEs despite still being, directly or indirectly, controlled by the state. The slogan for this ambitious reform drive was 'grasp the large, let go of the small'. This was a

[54] Hsieh and Song (2015) have an interesting account of these reforms.

euphemism for aggressive consolidation. What emerged was a much more financially sustainable – even profitable -- public industrial sector characterised by large companies and conglomerate groups with a nationwide footprint. Similar to Korean and Japanese interventions in industrial policy, the Chinese identified national champions in various sectors.

For instance, five large industrial groups were created in the steel sector, three central government owned and two owned by the provincial governments of Hebei and Shandong respectively. The Central government owned BaoSteel is the country's largest steel conglomerate, and controls six steel manufacturers, including the publicly traded Baoshan Steel. The automobile industry is another example of strategic state intervention of this kind. With the 1994 Automobile Sector Policy, the government forced consolidation of a cluttered industry, picking three SOEs as national champions. Beijing government's FAW, Shanghai government's SAIC and Hubei government's Dong Feng were encouraged to form JVs with Volkswagen, GM, and Nissan respectively. In addition, Hyundai also set up operations in partnership with a Beijing government entity. These JVs were subject to foreign ownership restrictions that kept the foreign party's shareholding to under 50 percent in exchange for import protection behind relatively elevated tariffs and measures to contain competition. The latter comprised entry restrictions and controls over product diversification by existing or potential domestic competition. This is how China's SOE backed auto manufacturers thrived.

In 2009, China became the largest auto manufacturer in the world, but the quality of domestically manufactured vehicles remained far behind the global technology frontier – the sector achieved scale, but not advanced indigenous technological capability. The premium end of the domestic auto market has remained completely dominated by imports from Germany, Japan, and the U.S. The government has responded by easing foreign ownership restrictions for auto manufacturing in Free Trade Zones, hoping to embed China in the high-end of the global auto industry's OEM supply chain. Meanwhile, the government has set its sights on trying to leapfrog by trying to create the eco-system for autonomous and electric vehicles as well as shared mobility platforms. It remains to be seen if this will encourage foreign majors to use China as a manufacturing hub for the premium segment of the industry and whether China will be able to break into global export markets for autonomous, and electric vehicles, especially after the growing geo-political tensions between the West and China.

A New Technocratic Elite

The dynamic role of the Chinese bureaucratic state has now expanded to a much more sophisticated network of like-minded elites that are spread across the highest echelons of government, business and the intelligentsia. To better understand this phenomenon, it is important to appreciate how much China has invested in enhancing state capability. With the passing of Mao, it became painfully clear to the Chinese leadership how much China's isolation from the rest of the world had cost them.[55] To a generation of Chinese whose lives were deeply

[55] This lesson must also have carried deep historical resonance from the consequences of previous episodes of Chinese

dislocated by the purges of the Cultural Revolution, and whose perspective was deeply distorted by Maoist propaganda, this came as a huge surprise when they got the opportunity to engage with the world starting in the mid-1970s (Shan, 2019).[56] The appreciation of this reality triggered a relentless focus amongst the Chinese to bridge the knowledge gap with the developed world. The government embarked on a very aggressive program of funding the overseas education of those willing to return to work for the government. They also took full advantage of any and all apprenticeship opportunities overseas for Chinese nationals.

I saw this at the World Bank. Most of our Chinese government counterparts were exceptionally bright individuals who had managed to survive the trauma of the Cultural Revolution through sheer grit and some luck, and then were fortunate to have learned English. Many were self-taught. Others were trained by the government. This gave them the opportunity to gain access to technical training – advanced degrees in the best universities of the Anglo-Saxon world -- which they used to brilliant effect. The Confucian meritocracy was systematically revived with mass training overseas and intense formal and informal engagement with the rest of the world. The best of this lot were then provided important footholds in government, domestic (government affiliated) think tanks and domestic business, an essential part of a wider focused strategy of revitalising the bureaucratic state.[57] This cohort evolved as a result of conscious effort and no doubt also serendipity, into a powerful, technocratic and collaborative elite. And it is no coincidence that the bulk of this elite is connected to, if not co-opted into, the Communist Party. In 2001, 'red capitalists', emerging leaders from the world of private Chinese business, were invited to join the Party and to serve in the National People's Congress, China's highest legislative body. Membership of the Party has since crossed 90 million or more than 6 percent of the country's population.

The Chinese state has not just relied on a foreign educated elite. It has made serious investments to modernise and upgrade its own education system of higher education. Aside from capability in STEM (Science, technology, Engineering and Math), a lot of attention was paid to nurturing higher education in business and economics. China's public expenditure on education was consistently low, hovering below 2 percent of GDP between 1970 and 2000. By 2008, it had almost doubled to 3.5 percent, where it has stayed ever since (World Bank, 2022). By the mid-1990s, in Hong Kong, there were already many young mainland Chinese who had joined the best American investment banks and investment companies. I was at Morgan Stanley at the time and saw how aggressively the Chinese pursued joint-venture opportunities with Wall Street firms as a way of diffusing financial markets expertise and knowhow into the country. By the early 2000s the China operations of all major Wall Street firms were run by mainland Chinese. Similarly, the transformation of China's university system, state-led R&D establishment and its business elite

---

isolationism, notably in the late Ming period, when the narrow near term political concerns led the Ming Emperor to destroy China's entire sea going fleet and close its borders to the rest of the world.

[56] Stories from friends who lived through this traumatic phase in Chinese history

[57] It is remarkable how many of my own counterparts who were mid-level officials in the early 1990s went to hold key positions in government, from Vice Minister of Finance, to Head of Banking Regulatory Authority, Governor of the People's Bank, Manager of the Exchange Reserves; Head of the Capital Markets Regulatory Agency, Head of the Sovereign Fund, Head of the largest PSU Bank, Founder of Asian Infrastructure Bank etc…

has been quite dramatic. The country is a world leader in e-commerce, digital technologies, including especially digital financial services, telecommunications, it is now competing in aviation and space technologies, and it is self-sufficient in military technology. While it may still be behind the U.S. technological capability frontier, the fact that the globally most cited researchers in STEM fields are now all Chinese is surely an indication that the Chinese will give the Americans a run for their money. China is becoming a global leader in many areas of R&D with no shortage of world-class talent, government funding and risk capital. The rise of a network of sophisticated, urbane, highly educated, technocratic elite to positions of influence and power in government, business and the intelligentsia gives us a glimpse into the next phase of China's version of state capitalism.

A few examples illustrate the point. Take the rise of Lenovo, the globally ubiquitous PC manufacturer. It was born in the mid-1980s as a spin off from the Institute of Computing Technology (ICT) of the Chinese Academy of Sciences. It was an experiment in the creation of a class of companies labelled *guoyou minying* – state owned, people managed. The idea was for state mother institutions to back autonomous management teams with equity capital. The company gained initial momentum by commercialising ICT technology for a Chinese language add-on card for PCs. With a dominant domestic market share in this product, the company moved to Hong Kong to gain access to capital, re-incorporating itself as the Legend Computer Group. It then returned to the mainland as a 'foreign investor'. Taking advantage of the associated benefits (pertaining to duty free imported inputs etc.), the company became one of the largest domestic PC manufacturers by the early 1990s. In the face of declining tariffs on PCs, however, Legend found it difficult to compete with the likes of Dell and HP. Other domestic PC manufacturers such as Greatwall, a traditionally organised SOE company, lost their footing at this time. Legend, however, managed to expand its market share even in the face of heightened import competition by developing a nationwide distribution network to which foreign players still did not have direct access. After China's accession to the WTO in 2001 even domestic distribution was opened up to foreign players; this is when Legend decided to internationalise. The company was rebranded as Lenovo and using help from white shoe U.S. private equity investors such as TPG and General Atlantic, it purchased IBM's loss-making PC business. It took a while, but by 2010 Lenovo emerged as the second largest PC company in the world, second only to HP. Liu Chuanzhi, Lenovo's founder, was one of the victims of the Cultural Revolution and spent time being 're-educated' on a farm in rural Hunan province. Like his father before him, he is a member of the Communist Party and served as deputy to the 9th and 10th National People's Congress. The company is listed on the Hong Kong Stock Exchange. Liu's Legend Holdings Corporation owns 34 percent.

Huawei is another example of Chinese state capitalism. It was founded in 1987 by *Ren Zhengfei* who started his career in the engineering corps of the People's Liberation Army, and like *Liu* of Lenovo, is also a member of the Communist Party. As an unlisted company, the company's ownership structure is somewhat opaque. It is a wholly owned subsidiary of a holding company, of which Ren owns less than 2 percent. The rest is owned by the company's labour union, registered with the city of *Shenzhen*. *Shenzhen*, which is where the company is headquartered, does not have any ownership. The union's ownership share is supposed to be nothing more than a proxy form of

employee ownership. Employees own phantom, non-transferable stock, which they must sell back to the company upon exit (Zhong, 2019). The extent of government influence over the company is as opaque as its ownership structure. What we know is that from early on, Huawei eschewed the joint venture path followed by other companies, such as Shanghai Bell, in the telecommunications and ICT sector. The company got its first breakthrough when, building on knowledge gained in part from reverse engineering imported equipment, it developed its own telecom switch. This gave the company an entrée into the business of government contracts. It built the PLA's first national telecom network in 1993 (Chong, 2020). The company grew by avoiding competition from familiar international players – Ericsson, Motorola, Nokia and the like – and by delivering customised network equipment and service propositions for smaller cities and townships in the interior of China. As a private company it did not have ready access to bank financing and had to rely on the high-cost Chinese curb market for credit. And unlike Lenovo, Huawei did not access global private equity funds for capital. Despite these challenges, it managed to invest heavily in R&D, setting up domestic R&D centres in Shanghai and Beijing and expanding its product range.

By 1996, the central government began to take notice and contracted the company to provide mobile telecom solutions and switches to the country's railway system. By the late 1990s, Huawei had emerged as the dominant domestic player in the carrier services and enterprise business segment of the telecom market relying on customisation and aggressive pricing to compete. As competition intensified, with international players seeking mergers and strategic partnerships with local players, Huawei was driven to globalise. It started with emerging markets and Russia, before entering European markets. Innovation at lower cost was the value proposition it offered, often undercutting competition by as much as 30 percent percent. A USD10 billion long term loan from the China Development Bank allowed the company to expand internationally, using the familiar Chinese strategy of trading market share for margins. By 2015, the company had filed for 49,000 patents; it had 170,000 employees, of which a quarter were non-Chinese; and it worked with 45 of the world's largest telecom carriers, with international revenues contributing two thirds of its total income.

Geely Ltd. led by Li Shifun is an interesting example from the automobile sector. Li Shufun, the son of a farmer from rural Zhejiang, has a master's degree in Economics from Yanshan University. From humble beginnings, the company has grown to take significant market share away from SOEs identified as national champions that have established JVs with global majors and backing from central government or powerful municipalities such as Shanghai and Beijing. Geely is now the fourth largest automobile company in China. Although the company remains reportedly "fiercely private" (Campbell, Clover, McGee, 2018), it is impossible to imagine that the company has gotten so far without support from the government. *Li Shifu*, is after all one of the red capitalists that has been co- opted into the Communist Party. The company's growth has been so phenomenal that it has established a significant international presence and acquired impressive R&D capability through acquisitions of global brands including Volvo, Lotus and a 9.7 percent stake in Daimler. So one of the merging patterns for the Chinese in their quest to catch up and indigenize the technology frontier is to use their financial muscle to acquire foreign companies and then integrate them, and absorb their technological capability into the Chinese parent.

Alibaba is as close as any company could come to being a purely private company in China. It is worth examining the company a little more closely for its distinctive features and for better understanding the evolving role of the Chinese state in dealing with this new breed of company in China. *Jack Ma* has been consistent and clear about how the company prioritises stakeholders: he has put customers first, employees second and shareholders third; and he walked the talk (Clark, 2016). The company really began to make money with the take-off of *Taobao*, its subsidiary focused on providing a marketplace for small merchants. *Taobao* was a hit with customers because the service it provides to merchants is free – any merchant can open a storefront with *Taobao* and distribute products for free. *Taobao* makes money from advertising sales to those merchants who want to pay to stand out from the rest.

Unlike Amazon, Alibaba does not buy merchandise to sell to retail customers. It just connects merchants to customers – it is a purely facilitating platform. Rather than disintermediate the small merchant, Alibaba has empowered the small merchant. This is relevant in the context of the Indian debate on e-commerce. Indian e-commerce companies are seen as competitors to the small merchant class, not facilitators. Despite being listed on both the New York and Hong Kong stock exchanges Alibaba management has not been swayed by shareholder pressure for quarterly earnings. *Ma* has been clear that investors who do not like the company's focus on the long term are free to sell his shares. In the aftermath of the GFC in 2008, out of solidarity with small merchants, the company provided discounted services to its customers even at the cost of short-term profits (Clark, 2016). While this is hardly an indicator of the social consciousness of Chinese business in general, it is noteworthy for the signalling effect coming from the country's most valuable private company.

What is the interface between Alibaba and the state? This is a company that has never had access to capital from the state-owned banking system, nor does it have any government ownership. The company took full advantage of access to capital from overseas. In the early days it received a start-up grant from Goldman Sachs, then growth capital from SoftBank. Yahoo became the largest investor in the company after it merged its China operations into Alibaba. A rift, that was later repaired, did develop between Yahoo and the company when the former protested the latter's decision not to support Google in its battle against the Chinese government on censorship. *Ma*, who is a member of the Communist Party, has also been forthright about cooperating with the government on security issues. The company has a market share of nearly 50 percent among China's comprehensive e-commerce retailers (Ma, 2023) and along with WeChat, Alipay comprises a duopoly in the country's e-payments market. As its stature has grown, the government has become more engaged looking to influence and regulate the company. Government public security personnel have been embedded in China's internet companies for a while, focusing on stamping out the spread of mis-information. The city of *Huangzhou*, home to Alibaba and several other high profile private Chinese companies, has recently gone further. It has embedded more government officials into Alibaba ostensibly to smoothen workflow between government and the company. More recently government regulators have fined the company heavily for non-market practices and have restricted the group's access to foreign capital. *Ma* himself has had to tone down his high-profile public image. This is no doubt an attempt by the

government to assert greater control over the country's high tech private businesses that control tons of valuable personal data. It is a reminder to the country's recently minted billionaires about where authority and power really lie. This, and similar regulatory interventions in other tech companies, has scared markets that have become skittish and lost considerable value over the past 2-3 years. It is a reminder that China's model for state engagement with business is still pretty 'old fashioned'.

Infrastructure Binge

Like in other East Asian countries, the Chinese state has invested heavily in energy, communication and transportation infrastructure, with all three key for the development of advanced industrial capability. An important contributor to the international competitiveness of Chinese business has been the development of infrastructure at a massive scale.[58] Infrastructure related fixed capital formation more than doubled from 5.7 percent of GDP in 1998 to over 14 percent in 2006[59], and the share of infrastructure in total investment spending ballooned from well under 20 percent in 1998 to almost one-third of gross capital formation in 2005. The outcome has been spectacular in terms of scale and pace: between 1990 and 2005, power generation capacity nearly quadrupled, the road network almost doubled, port capacity increased six-fold, and the length of civil aviation routes quadrupled. During this period, the gap between China and India in terms of infrastructure capacity widened significantly. China's infrastructure capacity is now several multiples larger than India's. Installed power capacity in China is fourfold that of India's; the freight handling capacity of its ports is almost 6 times larger; and its network of access-controlled inter-city express ways is 20 times bigger.

The interesting story is how this infrastructure was financed. In China all land belongs to the state. Private ownership of land was abolished when the Communists took over. Even today all land is leased from the government. What trades in the market is land use rights, not the title to land. This has given the government, pretty much at all levels, access to a huge pool of resources. As urbanisation gained momentum, land values soared. Municipalities, provincial governments, municipal, and various state-owned entities that were sitting on land, monetised this asset, the proceeds of which have been substantially invested in building the country's infrastructure. At the municipal level, for example, think of the proceeds from selling land use rights as the municipality's equity contribution for key infrastructure projects, from a ring road connecting a municipality to the intercity trunk highway network, a light rail system for public transport, or electricity distribution infrastructure. This equity was typically invested in special purpose vehicles or specialised companies co-owned by the municipality. These corporate entities then raised debt financing from domestic banks to construct the projects. Across the board, the Chinese have made

---

[58] This section is based on Developing Physical Infrastructure: A Comparative Perspective On the Experience of China and India (Lall et al, 2008)

[59] There are potential inconsistencies in data sources which need to be examined. According to OECD (2005) the National Bureau of Statistics (NBS) rarely presents comprehensive information on the sources, methods and procedures of the statistics. The Statistical Yearbook offers approximately one page of general explanations for each section (such as investment) and definition of variables.

extensive use of user fees for infrastructure services. By and large these have been sufficient to service bank debt. Contrary to popular perception, infrastructure has not typically been the cause of bad debts in the Chinese banking system – those have been the result of lending to zombie State Owned Enterprises (SOEs). What has made the whole system of infrastructure financing work is that such projects have typically been over- capitalised, i.e., their debt-to-equity ratio has been low, often less than one. And the equity -- because it has been contributed by some kind of government entity -- has been satisfied with sub-market rates of return.

When Changsha, the capital city of Hunan, was looking to build a ring road, for example, the municipality transferred to a public-private agency, the Ring Road Investment Corporation, leasing rights for strips of land on both sides of the highway that was to be built, of which some land had infrastructure access and development approvals. In its original state, without access to roads or infrastructure, the remaining land had very little market value. However, the plan was to sell off land parcels once the highway was built. A part of the total cost of the highway project was financed directly from sale of leasing rights to the land already having infrastructure service. The other half was financed through borrowing. The Ring Road Investment Corporation was able to borrow against the *future* anticipated value of the improved land to obtain financing from China Development Bank and from commercial banks, pledging to sell off land parcels in the future, after the highway was completed, to meet debt servicing obligations. In a variant of this model, city level last mile electricity distribution infrastructure has in many cases been financed by municipal governments in a similar manner, but with debt servicing obligations being met through suitable end-user charges rather than through continuing sale of land use rights. Also, contrary to popular perception, a significant segment of SOEs operating in various sectors are actually profitable. In fact, by 2005, retained earnings of SOEs accounted for an impressive 50 percent of gross domestic savings or 20 percent of GDP equivalent. City governments have not been shy to tap the free cash flow generated by SOEs owned by them to invest in, or even cross-subsidize, infrastructure development in their respective areas.[60]

Development Banking in the Middle Kingdom

The final aspect of the role of the state in China's economic transformation is the use of the state owned banking system. The China Development Bank, and the four giant state owned banks have played an evolving but critical role in this process. China never really abandoned its policy of the 'iron rice bowl', i.e. its policy of ensuring life-support for the SOEs that historically provided the bulk of jobs across the country's cities. The state owned banking system has never deprived these SOEs, whether viable or not, of credit. Over time, however, two things have happened. First, as we noted earlier, the state owned industrial sector has become smaller relative to the size of the economy. Although state owned banks still account for more than half of the Chinese financial system's total assets (Turner et al, 2012), industrial SOEs have become a progressively less important island in an expanding ocean of private and quasi-private economic activity. Non-SOE

[60] For example, a number of local government owned industrial companies may contribute equity capital to create local electricity generating capacity.

businesses may have had to raise capital at a higher cost than their state owned counterparts, but thanks to China's large pool of domestic savings, they have not been 'crowded out' out because of the credit needs of SOEs. Second, a significant segment of SOEs have become competitive and profitable over time. The central government in particular has worked hard to create national champions that are internationally competitive in strategic sectors. As a consequence, the asset quality burden arising from chronic loss making SOEs has become much less of a burden on the profitability of the banks. There has nevertheless been a recurring build-up of non- performing assets in the banking system, forcing the government to recapitalize the banks. But China has had the fiscal space to absorb the associated cost without much difficulty. After two rounds of major bank recapitalisation over the past 25 years, cumulatively amounting to the equivalent of 4.4 percent of GDP, China's public debt to GDP is still only 83 percent (He and Wei, 2022). With the current problems with Chinese real estate companies, it is possible that is headed towards yet another round of bank recapitalisation.

Multiple Roads: Chinese Models of State Support

To summarise, the Chinese model of industrial transformation and state activism is, as one might expect, considerably more complex than what we have seen in other East Asian countries. As we saw earlier, Japan and Korea largely ignored their small firms and relied mostly on helping their giant conglomerates in order to keep the country moving up the ladder of technological capability. Taiwan used SOEs and state-owned R&D platforms to embed domestic companies -- that were on average much smaller than their Korean and Japanese counterparts – into high-tech cross-border OEM supply chains. Companies in lower tech sectors such as clothing, toys, bicycle manufactures and such like, very soon became a smaller part of the export success of these countries. Within a decade from the start of their respective activist industrial policies, exports from these countries were already dominated by heavy and high-tech manufactures. China has nurtured many models of state assisted business over time. The earliest, going back to the late 1970s, was local government owned TVEs that partnered with Hong Kong led FDI to drive low value added manufacturing to absorb surplus labour from rural China. Then, central and provincial governments very deliberately nurtured SEZs and EPZs to kick-start light manufacturing for exports. This imparted a great deal of economic dynamism to coastal China. Over time SEZs evolved. They became magnets for attracting OEM operators that helped integrate China very deeply into the global supply Chain. Today, the tax and the special privileges of the Zones are much less relevant. With access to advanced infrastructure these Zones offer the benefits flowing from economies of agglomeration. The Shenzhen of today is hardly an SEZ in the traditional sense. It has morphed into China's Silicon Valley and is now a hotbed for high-tech start-ups that have access to high quality talent, venture finance, and first world infrastructure.

In parallel with the SEZs of the 1980s, a third model of state engagement took hold. Entrepreneurial mayors and local government officials competed tooth and nail to attract/facilitate higher value added FDI from around the world to locate in their respective jurisdictions. These efforts helped privatise, and brought dynamism to, the country's

state-controlled industrial sector. The first model of state-engagement involved the consolidation of strategic industries and the creation of national champions. This strategy has created some of the world's largest companies in industries such as steel and automobiles. And finally, the government is now extending its influence over, and regulating a new breed of purely private Chinese companies, such as Alibaba and Geely, in selected knowledge intensive and high-tech sectors.

In parallel with these forms of direct engagement with industry, the Chinese government has invested in creative ways to build transport, energy, and communications infrastructure on a massive scale. It has invested big time in higher technical and scientific education, helping build a new technocratic elite that straddles the economic bureaucracy as well as industry and finance, and one that has been systematically co-opted into the Communist Party fold. It has also used a largely state-owned banking system to channel low cost capital in favour of state owned industry, while not starving non-state owned businesses of capital. Learning from the experience of Japan and Korea, they have also tread very carefully on financial deregulation and liberalisation of cross-border capital flows. As a result, they have kept the Chinese financial system relatively protected from the type of convulsions experienced by their Asian neighbours.

This is how China has used the state to build a formidable economic growth machine. Impressive as this performance is, sceptics still believe, especially since Xi Jin Ping consolidated his position, that China is losing its way economically. The argument is that because of a perceived reassertion of authoritarian control over the economy China's version of state capitalism will lose out in the innovation race and remain stuck in the middle-income trap as its low wage base competitive edge erodes over time. The jury is still out on whether the Chinese economic bureaucracy has the sophistication to manage the remaining journey towards creation of a dynamic 'national innovation system'. The reality is that China has made serious progress on the technology front over recent years.

It is catching up fast in the areas of military, space, and medical technology, all of which are state-led. The country now has a domestically built and designed aircraft carrier in operation. It has significantly boosted its ballistic submarine fleet; added to its fleet of the sophisticated T-55 destroyers; successfully deployed the J-20 stealth fighter that is seen as a challenge to the American F-22 and F-35 fighter; and its defence related exports have made significant inroads into the global market for armaments. But the more important point is the ability of the Chinese state to adapt to changing circumstances. As we have seen, the Chinese model of state engagement on economic matters is evolving very fast. It would seem that that reliance on the 'special deals' type of state activism is being replaced with a different model of state-business collaboration, one that relies on co-opting an emerging new business elite while ensuring that the latter do not become too powerful and know their place vis-à-vis the state. All of this points to a certain resilience of the Chinese state. We would do well to note that the Chinese state has a 2000-year history, making it the longest surviving state in the world.

6. Challenges to the Asian Developmental State

Based on the economic success of Northeast Asia, it is difficult to argue that "for reasons inherent in the nature of government, no government is able to expand the wealth of the nation faster than unguided entrepreneurs on their own" (Wade, 1990, p. 6). That said, the model is not without its challenges. Japan seems to have lost its mojo and the Koreans have had their share of problems since the Asian Financial Crisis. Has the Asian developmental model lost its relevance? Or can it keep evolving to retain its dynamism?

The Rising Cost of Incubating Technology

One question that is often asked is: did the Northeast Asians not make mistakes in 'picking winners' as they prosecuted their activist industrial policies? It is certainly the case that each country made mistakes in timing their switching strategies from lower to higher value-added industry segments. And in some cases, they did pick inappropriate industry segments to back. However, after realising their errors, they each took corrective action to adapt to circumstances as they emerged. In Korea, the timing of their initial drive to enter Heavy and Chemicals Industries turned out to be problematic because it coincided with the 1973 oil shock. Just as the country had completed building significantly expanded shipbuilding capacity, for example, a huge global glut in tonnage developed. This meant prolonged losses for the concerned domestic companies. The Korean government responded not by shutting down the industry, but by shouldering part of the burden (in part through guaranteed contracts from the Korean Navy) and helping the relevant *chaebol* to ride through the storm. Japan's MITI had developed the concept of a 'recession cartel' whereby it would step in to protect pricing power during downturns by forcing consolidation or restricting competition in industries that it considered of long-term strategic importance – the steel industry being an important example. At various points in time, MITI stepped in to support and shape the Japanese steel industry to ensure its sustainability.

The Koreans took a leaf out of this book when it came to the travails of their own automobile industry, restricting domestic and import competition when circumstances turned adverse following the second oil shock of the late 1970s. The government stepped in once in the aftermath of the Asian Financial Crisis (AFC) to force Kia and SsangYong to merge with Hyundai and Daewoo respectively in 1997. Soon thereafter, the Daewoo group itself got into serious trouble. The government took steps to break-up the group, once the second largest conglomerate in the country, forcing the sale of its auto divisions to GM, Tata Motors and Mahindra & Mahindra in the early 2000s. This left only one domestic Korean player standing: Hyundai and its affiliate Kia, which has since made the leap to become one of the few Asian automakers to establish successful manufacturing operations in the U.S. In the case of Taiwan, the government, in its eagerness to ensure the country's entry into the automobile sector, made the mistake of encouraging too many assembly operations to set up shop in a domestic market that was too small for them to serve profitably. In a significant course correction, the government gave up on the goal of developing a Taiwanese car. Instead of following Japan and Korea in this respect, they established a state-owned joint venture with a large international manufacturer to focus on the manufacture of components and parts. The government used this JV to re-orient the focus of the domestic auto

industry away from assembly operations to getting itself integrated into the global supply chain for components and parts.

On the whole, as Amsden has pointed out, the economic bureaucracies in Japan, Korea and Taiwan did not so much ‘pick’ winners, as they ‘made’ winners by being adaptive in their policy actions, by sharing the burden of adverse developments with domestic firms in targeted sectors, and forcing consolidation or cutting losses where necessary (Wade, 1990). Despite repeated episodes of excess capacity and build-up of leverage these countries managed, by and large, to make productive use of capital, delivering consistently high rates of GDP growth. This was presumably because of the economic bureaucracies’ obsessive focus of using successful penetration of export markets as a benchmark to ensure that the companies and industries that they supported became competitive, even if in some cases it took longer to get there. But the reality is that the cost of making mistakes is rising. If Korea were starting to build its automobile industry today, it would be far harder and costlier to succeed. With the internet and robotics revolution, the technological frontier in the automobile industry has moved light years ahead from where it was when Korea first started. The investments required to build up a suitable technology ecosystem to support a globally automobile industry today would be much higher; the holding costs of riding out cyclical downturns and periodic industry consolidation would also be prohibitively higher.

China is a live test case of a 21st century developmental state. It is experimenting with multiple models of state engagement and is continuously adapting and evolving its approach to industrial policy. The automobile industry is a case in point. Strategic engagement with national champions in the auto-sector is changing. Having nurtured several conglomerates with powerful backing from provincial and state governments and allowed them to grow behind protective import tariffs and ownership caps on their respective JV partners, the government has allowed competition to emerge from mostly private players such as Geely and is supporting their internationalisation. In parallel, the government is opening the auto industry to 100 percent foreign ownership. The entire state-owned enterprise (SOE) sector more broadly has been deliberately subjected to greater competition. This has forced many SOEs to shut down. As a result, the number of loss-making SOEs has come down significantly and the share of private and quasi-private firms has continued to rise. SOEs that survive are now stronger. Second, in the age of the internet, given the importance of scale and network effects to the success of next generation businesses, the Chinese have not been shy to blatantly discriminate in favour of domestic champions. Restrictions on Amazon and Facebook, for example, have been key to the success of Alibaba and Tencent. Third, and most importantly, the state is backing the strongest of its national champions to expand internationally. State backed cross-border M&A has gained rapid momentum. The strategy that worked for Korea and Taiwan, of first buying technology licences and providing duty free access for the import of technology inputs, and then trying to indigenize both through a combination of time bound import substitution for intermediate inputs and export promotion for the final product in the targeted industry, is much harder and costlier to replicate in today’s world. One way that China is using to get around this challenge is through the acquisition of global firms with high technological competence. China is using its financial muscle to facilitate large ticket M&As by Chinese companies such that it makes them the owner of intellectual property into newly targeted

sectors.

Coping with financialization

Being a small, open economy Taiwan is potentially highly vulnerable to volatility and international contagion that comes with financial globalisation. Somewhat like Japan, Taiwan proceeded cautiously with financial liberalisation.[61] Although Taiwan's Ministry of Finance (MoF) started making moves in the direction of deregulation in the early 1990s, it was continually restrained by a powerful central bank concerned about financial stability. Whereas MoF had announced measures to deregulate access to Qualified Institutional Investors in 1991, the Central Bank of China (CBC) tightened up the regulations a few years later to tighten foreign ownership limits in Taiwanese companies and to make it harder for Qualified Institutional Investors (QFIIs) to trade in and out of the Taiwanese stock market. Similarly, while the country liberalised foreign exchange markets, CBC explicitly retained the legal right to intervene, re-regulate or even shut down forex trading if deemed necessary. Thus, in response to exchange rate volatility, the CBC did not hesitate to suspend trading in the non-deliverable forward market in the NT dollar 1998. Even as Taiwan allowed domestic companies direct access to overseas borrowing, they were required to invest a minimum share of such funds into investment in new plants and machinery onshore. And while Taiwan did proceed in 1998 to invite private participation in banking, it introduced measures in parallel to strengthen channels for development financing. Contrary to what Japan did with its FILP, Taiwan introduced its Long Term Funding system in 1994 earmarking all incremental growth in retail deposits and the life insurance reserves of the Postal Remittance and Savings Banks for funding long gestation public and private projects of national importance. Throughout the process of financial liberalisation Taiwan was careful not to lose control over the overall allocation of capital. The approach is captured in a quote from *Yuan-dong Sheu*, the head of the CBC in the mid-1990s: “industry is the root, finance is the leaf”. In a similar vein, in a much publicised speech to the National Assembly, President *Lee Teng Hui* argued that “manufacturing and R&D should be the foundation [of Taiwan’s economic policy] and the financial sector should be subsidiary and supportive.” (Thurborn, 2002, p. 255)

Korea’s experience has been different. As part of the worldwide push for ‘liberalisation’ and financial deregulation, by the mid-1980s the Koreans too had started reducing their use of import tariffs and NTBs and were persuaded to move much faster on financial liberalisation than either Japan or Taiwan. They de-nationalised their banks in the early 1980s, and then as part of the *Kim Young Sam’s* ambition for Korea to join OECD, they abandoned industrial policy in 1995, eliminated the EPB in 1996, and partly liberalised the capital account of the balance of payments, allowing domestic banks unrestricted access to short term borrowings from overseas. All these factors led to a domestic credit boom, with banks borrowing short from overseas and lending long in domestic currency to overleveraged *chaebol*. A deterioration in Korea’s terms of trade and a slow-down in export markets started to affect asset quality in the banks. With perceptions of rising risk, the cost to Korean banks of their short foreign currency borrowing began rising. By the time the Asian

[61] This section relies on *Two Paths to Financial Liberalisation*, Thurborn (2002)

Financial Crisis got underway in mid-1997, with short term foreign capital taking flight from Thailand's overvalued *baht*, contagion to Korea was inevitable. Soon Korean banks were having difficulty rolling over their short-term foreign debt. As foreign capital retreated, the Bank of Korea very quickly ran out of foreign currency reserves, trying in vain to support the *won*. Korea was engulfed in a full-blown capital account crisis that forced it to turn to the IMF for a huge bailout package. With the economy stumbling and real growth rates plummeting, the liquidity problem of the banks very quickly became an insolvency crisis – one that eventually cost Korea over a mind-boggling 20 percent of 2002 GDP (Meissner, 2013). By the time Korea emerged from the Asian Financial Crisis, the control over economic policy that used to be exercised by the Industry Bureau was much diminished. In principle, with the progressive 'financialization' of the economy the leadership role over domestic economic policy shifted more to the MoF, which as in the case of Japan was unprepared for the role. Even as MoF raced to implement sweeping IMF prescribed changes to financial sector regulations, Korea went through two more mini-crises -- the blow out of the mono-line domestic credit card companies in 2003 and a real estate bust in 2007 -- before it was caught unprepared for the contagion effects from the Global Financial Crisis (GFC) of 2008. Yet again, the banking system's dependence on short-term foreign debt led to liquidity stress and a run on the currency. This time, the U.S. Federal Reserve helped out with long-term foreign currency swaps. But the Korean economy had to endure considerable damage once again.

Looking back to the 1990s and early 2000s, in Taiwan, unlike Korea, the 'engineering mind set' prevailed over the 'economist or finance mindset'. Arguably, this allowed both countries to cope better than Korea with the 1997 and 2008 financial crises. That said, financial globalisation forced changes to the operation of the developmental state in all three countries. Capital markets weakened the old links between government and business and the reality is that the old approach to industrial policy has become less feasible. Besides, all three countries are substantially developed, and each is now a democracy. Their current circumstances are such that they will all need to address issues more pressing than just industrial development. In the coming years, consumer welfare, health care, and social protection, especially for the aged, will demand more attention. But it is unlikely that the developmental nature of these states will wither away. Culture, history, and path dependency suggest that the state in these countries will likely retain many of the characteristics of a developmental state, as Singapore has dome.

In terms of per capita GDP, Singapore is now amongst the richest nations in the world. Yet the developmental state remains very much alive. Whereas financial globalisation became the stumbling block for other East Asian development states, Singapore was able to ride the wave and pivot its economy from manufacturing to financial services and high value-added services. Singapore has emerged as a sophisticated regional financial centre generating many high-quality service sector jobs for its citizens. Such a transformation, from a 'mid-tech' (as distinct from a high-tech) manufacturing to a financial centre, was feasible only because of Singapore's small size. It would be much harder to effect such a transformation elsewhere in Asia, except for Hong Kong, which has managed a very similar transition. Singapore's regulation of its financial sector was tighter than that of its neighbours. As a result, the country was much better prepared to manage the fallout from the Asian and Global financial crisis. The country is now moving past the

traditional industrial policy route. Being a small country, it is unlikely to be able to build a national innovation ecosystem system for an indigenous manufacturing capability. Instead, learning from Israel, it is trying to develop human capital and research skills in selected sectors, such as bio-medical science and genetics, for example, in a bid to embed itself into global R&D networks.

In sharp contrast to Singapore, the rest of Southeast Asia was ill prepared for financial globalisation. Thailand raced ahead with financial deregulation and capital account liberalisation during the 1990s. Soon, the Thai economy was overwhelmed by the inflow of foreign capital. The *baht* became overvalued as domestic credit boomed on the back of short borrowing from overseas. As the capital flow began to reverse in 1997, Thailand's external accounts became untenable. In July, the Bank of Thailand announced a 20 percent devaluation of the baht, triggering what then became the Asian Financial Crisis (Bakhshi et al, 2002). Because the bulk of the damage in Thailand from the crisis was in housing and domestic consumer credit, the clean-up and resolution were easier than in the case of Korea where the financial system was burdened with a huge overhang of corporate debt. But even so, the Thai economy took a big hit with real GDP declining 9.4 percent before recovering. The Thais implemented the structural reforms advocated by the IMF as part of its $17 billion bailout package. Most related to strengthening regulatory oversight of the financial system and making the bankruptcy proceedings for corporate resolution more effective. In the process, the Thai financial system saw dramatic change. Sixteen finance companies were suspended in June and a further forty-two in August (Berg, 1999). Most of the mid-sized banks were taken over by foreign strategic investors from Japan, Malaysia, and Singapore. State engagement switched from active industrial policy to aggressive public investment in infrastructure. Bangkok's elevated light rail system that was stalled immediately following the crisis was resurrected and completed in 1999. The government followed this up with development of the underground metropolitan rail system for the greater Bangkok region and the Suvarna Bhumi international airport in 2006. This helped the recovery of the economy, but the Thai developmental state has not recovered. The AFC permanently impaired the institutional mechanisms supporting the country's industrial policy. IFCT, Thailand's development bank went bankrupt and with the most important source of long-term funding for industry disappeared. The country has not been able to break out of the mid-range of manufacturing technological capability.

Malaysia entered the AFC from a position of relative strength with strong fiscal balances and much lower levels of corporate and consumer debt than in Thailand. Even so, the flight of foreign capital was hugely de-stabilising. Since that shock, the country has fallen back on the cushion that its commodity wealth provides and has grown more concerned with the politics of ensuring a socially acceptable share in that wealth for its Malay community than about breaking through to the next level of technological capability. Indonesia was the worst hit by the AFC in 1997. The financial system was deeply exposed to short term capital flows, and it suffered deep damage as contagion spread from Thai *baht* to the Indonesian *rupiah* in 1997. Indonesia required IMF-led external support of close to $50 billion to stabilise the economy. A total of 16 local banks had to be liquidated. The country experienced food shortages which were exacerbated by a bad monsoon, and a consequent sharp rise in poverty levels. It suffered a permanent output loss of an astonishing 22 percent equivalent of GDP (IMF, 2023). This precipitated social unrest that contributed to the

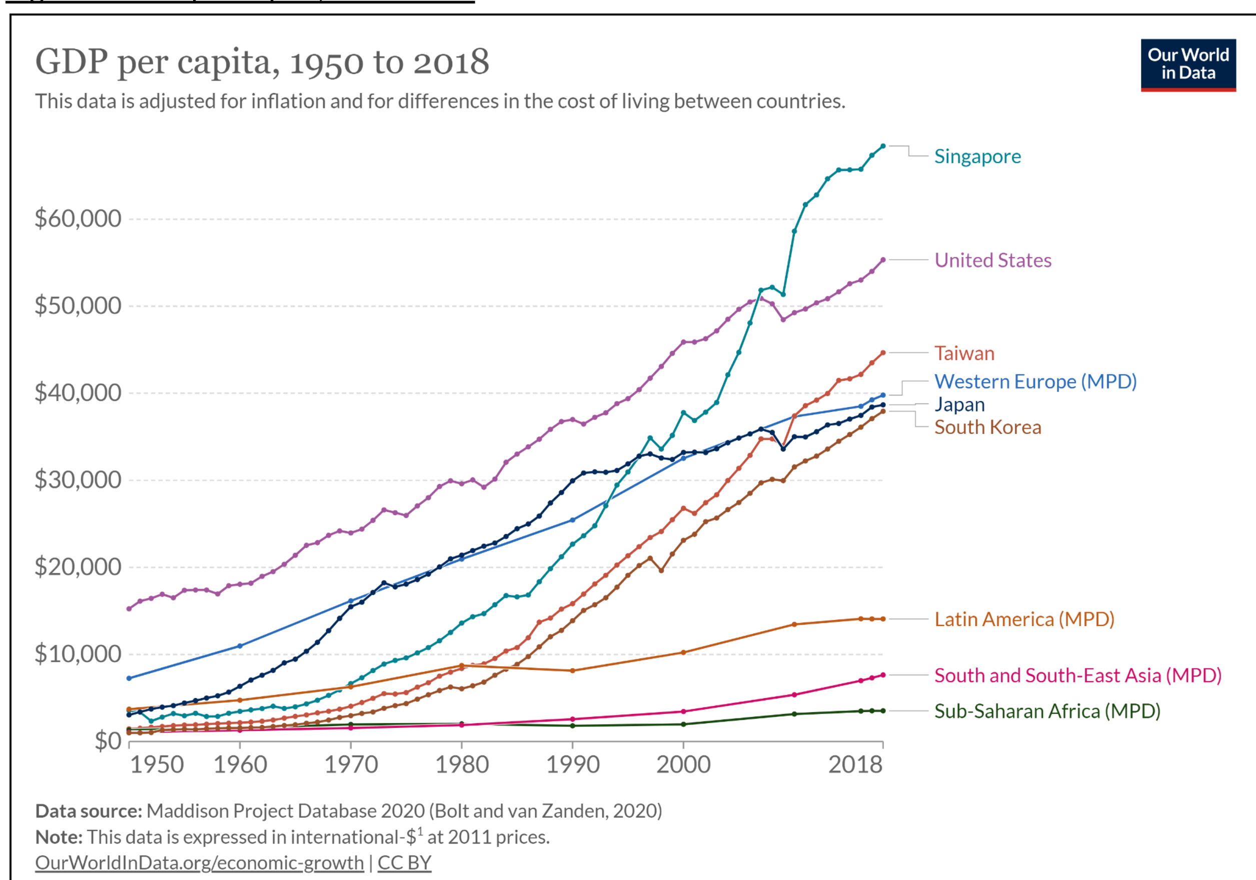
fall of the Suharto regime. As in Malaysia, the developmental state in Indonesia has since lost its focus.

China was admitted to the WTO in 2001 and has liberalised its trade regime in line with its obligations. Yet its merchandise trade surplus and its share of global exports has continued to rise dramatically. With ballooning foreign exchange reserves, China displaced Japan as the largest creditor to the U.S. in 2008, and it has become a significant investor overseas. With persistently large current account surpluses, China has been repeatedly blamed for currency manipulation. Meanwhile, China has adopted a cautious approach to financial deregulation and liberalisation of cross- border flows of capital. While this has kept the Chinese economy reasonably protected from financial damage arising from the volatility of cross border flows, because of how deeply segments of Chinese industry are integrated into cross-border supply chains, it has not been immune from shocks to global economic activity. As trade tensions between the U.S. and China have grown, charges of unfair trade and theft of IP, etc. have become more frequent and broader based. However, the lure of access to China's vast domestic market and the global dependence on a range of its manufacturing exports is such that it has not been easy for the U.S. to rally support from either its own business community or from the Europeans to force a Plaza accord type of deal onto the Chinese. The Chinese economy is 2.5 times larger than the Japanese in terms of nominal GDP. It accounts for almost 16 percent of global GDP, second only to the U.S.'s 23 percent. Unlike Japan, which was clearly a junior ally under the U.S. security umbrella, China has its own increasingly sophisticated military capability. As such, it will be much harder for the U.S. to address the growing competitive threat from China today than it was to deal with competition from Japan in the 1980s. With the U.S. ceding its global leadership role, the world is entering a new era of contestation for hegemony. China is still only a middle-income country; it has some ways to go on its path to economic transformation. While there are no doubt numerous challenges that China's developmental state is grappling with, like corruption, it continues to adapt and evolve in response to changes in the global competitive landscape in the domestic socio-economic landscape. The Chinese state has shown its willingness and ability to deploy very substantial financial resources to acquire technologies in key sectors through cross-border M&As. In parallel, it continues to invest heavily in technical education and infrastructure to develop its on-shore R&D capabilities and nurture its own network of state controlled and state influenced national champions in strategically important industry segments. The Chinese have made great progress on the technological catch-up front. Under *Xi*, it looks as if the state will continue to play a vital role in nurturing research and innovation. This has helped the country gain serious ground as a trading and manufacturing power. What remains to be seen is whether the Chinese model of state capitalism is robust enough to also gain ground as a financial power and threaten U.S. domination of the global financial system. Financial modernisation is one challenge that China has yet to navigate.

7. State Capacity and Economic Transformation: Lessons from the Developing Country Experience

Figure 4 below provides a snapshot of the relative performance of countries from Sub-Saharan Africa, Latin America, Southeast Asia, and Northeast Asia since WWII using a selection of parameters that indicate their degree of success/failure along the path of catch up. This is illustrated by significant increases in GDP per capita, expressed in international dollars[62] (accounting for purchasing power parity). Only Northeast Asia has succeeded in the pursuit of catching up, and the rest fall into three categories.

Figure 4: GDP per capita, 1950-2018



[62] International dollars are a hypothetical currency that is used to make meaningful comparisons of monetary indicators of living standards.
Figures expressed in international dollars are adjusted for inflation within countries over time, and for differences in the cost of living between countries.
The goal of such adjustments is to provide a unit whose purchasing power is held fixed over time and across countries, such that one international dollar can buy the same quantity and quality of goods and services no matter where or when it is spent.

The first category is Sub-Saharan Africa. Countries in this region face severe state capacity constraints; they simply lack an effective administrative machinery to play the required role. Despite the diligent adoption of standard issue neoclassical economic policies since the 1990s, their performance has been indifferent with no major gains in poverty reduction or in the standard of living. They have mostly remained dependent on commodity and agricultural exports and have failed to materially diversify their industrial base and create higher quality jobs for their aspirational young.

The second one is Latin America. The region's largest countries are not lacking in state capacity. Some- Brazil being a case in point - have done an impressive job of delivering well designed, targeted welfare support. Nonetheless their efforts at state support for industrial development have failed because in most cases the political economy of state-industry collaboration did not allow the 'magic carpet' to come together. In most Latin American countries, the ideological commitment to market discipline and to export competitiveness was quite patchy, at least until the 1990s. Rent seeking behaviour and populist, clientelist, policy making undermined the competitiveness of domestic industry. Since then, most have found it easier to eliminate restrictions on cross-border capital flows and enable domestic manufacturing to integrate into global supply chains. This strategy has yielded modest benefits. While it has allowed Latin American countries to become competitive in mid- technology industry segments, they have not managed to close the gap with the global technology frontier. Argentina and Chile, have in fact reverted to depending on agricultural and commodity-based exports. They all continue to languish in what has been called the 'middle income trap' and have become more vulnerable to terms of trade shocks and to the ebb and flow of internationally mobile capital.

The third category is Southeast Asia. Countries in this region have been much more committed to market discipline and export-led growth than their Latin counterparts. They have also managed macro-economic policy more prudently. Overall, these countries have made more progress on catching up than Latin America. Despite starting with materially lower levels of per capita GDP in the 1950s, the region had largely caught up with Latin America by the 1990s. Following the AFC, however, they have been forced to take the 'low road'. Although they have not quite given up on the idea of state support for industry, the reality is that with the internet and robotics revolutions the costs and the risks of building technological capability have risen very fast. Under the circumstances, these countries have been left with little choice but to rely on FDI from global players to help bring them up the technology curve. Unfortunately, except for Singapore, other Southeast Asian countries have not found the spill-over benefits from FDI to be enough to help them pivot domestic industry to higher levels of technological capability. Like the Latin Americans, their journey up the path of dynamic comparative advantage seems to have stalled. They are forced to continue competing on the basis of lower wage costs and so find themselves stuck in the middle-income trap.

The question is: what is it about the Northeast Asian states and Singapore that has allowed them to take 'the high road' to radical economic transformation? No doubt many factors, political, economic, and societal, were at play, some of which were not unique to these states. Many researchers have, for instance, pointed to the political and economic urgency of their post-war

predicament to explain the focused intensity of the effort of these countries to catch up with the developed world. But many other nations also found themselves in similarly challenging circumstances. Yet their efforts have not been rewarded with nearly the same measure of success as enjoyed by the Asian developmental states. Although hard to isolate, in what follows we identify three characteristics common to these countries that we believe are necessary, although perhaps not sufficient, for success.

Meritocratic Bureaucracy

A good part of the explanation for differential performance of these regions has to do with the nature of the state in these countries. In the case of Northeast Asian states, state capacity and competency derive from the meritocratic foundations of their bureaucracies. In all Northeast Asian states, selection to the civil service is based on highly competitive entrance examinations. With merit-based advancement and no lateral entry, there is little room for appointments based on political patronage. These bureaucracies have traditionally attracted the best, the brightest, and the most highly educated in the country. They have built a strong *esprit de corps*, and can pursue ambitious strategies, exercise independent judgement, and make discretionary decisions, mostly protected from political interference and influence peddling from other stakeholders.

The civil services of Japan, Korea and Taiwan were all modelled on the Confucian conception of the bureaucratic Chinese state that was run by an unabashedly elite class of mandarins for many centuries. War was the initial driver for state formation in China. “War made the state, and the state made war” (Ardant, 1975). Qin Shi Huangdi unified the Warring States under the *Qin* dynasty in 221 BC. The *Han* emperors that followed shortly thereafter built on the *Qin* legacy to create a centralised bureaucracy. A meritocratic selection process replaced old patrimonial systems of assigning administrative responsibilities. Crucially, the competitive entrance exams were open to all and therefore represented an opportunity for upward social mobility, theoretically at least, to even the poorest in Chinese society. The examinations were, however, very demanding. Success in the Imperial Examinations required sound educational training and was a ticket to immediate status and social standing.

Right from the earliest days of the Chinese state, those selected to serve in the state administrative machinery were able to conduct cadastral surveys, levy uniform land taxes, conscript armies, execute grand infrastructure projects, and enforce uniform weights and measures across the country to promote commerce. The Chinese were thus the first in the world to create a system of administration with attributes that Weber (1921) would ascribe to a modern bureaucracy. But the development of the Chinese state was neither smooth nor linear. As Francis Fukuyama points out, it took several cycles of political development and decay to get to the Chinese state in its current form (Fukuyama, 2014, p. 374). During its encounter with the West, the *Qing* dynasty was able to draw on a centuries’ old tradition of state administration to avoid total colonisation, a la Africa. By the nineteenth century, the machinery of the Chinese state was in decay. The Qing court was hampered by rigid ritual and lack of imagination that prevented it from

competing effectively against the Europeans. When the Communists took over following the convulsions of the Civil War, the remnants of China's state machinery were stripped of their autonomy and subordinated to the Party. During the Great Leap forward, Mao further attacked the bureaucratic state, using the Party apparatus to mobilise the masses in pursuit of totally unrealistic goals for industrialisation, resulting in famine in which an estimated 30 million people died. During the Cultural Revolution years, Mao went even further. Fearing erosion of his personal authority, he effectively destroyed the internal hierarchy of the Party itself. To connect himself directly to the masses, he empowered grass root level Revolutionary Committees and Red Guards to purge or eliminate intermediary layers within the Party. By the time of Mao's death, China was flirting with anarchy. Scarred by this experience, Deng Xiao Ping – who had himself been twice purged from the Party – was determined to rebuild a rule-based, disciplined administrative machinery. After 1978, China re-introduced merit-based entrance exams and through a series of reforms in subsequent years, resurrected performance-based evaluation and advancement. So coveted is a job in the present-day Chinese bureaucracy that over 1 million people compete for 20,000 odd civil service positions through the competitive entrance exams held across the country. The Chinese state is clearly able to attract the best of talent that the country has to offer (Fukuyama, 2014).

Korea was a remarkably stable polity under the Chosun dynasty that had survived since the 14th century. By the late 19th century, however, Korea was a backward state. It had a decaying monarchy supported by a centralised, albeit weak administrative machinery, managed by the *yangban*, a class of scholarly bureaucrats. Although the *yangban* were originally recruited through competitive exams, over time their status became hereditary. This caused the meritocratic roots of the bureaucracy to erode.[63] A peasant revolt gave the Japanese, already present in the country as predatory traders, the opportunity to establish a significant military presence in 1894. It did not take long after that for Japan to get rid of a weakened monarchy and formally annex the country in 1910. The Japanese strengthened the centralised bureaucracy, stripped the peasantry of all rights to the land and converted the feudal lords into a class of rentier landlords enjoined to share their contractual rental earnings with their colonial masters. The basic framework of the modern Korean bureaucratic state bolted onto historical foundations, thus emerged in Korea under colonial rule. The key feature of the historical Korean state that was carried over to its modern version was the social standing and prestige for the bureaucracy. When the Americans arrived after WWII, they needed to enlist support from a restive peasantry in the war against the Communists. They implemented draconian land reforms, distributing all land to the tiller, thus pretty much eliminating rentier landlordism and leaving the bureaucracy as the dominant elite.

The Americans also built the South Korean military from scratch. As the Korean War unfolded, the military gained in importance and social standing. It also provided an economic opportunity for domestic businesses to regain their footing. Many of the groups that would emerge as *chaebol* in later years got their start at this time. Meanwhile, corruption under the first post-War government led by U.S. supported Synghman Rhee spiralled out of control. This eventually gave General *Park*

[63] *Yi* monarchs shared power with powerful feudal lords that kept the bulk of extractive taxes imposed on an impoverished peasantry over which they exercised violent control.

Chung Hee the excuse to overthrow Rhee in a military coup in 1960. One of the first things that Park did was to reinstate competitive entrance exams for the bureaucracy, enforce compulsory retirement of the old guard of public employees, and a revamped merit, as distinct from seniority based, system for advancement was implemented. In parallel, Park very deliberately selected a few business groups, based in part on their manufacturing experience – to take centre stage in the economy, and empowered the bureaucracy to implement his broad vision for industrial modernisation. Under these circumstances, the Korean bureaucracy was able to function with autonomy, exercising immense authority over a subservient business community and with full support from the political leadership.

Taiwan was colonised by Japan following the latter's victory in the Sino-Japanese War of 1895. The Japanese proceeded, as they did in Korea, to build a centralised state machinery in the image of the largely agrarian *Tokugawa* Shogunate, one designed to collect taxes from a class of rentier landlords. In the initial years of Occupation, the Japanese intent was to use Taiwan to secure its food supply. It was only in the late 1930s that efforts were made to create light industry to support Japan's war effort.[64] In any event, Taiwan's experience in state formation is very similar to Korea's – in both cases the impulse for modernising the state came from colonisation. Upon arrival, Chang Kai Shek's Koumintang (KMT) took over the centralised state administration left behind by the Japanese and immediately started merit-based competitive entrance exams to rebuild the civil services. The new bureaucracy, down to almost the junior most rungs, comprised emigres from the mainland, whose families had left China along with the Kuomintang. Not surprisingly, given their familiarity with the examination system, it was these families that spawned the most successful candidates for the entrance exams when they were first introduced in 1949. As a consequence, mainlanders became Taiwan's equivalent of the Japanese *samurai* and the Korean yangban*:* an elite with high social standing and prestige.

In all four Northeast Asian states, selection through intensely competitive entrance exams made the bureaucracy, as in ancient times, a ticket to high status and social standing. A position with government remains highly coveted for the prestige attached to it. This social foundation for a meritocratic bureaucracy has been key to building and nurturing superior state capacity.

Contrasting Northeast Asia with Other Emerging Markets

The history of state formation and civil administration in Sub-Saharan Africa is in sharp contrast to the Northeast Asian experience. There were few centralised states in the region before its encounter with the Europeans. Relatively few stretches of flat open land free of dense tropical forest, except in the rift valley and southern Africa, meant that it was not easy to project state power. Low population density meant that agriculture did not have to be as organised as in Egypt. Agriculture was largely rain fed, and agricultural technology did not need great sophistication for communities to be self- sufficient. With no pressure on land, communities always had the option of simply moving away when subjected to pressure from a centralising authority. Which is why

[64] A similar exercise was repeated in Manchuko to make it support the Japanese war machine

authority was exercised "through networks of tribute-paying clients" (Fukuyama, 2014, p. 221) than through control over physical territory. Society was organised based on segmentary lineages, or tribes, coalescing into larger groups when under attack as a group, but otherwise quite fragmented. Chiefdoms with state-like characteristics would easily fracture with the departure of subgroups.

Another important feature of sub-Saharan Africa was the lack of organised social hierarchy – very different from Asia or feudal Europe. Even the most powerful *Zulu* kings, unlike European sovereigns, did not have the power to take away land or extract taxes. All of these characteristics together meant a tradition of weak states in the Weberian sense. Africa never developed strong administrative structures to enforce rules and authority over a defined territory.[65] Unlike in Southeast Asia, this did not change with colonisation. The Europeans did not ramp up their colonisation drive in Africa until the late 19th century and soon found that it would be much harder to reap returns from their African colonies than their Asian ones. For this reason, they invested much less effort and resources in the region, relying on local elites to exercise power. In the end, none of the European colonial states in Africa left much of an institutional legacy behind. The fledgling nations that came into being when the colonisers departed inherited administrative machineries with weak human capital. The Congo had less than a dozen university educated administrators when the Belgians left in 1960. In Nigeria, for a population of 45 million at the time of independence also in 1960, there were only two universities with less than 1,400 students enrolled (Fafunwa, 2018). It is true that over the past decade and a half, Sub-Saharan Africa has turned in a respectable performance in terms of GDP growth. Some of this performance masks the salutary effects of a cyclical commodities boom. More importantly, the fundamental challenge of the region has not changed. As Fukuyama argues, relative to East Asia, the institutional deficit in sub-Saharan Africa is not democracy; in fact between 1960-2000, the degree of democratisation was greater across Sub-Saharan Africa than in East Asia where most regimes were under authoritarian control. The real deficit is state capacity. After the departure of colonial powers, across a large swathe of Sub-Saharan Africa, the weak, low capacity state has become more a means to gain power to benefit the narrow interests of competing elites than a vehicle for the pursuit of coherent national interests. In this context, state machineries with historically low capacity and capability are easily captured and manipulated by vested interests. In many cases, as in DRC and Nigeria, legitimacy is bought through the ad hoc division of the wealth generated from the countries' abundant natural resources. This has spawned institutional structures and arrangements that have facilitated extraction and the distribution of the associated spoils through networks of patrimonial and clientelist patronage.

There are of course notable exceptions. Botswana has evolved as a stable and prosperous democracy since independence in 1966. Rwanda has recovered from the trauma of an incredibly violent civil war to thrive under the dynamic but very authoritarian leadership of Paul Kagame. The record of several other countries such as Ghana, Ivory Coast, Tanzania, Uganda, to mention a few have been mixed, but showing signs of improvement. Elsewhere in Sub-Saharan Africa,

[65]It is important to note that modern African state boundaries were arbitrarily drawn in the late 1800s, ignoring tribal, cultural and migratory patterns. See also Herbst (2014), *States and Power in Africa*

including in the continent's largest countries such as Nigeria and DRC, the state has unfortunately become more a vehicle for gaining control over public resources for the benefit of the group in power, than an institutional mechanism for the pursuit of coherent policies for national development.

Latin America is an interesting case. With the discovery of the New World, the Spaniards and Portuguese created systems of administration intended solely to facilitate extraction. This involved the extensive use of imported slaves. All traces of pre-Columbian state structures, be it Inca or Aztec, were pretty much eradicated. Local elites then broke free from their colonial patrons and recreated similar systems of patronage-based government to ensure their own continued control over wealth and power. Latin America thus spawned 'comprador states' (Cohn, 2015) that were designed from birth to be captured by the local elite. Given the circumstances of their birth, these states were deeply inequitable. This has been the source of continuing social conflict that has repeatedly convulsed the region which alternated between democracy and authoritarian despotism for the past couple of centuries. The state bureaucracies in these countries have gone through repeated cycles of "construction, deconstruction and reconstruction" (Grindle, 2010).

By the 2000s, on paper at least, most Latin American countries had laws in place requiring civil servants to be selected based on merit and for the equivalent of civil service commissions to be set up to oversee recruitment and ensure fair treatment and political neutrality of public sector employees. The reality, however, remains very different. Other than Costa Rica, Chile, and Brazil, none of the other countries in the region have a structured career civil service system. Even in Brazil, where the Cardoso government ushered in the latest cycle of state machinery reconstruction, the efficacy of administrative reforms intended to professionalise the civil services was called into question with the corruption scandals that marred Lula de Silva and his Workers' Party tenure in government. With Bolsonaro, Brazil entered yet another cycle of bureaucracy destruction, where, under the guise of anti-corruption and an ideological penchant for small government, he politicised the bureaucracy (Rapoza and Forbes, 2018). In Mexico and Argentina, merit-based systems of recruitment survive at lower levels of the bureaucracy that are now protected by powerful unions. But most positions of authority are still filled based on clientelist influence or patrimonial authority. Across Latin America, despite the *de jure* veneer of professionalism in public administration, the economic elite have managed *de facto* to manipulate successive authoritarian as well as democratic regimes to retain disproportionate influence, if not indirect control, over the administrative machinery of the state. A meritocratic bureaucratic state machinery has never really survived for any length of time in this part of the world.

With the exception of Thailand, all modern Southeast Asian states are much younger than their Latin American counterparts. Except for Thailand, the other countries of the region inherited administrative systems created by their respective colonial regimes. Historically, none had a tradition of a meritocratic bureaucracy. The Malayan and Javanese Sultanates as well as the Kingdom of Siam all had state administrative systems that were dominated by the aristocracy based on patrimonial linkages of trust and loyalty. Malaya was commercially and strategically much more valuable to the British colonial authorities than any territory in Africa. Tin, rubber,

gold, and the prospect of controlling trade through the Malacca Straits were incentive enough for the British to engage more actively with the Malayan Sultanates than they did with any of their African colonies.

After Raffles[66] acquired Singapore from the Sultan of Johor, the British not only built a port, but they also established a crown colony and built the foundations of a merit based administrative service to manage their economic interests in the region. The birth defect of the Malayan Administrative Service (MAS), however, was that entrance to it was restricted to the Malay aristocracy. This was done to buy the support of the Malay community feeling threatened in the face of the growing British instigated migration of Chinese and Indians. Post-independence, this legacy was institutionalised as part of United Malay National Organisation's (UMNO) Bhumiputra policy of affirmative action. Thus, a reasonably competent and effective administrative machinery left behind by the British became the basis for a state designed to systematically help one ethnic community restore and build its share of the country's economic wealth.

The story of the Indonesian state administrative apparatus is in many respects quite similar. Indonesia inherited a civil service created by the Dutch who drew heavily from the Javanese aristocracy, just as the British did from the Malay aristocracy. At independence, *Sukarno* replaced the old aristocracy with a new class of nationalist activists engaged in the independence movement. The initially public-spirited bureaucracy became, under the Suharto regime, increasingly beholden to, and aligned with, the ruling party. There was an attempt to rebuild the bureaucracy after his departure. As the country democratised, the state administrative apparatus underwent radical transformation. In an audacious effort to decentralise government, over two million civil servants were transferred from federal to district level administration. Since then, the bureaucracy has grown rapidly and steps have been to make the civil services more meritocratic. However, progress has been very slow, and as in the case of Malaysia, the Indonesian state apparatus at senior leadership levels has not acquired the competency to pursue a disciplined Korea or Taiwan style industrial policy.

Thailand was never colonised, but like Japan in the nineteenth century, it responded to the threat of European expansionism in the region with a drive to modernise the nation. The Thai bureaucracy in many ways reflects the state's attempt to traverse the bridge from an archaic autocratic despotism to a modern-day constitutional monarchy. The National Civil Services Act of 1928 created a career administrative service, modelled on the British system, all the way up to Cabinet level positions in government. Traditionally the civil service has enjoyed high prestige and standing in Thai society. Until recently almost all college graduates in the country found a place in the bureaucracy. Through frequent and turbulent political transitions over the past several decades, the Thai civil service has provided valuable stability and continuity. However, the bureaucracy has grown less impersonal in the Weberian sense. Traditional social norms binding status-unequals into relationships of trust and loyalty have created patterns of authority and accountability that do not necessarily follow the bureaucratic hierarchy. The authority of the Civil Service Commission nominally in charge of enforcing uniformity of rules has eroded with growing

[66] Sir Stamford Raffles, Lieutenant Governor of Bencoolen, 1818-1824

political meddling in personnel management, especially at the senior levels of the bureaucracy. This has made the state administration more susceptible to influence or capture from competing elite interests and less able to conduct a disciplined industrial policy requiring reciprocal and time bound commitments.

Singapore is the only Southeast Asian nation that has been able to build and maintain a high performing Weberian bureaucracy. Like in Malaysia, the foundations of Singapore's civil services were laid by the British colonial administration. Unlike Malaysia, however, Singapore has managed to keep the civil services both meritocratic and secular. Academic excellence has been used as a key selection criterion for entry into the services. Government scholarships for high performing students tied to service obligations have been used extensively to induct talented candidates into government service. This, along with high levels of social prestige associated with government service and highly competitive remuneration even compared to private industry, has allowed the Singaporean bureaucracy to recruit and retain the best and the brightest.

The Hard State: Engaged Yet Autonomous

The bureaucracy of an effective developmental state must go beyond the Weberian ideal. It must also be capable of managing public-private linkages in a very disciplined manner – it must have the clout to make credible commitments to private business and have the authority to withdraw the same in the event outcomes are not achieved. For this, autonomy is vital. The bureaucracies of the effective developmental states in Asia have enjoyed what has been quite elegantly described as 'embedded autonomy' (Ornston and Vail, 2016). The bureaucracies in Japan, Taiwan, Korea, China, and Singapore are embedded in the sense that they engage actively, through institutionalised channels, with non-state stakeholders including business associations, organised labour, banks and firms. Yet, they have limited accountability to the societal actors with whom they interact and can steer the economy and the concerned stakeholders, mostly free from political pressure, in the pursuit of broader national goals.

Several explanations have been offered for how they are able to do this. One is the high societal standing that the bureaucracy enjoys in these countries. In a context in which enormous social prestige is attached to, and respect reserved for, bureaucracy, business is typically in a subordinate relationship with the state. This allows the bureaucracy to 'guide' the business sector in ways that would not be feasible in contexts where the state-society balance is more even.

A second, related explanation has to do with the *esprit de corps* that binds the bureaucracies of these countries together and holds them apart from the rest of society. In Japan, the bureaucracy's legitimacy has derived principally from the widely shared respect for its public-spirited ethos of 'Kanryou.' This is what gave it its autonomy in the late nineteenth century during the transformative period of the Meiji Restoration, even more than the authoritarian nature of the regime itself. And this is what preserved its autonomy under the post-War democratic state. If anything, the bureaucracy's decision-making autonomy and prestige were enhanced once the country became a democracy. The 'zaibatsu' that had gained influence because of their support for

the military regime's War effort, saw their business empires dismantled as the Americans and the newly elected Diet tried to reduce the influence of all connected with the old regime. The bureaucracy then proceeded to recreate national conglomerate champions in their new avatar as 'keiretsu.' In Taiwan, at least in the early years, the bureaucracy which comprised almost exclusively of mainlanders who had migrated with the Kuomintang, guarded their elite status by very self- consciously maintaining a distance between themselves and the locals. This made them naturally more impervious to pressure from local vested business interests and allowed them to operate with great autonomy and authority.[67] In Korea certainly during the Park Chung-Hee years, the political and economic predicament of the country was such that the bureaucracy was driven by a sense of urgency and national purpose that allowed it to function in a manner detached from the pulls and pressures of various stakeholders.

For these reasons, the Northeast Asian states and Singapore have often been characterised as 'hard states', i.e., states with bureaucracies that have managed to remain mostly impervious to capture by big business interests despite working very closely with them in the implementation of industrial policy. It may even be the case that the authoritarian nature of these states made it easier for their bureaucracies to seek the political leadership's protection against influence peddlers.

That said, none of these countries have been corruption free. But, with the exception of China, where the phenomenon of the 'entrepreneurial state' has in fact contributed to widespread corruption, the extent of corruption in Northeast Asia has been modest, compared to elsewhere in Asia, Latin America, and in Africa. Japan, Korea, and Taiwan have had consistently low levels of corruption since the 1990s, especially in comparison to other Asian countries (Nielsen, 2022; You, 2014).[68] The corruption that does exist in these countries has generally been confined to relations between politicians and business – it has tended not to involve bureaucracy.[69] In Korea, there have been a spate of recent scandals involving *chaebol* financing political campaigns soon after the country became a democracy. Similarly, Japan has seen a steady stream of corruption scandals involving Diet legislators doing favours for business groups, but rarely have any involved the bureaucracy. Even in China, where by all accounts corruption runs much deeper, the ubiquitous 'side-deals' that *Hsieh*, for example, describes in how state-business relations operate in the country, involve local Party leaders – not the career bureaucracy – pro-actively helping businesses deemed beneficial to the local economy. And in a political context such as China, in which economic growth is of paramount importance for securing the legitimacy of the Party, corruption does not seem to have come in the way of growth.

[67] That said, Nationalist Party leaders did worry about corruption, of which they have seen a lot in mainland China. They therefore enforced very granular anti-corruption regulations for government staff.
[68] Japan does better than either Korea or Taiwan on any corruption related ranking. It is not clear that this is because Japan was a functioning democracy presumably requiring higher levels of transparency than the then authoritarian regimes in Korea and Taiwan. As it turns out, in both Korea and Taiwan, the incidence of corruption seems to have risen after the democratisation process started. Ironically, neither country has not yet recovered its pre-democracy transparency international ranking.
[69] See Johnson (1982), *MITI and the Japanese Miracle*, for example.

This is to hardly argue that corruption is a good thing; the distributional and social consequences of corruption have been decidedly sub-optimal across Northeast Asia. Corruption in this part of the world, including in China, has been different from what we find in Africa and Latin America. In the latter regions the government-business interface has produced more rent seeking and prebendalism[70] type of behaviour that has been inimical to growth. The history of state formation in Africa and Latin America has been such that the bureaucracy has not enjoyed the same level of social prestige as in Northeast Asia and has thus not been able to stand above the business community.

Across most of Southeast Asia, the social standing of the bureaucracy seems to have diminished over time. The pattern of patron-client relationship emerging in the Thai, Malaysian and Indonesian bureaucracies has undone their 'separateness' and neutrality. In each of these cases the state has become 'softer' over time making it more vulnerable to influence by various stakeholders, especially domestic business interests, in ways that are not constructive for long term growth and competitiveness. In Malaysia, for example, the explicit policy of using state power to protect and enhance the interests of the Malay ethnic community, has contributed to the resurgence of a culture of clientelism reminiscent of the type of patron-client relations that were characteristic of the Malayan Sultanates. To try and address this predilection, efforts have been made periodically to subject the lower levels of the country's all Malay bureaucracy to modernising reforms. These have helped improve the delivery of basic public services. But the higher echelons of the civil service have become politicised and cannot be said to function autonomously. Following the National Economic Policy of 1971, the mandatory transfer of thirty percent of the stock of non-Malay corporations to government trusts supposedly managed on behalf of the Malay community, has spawned widespread cronyism. This trend has, arguably, also contributed to the growth of 'rent seeking' type of corruption that is more damaging because it ends up serving much narrower objectives rather than the reciprocal altruism of patronage and clientelist relationships. More recently, there have been high profile instances of prebendalism. The Indonesian state, over the *Suharto* years, saw a similar deterioration from a relatively impersonal state machinery to one more susceptible to patronage and clientelism, to one vulnerable to the temptations of straightforward diversion of public wealth for private gain.

Singapore stands out as the lone exception amongst Asian developmental states where corruption in the state bureaucracy remains very low. Lee Kwan Yew was well known for his insistence on competitive remuneration for civil services. The Singapore bureaucracy is indeed one of the highest paid anywhere in the world. It is no doubt true that the superior compensation of the Singaporean civil service has not only enhanced the prestige but is likely also to have materially reduced the vulnerability of the bureaucracy to temptation.

[70] Prebendalism is a worse form of corruption involving the diversion or outright theft of public funds for purely private gain.

Mechanisms for Social Compensation and Focus on Equitable Growth

An important common feature of the economic transformation story of Asian developmental states is the attention that these countries paid to equity. Simon Kuznets famously observed that development has historically been accompanied by a rise in levels of inequality. This contributed to an expectation that rising inequality was inevitable in fast growing economies. The Northeast Asians proved otherwise; their record is one of growth with equity. They did not achieve this through the traditional mechanism of the welfare state. Land reforms played an important part in levelling the playing field in Japan, Taiwan and Korea. In all three cases, radical land reforms transferred land from rentier landlords to small farmers. The American pushed land reforms through in post-war Japan and Korea for political reasons. These reforms abolished tenancy farming and created a new class of land owning small farmers that became the bedrock of political support for the Liberal Democratic Party in Japan. In the case of Korea, land reforms prevented the Communists from mobilising impoverished peasants and provided valuable political support for the war against North Korea. The Kuomintang, who arrived as outsiders in Taiwan, used similarly draconian land reforms to build domestic political support. The impact of these reforms on income distribution was material and dramatic.

The emphasis on equity in these countries did not end with land reform. Land reforms helped create starting conditions with relatively low levels of income and wealth inequality. This was followed by very substantial investments in public education. In the early years, the education effort in these countries was focused on achieving universal access to primary and secondary education. It then progressively shifted to investments in post-secondary scientific and technical education and training. Investments in education, especially in engineering and technical skills, helped the workforce in these countries keep up with, and benefit from, rapid industrial transformation which required breaking through into progressively higher value added technology and skill intensive sectors. As a result, average decadal real wage growth in these countries between 1970 and 1990 was consistently high at an astonishing 70-90 percent (IMF, 2023; Perkins and Tang, 2017). Even as GDP per capita grew 10-15 fold, the Gini-coefficients did not see any material deterioration. The approach to social welfare in these countries was not one of redistribution – they eschewed the traditional approach of providing social protection and insurance. Instead, they chose mostly to invest their social capital into making high quality education and skills training widely accessible. Organised labour did not have much of a voice, but like the Japanese system of life-time employment contracts and Korea's restrictions on termination of employment, alternative institutional arrangements were used to manage and contain the potential for social dislocation from rapid industrial change.

China's approach to catch up has been broadly similar. At the starting point of their market reform journey, the distribution of income and wealth in China was relatively equal. Nationalisation of all land and collectivisation of agriculture under Mao's leadership pretty much ensured this. Instead of land being transferred from rentier landlords to the tilling farmer as in other Northeast Asian states. However, China's journey of economic transformation started with the de-collectivisation of farming when the stewardship, not the ownership, of agricultural land was transferred from the state back to individual farmers. Even today, no individual or company can own land in China, but

rights to land use are quite widely tradeable and typically secured by long term lease contracts. Like the other Northeast Asian countries, China largely avoided policies of welfare support. It has invested in securing broad-based access to education while also using indirect subsidies and support from SOEs to protect the 'iron rice bowl' of state sector employees as the economy has navigated market reforms. Despite these measures there has been a marked deterioration in income distribution in China. Different estimates place China's Gini coefficient between 0.4 and 0.52, which is worse than the U.S (Mazzocco, 2022). This is undoubtedly one of the driving forces behind *Xi Jin Ping*'s Common Prosperity agenda that has prompted a prolonged anti-corruption campaign and heavy-handed regulatory intervention in the country's private companies, especially in the tech sector. Citing concerns about unfair market practices and abuse of monopoly power, the State Administration for Market Regulation (SAMR) has imposed heavy fines on the country's largest internet companies. There is likely a political message as well that is being conveyed to high profile billionaires perceived to have acquired too much influence and too high a profile.

The leaders that spearheaded Singapore's independence were operating in the context of radical organised labour activism at the time. They had all been exposed to the socialist ideas linked to the anti-colonial movement in the U.K.. Mindful of the need to build broad-based support, Lee Kwan Yew's Political Action Party was seized of the importance of addressing popular concerns about social equity. A commitment to universal home ownership facilitated through major public investment in affordable housing went a long way towards managing this issue. About 80 percent of the housing stock in Singapore has been developed through public funds and the percentage of home ownership is amongst the highest in the world. Over time, home ownership was supplemented with significant investment in education and training and the resources of the Central Provident Fund. The latter, funded with mandatory employer and employee contributions, is intended to provide support for medical, retirement and other select welfare needs of wage earners. Overall, Singapore's approach to social policy still remains relatively narrow compared to the European social democratic conception of the welfare state. Post-Pandemic, however, the Singapore government has begun to articulate the contours of "new social compact" that aims to extend state support for the more vulnerable segments of society and invest in strengthening social solidarity.

Over time, as democratisation has taken hold across the region, the nature of social policy in Northeast Asia has shifted. Democratisation has changed the intent of social assistance programs in Korea and Taiwan. From being investment oriented or 'productivist', i.e., focused on enhancing the productivity of the nation, they have turned more towards protecting the well-being and basic consumption needs of the population. They have gone from targeting only 'residual' social needs, i.e., the gaps left after familial support has been exhausted, to becoming more universal in nature. Thus, for example, health insurance became universal in Korea and Taiwan only in the late 1980s, shortly after both countries became democracies. In the face of growing income inequality, even China has become more responsive to concerns about social equity. Not only has it been investing heavily in affordable housing, but it has also turned systematic attention to broadening access to health care and retirement benefits as part of the regime's Shared Prosperity campaign.

Conclusions

What is remarkable about the developing world's experience in the post-WWII era is that none of the countries that have succeeded in pulling themselves out of low-income status have been democracies, at least for the most part of their respective journeys.[71] All of them have had strong bureaucratic and state capacity. The most successful amongst them have been 'hard states' in the sense they have autonomous state bureaucratic machinery able to navigate independently of vested interests. Moreover, all the successful countries have used what political scientists call social "side-payments" to facilitate the changes and adjustments essential for economic transformation without material social disruption. The social compensation mechanisms used by successful countries have, at least historically, taken the form of social investments, such as access to education and healthcare, rather than redistributive entitlements. In fact, effective social compensation policies were key to creating the political space these countries needed to build a 'hard state. It gave the bureaucratic state legitimacy, and hence the autonomy, to implement an activist industrial policy without stoking anti-business sentiment. In the light of this experience the obvious question that arises is the following: can hard states with superior capacity develop only under authoritarian regimes? And, therefore, to the extent that a high performing state is a necessary condition for economic catch up, then is successful economic transition not possible for poor democracies? To shed light on this question it is useful to examine the relationship between democracy and markets more deeply.

[71] All Northeast Asian states and Singapore had one-party or military rule at some point ahead of their transition to democracy.

8. Democracy and Free Markets: Uncomfortable Bedfellows

The libertarian narrative on markets and democracy is steeped in the emotive vocabulary of freedom. The argument is that both are about freedom, one about economic freedom, the other about political freedom. Economic freedom begets political freedom and vice versa, and hence, the two are complementary. The reality is more prosaic.

Markets are amoral. They do not care about equality. They function for efficiency. The foundations of democracy, on the other hand, are rooted in the notion of popular sovereignty which itself stems from a yearning for representation and voice. As Michael Sandel (2012) puts it: "Democracy does not require perfect equality, but it does require that citizens share in a common life." The drivers of democratic politics are inextricably linked to a quest for fairness, dignity and social justice and thus often collide with the logic of freely functioning markets. It is no coincidence that in all Western democracies, markets flourished before democracy did. Although many believe that modern democracy took hold before the industrial revolution and the spread of capitalism, the reality is otherwise. It is true that the democratic idea was very much enshrined in the American Constitution and the French Revolution. Nonetheless, it took more than a century, and a lot more violence and social mobilisation before these democracies recognised that the philosophy of natural rights that underpinned their respective revolutions must also extend to the poor, to the uneducated, to women and to people of colour. Meanwhile, capitalism was spreading fast, generating unprecedented wealth for the beneficiaries of the First and Second Industrial Revolutions.

Historical Sequencing: Markets Before Democracy

A necessary condition for democracy is mass participation in the political process. Through it, democratic accountability, that is accountability to broader society, is established. Liberal democracy, however, sets a higher bar; it also demands the rule of law. In essence the rule of law refers to a set of socially acceptable rules and principles that apply equally to all, including the most powerful in society. If the political leadership of a country is able to hold itself above the law, even if the law applies uniformly to all others, that country does not qualify as a liberal democracy. The rule of law protects the citizen from the state's exercise of absolute power.

Historically, the rule of law is not a new idea. It evolved independently from systems of democratic participation. The rule of law has existed in many societies around the world for a long time, especially where spiritual or religious authority was distinct from political authority. In Ancient India, for example, the authority of the Kshatriya Kings was circumscribed by the Brahman priests. The same was true of Christian and Islamic monarchies in which even the sovereign was subject to the religious laws upheld by the Church and by the Caliphate respectively. It was the work, rooted in the ideas of the Enlightenment, of the likes of Thomas Hobbes and Samuel Pufendorf, that helped absolutist monarchs rid themselves of the restraints of ecclesiastical jurisprudence. These thinkers popularised the theory that sovereignty legitimately rests with those who can protect the

natural rights of individuals, notably the right to live in peace.[72] The monarch, as guardian of the 'social contract' between the individual and the state, could thus lay legitimate claim to sovereignty.

Pufendorf (1703)[73] was especially influential in the process of Prussian state formation led by Frederick William of Brandenburg and his successors from the House of Hohenzollern. As a result of these competing trends, the Prussian state of the mid-18th century was a curious mixture in which the Junker aristocracy governing the estates had to abide by a body of administrative law that included a host of charters and contracts defining feudal rights and duties, while the Emperor managed to remain above the law. By the end of the 18th century, the body of administrative law across Prussia's various provinces was aggregated into a unified system culminating in the Prussian Civil Code of 1794, which incorporated a system of lower courts that allowed individuals to settle matters with other individuals or even sue the state if they believed that they had been treated illegally by the government. The Stein-Hardenberg reforms of 1807 opened up the bureaucracy to meritocratic recruitment, eliminating all remaining legal privileges to the nobility, including especially their sole ownership rights to landed estates. This completed Prussia's transition from a patrimonial monarchy to what has been called a 'liberal autocracy', one in which the emperor, seen as the embodiment of the public good and national interest, ruled free of constraints from any other authority, but through an impersonal, autonomous, bureaucracy functioning within a framework of laws and procedures applicable equally to all, except the emperor. The Prussian 'Reichstaat' was not subject to the 'rule of law' as defined earlier but functioned efficiently as per the 'rule by law' (Fukuyama, 2014. This framework of national governance was enough to allow markets to take hold and for private enterprise to thrive. Over the next century, Germany saw the rise of formidable corporations, including Siemens, Krupp and Phoenix AG to name a few, that helped the country catch up in the race to industrialise. Industrial strength was seen as strategically vital to the goal of securing Germany's position as a great power. Thus, as Bismarck navigated the journey to German unification and beyond, he used the bureaucratic state to protect the interests of the emerging industrial middle-classes. Anticipating demands from a growing working class for democratic participation and redistribution he fashioned a formidable coalition between the new industrialists and landed Junkers, the so-called steel and rye coalition, which was able to resist meaningful progress towards universal suffrage until the aftermath of WWI in exchange for the introduction of a series of social protection measures. Germany's early adoption of a welfare state, including universal health insurance and pensions, prevented the radicalisation of the Social Democratic Party and of the working classes that it sought to represent. It facilitated the rapid industrialisation of the country, but delayed democratisation.

The French Revolution of 1789 did not result in a seamless transition to democratic participation. The Revolution's *Charter of the Rights of Man and the Citizen* was crafted by an emerging bourgeoisie more concerned about protecting their own interests than in democratic participation of the peasantry, and the working classes were much too small at the time to have any meaningful

---

[72] Best known for Leviathan

[73] *Of the Law of Nature and Nations*

voice. In the counter revolution and turmoil that followed, this incipient middle-class was happy to align itself with the Napoleonic coup of 18 Brumaire to restore a measure of order and stability. The introduction of the French Civil Code in 1804 represented a major advance in the country's legal system. It set the framework of rules and procedures for commerce, and secured the right to private property for the post-feudal world, triggering an economic boom that facilitated the industrialisation of the French economy. However, meaningful democratic participation would have to wait until the Third Republic (1870-1940).

Britain also developed a legal culture early, not so much from a conflict between Church and State, but from a conflict between the sovereign and feudal estates, the latter acting as a check on the former's power. Following their conquest of Britain, in a bid to gain legitimacy with their subjects, Norman monarchs set up a King's Court in London. The idea was to provide access for the public to a more reliable forum for adjudication of disputes than that available to them in their respective Lords' Courts, i.e., the local courts of feudal landlords. The King's Court was administered by a combination of clergy and crown bureaucrats and became the repository of judgements that eventually comprised the body of case law that came to be applied uniformly across the estates owing allegiance to the King. This body of law became the foundation of the system of Common Law. The uniformity and predictability that this provided for matters pertaining to tenancy rights, to contacts, and to the transfer and ownership of land, facilitated the growth of merchant capitalism in Britain.

It also facilitated innovations in banking, credit and accounting that helped the British East India Company, the largest and most complex private corporate organisation of its time, to spread its business around the world. Ironically, Common Law in Britain originated as an effort by the King to protect individual peasants and merchants from the capricious exercise of power by feudal estates; the 'rule of law' came later. It was the outcome of efforts by the estates to restrain the power of the monarch. The Glorious Revolution of 1688 marks the institutionalisation of the rule of law in Britain. Parliament, which, at the time, was an assembly of the feudal lords, resisted the efforts of Stuart kings to impose taxes on the estates to fund their military campaigns. The revolt, led by Oliver Cromwell, resulted in the Stuarts being deposed and replaced with William of Orange who, under the Lockean principle of 'no taxation without representation', accepted Parliamentary constraints upon sovereign authority.

By the time the First Industrial Revolution arrived in the early 19th century, Britain was well placed to capitalise on innovation. Its existing landed elite of the Conservative Party and the emerging urban industrial elite worked together in Parliament to slow down calls for democratic participation, a trend seen across Europe. It took almost a century from the First Reform Bill of 1832 for Britain to embrace universal adult suffrage in 1929, when women were finally allowed to vote. Through the 19th century, all manner of arguments, including from highly respected intellectuals, were used to keep the poor from voting. John Stuart Mill, for example, argued that non-taxpayers should not vote and that the vote of the better educated should carry greater weight. Edmund Burke was of the view that working class people were not qualified to rule. Walter Bagehot argued that the "working classes contribute almost nothing to our corporate public opinion and therefore the fact of their want of influence in Parliament does not impair the

coincidence of Parliament with public opinion" (Fukuyama, 2014). The intellectual arguments of influential voices were used to justify excluding the poor and uneducated from coverage of the franchise. It was not until after WWI in 1919 that Britain got suffrage for all adult males.

Finally, let us turn to the American experience. The American colonists carried the principles of Common Law with them to the New World and established the legal foundations for the development of markets in the United States. Up until the Civil War in the mid-19th century, the U.S. was largely agrarian, decentralised and unburdened of the class rigidities of feudal Europe. In this milieu, the Common Law emerged as an important source of authority, turning America into a society of courts and contracts in which lawyers and judges enjoyed great social prestige and legal institutions played a vital role in public life. Even though the U.S. started with a more level socio-economic playing, by the late 18th century, a class of powerful, wealthy, elite comprising the banker-merchants from the Northeast and the planter-gentry from Virginia dominated the public discourse. The framers of the Constitution all came from this elite.

It is hardly surprising that although their conception of "We the People" was more inclusive than that of their counterparts in Britain and Europe, they were much more concerned about the rule of law than they were about democratic participation. At the time of the promulgation of the American Constitution, only white male property owners were allowed to vote. All white males were allowed to vote starting in the 1820s, but despite the Civil War, the franchise was not further expanded thanks to the 'Jim Crow' laws that made it impossible for people of colour to vote until well into the 20th century. Women did not get the vote until the 19th Amendment in 1920, and it took the Voting Rights Act of 1965 to finally guarantee all African Americans the right to vote.

For much of the 19th century, the U.S. was a classical libertarian paradise with a strong commitment to protection of property rights, the freedom to enter into voluntary contracts supported by a well-functioning court system, decentralised government with most decisions being taken at the state and local levels, minimalist state intervention of any kind, very low federal taxes, and a small military focused essentially on securing the expansion of the country's Western Frontier. During this time, the country saw vigorous economic development. The expansion of cultivable land fueled an agricultural boom in the West and Midwest. The invention of the ginning machine and a ready supply of slave labour propelled the South's plantation economy. The development of the railroads, steam engine, and telegraph vastly improved transportation and communications helping America become the primary supplier of food grain and cotton to Britain. By the 1870s, the country entered the Gilded Age with the development of a dynamic industrial sector, the labour requirements of which were fed by new waves of trans-Atlantic migration. Starting with the railroad companies, the U.S. pioneered the development of the large, professionally run, hierarchically organised, industrial corporation, that were then followed by breakthroughs in mass manufacturing technology that marked the beginning of the Second Industrial Revolution in the early 20th century. Consequently, huge opportunities emerged in real estate, trading, transportation, banking, industry and retail.

As the American economy was being transformed, in the absence of a strong bureaucratic machinery of state, a political culture of clientelism took hold. Francis Fukuyama explains how the

rise of party politics contributed to the creation of the American system of bureaucratic patronage. Party machines evolved to mobilise mass political support, which became necessary after the expansion of the franchise. A patronage and spoils system was used as the means to garner political support, especially from the poorer segments of the electorate. Access to positions in government, contracts to favoured parties, all became part of this early stage of the democratisation process. A new class of wealthy rose to prominence, amassing great family fortunes and great influence. For example, the Vanderbilt fortune came from shipping and the railways. The Rockefellers grew Standard Oil into a vertically integrated oil giant. Andrew Carnegie was key to building the country's steel industry, as J.P. Morgan was for banking, and Henry Ford was for the automobile industry.

Compared to the 'hard states' of East Asia that we described earlier, the U.S. was a very 'soft state' indeed. Given this milieu, it is hardly surprising that corruption and influence peddling became rampant as vested interests became more assertive. The Gilded Age is well known for the nexus between big business – the giant conglomerates of the time that were organised as 'trusts' -- and Congress. The railroads were particularly notorious for buying political influence.

On the flip side, the rapid pace of industrialisation also created a new urban middle-class. Educated professionals left out from the old elite circles and excluded from the spoils system made common cause with a new generation of small business owners feeling stifled by the burgeoning business empires of the trusts. Together they became an influential voice demanding reforms of the bureaucracy and restraints upon big business. In response to pressure from this emerging constituency, a beginning was made towards reform of the civil service with the Pendleton Act of 1883, and towards anti-trust regulation with the Sherman Act of 1890. But it took another quarter century before a comprehensive framework for dealing with unfair trade practices was set up with the Federal Trade Commission Act of 1914. And it took more than half a century before the civil service rules were comprehensively rewritten and made primarily merit based in the late 1930s. Along the way, the leadership of Theodore Roosevelt and the ideas of the likes of Woodrow Wilson played a pivotal role in mitigating the influence of big business on government and in bringing change to the clientelist nature of the American state. As the spoils system was dismantled and the franchise further expanded with the 19th Amendment, it became harder for Congress to ignore the voice of poor and lower middle-classes. But it took the Great Depression to pave the way for Franklin Roosevelt's New Deal and for a system of social protection to be introduced in the U.S.

The Theory of Democracy's Social Drivers

The historical evidence is quite clear: democratic participation only gained momentum once markets had taken hold and the transformation to modern industrial economies was well underway. In fact, the dominant theory of democratisation is that democracy is the result of social mobilisation triggered by transformational economic change. The previous section highlighted examples in France, the U.S., and the U.K., but their trajectory is the same across all the other

mature democracies of today, including Germany, the Netherlands, and the Scandinavians. The causal path for all Western market-oriented democracies led from rule of law to markets, to economic growth, to social mobilisation, to changes in values and demands for political participation and ultimately, to liberal democracy.

The journey was long and not always smooth or continuous. Barrington-Moore was one of the earliest and amongst the most influential to argue that the bourgeoisie or the middle-class is the social bedrock of liberal democracy (Moore, 1966). Historically, as market based economic systems developed, the division of labour and capital accumulation that characterised them led to great social change, creating not only a whole new industrial working class as predicted by Marx, but also a new urban middle-class. The working classes, especially in the early stages of industrial development, sought democratic participation to register a voice for labour rights, redistribution and social protection, an agenda that the established landed elite resisted, leading to confrontation, even violence, making the journey to liberal democracy unpredictable and discontinuous. The middle-classes on the other hand, sought democratic participation not as a means for forcing redistribution, but rather as an act of individual political agency intended to restrain the power of the state and secure their right to property. As we saw earlier in the case of the French journey, the bourgeoisie that drafted the Revolution's Charter of the Rights of Man and the Citizen was happy to align itself with the counter-revolution when the deteriorating law and order situation became a threat to their property. Meaningful expansion of the franchise in France had to wait another eight decades under the Third Republic. By that time the bourgeoisie had itself expanded considerably in size, wealth, and influence, and the idea of the right to vote as just another legal right that was part of the broader framework of the rule of law had become a popularly accepted idea. Consequently, the old elite also felt less threatened because the congruence between their interests and those of the new middle-class had become more evident. Liberal democracy took hold only when the middle-classes were large enough to win the support of the ruling elite in accepting broader based democratic participation as a means of securing the rule of law and the right to property, rather than as a means to seek redistribution. The latter was the agenda of the emerging working classes. As they themselves became more prosperous on the back of rising labour productivity and rising real wages, a turn of events not anticipated by Marx, they became less susceptible to radicalisation, paving the way for the peaceful expansion of the franchise with support from the ruling oligarchy.

As prosperity spread with economic growth, the potential median voter went from being poor and focused only on redistribution, to being middle-class with a stake in shaping the existing system. Thus evolved the golden era of democratic capitalism in Western Europe, Britain, Japan, and the United States. Based on this experience, the theory is that the emergence of a stable liberal democracy is contingent upon the emergence of a prosperous middle-class that identifies with the twin goals of protecting the right to property as well as the right to vote. And further that the emergence of such a middle-class is itself contingent upon economic growth and the prosperity generated from, and social changes triggered by, the development of a modern capitalist economic system. It is in this sense that the success of liberal democracy depends on sequencing markets first, followed by political participation.

Alas, few countries have been so fortunate. Very unequal agrarian societies such as Russia and China, when confronted with the forces of economic modernisation, did not produce a large enough middle-class to play any meaningful role in the political evolution of those countries. In both cases, a large, impoverished peasantry and militant working class rose in violent revolt, eventually prevailing over the ruling oligarchy to establish communist regimes. In much of Latin America, also very unequal societies, land- and resource-rich oligarchies have been successful in repeatedly imposing right wing authoritarian rule. In this case, radical, largely indigenous, peasant movements, such as the Sendero Luminoso in Peru and the Revolutionary Armed Forces of Colombia – People's Army (FARC) in Colombia, or organised working class movements, such as the Workers Party (PT) in Brazil, the Communists in Chile, and the Tupamaros in Uruguay, have been pitted against the military establishment and landed oligarchy in cyclical, often violent, battles for power that have caused these countries to lurch back and forth between short lived democratic experiments and periods of authoritarian rule. In this politically polarised context, being small relative to the rest of society, the middle-classes have mostly chosen order over the fear of anarchy. They have chosen to secure their wealth rather than fight for democratic voice. A similar dynamic was at play in Germany, Italy, and Southern Europe during the interwar years. The middle-classes in these countries saw much of their wealth eroded in the years leading up to WWII because of the mismanagement of incipient democracies. In the face of rising radicalisation of the working class during this period, the middle-classes threw in their lot behind the Fascists.

In sum, the lesson from history is that while the emergence of a middle-class is important, it is not by itself sufficient to ensure a transition to a democracy. The middle-class is more likely to play a constructive role in building and sustaining a liberal democracy, if it is the pivotal group in society. To the extent that economic growth is vital to the expansion of the middle-class, it is not surprising to find that more prosperous societies also make for more stable liberal democracies. Indeed, the successful transition of countries like S. Korea and Taiwan in East Asia, and that of the Czech and Baltic Republics in Eastern Europe, has been very much as per what the theory of the social origins of democracy would predict.

The theory is clearly not universal – it does not explain the path to, or away from, democracy in many countries. Economic growth and the emergence of a middle-class do not necessarily lead to democratic systems of governance. Social change and mobilisation triggered by economic transformation is not the only reason why countries have turned to democracy. In some cases, external pressure -- as in the case of Germany and Japan after their military defeat – led to democratisation. In other cases, like India, the eroding legitimacy of the authoritarian or colonising incumbent was the proximate impulse for democratisation. In the case of many countries that have been part of the Third Wave of democratisation, especially those from the ex-Eastern European bloc, economic crises, contagion, and imitation, have also been factors that have led to democratisation. Even though the theory does not explain how these countries turned to democracy, it does offer a plausible perspective about the durability of liberal democracy in each case. What the theory suggests is that as long as a sufficiently large middle-class does not emerge – one with a self-interest in safeguarding individual and property rights and democratic participation – the hold of liberal democracy is likely to remain tenuous. The theory does provide

useful insight into why so many countries that adopted democratic forms of government in the second half of the 20th century have become what are being labelled 'illiberal democracies'. Absent a large enough societal basis with values that align with liberal democracy, these countries have ended up as 'isomorphic mimics' (Pritchett et al, 2012) of the real thing – they have become liberal democracies in form rather than substance.

Democracy and the Transformation Challenge of Developing Countries

Much of the world today is characterised by what one might call 'development without modernisation'.[74] This is a phenomenon typical of many countries around the world in which economic growth has not been accompanied by transformative industrialisation. In much of Sub-Saharan Africa, Latin America, and parts of Asia, economic growth has not created a large enough middle-classes to provide the appropriate social bedrock considered to be essential for stable liberal democracies.

Instead, economic development has created a rapidly growing class of urban or semi- urban poor, displaced from agriculture, but now dependent on a low paying informal sector. As agricultural productivity has grown in these countries, marginal farmers and other farm workers have had to turn to an urban informal economy for their livelihood. In many cases, the informal sector now accounts for 60-70 percent or more of total employment and it operates largely outside the framework of law, regulation, and taxes. The problem is greatly compounded by low levels of state capacity and capability. In such a context, the application of the rule of law remains patchy, extending mostly, and that too, not always, to the formal parts of the economy. Many countries with these characteristics have, contrary to the predictions of theory, adopted democratic forms of government. Elections based on universal suffrage do take place and are highly contested. Given their weak state capacity, they have become fertile ground for various forms of clientelism, insider capture and corruption. Electoral contests, not always conducted freely or fairly, have descended into contests for control over state resources. The state has essentially become a piggy bank to be used for building and retaining a base of political support, which is mobilised based on appeals to religion, race, ethnicity, nationalism or whatever is most effective for building networks of clientelist loyalties. Such is the nature of electoral politics in the likes of Nigeria, Kenya, Iraq, Pakistan and Benin.

Recall our earlier narrative about Benin in the late 1980s. General Kerekou had little choice but to avail of the balance of payments support offered by the Bretton Woods institutions in exchange for implementing a pretty draconian fiscal austerity plan and a program of orthodox economic reforms. This "structural adjustment program", compounded with the end of the Cold War, contributed to the decline and end of Kerekou's leadership. Benin became a republic in 1990, adopting a new constitution and a multi-party democracy. Ironically, it did not take Kerekou long to return to power. He won the country's second presidential election in 1996, having abandoned

---

[74] Fukuyama uses this term to explain the predicament of Southern European countries in Political Order and Political Decay (2014).

his attachment to both Marxism and atheism, and having turned himself into an evangelical pastor! Benin has since joined the long list of countries where elections are contested, albeit not always in a free and fair manner, where commitment to the rule of law remains uncertain, and where substantive economic transformation remains elusive despite economic growth.

In other developing countries, a more perverse variant of the above system has taken hold: one in which power is more concentrated and contestation between members of the oligarchy is much more limited or non-existent. In such systems, the ruling oligarchy has, usually with tacit or explicit support from the military establishment, used a combination of strategies to retain authoritarian or quasi-authoritarian control. These strategies include co-opting a relatively small and insecure middle-class of merchants and professionals on the promise of order over anarchy; using state resources to fund pro-poor populist policies; repressing organised political opposition; using identity politics to shore up legitimacy; and manipulating or even doing away with electoral competition altogether. This is the system of governance that has emerged in Guatemala, El Salvador, Egypt, and the poorer Central Asian states like Turkmenistan. The African version of this model is quite distinct. It revolves around a neo-patrimonial 'Big Man' culture. A 'patrimonial' system differs from a 'clientelist' one in the degree of personalisation of relationships. In clientelist systems, although patron and client are linked through a bond of mutual loyalty, the ties between the two tend to be impersonal, involving the same ethnic group or co-religionists. In patrimonial systems, the bond between patron and client is personal – patronage is extended mostly to friends and extended family of the Big Man. Mobutu of the Democratic Republic of Congo was in power for 32 years. Biya of Cameroon, Obiang of Equatorial Guinea, and dos Santos of Angola, have each been in power for over three decades each, and are still in office!

The theory of democracy's social drivers offers no helpful insight into the future trajectory of the range of developing countries described above. The optimists doggedly continue to project that the pursuit of market friendly policies and integration into the global trading and financial systems will deliver economic growth such that a large enough educated middle-class will eventually emerge to imbue the politics of most developing countries with a commitment to the rule of law and a commitment to genuinely more democratic systems of governance. The belief is that to the extent that the urge to seek voice and to exercise individual agency is a universal phenomenon, economic development will eventually bring about a stable and more democratic political culture around the world.

Arguably, the evolution over the past several decades of the likes of Brazil, Argentina, Chile, Mexico, Ghana, Botswana, Indonesia, and Thailand, despite their respective difficulties and setbacks, validate the basis for optimism about inexorable global progress along the path of democratic capitalism. Realistically though, such a future is far from assured. As we argued in earlier chapters, the experience of the few latecomers who have been able to navigate an economic transformation from developing to advanced economy status since WWII is that state capacity and capability is vital to success. The real difference between Sub-Saharan Africa and East Asia is not the degree of democratic participation, or their respective commitment to market reforms. The fundamental factor that accounts for their different trajectories is state capacity. In

fact, over the second half of the 20th century, democracy was more widespread in Sub-Saharan Africa than in East Asia.

What should be clear is that without addressing the challenge of state of capacity, most developing countries would be unlikely to deliver the sustained economic performance that the theory predicts is necessary to allow stable liberal democratic systems to take hold. But state building is not a trivial challenge. State capability is the outcome of history, geography, conflict, culture, and serendipity. As Fukuyama eloquently explains, "getting to Denmark" -- where Denmark is a symbol for a prosperous, democratic, secure, and well governed place – is no easy thing. Many countries are thus at risk of remaining caught in the poverty trap with very remote prospects of ever 'getting to Denmark'.

It is equally the case that even mature liberal democracies with advanced market economies are vulnerable to state decay. Indeed, the rise of populist and extremist politics and the growing backlash against globalisation across Western democracies is an indication that something is broken. Is democratic capitalism losing its legitimacy? This is the question that we turn to next.

9. The Crisis of Democratic Capitalism

Marx's dire predictions about the collapse of capitalism were belied. Contrary to his expectations, rising levels of labour productivity led to a sustained rise in real wages, helping large swaths of the working class to join the ranks of the prosperous middle-class across the developed world. He also did not foresee the democratisation and expansion of the electoral franchise across capitalist systems. Following WWI and the Great Depression, political action by organised labour helped lay the foundations for present day worker and social protection frameworks. With the influence of organised labour in the ascendant, variants of Social Democratic Capitalism took hold in most of Europe. Whereas in the U.K., France and Southern Europe, labour-management relations tended to be more confrontational, in Germany, the Netherlands and Scandinavia, there evolved a system of consensual decision making involving annual consultations between representatives of industry, banking and labour on wage setting, and with government on social protection. Social Democratic Capitalism led to the steady expansion of the welfare state across the board. Immediately after WWII, the Labour Government in Britain implemented a sweeping program of nationalisation that included the Bank of England, rail transport, coal mining, electricity, gas and civil aviation. Even in the U.S., the home of classical libertarian capitalism, after Franklin Roosevelt's New Deal and Lyndon Johnson's Great Society program expanded the scope of social protection and welfare between the 1940s and 1960s. The most important of these was Social Security, and public health insurance in the form of Medicaid and Medicare. This was a period of vigorous economic growth for the West and so the escalating costs of these programs were comfortably absorbed.

The apple cart of Social Democratic Capitalism was upset by the oil shocks of the 1970s. Productivity growth, and economic growth more generally, slowed down. The world confronted stagflation: a combination of stagnant growth and inflation at the same time. The Anglo- American response to this was Thatcherism, Reaganomics and the financialization of capital. The diagnosis was that the real economy, the financial system, and entrepreneurial animal spirits were being stifled by an overbearing state, burdensome taxes, and extortion from powerful labour unions. Privatisation, deregulation, lower taxes on corporations and capital, and a reduction in the power of organised labour became the new prescription. Keynesian demand management was replaced with Friedmanite monetarism. From being an ardent proponent of capital controls before Nixon abandoned the dollar peg, the U.S. became the most aggressive advocate for international capital mobility. Thatcher famously broke the back of the coal miners' union in the U.K. In parallel, trade union membership as a share of total employment in the U.S. saw a steady decline from the 1970s onwards.

The 1980s triggered a revival of libertarian values. It gave shape to the dogma of neo- liberal capitalism and gave voice around the world to the Washington Consensus. This had major implications for the development of financial markets and for the broader process of globalisation. At the time, the consensus of opinion was that these were forces for good. That the European model – variously labelled social democratic capitalism, corporatist, or relationship capitalism – had run its course. That this model, while good for social stability, was not capable of nurturing innovation. Schumpeterian creative destruction needed the discipline and democratising power of

transparent and impersonal financial markets, rather than the opaque and exclusionary mechanics of relationship banking and consensus-based decision making amongst supposedly representative power brokers. Efficiency, access and diversification were the three pillars on which the edifice of late 20th century Anglo-American financial capitalism was built. But in retrospect, too much of a good thing eventually became problematic, not just for America, but to varying degrees also for other mature democracies with market economies. To understand how this happened, it is useful to delve a bit further back in history.

The Bretton Woods Framework and the Rise and Retreat of Globalization

At the start of WWI in 1914 global trade and finance functioned on the basis of the gold standard, whereby each major currency was backed, at a fixed exchange rate, by gold bullion held in reserve with the central bank issuing that currency. This was close to the end of the era of Pax Britannica. Sterling was still the currency of choice for transacting global trade, but the U.S. had overtaken Britain as the largest economy in the world by then. To finance their extraordinary wartime expenses most countries, including Britain, resorted to devaluing their respective currencies so that they could expand domestic paper money supply to meet their payment obligations without a commensurate expansion in their gold reserves. This undermined confidence in sterling as a reliable store of value. There was a run on sterling and Britain was forced to abandon the gold standard in 1919, marking the end of sterling as an international reserve currency. Meanwhile, the U.S. emerged as the world's largest creditor nation and trading power and the dollar replaced sterling as the world's preferred reserve currency. Although efforts were made to restore the gold standard during the interwar years, these were halfhearted. The Great Depression was the last straw. With most nations in desperate need to spend their way out of trouble, the gold standard was abandoned in the early 1930s. During WWII, the U.S. became the main supplier of military equipment and other goods to the European Allies, for which it extracted payment in gold. By 1945, the U.S. was sitting on the largest stockpile of gold reserves in the world. With the gold reserves of the Europeans having been significantly depleted a return to the gold standard was not feasible. Instead, the nations that convened in Bretton Woods after the War laid the foundations for a new international monetary system. The U.S. agreed to keep the value of the dollar fixed to gold and the remaining countries agreed to maintain a fixed exchange rate between their respective currencies and the dollar. As a result, the dollar officially became the world's reserve currency and thus began the era of *Pax Americana.*

In 1944, then U.S. Secretary of the Treasury Edward White convened a conference for delegates from 44 countries to come to deliberate on the future of the international trading and financial system. What emerged was the Bretton Woods Agreement that marked the transfer of stewardship of the international economy from Britain, then heavily burdened with War related debt, to the U.S., which had emerged as the largest economy in the world. In 1946, the U.S. accounted for 52 percent of global GDP (World Bank, 2023), 27 percent of global exports (WTO, 2023) and 55 percent of global gold reserves (Federal Reserve Bank of St. Louis, 1948).

With huge and recurring current account surpluses, the U.S. had also become the largest creditor to the rest of the world. White's objective was to ensure that the rest of the world remained open to U.S. exports and to secure pole position for the U.S in global economic affairs. The British delegation was led by John Maynard Keynes. While Keynes was happy to support a framework agreement that bound all members to freer global trade, he was keen, having lived through the Great Depression, to protect the ability of each member country to keep control over domestic demand management. Under the Gold Standard, no government had independent control over its own money supply. Attempts to stimulate domestic demand through government spending would get partially undone because the consequent rise in the country's trade deficit would deplete the country's gold reserves and cause a monetary tightening.[75] But this led to competitive beggar-thy-neighbour policies of currency devaluations that were hugely disruptive for international trade. To restore order to international trade, and yet allow each country space to control its own demand management policies, a hybrid system had to be devised. Thus, the Bretton Woods Agreement created a system of fixed exchange rates with the US dollar as the anchor currency, itself tied to a fixed parity versus gold. Stable exchange rates along with rules to preserve free trade tariffs were intended to promote cross-border trade in goods, while agreements requiring all members to cooperate in enforcing restrictions on capital account mobility were intended to preserve domestic policy autonomy. This system worked well for a while. World trade flourished even though international capital mobility ground to a halt, and along with it, financial market development was placed on the back burner.

Things began to change when Lyndon Johnson's Great Society Program and the accumulated costs of the Vietnam War caused the U.S. to flood the market with paper money – as the British had done in the wake of WWI. This rise in government spending pushed the U.S. from running surpluses to running balance of payments deficits. This trend greatly increased the circulation of dollars outside the U.S, with gold reserves depleting at a steady clip. Keen to secure London's position as an international financial centre, Britain capitalised on this trend and allowed the Euro-dollar market to grow within its jurisdiction; this violated the spirit of the Bretton Woods Agreement because the growing volume of offshore dollars made it progressively harder to enforce controls on cross border capital flows. Those in need of financing from anywhere around the world found it convenient to borrow in dollars from the London market. Sensing opportunity, Wall Street itself got into the act, developing a profitable presence in London as intermediaries of dollar denominated flows outside the restrictive purview of U.S. regulatory oversight. But the phenomenon that was good for the profits of Wall Street accentuated the outflow of dollars and gold from the U.S.. Consequently, as was the case for sterling in 1919, countries began to lose faith in the dollar as a store of value and sought to exchange their dollars for gold. The U.S. could not meet this burgeoning demand for gold. And hence, quite abruptly and unilaterally, Nixon de-linked the dollar from gold. But unlike Britain in 1919, the U.S. was very much still the dominant economic power in, and net creditor to, the world. Whereas sterling was displaced as the world's reserve currency, the dollar was at no such risk in 1971. Egged on by Wall Street, the U.S.

[75] This explains why, in the wake of the Great Depression the Gold Standard was abandoned.

authorities did a complete about-face. From being strong advocates of controls on capital mobility, they became champions for the dismantling of capital controls around the world.

In dismantling the dollar's fixed parity to gold, Nixon basically gambled that the U.S., as issuer of the world's reserve currency, would get away with not submitting itself to the same rules of macro-economic discipline as the rest of the world. He was right. The international system that has been with us since has two features: the dollar, instead of gold, as the global standard; and largely market determined exchange rates. This arrangement has allowed the U.S. to be profligate in its spending, confident in the knowledge that the rest of the world will continue to fund its debt. But any other country attempting to spend beyond its means has been subject to the risk of markets de-stabilising the value of its currency.

The trend of financial deregulation that gained momentum during the Reagan years unleashed financial innovation. Pension funds and life insurance companies were allowed to, and became comfortable investing in, riskier equity and debt products. Access to finance also improved by leaps and bounds. Mutual funds, private equity funds, venture capital funds, leveraged buy-out funds proliferated, making capital available to companies previously dependent on friends and family or their own surpluses for equity financing. Junk bonds and subprime loans made credit available to millions of individuals and companies for the first time. Pushed aggressively by the Washington Consensus the pace of financial deregulation gained momentum. Country after country went down the path of capital account convertibility, restoring international capital mobility to levels not seen since the early 20th century, the previous peak of globalisation. Meanwhile, derivatives, securitisation, collateralized loan obligations (CLOs), and new hedging techniques, brought radical improvement to financial risk management. The complementary expansion of insurance and reinsurance were instrumental in diversifying risk. Risk was spread more widely and evenly, with fewer pockets of concentration across a financial system that was growing rapidly in scale and complexity.

In parallel, rapid developments in technology were fueling changes to the real economy. With breakthroughs in technology, global networks, and financial innovation, the established logic of manufacturing processes and organisational design was revisited. The Third Industrial Revolution led by innovations in computing, electronics, and numerically controlled machinery, contributed to the unbundling of the manufacturing processes. Japanese just-in-time manufacturing dramatically reduced the need for inventory. As capital became more mobile, unbundling went international. The global supply chain was invented, further reducing the cost of manufacturing. With the development of broadband technology and densification of global telecommunications connectivity, outsourcing took off. Even services -- previously protected because of their non-tradeable nature -- became subject to outsourcing. Offshoring of back-office operations and customer service support induced further cost-reducing efficiency gains across a range of businesses.

To accommodate the new challenges and opportunities arising out of the growth of financial markets, outsourcing and offshoring, the General Agreement on Trade and Tariffs (GATT) which related to merchandise trade had outlived its usefulness. In 1995 it was replaced with the World

Trade Organisation (WTO) which now included a framework agreement on trade in services. This effectively marked the end of the Bretton Woods compromise framework as it was originally conceived. In many ways it also marked the victory of finance and capital over manufacturing and merchandise trade and the beginning of the post-Industrial era.

The standard arguments in favour of financial deregulation and capital account liberalisation have to do with being able to gain access to foreign savings, and the associated 'financial know-how', to fuel faster growth than would otherwise be possible, and improved efficiency by letting the market decide how capital should be priced and to what sectors it should be allocated. Most sensible economists would now concede that the benefits from financial globalisation are unclear, especially for small open economies.[76] Since the U.S. abandoned its obligation to maintain a fixed exchange rate against gold, the international monetary system has been seriously asymmetric, enabling the U.S. to be chronically profligate in its spending. It has further made the rest of the world hostage to the Federal Reserve's monetary policy which is anchored in concerns about the needs of the U.S. economy, with little regard to the 'spillover effects' for the global economy, for which the dollar still serves as the reserve currency.[77] As a result, and given the tendency of markets to make mistakes, or to 'overshoot', small, open economies have lost some control over domestic monetary policy and have been made vulnerable to cross-border movements of financial capital reacting to signals from the American central bank. After the Global Financial Crisis (GFC), scepticism about capital account liberalisation has only become deeper. Even in the U.S., many are wondering about the value of financial deregulation and of the financial innovation that contributed to the build-up of the sub-prime crisis. It is far from clear whether the extraordinary financialization of capitalism that has taken place over the past couple of decades has been a good thing for the global economy.

The backlash began to build up when the dark side of financial markets and the associated hyper globalisation led to repeated bouts of instability and contagion.[78] At around the same time as the technologies of the so-called Fourth Industrial Revolution were bringing about further disruption to labour markets with the commercialisation of robotics and the Internet, the world was hit by the GFC in 2008. Since then, the sheen has come off the model of neo-Liberal Democratic Capitalism. The public discourse is flooded with arguments and explanations for the dysfunctionality of liberal democracy and the failings of Anglo-American capitalism, disenchantment with which has grown to acquire significant political and social dimensions. Across the pond, the so-called European models of Social Democratic Capitalism have hardly been immune from these trends. The 2008 financial crisis affected all of Europe. Italy and Greece have fundamental fiscal challenges. The levels of structural unemployment, especially amongst the young, are chronically high, especially in Southern Europe, but even in Northern Europe. The

---

[76] Prasad, Rajan and Subramanian (2007), for example, find little benefit to economic growth from unrestricted access to foreign capital. Kose, Rogoff, Rajan and Wei (2006) from a careful evaluation of data up to 2006 found the evidence for growth benefits from capital account liberalisation to be inconclusive.

[77] Tomasso Padua-Schoppa provides a succinct and accessible description of the international monetary system's problems in *Reform of the International Monetary System* (Boorman and Icard, 2011)

[78] 1987 (US, Black Monday), 1989 (US, Brazil), 1991 (Japan), 1992 (UK, Black Wednesday), 1997 (Asia), 2000 (US, dot com) and then 2008 (GFC).

political discourse everywhere has gotten more polarised. It is to an examination of the causes of this disenchantment that we turn to next.

Technology and Social Dislocation

The Third and Fourth Industrial Revolutions have brought about such radical improvements to computing power and communications technology that their impact on the nature of work across has been profound. The Second Industrial Revolution of the Henry Ford era ushered in new manufacturing technology that created millions of high productivity jobs for low skill workers. At the time, higher skilled white-collar managers worked together with lower skill blue collar workers in hierarchical structures in a complementary manner. The technologies of the late 20th and early 21st century triggered the unbundling of the manufacturing process into geographically disparate clusters of workers, separating highly skilled workers from the low skilled. Since then, low skill jobs have become more mobile and vulnerable to being exported to lower wage economies as part of global supply chains. Contrary to popular belief, onshore manufacturing volumes in the U.S. have increased, not declined over the past several decades. In fact globalisation has not hollowed out manufacturing. Instead, technology has made manufacturing radically less labour intensive and much more skill intensive than before. Unskilled workers displaced because of 'unbundling' have struggled to upgrade their skills to secure a replacement job onshore, with the skill gap between jobs disappearing and those being created far too large for a displaced person to re-enter the labour market at a higher wage. Such workers have either been forced to take up employment in the service sector, where the output per worker is lower than in manufacturing, resulting in lower wages. In some cases, they have become unemployable. Recent advances in robotics and Artificial Intelligence (AI) will further accentuate this problem. In parallel, the influence and reach of labour unions has steadily declined. Politically, capital has prevailed over labour.

A second trend is the offshoring of many service sector jobs that were previously protected because they were physically non-tradeable in nature. Thanks to broadband telecommunications, jobs in back-office operations, customer service support, but also in legal services, accounting, and even medical diagnostic services, become tradeable because they can now be delivered from remote, lower cost, locations. This trend too is not easy to reverse. Vulnerable workers in offshore-able services cut across many sectors that are not organised as the traditional blue-collar workers were. They do not comprise a cohesive enough interest group that can force change in business behaviour. At best, their insecurity and fears manifest themselves into support for the politics of the political extremes. This has accentuated the polarisation of politics and fed resentment towards foreigners.

A third trend is the 'winner take all' phenomenon. The internet has had a profound impact on retail distribution, for example. With e-commerce platforms, scale has become a vital competitive advantage. Network effects kick in for any platform that is first to acquire a user base of a critical minimum size. Once a platform becomes the popular standard, scale becomes a self-reinforcing advantage for the incumbent and a formidable entry-barrier for any new competitor. This dynamic

is not only driving malls out of business, but also poses an existential threat to mom-and-pop corner stores and associated livelihoods. The internet is disrupting labour in other ways too. Whereas hitherto communities in second-tier towns and cities were forced to rely on locally available talent and service providers, from legal advice to entertainment, thanks to the internet, they do not need to settle for second best any more. As a result, 'second tier' talent find themselves less in demand.

Financialization and Economic Disruption

Financial innovation and the development of financial markets was supposed to deliver three things: democratisation of access to finance, diversification of risk, and economic efficiency, through better resource allocation. As we saw earlier, it did indeed achieve all three. But then it went overboard.

As it turns out, markets are not as efficient as they are made out to be. The theory behind the better resource allocation argument is that markets provide greater transparency, better price discovery, and therefore better signals to guide investment. Take the stock markets. Stock prices are supposed to reflect the accumulated wisdom of thousands of participants who have access to information and understand the goings on in listed companies. This is quite different from a bank-centric system of relationship capitalism in which only a club of privileged bankers has access to information. However, markets are not as efficient as financial theory has made them out to be. Stock prices can be disconnected from the fundamentals for extended periods of time and investors do not always behave rationally.

One of the characteristics of more sophisticated equity markets is the dominant role of institutional, as distinct from retail, investors. The former manages other people's money, while the latter invest their own money. Theoretically, professional fund managers are much better at investing than the public, and as such deserve generous fees for managing your assets. In practice, their compensation levels are typically based on their performance relative to some well recognised industry benchmark, usually an index such as the S&P 500. In this construct, to insure themselves against the risk of relative underperformance, even the smartest fund managers are inclined to build portfolios that mimic the index. This behaviour accentuates herd momentum and mispricing of stocks because investors become reluctant to take contrarian positions even when they know that the stock prices are becoming disconnected from the fundamentals.

Over recent years, the U.S. market has seen a dramatic rise in the volume of Index funds that simply replicate the composition of the index. Technology has taken trading to the next level with algorithmic and high frequency trading becoming increasingly fashionable. Billions of dollars have been spent on technology by traders to gain milli-seconds of advantage in price discovery. The theory is that near instantaneous access to information will produce more efficient price arbitrage. To what end? Other than generating huge compensation for a small coterie of tech savvy investment professionals, it is hard to find evidence of any commensurate real sector efficiency gains. While it has radically reduced the role of overpaid fund managers, these trends have further

accentuated herd behaviour in markets. There is thus a built-in tendency, even in the most sophisticated of markets such as the U.S., for bubbles to develop and for this to cause cycles of over-investment followed by disruptive value destruction. The boom-and-bust syndrome associated with financial markets has, as we know, a long history (Reinhart and Rogoff, 2009), but it could be that the increasing technological sophistication of markets is amplifying these swings. There is certainly no evidence that better financial infrastructure has helped to mitigate these gyrations. It is too simple to blame the 2008 crisis on regulatory failure. As many learned observers have pointed out, there are features inherent to financial markets that cause these disruptions. Regulations, such as the Dodd Frank Act, the U.S. Congress' regulatory response to the GFC, is unlikely to be able to prevent a recurrence.

The benefits from financial innovation have been greatly exaggerated. Paul Volcker, the no nonsense Chairman of the Federal Reserve during the troubled 1970s, noted in his characteristically blunt memoirs that in all his years in finance, the only innovation of any consequence was the ATM! Rhetorical for sure. But pretty much on the mark. Since the 1970s, the median male income in the U.S. began to stagnate. This phenomenon remained hidden from view for quite a while for two reasons. First, the rising participation of women in the workplace over the last quarter of the 20th century helped to shore up household incomes even as the men in these households saw their real paychecks shrink. Second, household consumption growth remained unaffected by stagnating/declining male income because of a massive rise in household debt. Financial innovation that followed the Reagan era deregulation, along with much expanded Federal Government support, through the likes of Fannie Mae and Freddie Mac, during the Clinton years, delivered vastly expanded access to mortgage financing and consumer credit. Consequently, household debt ballooned even as household incomes stagnated. This worked fine for a while. But eventually it emerged as a key contributor to the build-up of systemic risk in the American financial system that led to the subprime crisis and eventually to the GFC in 2008 (Rajan, 2017).

Excess systemic leverage also caused deep damage to bank balance sheets. These needed the infusion of vast amounts of public money to survive. Raghuram Rajan has argued that financial markets have intrinsic 'fault lines' that have given rise to repeated crises. John Kay, Adair Turner, and Mervin King, amongst others, have come to similar conclusions. Our assessment is that financial innovation in the U.S. has contributed much more to creating complexity in the financial system than it has added value to the real economy. Escalating complexity served primarily to feather the nest of a bloated financial services industry and to keep it one step ahead of regulators. This was the single most important driver of the 2008 crisis. Under the guise of sophisticated risk management, the finance industry in the U.S. had created so much complexity that no regulator understood where the risks actually lay before it was too late.

So overall, financialization in the U.S. has exacerbated volatility and severity of market swings, causing severe economic dislocation in times of crises that have had a marked impact on income and wealth inequality. The interconnectedness of financial markets and globally mobile capital have transmitted this volatility globally, leaving small open economies especially vulnerable to the ebb and flow of cross-border capital. Financialization has ended up increasing systemic risk,

rather than mitigating it. And it has generated disproportionate income and wealth for the financial services industry, with no commensurate contribution to the real economy.

Inequality and the Decline of Meritocracy

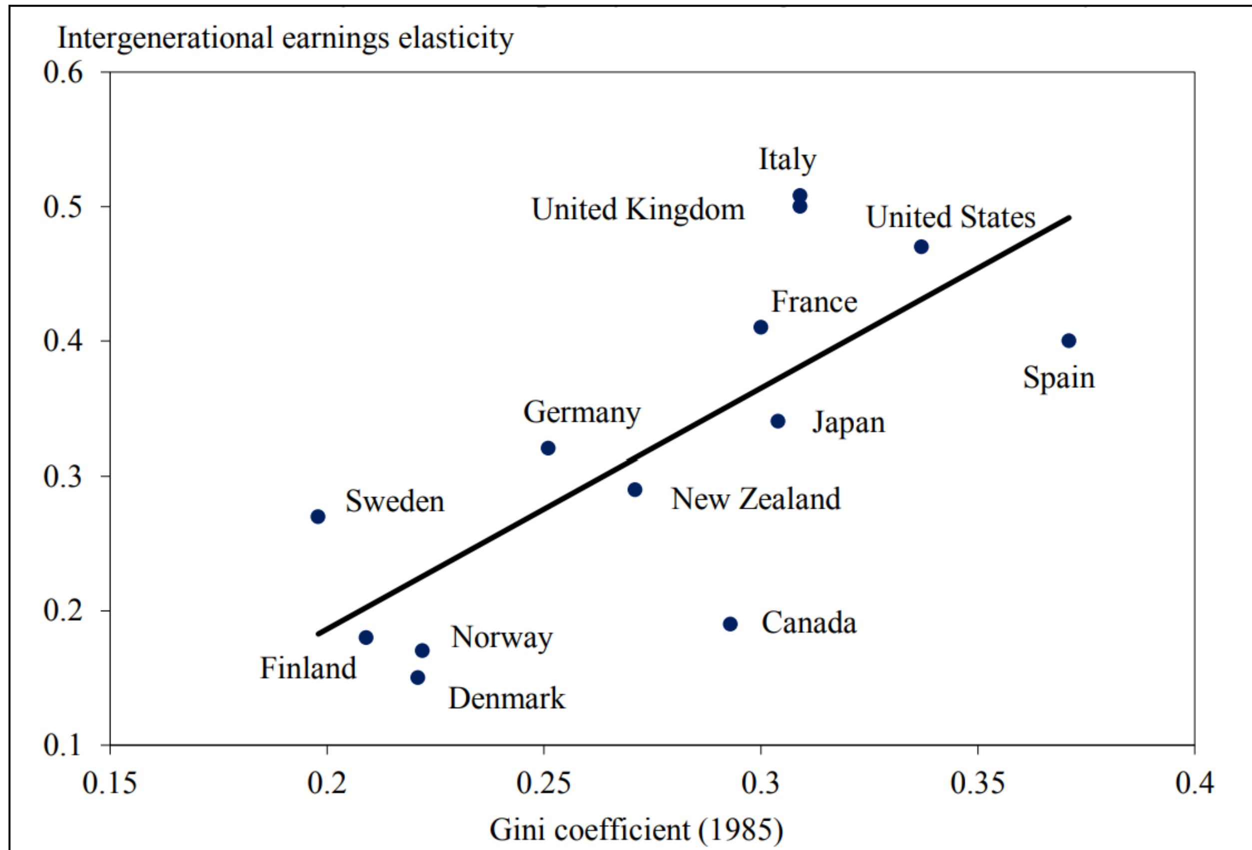
Students of neo-classical economics don't spend much time worrying about concepts of justice and fairness. On these issues, they mostly take shelter behind the work of Vilfredo Pareto, a late 19th century Italian economist and sociologist known for his views about the distribution of wealth and income. Pareto essentially argued that economic inequality was inevitable under Pareto's Law or the 80/20 rule.[79] This was encapsulated in the Principle of Pareto Optimality according to which any policy that makes someone better off without making any else worse off must be 'optimal'. Sounds reasonable enough, except that it does not consider the starting point of societal wealth distribution. Some level of economic inequality is indeed inevitable, but extreme inequality becomes problematic if it becomes self-perpetuating. Economists tend to focus on Gini coefficients that measure income distribution. However, income is only a flow, whereas wealth is a stock and is generally a much better indicator of the distribution of power in society. If the class of wealthy does not churn, the same narrow group is able to retain power intergenerationally. Persistently high inequality breeds insider control, rent-seeking – it allows vested interests and incumbents to become entrenched. This undermines meritocracy and the equality of opportunity vital to producing social mobility. The empirical evidence does suggest that in countries where income inequality is higher, intergenerational income mobility is lower. Figure 5, below, depicts the correlation between levels of inequality and scope for intergenerational socio-economic mobility.

The promise of upward social mobility is important to keep aspirants striving. Indeed, this has been the historical strength of the U.S.. By offering the opportunity to migrants from all over the world to build new lives, the U.S. has been able to harness their dynamism, ambition, and enterprise. However, the three trends of technological development, globalisation and financialization have together made social mobility much harder. Since the 1980s, the U.S. technology and financial services sectors have attracted and absorbed a disproportionate share of the educated domestic as well as international talent pool. This created a new meritocracy that has over time become increasingly distanced from the rest of American society. In fact, the high incidence of inter-marriage amongst this elite community has given rise to what some are now calling a hereditary meritocracy or a permanent upper class. Conversely, as opportunities for the unskilled and less educated decline, these trends are also creating a permanent underclass. Financial or other crises affect the poor disproportionately, making social stratification more rigid. As a consequence of the Pandemic, in the U.K., for example, one-third of workers in the lowest quintile by pay have lost jobs against just 15 percent in the top quintile (Murphy, 2022). The result, as documented by Case and Deaton for the U.S., is a disturbing rise in despair as manifested in rising suicide rates, domestic violence, and opioid addiction.

---

[79] Pareto's Law posits that over time and space, there is an inexorable tendency in any society for 80 percent of wealth to be held by 20 percent of the population, which shaped his views on justice and fairness.

Figure 5: The Gatsby Curve (Corak, 2011; OECD, 2010)



Although not quite framed in this way, Thomas Piketty's work is interesting because it does focus on the distribution of wealth, not just income. He has done painstaking analysis to try and capture trends in the distribution of wealth around the world. He makes the case that inequality becomes self-reinforcing when the return on capital systematically exceeds the rate of real growth. Intuitively, the argument is that wealth begets wealth. When the wealthy are able to generate financial returns on their stock of capital that are higher than the rate at which average real incomes grow, the wealth gap widens and becomes persistent. Piketty finds that after WWII, which resulted in large destruction of wealth, tax policies in most Western democracies were able to restrain the transfer of wealth from one generation to the next through estate duties and taxes. In the latter half of the 20th century this trend was reversed, and since then the wealth gap has seen a significant widening. Piketty's work struck a deep chord, coming as it did after the GFC of 2008. Whether it is Bernie Sanders' supporters of the far Left or Trump supporters on the far right, whether the anti-globalisation protestors or the Brexiteers, the root cause of the growing angst within especially the Anglo-American democracies, is rooted in the feeling of being left behind. The facts speak for themselves. The share of the top 10 percent in pre-tax U.S. national income has risen steadily from 35 percent in 1980 to 45 percent in 2021 (World Inequality Database, 2023). Likewise, the share of the top 1 percent in wealth has grown from 9 percent of GDP equivalent in

1970 to 23.5 percent in 2007. Meanwhile, the real incomes of middle-class men, defined as those with at least a high school education, some assets, and social status in the U.S., has been stagnating for several decades.

10. State Capacity and Economic Fault Lines: The Experience of Mature Democracies

Earlier, I argued that a key differentiator of developing country economic performance is state capacity. The reasoning holds in explaining the difference across developed countries to the challenges of democratic capitalism. In what follows I examine how historical forces have shaped different attitudes towards the state and to the development of its capacity in the U.S., U.K, Europe, and Japan.

The Anglo-American Neo-Liberal Model

The U.S. and U.K. share the same broad philosophical attitude towards the state. The Anglo-American view of the state grew out of a history of checks and balances. Historically, both countries have been much more preoccupied with curtailing the power of the state than worrying about its effectiveness. There has been much soul searching and discussion in recent years about how to deal with the social dislocation caused by the triple trends of technological development, globalisation and financialization. The reality is that in both the U.K and the U.S., especially in the latter, there is relatively little state engagement or support for facilitating the adjustments needed to help those dislocated in the face of these mega-trends. The state has done little by way of support for skilling, re-skilling, continuing education or even education more broadly. The highly contentious question of universal health is another key issue. The U.S. remains the only major Western democracy that still does not provide universal access to health care to its citizens.

In an astute analysis of the U.S. predicament, Francis Fukuyama locates the problems of the U.S. to the weakness of, and attitude towards, the state. The development of a Weberian state machinery came late to America. As we saw earlier, the rule of law and a measure of democratisation came first, giving it a clientelist character. After the expansion of the franchise in the 1820s, Andrew Jackson was the first anti-elitist President who popularised the custom of large-scale political appointments to the federal bureaucracy. It took the rise of the middle-class to increase pressure for greater professionalism in state functioning. By the late 19th century, an emerging community of small business people was keenly aware of the importance of an impartial state bureaucracy, one not under the influence of big business and the so-called trusts. And a new professional class was searching for social standing and voice in a system that was dominated by the Boston elite and the Gilded Age tycoons. This led to the Pendleton Act of 1883 and propelled the likes of Woodrow Wilson and Theodore Roosevelt to make the bureaucratic machinery of the state more autonomous and merit based in the early 20th century. Although the American bureaucracy became substantially modernised, even today, the scale of political appointments in the U.S., 4000 for every incoming President, remains the largest of any Western Democracy. Compared to the Northern Europeans, such as the Germans who developed a strong and autonomous state bureaucracy during Bismarck's time, the U.S. has inherited a tradition of weaker state capacity. There is compelling evidence to suggest that over the years, the U.S. has become less representative (Fukuyama, 2014). Although this is not necessarily accepted by the establishment,

American political parties have regressed. They have once again become hostage to powerful interest groups – a 21st century version of the days of the Gilded Age. Big tech, big pharma, Wall Street, farmers, the National Rifle association, are all examples of extremely powerful lobbies that exert huge influence over the functioning of the Senate and Congress. More significantly, the political bases of the Democrats and Republicans have become much more polarised around political extremes even as both have become more homogenised. The homogenisation of respective political bases of the two parties has been accentuated by the primary system which by its nature tends to be controlled by the most ideological party members, the practice of gerrymandering that has allowed the parties to redraw the geographical boundaries of constituencies to make them safer for the incumbent, and the regional concentration of blue (Democrats) versus red (Republican) voters. The problem is not so much the polarisation itself, but the decay in mechanisms to achieve consensus and make collective decisions. The litigious nature of Americans is well known. Their cultural context, which is shaped by low levels of trust in the state, a lot of decisions that would elsewhere be taken by the government are litigated. Public administration has become an adversarial affair with the locus of decision-making shifting from the state to the courts. The U.S's incoherent response to the COVID-19 pandemic was the starkest manifestation yet of this trend of state dysfunction. This does not bode well for America's ability or willingness to revisit the role of the state in their lives.

The British attitude towards the state is like that of the U.S., but the functioning of the state machinery is somewhat better. The relative simplicity of the Westminster system of government produces more decisive governments and that makes public administration easier. We saw earlier that the origins of Parliamentary democracy in the U.K. go back to the Glorious Revolution. Parliament was then essentially just an assembly of largest landowners. In the 16th century, a new landed gentry had been created by the Tudors who gave away and/or sold large tracts of land usurped from the Catholic Church to loyalists in a bid to bolster their own support base against Rome. A new class of landed gentry that lay between the feudal lords and the peasantry was created. This new 'squire-archy' prospered off the land. Unlike the feudal satraps who lived by taxing the peasantry, the squires were in essence large scale agriculturists keen to improve the productivity of their lands. Parliament became an assembly for squires to coordinate and address common challenges. The Glorious Revolution was about limiting the power of the Stuart monarchs, who were connected to the Roman Catholic Church, to tax the squires. Parliament's main function was to serve as a check on the power of the monarchical state. Over time, sovereignty shifted to Parliament, but it too remained dominated by a landed elite. As such the state machinery remained patrimonial, largely a matter for friends, family, and connections within the aristocracy. Like in the U.S, it was only when a new middle-class emerged that demands for a professional bureaucracy grew in the second half of the 19th century.

The template for civil service reforms was developed in the colonies. In fact, the very term 'civil service' was coined to distinguish the civilian from the military employees of the East India Company. This is how the Indian Civil Service (ICS), was created. Sir Charles Trevelyan, Assistant Secretary of the Treasury, became the most influential advocate for civil service reform in the U.K based on his experiences with ICS' patronage-driven decision-making and in turn, incompetence

while in India during the 1830s. The Trevelyan-Northcote proposals of 1854 to create a merit-based bureaucracy were far reaching, and their timing turned out to be of critical importance. Unlike the U.S., the creation of a modern, merit-based bureaucracy occurred *before* the substantial expansion of the voting franchise. This allowed the U.K. bureaucracy to develop a culture of autonomy relatively early.

The U.S. state bureaucratic machine, on the other hand, became vulnerable to a culture of clientelism. Consequently, even today, it is weaker than in the U.K. In the post-WWII era, under the leadership of an ascendant Labour Party, the British state expanded its economic engagement very substantially through nationalisation of industry as well as the systematic expansion of social welfare protection. This trend continued until Thatcher, who like Reagan, embraced the goals of a neo-libertarian agenda. Such was the shift in the landscape of the country that took place in the 1970s that the trade unions lost much of their influence. As a consequence, even the Labour Party under Blair had to tack from the Left to the political centre to retain its political relevance. Over the past four decades the U.K. has seen a major scaling back of state engagement in general. Aside from deregulation and privatisation, spending on education and healthcare has seen severe cutbacks. Now, in a post-industrial era, when the forces of technology, globalisation and financialization are causing major social dislocation, the U.K., like the U.S., finds itself with much diminished state capacity to respond. Compared to the U.S., however, the British government is still in a better position to respond to the challenges of social dislocation because its public administration is not stymied by as many checks and balances as in the U.S. The U.K. problem is not so much the functioning of the state bureaucracy as much as the deep political cleavage between parties. This will depend on political consensus, which has been elusive over recent years because of the deep ideological divide between the rural north and urban south, between Scotland and England, and between an educated elite and a disgruntled working/middle-class and is more fragmented than before. Following the deep economic and social damage wrought by the pandemic it would seem more likely, but not assured, that the British voter would rally around some vision of bigger government.

Northern Europe's Coordinated Market Economy Model

When it comes to state capacity and competence, Europe is hardly uniform. Broadly, there is a distinction between Northern and Southern Europe. The former has a history of strong and relatively effective states, whereas the latter tends to be weaker and less autonomous. Outside of Northeast Asia, successful developmental states in today's world are few and far between in the universe of emerging markets. There are, however, several examples of activist states amongst the old industrialising nations of Northern Europe. Neither Germany nor France is commonly identified as a developmental state, but both have a long history of state support for industrialisation.[80] Their stories are embedded in the growing literature on the 'Varieties of Capitalism.'[81] Previous chapters highlighted the setup of Germany's Coordinated Market

[80] A similar trend is seen with the Dutch and Scandinanvians.

[81] Read *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* by David Soskice, Peter A. Hall (2001)

Economic (CME) model, including the 'iron and rye coalition', universal banking, basic social protection, and state support for industrialisation.

It was not until after WWII that the second version of Germany's CME came to life. Focused on rebuilding the nation after the debacle of the war and faced once again with the challenge of catching up with their Anglo-American counterparts, Konrad Adenauer and Ludwig Erhard, former West German Chancellors, pulled together various stakeholders to fashion the contours of what came to be called the 'social market economy'. This model of democratic corporatism drew on the thinking of the Ordoliberals of the Frieburgh School, a group of intellectuals looking for a 'third way' between classical liberalism and socialist dirigisme. Their concern was that post-war Germany did not have the luxury of allowing capitalism to slowly evolve as it had in the Anglo-American world. . Their idea was to use the organising and convening power of the state to keep Germany on the road to free markets by building institutions to contain militant unionism on the one hand, and the monopoly power of the *Verbande* or pre-war industrial cartels, on the other. The system that emerged was one in which workers' representatives participated in the governance of Germany's largest industrial companies, and solutions to the challenge of competing globally while also generating consistent increases in the real incomes of workers were arrived at through consensus. This consultative model gave rise to a new approach to innovation distinct from Schumpeterian creative destruction.[82] Germany became a global manufacturing powerhouse not by leading the world in new discoveries, but by innovating in product design and manufacturing process. This allowed the country to consistently improve labour productivity and wages across the board, while remaining highly competitive in international markets and delivering more equitable growth than that produced under Anglo-American *laissez faire;* in parallel, the network of Assemblies also helped maintain social solidarity. Though cumbersome, the system was a powerful mechanism for building social consensus. It allowed Germany to adjust to the oil shock of the 1970s and still retain its competitive edge in international export markets. Following German Reunification, structural adjustment challenges became materially harder for the German economy during the 1990s. With union membership declining the old institutional platforms for consensus also began to weaken.

In parallel, the German financial system also had to adjust to the American-led liberalisation of cross border capital flows. A bank-centric financial system was an important feature of the German version of the CME. A bit like the Japanese main banking system, German banks had carved out deep and long-standing and mutually reinforcing relationships with Germany's industrial giants, be it auto, steel, chemicals, or big business banks, thus managing competition in the financial system. While this relationship-based banking model was effective in providing long term finance for investment and manufacturing growth for large established businesses, it was neither helpful in giving access to smaller companies, nor was it helpful in disciplining

---

for more detail.

[82] Schumpeterian creative destruction refers to the innovative process by which new technologies, products, and business models displace older ones. The concept was coined by the Austrian economist Joseph Schumpeter in his 1942 book *Capitalism, Socialism and Democracy*.

underperforming borrowers. The underdeveloped nature of equity capital markets did not matter as much for the big companies, but it was not good for encouraging innovation.

Perhaps the system's biggest weakness was the lack of transparency. Traditionally the German public and retail shareholders knew very little about the finances of their industrial giants. Disclosure norms certainly did not incentivise these companies to share much information with the public. The same was true for German banks. As the structural problems of the economy grew in the 1990s, there was little knowledge of the growing problems in bank balance sheets. It was only in the aftermath of the GFC in 2008 that the true scale of the fragility of the German banking system came to light, which have been subsequently, to a large extent, repaired. The German financial system did show some improvement, but the economy remains vulnerable in a world with heightened geo-political tensions given its dependence on Russian gas for its energy requirements and on China for its exports. Since the departure of Merkel, no clear future direction has yet emerged for the country's Coordinated Market Economy model.

Germany is not the only European nation to choose the 'third way' amongst the varieties of capitalism that have evolved over time. Indeed, the Northern Europeans - in particular, the Scandinavians, the Dutch, and the Swiss, have adopted variants of the German model of democratic corporatism. Their experience has been broadly like that of Germany. It is possible that in the case of all these countries, including Germany, the experience of the Pandemic, the challenges posed by climate change, geo-political uncertainty, and the rising tide of migrant refugees, may force the regeneration of state activism and produce a vision for a new version of the consensus-based approach to collective decision making: a 21st century version of Social Democratic Capitalism.

France's story is distinct from the other Northern Europeans. During the late eighteenth century, France became the ultimate development state under despotic Napoleonic rule. French state formation had of course begun earlier under the Absolutist regimes of the Bourbon monarchs. These monarchs sought to centralise power away from the feudal lords. They created a new class of administrators called 'intendants' who were dispatched from Paris to provinces where they had no kinship ties to the local population. Being chronically short of money, the Bourbons also started the practice of selling public offices to raise money for their military campaigns. These venal office bearers were interested only in stripping the state. It took the Revolution to get rid of this practice. A new administrative hierarchy was built with talent from the Grandes Ecoles. Even before Bismarck's Germany, France had built a modern, merit based bureaucratic state. The intersection of this legacy with the arrival of Napoleon, gave the French bureaucracy huge power, elite status, and great autonomy. Where the French experience begins to depart from Germany is in the evolution of the interface between state bureaucracy and society. Where Germany developed a consultative culture, the French bureaucracy developed a culture of aloofness. It kept itself at arms-length from civic organisations and industry groups. It never developed any institutional mechanisms for continuing dialogue with industry or society. This trait worked to the country's advantage as it was trying to rebuild its economy after WWII. France saw itself as a late developer. A bit like Germany, the state led the economic transformation. Industrialisation had to be force fed. Government owned companies in key industries such as aerospace, transport equipment, and

armaments were nurtured as national champions and run by civil servants trained at the Grandes Ecoles. The state directed credit and subsidised lending from state owned banks along with capital controls. Under the Socialists, more than half of the banking system was under state control as late as the early 1980s. For as long as France was in 'catch-up' mode, this model worked well. As in Germany, by the late 1980s however, it had run its course. Unlike Germany, the French state was not nearly as effective in facilitating the needed structural change. The aloofness of the state bureaucracy reflected in the policy choices made by the French compared to the Germans. The French tried to implement market reforms of a neo-liberal variety. This led to an adversarial dynamic with a more militant organised labour force that extracted 'side payments' in the form of generous social protection as the price for going along. The fiscal cost of this form of social compensation spun out of control even as French industry's competitiveness continued to suffer. After several years of financial deregulation and privatisation, the French economy of today looks much more like an Anglo-American one.[83] A system of generous social welfare schemes of the traditional variety works only under a framework of managed competition. Besides, because of the adversarial way these welfare payments were negotiated, it has fueled resentment and anger as is evident in the militancy of the 'Gilet Jaunes' protests. France is an example of how not to pursue market-oriented reforms.

Finland, on the other hand, offers a counter example. The Finnish state has evolved a consultative process of engagement with community stakeholders. These formal and informal mechanisms were used very effectively to significantly shift the country's labour force into higher wage opportunities in the country's rapidly expanding "innovation" economy (Orston and Vail, 2016). The Finnish state invested heavily in competitiveness enhancing public goods such as STEM education and R&D capability, rather than spending heavily on expensive social side payments in the form of expanded welfare programs. The Germans and other Scandinavians, at least in principle, have the state capacity and institutional mechanism to tread a similar path.

Southern Europe's Social Democratic Model

Southern Europe was not as fortunate with its historical sequencing as the North. Neither Greece nor Italy went through a period of effective state building in the 19th century. Under Ottoman rule at the time, the Greeks started a revolt against Turkish occupation. France, Britain, and Russia intervened on 'humanitarian' grounds to deliver independence to the Greeks. Thereafter, Greece was overseen by the Great Powers and foreign engagement remained high. Attempts were made by well-meaning outsiders to impose a modern centralised administrative machinery in the country, but with little success. North and South Italy, historically very different from each other, were forged into one nation between 1861-1871. Although most explanations of the gap between the industrious North and bucolic South rely on the cultural differences between the two regions, fundamental differences in attitudes towards the state help to explain Italy's trajectory.

[83] The country has managed to implement efficiency enhancing market-oriented reforms. But the cost, in terms of more generous welfare payments, to make the accompanying worker retrenchment socially acceptable has been very high. France's welfare programs have become unsustainable

Southern Italy, like Greece, remained largely agrarian with social allegiances restricted to relationships within tight-knit communities (Putnam et al, 1994). The relevance and legitimacy of the unified Italian state remained remote for most in the South of the country contributing to a culture of low trust in state authority and therefore insufficient investment in state capacity. Layered on top of this was the fact that neither Greece nor Italy had much of an industrial sector in the late 19th century when the rest of Europe was industrialising. Both had developed a modest industrial footprint by the time of WWII, but this did not throw up a large enough working class as it did elsewhere. In Northern Europe, urbanisation followed industrialisation as peasants displaced from agriculture were absorbed in urban industry. This helped change social behaviour norms from those typical of insular rural communities built on a culture of personalised relationships and patronage to norms better suited to the more impersonal and contractual structure of the urban/industrial economy. It produced a process of social transformation that has been described as a shift from '*Gemeinschaft* to *Gesellschaft*'.[84] In contrast, Greece saw entire villages moving into cities, keeping their agrarian social structure intact. Likewise, Southern Italy remained substantially agrarian in character, even as the North developed industrial capability.

Thus, modernisation did not produce the same social transformation in these countries as it did in Germany and Scandinavia. As the voting franchise was expanded in this context of a weak state in a societal culture built on personalised relationships and patronage, clientelism was the result. The U.S. went through a similar phase but was able to pull itself out of it thanks to a rapidly growing middle-class's demands for a more effective and professional state bureaucratic machinery. In Greece and Italy, a much smaller middle-class got co-opted into the clientelist culture, and as a result, these countries have ended up with much weaker state capacity than their Northern European neighbours. Greece, and to a lesser extent also Italy, never really got around to creating a modern, impersonal state.

Given this history, it is not surprising that party politics in the post-War democracies of Greece and Italy turned to large-scale patronage, like the machine politics of 19th century America, to mobilise voter support. Until the 1980s in Greece for instance, recruitment to public schools and state owned banks was politicised, where university students were guaranteed automatic recruitment as teachers into the public school system in the order in which their applications were received (Fukuyama, 2014, p. 103). Similarly, recruitment to government owned banks was exempted from competitive exams, resulting in recruits that were not hired on merit. The Italian party system similarly turned to patronage for voter mobilisation in the post-War era. And by the 1980s, the

---

[84] The concepts of *gemeinschaft* and *gesellschaft* were introduced by the German sociologist Ferdinand Tönnies in his 1887 book *Gemeinschaft und Gesellschaft* (Community and Society). Gemeinschaft refers to small, rural, traditional communities which are characterised by strong personal ties, shared beliefs, and a sense of togetherness. Social relations are intimate, cooperative, and governed by tradition and emotion. The family is seen as the purest example of gemeinschaft. In contrast, gesellschaft refers to large, modern, industrial societies dominated by impersonal relations, individualism, and self-interest. Social relations are more detached, calculated, and governed by rationality and efficiency. Examples of gesellschaft include large organisations like corporations and government bureaucracies. Tönnies used these concepts to describe the shift from traditional, rural societies to modern, urban industrial societies in Europe in the late 19th century. He saw the progression from gemeinschaft to gesellschaft as an evolutionary process, with traditional bonds of family and community giving way to impersonal, self-interested relations based on rationality and efficiency.

fiscal costs of maintaining a disproportionately generous welfare system created as a result of dynamics similar to that which played out in Greece, had become unsustainable.

Japan's Corporatist Model

The Japanese Model is *suis generis.* Japan is not an illiberal democracy, but is very different from Western democracies. The Meiji Restoration produced rapid industrialisation in 19th century Japan and brought about accompanying social change; peasants displaced from the land moved to the cities and were absorbed into industry and its emergent middle-class did not immediately push for democratisation. Like Bismarck's Prussia, it got co-opted into the meritocracy nurtured by the Meiji oligarchs who felt compelled, in the face of a perceived threat from external forces, to modernise Japan. In fact, the Meiji oligarchs imported the important elements of the German constitution and legal framework in their bid to build their own version of the Reichstaat, an industrialised and autonomous, yet monarchical state. Until then, Japan was a culturally homogenous agrarian nation, nominally under the writ of the emperor descended from an imperial lineage remarkably uninterrupted for over a thousand years. Actual power was wielded by the Tokugawa Shogun, the military overlord of close to three hundred feudal domains or *han*, each overseen by an independent military lord or 'daimyo', and supported by their respective contingent of *samurai*. Administrative authority was split between the *daimyos* and the *'bakufu,'* or the Shogun's bureaucracy who were able to enforce a strong element of uniformity. Having witnessed the Opium Wars in neighbouring China, Perry's arrival on Japanese shores propelled the Meiji oligarchs to act on their perception of an external threat. Japan was converted into a centralised bureaucratic state to prevent it from meeting the same fate as China under the Qing. The *daimyos* were stripped of their powers, the 'samurai' were forced to give up their swords, and the 'han' were consolidated into centrally administered prefectures. A new meritocratic bureaucracy was created along Confucian principles. With a competitive entrance examination system and no lateral mid-career entry, there was little room for patronage-based appointments.

As it happens, many displaced samurai got recruited into the early Meiji bureaucracy. Over time, like bushido for the warrior samurai, *kanryou*, the 'way of the bureaucrat' became the public-spirited ethos that characterised the functioning of the bureaucracy and the esteem in which it was held within wider Japanese society. As in the case of Germany, the Japanese were so successful in this endeavour that their autonomous bureaucratic and military elite drove them down the path of military adventurism in the build-up to both the Wars.

After Japan became a democracy under American occupation post-WWII, the same state machinery also helped them deliver the country's economic miracle. Not only did the Americans give Japan its current constitution, but they also made a vital contribution to the country's revival journey by forcing through a radical land reform program. These reforms dramatically improved social equity in the country. By one estimate, the Gini-coefficient of income distribution in Japan improved from 0.5 to 0.35 as result, providing a lot of political support to elected governments in subsequent years that allowed them to pursue an aggressive industrial policy (Kawagoe, 1999). It

is no small measure that the very effective social compensation mechanism of land redistribution enabled the Japanese bureaucracy to reclaim the autonomy it enjoyed before the War. As a result the Ministry of Trade and INdustry (MITI), had the political space to even resurrect the politically discredited *zaibatsu* in their new avatars as *keiretsu* and lend state support to these new conglomerate groups in pursuit of the country's strategy of export-led industrialisation.

My first encounter with the Japanese establishment was in the mid-1980s, upon joining the Asian Development Bank headquartered in Manila. At that time, Japan was at its post-War peak. Just as the President of the World Bank was appointed by the Americans, in view of Japan's global economic stature, the President of the ADB was appointed by the Japanese. These appointees were typically always ex-Ministry of Finance officials, who after a distinguished career in the elite corps of the Japanese development state were offered prestige posts as sinecures in *amakudari*, their 'descent from heaven'. *Masao Fujioka* was the imperious incumbent at the time. It was interesting to watch the dynamic between the Anglo-Saxon and Japanese members of senior management and staff – it was a real clash of cultures. The latter were focused on "projects", and on building and financing things, especially infrastructure, whereas the former was all Washington Consensus talk about getting the prices right and letting the market and the private sector do its magic. To pay obeisance to American influence on the ADB's agenda, a whole bunch of professionals, mostly British or American, would be flying around trying to figure out what the Bank could do to empower the private sector in the likes of Papua New Guinea, Tonga or even Afghanistan. Meanwhile, you would find most Japanese and European staff working on project loans for port, road, and agriculture development. There was a real divide between an 'engineering' and economist' mind set.

MITI, and its all-powerful Enterprise Bureau, were the post-war reincarnation of the erstwhile Ministry of Commerce and Industry, that became the Ministry of Munitions during the War. It was during the War that the ministry acquired its sectoral expertise because of its role of ensuring that key industries, steel, coal, machine tools, aircraft, were nurtured in support of the war effort. In the immediate aftermath of the War, the focus of the Supreme Commander of the Allied Powers (SCAP) was on macroeconomic stabilisation; inflation was running rampant because of wartime pump-priming. The Japanese industrial bureaucrats on the other hand believed that "material, labour, and output – not prices and money" is what mattered (Johnson, 1982, p. 178). The Americans were also keen to curtail the political influence of the *zaibatsu*, who had become hugely powerful because of their close association with the pre-war Meiji oligarchs and their importance to the war time economy. The American view prevailed, of course. The Dodge stabilisation plan was so draconian that while it succeeded in stamping out inflation it also snuffed out prospects of an economic recovery. The bureaucrats of the newly created MITI took advantage of the circumstances to re-assert their authority over large business houses and to set up the basic institutional infrastructure for the activist industrial policy that was to resurrect the Japanese economy in the years to follow.

MITI's Enterprise Bureau, which played a vital coordinating function, was especially powerful. It formulated sector specific laws and used the Indicative Plans of the Economic Planning Agency (EPA), one of the few independent agencies to be directly affiliated to the Prime Minister's Office,

to signal which sectors were to be targeted for government support. MITI did not hesitate to influence, incentivise, guide, or even direct the investment decisions of Japanese business. In essence, it sought to actively shift the country's industrial structure. It recruited the best and the brightest in the country. Imagine novels being written featuring top bureaucrats as protagonists. The stories about Britain's state intelligence apparatus, as for example in the John Le Carre novels on the spymasters of MI5, can make for riveting fiction. But a novel about the Secretary of Commerce in the Government of India would, on the other hand, be unbelievably boring. Yet the equivalent official in Japan was the subject of three popular novels in the 1960s. *Sahashi Shigeru*, the head of MITI's Enterprise Bureau and then the ministry's Vice Minister during the 1950s and 60s, was much celebrated as the 'samurai among samurais', and the 'leading industrial nationalist' of his time (Johnson, 1982, p. 243). Such was the place of Japan's economic bureaucracy in the popular imagination.

Although MITI's role evolved over the decades it focused consistently on two broad objectives: to deepen Japan's industrial capabilities from the Meiji era's light industries such as textiles and food processing, to capital and technology intensive industries; and to ensure 'rational' industry structure so as to keep each targeted sector internationally competitive. Notwithstanding the enormous authority that MITI wielded, its interventions were generally within a framework tied to market performance. For targeted industries, it used an array of measures. Tax incentives, subsidies, selective import protection in the form of tariff and non-tariff barriers, export promotion and target setting, discriminatory access to foreign exchange, and privileged access to free government land for industrial use, formed the core of the Enterprise Bureau's tool kit.

A second important pillar of MITI's arsenal of instruments for supporting industrial development was access to concessional capital. The Japan Development Bank was created to provide long term funding for business expansion. Commercial banks were recruited to channel 'policy loans', backed by Bank of Japan refinancing – which worked as a *de facto* sovereign guarantee -- in support of targeted sectors. MITI also reconstituted the old *zaibatsu* into new enterprise groupings each with a bank and trading company at its centre. Six large *keiretsu* emerged around the Daiwa, Mitsui, Mitsubishi, Fuji, Sanwa and Sumitomo banks respectively. Although the government did not have ownership stakes in any of these banks, MITI used JDB financing as a signalling device to get these commercial banks to allocate complementary resources to targeted sectors within their respective *keiretsus*.

The third pillar comprised complementary public investment, especially in infrastructure. MITI perfected the framework for channelling household savings into the Fiscal Investment and Loan Plan (FILP), the government's extra-budgetary mechanism for funding development projects, many of which were intended specifically to support targeted industries.

The fourth pillar of MITI's industrial policy was in pursuit of the objective of maintaining rational industry structure. MITI did not hesitate to force consolidation when required, using directives or administrative guidance to nudge/orchestrate mergers and acquisitions. Nor, if it was deemed necessary from time to time, was MITI shy to protect the pricing power of industry players by seeking legislative and regulatory support for cartelisation.

The final pillar of MITI's policy support framework was assistance for access to, and acquisition of, foreign technology, and market intelligence to help Japanese exporters. MITI established the Agency for Industrial Science and Technology (AIST) to help Japanese companies negotiate technology licensing agreements and patents from foreign firms. The Japan External Trade Representative Organisation (JETRO) was set up as an international commercial intelligence service and was used by MITI as its operating arm in overseas markets.

How did MITI choose target industries?[85] They identified items with high income- elasticities of demand in the main markets of the world, but particularly in the U.S. This provided an indication of the most promising sources of demand. In parallel, they identified those sectors in which technology was developing the fastest. They then mapped the list of industries with the highest demand potential and the fastest technological change against Japan's 'specialisation index' or the share of each of these identified sectors in Japan's exports compared to their share in total global trade. Third, they mapped the sectors identified based on the above metrics against what was called the 'export and industrial estrangement coefficient', or the sector's share in Japan's exports relative to its share in total domestic industrial output. This information was then used to decide what sectors were potentially worthy of targeted support.

MITI's universe of targeted industries was dynamic, changing over time to take account of rising domestic real wages and the direction of the global technology frontier. Support to targeted industries was time bound. Protection against import competition, tax incentives and access to concessional credit were intended to mitigate the risks of scaling up investment and to help selected enterprises/business groups absorb temporary losses until they found their competitive foot-hold in export markets. MITI also calibrated and re-calibrated its interventions by seeking continual feedback from industry through a variety of consultative fora.

From synthetic fibres, steel, automobiles and shipbuilding in the 1950s, then to petro- chemicals, plastics, machine tools and electronics in the 1960s and 70s, MITI's industrial policy had a big impact on the post-War evolution of Japanese industry and its systematic embrace and mastery over technology and skill-intensive industry segments. The system worked very well until well into the 1970s by which time Japan was even seen as a potential threat to the U.S.'s economic hegemony.

While Japan's competent and agile economic bureaucracy was key for catalysing industrial transformation, it must be said that their record in managing the evolution of the country's financial system has been patchier. Because an 'engineering' mind-set dominated the 'economist' mind-set at the highest leadership levels, industrial policy, as distinct from macro-economic policy, was the foundation for the government's engagement on matters pertaining to the economy. The other Northeast Asian countries learned the art of, what economists call 'financial repression', from Japan. The Japanese authorities regulated interest rates and directed the flow of often concessional domestic and foreign credit to targeted sectors. In essence, they allocated credit in a manner that deliberately favoured industrial development over consumer borrowing.

[85] I draw from Robert Wade (1990) for this information.

How did they achieve this? They exercised control over state-owned specialised development banks and/or state owned or controlled commercial banks in a financial system that did not give much room to debt and equity capital markets. Such an approach, combined with target setting and an 'engineering mind-set' favouring capital accumulation, scale and market share over the economist's concern for efficiency of capital allocation, rates of return and macro-economic stability, led to a persistent 'investment hunger' – a tendency to over-invest. Consequently, investment to GDP ratios in Japan, as in Korea, Taiwan, and China, have been materially and consistently higher than in most other countries over the past several decades. This led to repeated episodes of excess capacity. What is remarkable is that, by and large, this investment turned out to be productive.[86] Then the country got into serious trouble with the bursting of its asset bubble and its cascading consequences. Let's examine what happened.

The dismantling of the Bretton Woods system and the rapid financialization of the global economy that followed encouraged the U.S. to act increasingly as the world's economic hegemon. For as long as the competition trailed way behind, the U.S. played a constructive role in international economic affairs. It provided vital leadership for the recovery of the global economy after the War. It was generous in its financial assistance through the Marshall Plan and country specific aid programs. And it was supportive of multilateralism, helping smaller nations gain access to the global trading system and to its own domestic market. During this period, the U.S. provided its full backing for the economic transformation of Northeast Asia – Japan, Korea and Taiwan were, after all, allies in the fight against the common enemy that was Communism. But as catch up became a reality, the hegemonic tendency within the U.S. began to stir.

Japan's rapid ascent in particular began to attract political attention in both the U.S. and Europe. There was growing discomfort with Japan's trade surpluses and the deepening penetration of high-end Japanese manufacture into developed country markets. The most visible and politically sensitive was the rise of the Japanese automobile industry on the global stage and the parallel decline of Motown and the British auto industry. This was the context in which the US Treasury Secretary, Jim Baker, forced the Plaza Accords on Japan in 1984; the aim was to appreciate the yen. The Japanese were accused of currency manipulation and mercantilism. But, as Surjit Bhalla for example has demonstrated, in 1985 the yen was only marginally undervalued, having appreciated by almost 30 percent in the period 1970-85. Japan had accumulated foreign exchange reserves of only 2 months' worth of imports and had a current account surplus that averaged under 2 percent of GDP over the same period. Based on these indicators, Germany was equally as 'mercantilist' as Japan, but it joined hands with the U.S. to isolate Japan in the Plaza negotiations (Bhalla, 2012). As the U.S. and Europeans made concerted non-market interventions in foreign exchange markets, the yen-dollar exchange rate halved between 1985 and 1988. In other words, within 36 months, the yen appreciated 100 percent versus the dollar, slowing down the Japanese economy and providing a stimulus for European and American industry.

At around the same time, Western economies were reaching a post-industrial state, with drivers of their dynamic comparative advantage in international trade shifting from high-end

[86] In Japan's case, till the 1980s.

manufacturing to services and R&D. This led to aggressive lobbying from Wall Street to open access to international financial markets, and from big pharmaceutical companies to campaign for protection of intellectual property. It also triggered growing demands to replace GATT -- which was focused only on trade in goods -- with a new multilateral agreement that would also include trade in services, cross-border investments and intellectual property. These priorities were taken up by the Washington Consensus and became the focus of the Uruguay Round of Trade Negotiations (1986-94). Amsden (2001) has likened the American agenda on international trade and finance from the mid-1980s onwards to Britain's 'imperialism of free trade' from a century earlier -- one that sought to "pry open" the markets of smaller competitors. A quote she reproduces from the U.S Trade Representative in the 1990s is quite revealing (2001, p. 256):

> *"It is vital to the prosperity and prestige of the United States that we take advantage of our strong global position and continue to push our trading partners for even more open markets and economic liberalisation. If we abdicate our strength, we risk missing a prime opportunity to advance those policies and values that we have been so instrumental in making our economy the strongest and most efficient in the world."*

The Uruguay Round culminated in 1995 in the creation of World Trade Organisation (WTO); General Agreement on Trade in Services (GATS); Agreement on Trade Related Investment Measures (TRIMs), and Agreement on Trade Related Intellectual Property Rights (TRIPs) (WTO). In 2001, China was admitted to the WTO and offshoring and the transformation of global supply chains picked up pace. In parallel, the World Bank and IMF pushed the financial deregulation and cross-border capital mobility agenda very hard through conditionality linked to structural adjustment loans and standby financing facilities to a whole bunch of countries during the 1990s.[87] This drive was certainly instrumental in accelerating the pace of globalisation as trade volumes expanded rapidly and the scale of cross border capital flows exploded. But this process also sowed the seed of financial instability that would cause widespread damage to economies large and small in the years to follow.

Even before the Plaza Accord, the Japanese had begun to act on managing their merchandise trade surplus with Europe and the U.S. Already by the mid-1980s, import tariffs and NTBs had been substantially reduced. The Japanese were well prepared for these changes, but there was little preparation ahead of the financial deregulation and liberalised access to domestic debt and equity capital markets that would follow the Plaza Accord. When the Japanese gave in to pressure from their G-5 peers on this front, the flood gates for capital inflows into yen denominated assets were opened. By the mid-1980s Japan had become the largest creditor nation in the world, and the U.S. had for the first time in over seven decades become a net debtor. In 1986, net capital outflows from Japan were almost 6 percent of GDP equivalent. By 1992, net capital inflows stabilised at 3 percent of GDP (Kahkonen, 1995). This meant that in over 6 years, the Japanese

[87] To be fair, the U.S. was not alone in pushing this agenda. The Europeans were complicit. The interests of the two were also aligned on agriculture, which for socio-political reasons was important for each of them to protect. So all the while countries in Africa and Latin America, for example, were being advised to deregulate agricultural price support schemes and get rid of food subsidies, the Europeans were busy creating butter mountains and the Americans were busy fattening millions of cows for beef production using a slew of agricultural subsidies.

financial system had to absorb the equivalent of 7.5 percent of GDP equivalent of international capital. Consequently, not only did the yen appreciate significantly, but Japan's foreign exchange reserves increased by 70 percent, fueling an unprecedented domestic credit boom. An economy already prone to chronic over-investing for the reasons discussed before, this flush of excess liquidity sent the financial system into a tizzy – one for which the Japanese regulators were totally unprepared.

The result: a torrid escalation in Japanese asset prices. The Nikkei Average tripled between 1985 and 1989. With plummeting credit and underwriting standards, so did urban real estate prices between 1985 and 1991 (Park et al, 2013). The party ended in 1992, when international capital inflows reversed. When the bubble finally burst and asset prices started to plummet, the resulting collapse in corporate wealth and in the value of the collateral underlying the banks' massive exposure to real estate led to a rapid deterioration in the banking system's asset quality and a depletion of its capital base. Japan lost a decade of growth. The Japanese were painfully slow to clean up their banking system. It took two decades for the country's banks to heal, and for asset prices to return to pre-bubble levels. The world was left to believe that the Japanese system was broken.

However, following the country's painful 'lost decade', major changes were made to the Japanese financial system. Bank balance sheets were substantially strengthened, and the industry was consolidated. The 25 large banks of the 1990s were brought together into four bank holding companies. The country dismantled its machinery for financial repression. The Fiscal Investment and Loan Program (FILP) system was reformed. The post office was corporatised, although not privatised, such that small savings were no longer funnelled directly into government investment projects.

The country's regulatory architecture was overhauled. Interest rate regulation was discontinued, and banks were no longer subject to credit allocation guidance from the government.. The power of MITI shifted to the Ministry of Finance (MOF), which itself saw its authority curtailed. The Bank of Japan was made 'independent' and debt and equity capital markets grew in size and stature. Overall, Japan pretty much conformed to what neo-liberal economists would have recommended for its financial system. Paradoxically, there is yet no compelling evidence that these reforms materially improved the efficacy of capital allocation in the country (Park et al, 2013).

In response to the realignment of the value of the yen following the Plaza Accord, Japan became a major investor overseas, relocating the manufacturing operations to lower cost destinations, especially across East Asia. This greatly accelerated the globalisation of supply chains. The Japanese remain a formidable presence in key sectors of manufacturing. Japan's current account surplus with the U.S. has still not disappeared. Its foreign exchange reserves are larger than they have ever been, and the country remains a largely bank-centric financial system, with financial markets not nearly as integrated into the rest of the world as most would have expected.

It seemed as if Japan had arrived at some compromise about the degree of financialization it really wanted. It is true that growth has been mostly anaemic over the past couple of decades, but the country has remained an island of great stability. It could be that Japan has settled on a model that

does not prize continuous 'creative destruction' – the endless quest for innovation and efficiency enhancement. As a rapidly ageing society, it is more concerned with social harmony, maintaining quality of life, rather than chasing ever-rising living standards. But these, I must acknowledge, are subjective interpretations of distant observers.

Lessons from the Experience of Mature Democracies

Contrary to the advocates of neo-liberal capitalism, history tells us that state capability and the nature of the state's engagement with society and business has been of vital importance to the economic success of mature democracies with developed market economies. This is especially true of Europe that has evolved various versions of Social Democratic Capitalism with significant activism. It is even true of the U.K and the U.S. who come closest to the theoretical model of Liberal Democratic Capitalism. The U.K. 's rising economic stature in the 18th and 19th centuries was in no small measure assisted by imperial state using its hegemonic power to enforce mercantilist trading arrangements distinctly favourable to Britain. The U.S. in the 20th century has made similar use of its economic hegemony to pressure others to accept international financial arrangements favourable to it. With the world trying to deal with the social consequences of the triple mega trends of technological advancement, globalisation and financialization, the importance of consensus building and collective action have emerged as equally important as innovation, productivity growth and efficiency enhancement. Differences in attitudes about state activism and state capability will determine which countries succeed in dealing with the challenges of political polarisation, income inequality, and the decline of meritocracy, and which fail. The Pandemic aggravated this challenge. The question of state capacity and state functioning has now also become central even for developed countries.

Based on the developed country experience, three insights emerge. First, given the types of problems faced by developed countries, the libertarian idea that the state itself is the enemy seems to have become anachronistic. The challenge is less about how to check the power of the state, and more about how to improve its functioning. Second, the biggest challenge facing developed countries in this context is how to make the state more autonomous – i.e., the ability to make decisions without undue influence for particular stakeholders or special interests, while also remaining 'embedded', i.e. retaining formal and informal institutional mechanisms for consultation. Getting that balance right is key to success. At one extreme, as in Greece, the state has become clientelist, serving the interests of a hugely bloated and unionised public sector workforce. This has created a version of Democratic Capitalism that has undermined the proper functioning of the market economy. At the other extreme, as in the U.S., thanks to organised lobbies, the voice of big business has generally prevailed over the interests of middle-class workers. This has allowed market forces to dominate and the triple mega trends to gain momentum without sufficient regard to their social consequences. Third, what is clear is that even amongst developed countries, there are some that could benefit from strengthening the quality and bolstering the capability of their state bureaucratic machines. The American state and the Southern European states could learn lessons from their Northern European counterparts.

11. Learnings for India

State Capacity: Taxonomy of Success

Before discussing the implications of international experiences for India, it is useful to develop a simple taxonomy of different types of state capacity and different attitudinal approaches to the role of the state. As we did in the case of our discussion on Asia, let us define a “hard” state as one with an autonomous bureaucracy, i.e., one that can take strong action independent of pressure from stakeholders Japan during the heyday of MITI would be an example. A "soft” state would be the opposite, i.e., one where the bureaucracy cannot operate above pulls and pressures of stakeholder interests – most developed country democracies fall into this category. A “strong” state is one with superior competence and capability – the Northern Europeans, Singapore and the Japanese would fit this bill. Italy, Greece, Latin America, Africa in contrast would be “weak” states. Even the U.S. would, in relative terms, qualify as a weaker state, relative to the Northern Europeans. Finally, a “consultative” state would be one like Germany that has institutional mechanisms for building social consensus. The Anglo-Americans, on the other hand, tend to be “adversarial”. For achieving the goal of successful and lasting economic transformation, the normative best would be a state that is “hard, strong, and consultative”. Note that in our definition a “hard” state does not need to be authoritarian. Nor does a normatively superior state need to be a democracy. This is how a country like China has been able to deliver consistently superior outcomes in terms of economic performance for close to half a century now.

State Engagement with Markets

Alexander Gerschenkron (1962) was one of the first to posit that the chronological order of industrialisation matters. He argued that the later industrializers would require greater government intervention to help firms master more ‘roundabout’/capital intensive products or knowledge-based assets. The most important lesson from comparing the experience of Africa with Asia is that in a world in which technology is evolving at an astonishing pace, late industrializers cannot hope to catch up without pro-active support from the state. Incumbent firms at the leading edge of technological development and nations that are already economically advanced are, not surprisingly, focused on guarding their edge. Competitive and open markets have no respect for the starting position of players. Latecomers, by definition, especially in technology intensive industries, are therefore handicapped. Now more than ever, the state needs to step up to provide proactive support for businesses in late industrialising countries to help them overcome the starting handicap they face.

It turns out that Gershenkron was right. Strong state capacity has become a necessary, albeit not a sufficient condition for national economic success. In fact, for nations that want to catch up to the wealthier countries of the world, it is no longer just about creating a ‘national innovation system’ to assimilate and nurture advanced industrial capability, but it is also about building a resilient

financial system that can interface with a highly financialised global economy characterised by enormous pools of internationally mobile capital. Hence, latecomer states must not only have economic bureaucracies capable of nurturing an ecosystem for nurturing domestic technological capability, but they must also be sophisticated enough to provide expert regulatory oversight over increasingly complex financial systems.

In all cases, Northeast Asian states have operated with a very strong sense of strategic and national purpose. One explanation that has been offered for the Northeast Asian states' sustained drive and focus has been driven by severe resource constraints and the perception of national vulnerability. Japan, Korea, and Taiwan felt compelled to focus on rapid economic growth precisely because they felt geo- politically threatened. Since they were not resource rich like the Latin Americans and most Southeast Asians, they could not afford inefficient import substitution. They were obliged to embrace export markets to generate the foreign exchange so vital to their longer-term goal of technological self-sufficiency. An environment of "systemic vulnerability" is what forced Northeast Asian states to devise institutional mechanisms to drive productivity enhancing industrial deepening. Mostly, they chose to drive their strategies through pilot bureaucratic agencies working within an indicative planning framework. These plans were not of the Soviet variety, but more akin to long term business planning. And inevitably, when mistakes were made, or circumstances took an unexpected turn, the state machinery had the pragmatism, the patience and the determination to course correct. That is why, as we observed earlier, the skill of the economic bureaucracies of Northeast Asia was not how to 'pick winners' and 'avoid losers', but rather to make long term strategic choices and then 'make winners' in the chosen domains.

Commitment to Markets, Aggressive Export Promotion

Although the economic bureaucracies of Northeast Asian economies did engage very closely with, and provided targeted support to, domestic industry, one lesson that cannot be drawn from their experience is that they pursued such policies because they did not have faith in markets. In fact, in all cases, the concerned governments had a fundamental belief in the competitive discipline of market forces. They played an active role to nudge private players to enter sectors that were not immediately profitable for them. Industrial policy was used to help domestic firms assimilate technologies and processes that were vital to build the country's capability to catch up with an ever-advancing global technology frontier and remain competitive in global markets over the longer term. Even though they resorted to some protectionist policies, these were always time bound and targeted to provide support only until such time as the chosen industries were able to export profitably in international markets. They did not pursue import substituting growth. A deep and obsessive commitment to export markets and aggressive export promotion, irrespective of the size of, and opportunity presented by, their respective domestic markets, was a defining feature of the Northeast Asian approach to industrial policy support.

For successful catch up, a late comer to industrialisation must have all three of the above ingredients: a state bureaucratic machinery with the capacity and skill to support and regulate

industry and finance; a strategic policy framework that adapts and course corrects in pursuit of the goal of building domestic technological capability; and a strong commitment to market discipline, especially to achieving competitiveness in export markets. This is not easy to do. It is hardly surprising that very few latecomer countries have successfully navigated the high road to prosperity – “developmental states are significant but rare” (Doner et al, 2005, p. 328).

State Engagement for Market Legitimacy: Social Investment, Protections and Redistribution

All latecomers that navigated a successful economic transformation paid attention to the social implications of that transformation. In the case of Northeast Asia and Japan, land redistribution provided important political space for each of these countries to pursue a pro-business industrial policy. This was then supplemented with heavy investments in public goods, notably access to good quality education and pragmatic country specific forms of engagement with industry to mitigate worker displacement. The *chaebol* in Korea were never allowed to fire workers at will. And Japan had evolved their own mechanism of life-time employment guarantees in *zaibatsu* to address this challenge. In all cases, the state was actively engaged with stakeholders to find solutions to emerging challenges as they arose through this process. This allowed workers to benefit from the shift of these economies from low to high tech industry, earning substantially higher real wages as labour productivity improved on a consistent basis. Workers benefited through higher real wages and the economy benefited through productivity gains. The lesson from the experience of mature democracies with more advanced economies is that partnership with stakeholders is important for success. Where France has struggled to manage the social dislocation caused by its market reforms despite making hugely generous welfare payments, Finland has succeeded by investing in a consultative manner in public goods.

An important takeaway from the international experience of both developing countries as well as mature democracies is that the state has an important role to play not only for supplementing market forces to build domestic innovation capacity, but also in managing the social implications of market led economic growth. Therefore, for India -- a democracy and a late comer to industrialisation -- to be able to transform itself from a low income to a high-income country, it is vital to improve the capacity and capability of the state. India must strive to build a state machinery that is ‘strong, hard, and consultative’.

12. Indian State Capacity: Broad Characteristics

Strong and Weak: the Paradoxical State

A popular impression of the India state is that it is a “flailing” (Pritchett, 2009), incompetent beast hobbled by corruption and predatory instincts. Few people have good things to say about their interface with the state. Whether it is an encounter with the traffic police, an appearance in court, registering a property, or dealing with the tax authorities, it does not take much to surface stories of frustration, despair, and even fear. The reality is more complex. Compared to most other developing countries, India is blessed with administrative capability that is quite deep.

It is true that the country inherited an administrative machine that was designed for the colonial state. But this machine did come with a culture of autonomy and meritocracy based on competitive exams and a strong *esprit the corps*, both essential ingredients for a strong, hard state. Devesh Kapur (2020, p. 31) aptly describes the conundrum that is the Indian state as one with a remarkably uneven performance “spanning the spectrum from woefully inadequate to surprisingly impressive”. The Indian state has a terrible record of managing public services such as education and healthcare. It ranks low on its ability to enforce contracts, and pendency in the court system is atrocious (Datta and Rai, 2021). It has a remarkable record of managing programs and tasks on a massive scale, such as the elections, the Kumbh Mela, and the Aadhaar biometric ID program. Over the past few years, impressive progress has been made in improving state effectiveness and delivery. The government has, for example, delivered gas connections to more than 80 million households, built around 100 million toilets reaching 600 million people, eradicated polio through a massive program of child vaccination, and greatly expanded the connection of rural households to the electricity grid. The Aadhaar platform for biometric identification which now encompasses almost the entire population, and the Unified Payments Interface for digital payments, combined with deepening penetration of digital telecommunications connectivity across the country has allowed the government to successfully open bank accounts for over 350 million people. In turn, it has improved the targeting and impact of social protection schemes, including the delivery of direct cash transfer schemes to tens of millions of farmers.

On the other hand, the state continues to struggle when it comes to improving child nutrition and primary health care or educational outcomes. It can connect most homes to the electricity grid, but it has difficulty delivering a reliable supply of electricity. The pattern that emerges is that of a state that performs better in ‘mission mode’, delivering on time-bound episodic tasks rather than in the provision of services that require sustained engagement.

The failure of the Indian state in education, healthcare, and other essential service delivery is a conundrum. Why is it that in a democratic polity the government is not held to account by voters on better access to education and health? One explanation could be that the level of quotidian hardship that the median Indian voter must endure is high. For him/her, access to supplementary food rations or cash income support is visible, tangible, and of greater immediate benefit than improved access to primary education or health care. The median voter demands immediate relief

for their predicament. This is why electioneering is associated with mass distribution of freebies and giveaways from free food, alcohol, bicycles, to laptops, and even cold cash, rather than with promises to improve the quality of school education or public sanitation.

Second, where electoral mobilisation takes place based on caste, ethnic, and religious identities there is a tendency for the state to distribute public resources as "club goods" benefits from which can be restricted to favoured subgroups of constituents, rather than as broad public goods. Politicians prefer, for example, to provide housing schemes for particular communities, than to tackle the broader challenge of low cost housing.

Failure to deliver to essential public services may also be attributed to the lopsided nature of the Indian state. More than two-thirds of government workers in the U.S. and China work for local governments which account for 27 and 51 percent respectively of total government spending in these two countries. This makes good sense given that essential services such as water, sanitation, primary healthcare, and education are best provided by tiers of government that are closest to the people being served. By contrast, in India local governments employ only 12 percent of government workers and account for a paltry 3 percent of total government budgetary spending. It is thus not surprising that the quality of public service delivery is so poor. State governments have not devolved any powers to the third tier of government despite the 73rd Amendment to the Constitution and the guidance of subsequent Finance Commissions.

Becoming Softer: The State's Declining Autonomy

India is fortunate to have inherited a well-oiled administrative machine from the British who set up the foundations for meritocratic recruitment. More than four-fifths of those who join India's federal civil service today are recruited through competitive exams. The rest are mostly hired through public advertisements and interviews conducted by the Union Public Services Commission (UPSC), an autonomous constitutional body. There is little lateral entry into the system. The exams are very competitive with a success rate of less than 0.1 percent. More than a million candidates sat the exam in 2022 of which only 933 were recruited. Recruitment at the subnational and local levels is more vulnerable to patronage and corruption but is still mostly also based on competitive exams conducted by State Public Service Commissions, and autonomous recruitment boards. In theory this should make for an autonomous bureaucracy, a necessary foundation for a 'hard state'. Indeed, during the early years after Independence the Indian bureaucracy enjoyed tremendous prestige and was widely regarded as the vital 'steel frame' of the country. Over time, however, the bureaucracy at all levels has become more politicised and subject to patronage. The deterioration gained pace during the Indira Gandhi years when politicians learned to use transfers as a tool for controlling the bureaucracy. Tenures of central government officers in key posts have become short and unpredictable as they are shunted around at the discretion of political bosses.

Chances are that most people who have interfaced with the state in some context or the other have had to deal with corruption. As an individual, whether it is a traffic violation or accident,

registering the sale or purchase of a property, paying taxes, settling a legal dispute, or even getting a hospital bed, we are confronted with corrupt officials everywhere. As a business, seeking regulatory clearances of various kinds, trying to enforce contracts through the court system, getting loans from government owned banks – and even from some private banks – it is not unusual for bribes to be paid. Since liberalisation, as the volume of commercial litigation has grown, and financial stakes have risen, so has the incidence of corruption in the judiciary (Huchhanavar, 2022). Although it is difficult to come by hard evidence for it, there is a sense that corruption in the allocation of assignments and transfers of bureaucrats and police officials has grown. Politicians are, for example, known to take a strong interest in the appointment of police officers to certain posts that are important for dealing with land disputes. Similarly, it was a matter of open discussion during the tenure of the second UPA government over 2009-14 how appointments of PSU Bank chairpersons were "for sale" – potential candidates for the job were expected to make payments to government officials with "influence" over appointment decision making process.

The tenure of the second United Progressive Alliance (UPA) government over 2009-14 was marred by several corruption scandals in which politicians and senior bureaucrats were implicated in decisions that favoured certain businesspeople. This prompted the Supreme Court to intervene and force investigative action that led to the prosecution of several prominent businessmen and politicians. When the BJP government took over in 2014, it unleashed an aggressive anti-corruption campaign that only worsened the trust deficit between government and the private sector. This environment made the state administrative machinery hyper-conservative about making discretionary decisions on matters pertaining to private businesses for fear of being charged with complicity. Such pathologies are not conducive to the pursuit of industrial policies of the type successfully pursued in East Asia that were designed to help build domestic innovation capacity.

The cost of electioneering has gone up by leaps and bounds. Compared to the roughly USD 4.2 billion spent on the 2014 elections, the price tag for the 2019 national election was an estimated USD 6 billion (Pradhan and Kumaresan, Bloomberg, 2019). With the introduction of the Electoral Bonds Scheme in the 2028 Budget Bill, which anonymised and eliminated the cap on corporate funding for elections, we have moved into an era of large corporate funding of elections. While the scheme should sharply reduce the use of black money for electioneering purposes – which is a good thing – it could increase the influence of big business on government policies in undesirable ways. What is clear is that rising dependence on corporate India for political funding will affect the autonomy of the state machinery in ways that are not yet transparent or fully understood.

In sum, although entry to the bureaucracy is still subject to competitive entrance exams, the state administrative, judicial, and policy decision making machinery is not as autonomous as it once was. Political interference in transfers, and growing avenues for corruption, growing dependence on corporate India for electoral funding, all imply that the state is not as distant from stakeholders as it ought to be.

The Rising Public-Private Trust Deficit: Confrontational, not Consultative

In many respects the Indian state is still struggling to adjust to its role in a liberalised economy. The bureaucracy is reluctant to relinquish control it enjoyed over the economy during the era of the License Raj. Both the bureaucracy and the higher judiciary remain wary of markets. They see themselves as protectors of the public interest against markets prone to excess. This makes them generally distrustful of the private sector. The trust deficit between public and private is manifested in various ways. There is the burdensome, over-determined regulatory framework. The thicket of laws, regulations, and associated compliances applying to business has been described as 'regulatory cholesterol'. Some effort was made a few years ago at the level of the union government to improve the 'ease of doing business'.

We still have a long way to go. According to a 2022 analysis, there are over 1536 laws that govern doing business and more than 69,000 compliances that businesses need to follow in India. What is striking is that 44 percent of the laws and 38 percent of the compliances carry imprisonment clauses (Chikermane and Agrawal, 2022). It is very easy for businesses, especially small businesses, to fall afoul of the law and be subject to criminal charges, which ironically creates opportunities for state predatory behaviour and rent seeking. The problem is especially acute for small and micro-enterprises who do not have the resources that large corporations do to 'manage the system'. This creates a systematic bias against small businesses that have a perverse incentive to stay small, operating in the informal sector to avoid scrutiny from the inspectorate.

As private sector activity has grown and the state's direct engagement in industry and business has shrunk, its regulatory role has expanded very considerably. But appointments to regulatory posts have been allocated disproportionately to retired IAS officers. In this quasi-judicial role, the generation of first-time regulators that have emerged have been susceptible to influence and pressure from erstwhile colleagues still in government, leading to a pattern of decision making that systematically favours government. This, for example, has been the case with state power sector regulators. Then there is often a strained, if not confrontational, dynamic between state agencies and the private sector. A good example of this is the way in which the tax administration bureaucracy deals with treating private businesses. This has been described by Rahul Bajaj, a well-respected businessman, as 'tax terrorism'. The Indian state can hardly be described as consultative.

Surprisingly Small and Under-resourced, with Unproductive Spending

In terms of number of people, the Indian state is not very large. As Devesh Kapur (2020) points out, when normalised for population the size of the Indian federal government is half that of the U.S. Compared to what it needs, the Indian state has too few judges, police officers, diplomats, doctors, and teachers.

The judiciary is especially under-resourced which partly explains the shocking levels of pendency in the Indian court system. As of March 2013, there were 31.4 million cases pending across

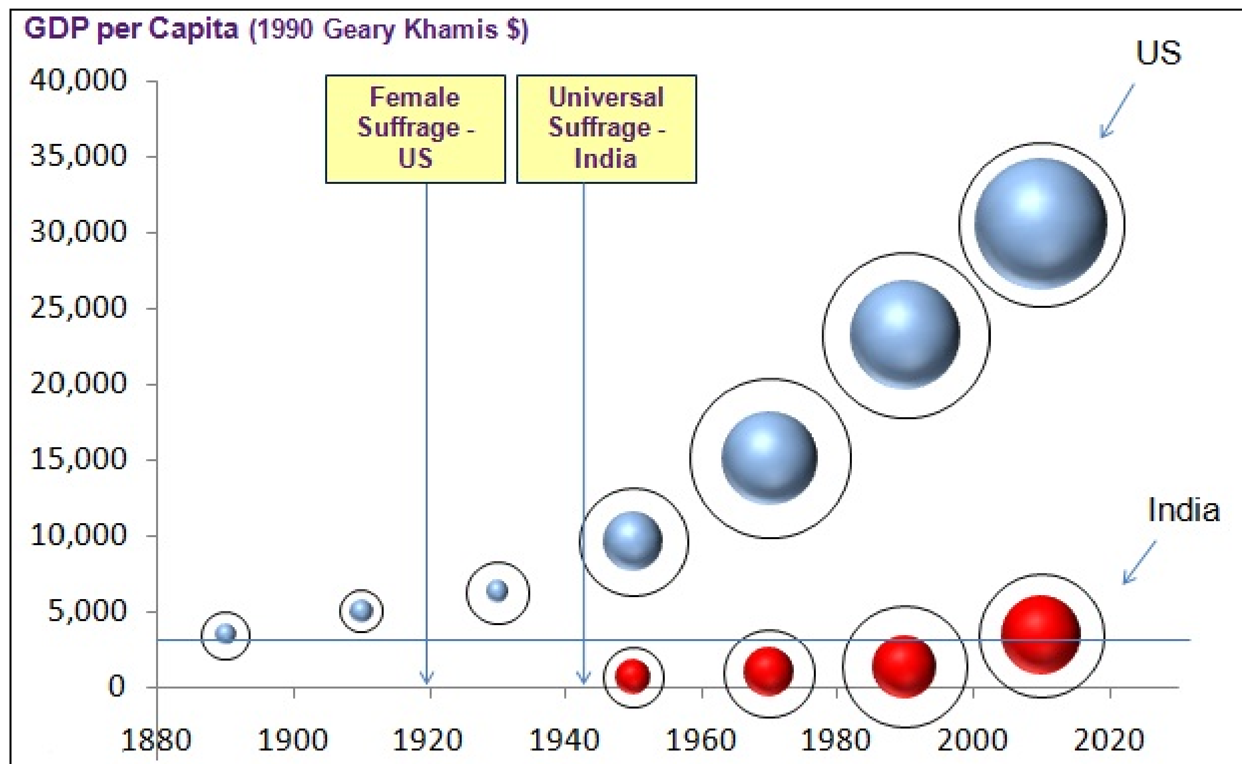
different levels of the judicial system compared to an estimated 600,000 in 1982 and 164,000 in 1957. Of these 64,330 were pending in the Supreme Court (compared to 771 pending cases in 1950); 4.5 million cases across the 24 High Courts; and 26.83 million cases in the district and subordinate courts (Choudhry et al, 2016). This is a festering sore in the underbelly of Indian democracy that needs fixing. The administration of the judicial system needs massive improvement at all levels for which it needs resources that only the executive can provide.

At 1 percent, the share of general government employment in total employment is half what it is elsewhere in Asia, but as Chibber and Soz (2021) argue, the composition of the government workforce is quite lopsided, with too many class IV employees and too few teachers, specialist experts, doctors, and police officers. The pay scales of the government employees are also quite distorted with lower end employees getting paid much better than the private sector and the senior officers getting real wages that are well below the private sector.

Government's spending on the other hand is not small. On average since 1991, consolidated spending of the central and state governments has hovered around 28 percent of GDP. It is the composition of this spending that is lopsided with a disproportionate share spent on consumption including debt servicing, wages, and social protection. The latter is not surprising. In a democracy where most voters are poor, the logic of electoral politics pushes the state to focus on interventions and programs of a redistributive nature. This creates a systematic anti-investment bias in government spending with the state driven to spend much more on social protection at a much lower level of economic development than was the case for more mature democracies. India's per capita gross domestic product (GDP) today is, in purchasing power parity terms, about the same as the U.S. in 1880. Yet, its budgetary spending on social protection as a share of GDP is 15 times larger than what it was for the U.S. in 1880, while its budgetary revenues are only seven times larger. See Figure 6.

Figure 6: GDP per capita and voting rights

The outer circles indicate Government revenue as share of GDP, and the inner solid circles indicate spending on social protection as share of GDP. The Y axis indicates GDP per capita in terms of Purchasing Power Parity.



Finally, a striking feature about the Indian state's revenue base is how narrow the base of direct taxpayers still is. Out of a total income taxpayer base of 74 million, there were only 22.4 million non-zero taxpayers in 2022 (Aurtus Consulting, 2023), which is less than 2.5 percent of the voting population. Given the poor quality of public services, most of these taxpayers turn to private service providers and do not depend on the state for any essential services, especially education and health care. This weakens the legitimacy of the state and makes it harder to expand the tax base. Chronically weak fiscal capacity, especially at the level of local governments, comes in the way of improving the quality of public services and reinforces a negative feedback loop.

Concluding Observations and Priorities for the Future

While there can be little doubt that Indian state capacity needs strengthening in multiple dimensions, it is an incredibly complex challenge. Unlike previous governments, the current regime at the very least understands the importance of addressing this challenge. Their use of technology to improve the delivery of welfare and social protection schemes has been impressive. The state's project management skills have also been deployed effectively to improve the country's network of physical infrastructure, including roads, airports and electricity supply. Less progress has been made on improving the state's regulatory capabilities. The production-linked incentive (PLI) scheme is an ambitious experiment to form a WTO compliant industrial policy that will build indigenous technological capability in selected sectors. However, this effort does not seem to be coordinated with trade policy. Indeed, it is not clear if lessons from East Asia about the importance of export competitiveness have been internalised. We still have a long way to go towards tackling the weaknesses of the Third Tier of government,[88] which is key for improving the delivery of educational and health services. Perhaps the biggest issue of all is the lack of clarity and conviction about the contours and goals of a '21st century development state' that India must build to attain the goal of transformative economic change.

There are many within the government and outside it who doubt the feasibility of improved state capability in India, pointing to the disastrous rent seeking of the License Raj. While it is true that India cannot replicate the East Asian model, we are much better placed than most other emerging markets to try. Although the capability of the Indian state is variable, it is not intrinsically weak. We have the foundations of a meritocratic bureaucracy and judiciary. We must develop a vision and systematic plan to strengthen its autonomy and build its responsiveness over time. This is probably the most important reform challenge that the country must tackle in pursuit of the goal of sustained economic growth with social stability.

Over the last few years there have been sustained improvements in the delivery of public infrastructure, and more recently the state has attempted to deploy digital public infrastructure. Drawing lessons from the post-War development trajectory, India needs to invest heavily and systematically in strengthening state capacity to transform its economy. Important progress has been made in improving the delivery and targeting of redistributive schemes. However, social protection alone is not sufficient - the state must provide basic public goods, especially health and education. East Asia successfully caught up to the west because of this focus on public goods and on redistribution. Only then would it be possible to build a politically compelling case for markets and to legitimise continued market reforms in the public perception. This will probably require, amongst other things, a greater degree of decentralisation to the level of local government.

Second, work is needed to improve the interface between the state and private sector. The enduring trust deficit between the state and business needs to be overcome. Technology can help in this regard by significantly reducing friction between the last mile of the bureaucracy and the business sector. But technology can only go so far. Technology cannot solve the problem of poor or

---

[88] The 'third tier' of government refers to subnational governments below a state government in a Federal System.

biased regulation, for example. This will require a range of changes, from reducing the burden of regulations, to reforms for inducing behavioural change in the inspectorate.

Third, the autonomy of the bureaucracy needs to be restored and the politicisation of transfers needs to cease. The bureaucracy must be adequately trained to be able to oversee private sector activity effectively and objectively. More importantly, we need a competent bureaucracy confident to exercise discretion to manage an industrial policy flexibly and effectively to help build a domestic innovation system. In this context it will be interesting to track how the production linked incentive (PLI) scheme of government is working out. Keeping lessons from East Asia in mind, we would do well to calibrate the performance of the companies and sectors being supported with respect to how effectively they are able to compete in world export markets.

All the above are tough challenges. But they must be addressed if India is to deliver on its goal of economic transformation.

ARTHA GLOBAL

Bibliography

Acemoglu, D., & Robinson, J. A. (2012). Why Nations Fail: The Origins of Power, Prosperity and Poverty. Profile Books.

Agrawal, G. C. and R. (n.d.). Jailed for Doing Business: The 26,134 Imprisonment Clauses in India's Business Laws. Observer Research Foundation. Retrieved October 20, 2023, from https://www.orfonline.org/research/jailed-for-doing-business/

Allen, C. S. (2010). Ideas, Institutions and Organised Capitalism: The German Model of Political Economy Twenty Years after Unification. German Politics and Society, 28(2). https://doi.org/10.3167/gps.2010.280209

Amsden, A. H. (1992). Asia's Next Giant: South Korea and Late Industrialization. Oxford University Press.

Amsden, A. H. (2001). The Rise of "The Rest": Challenges to the West from Late-Industrializing Economies. Oxford University Press.

Ardant, G., & Politics, S. S. R. C. (U S.) C. on C. (1975a). The Formation of National States in Western Europe. Princeton University Press.

Aurtus Consulting. (2023, July 6). Aurtus Direct Tax Alert. Aurtus Consulting. https://www.aurtusconsulting.com/insights/7th9ls8l25t3fzy-ex7yh

Bai, C.-E., Hsieh, C.-T., & Song, Z. M. (2019). Special Deals with Chinese Characteristics (Working Paper 25839). National Bureau of Economic Research. https://doi.org/10.3386/w25839

Bakhshi, A., Roy, D., Averyanova, N., & Goh, R. (2002). Thailand: Financial Crisis of 1997. https://doi.org/10.7916/D85Q4T25

Berg, A. (1999). The Asia Crisis: Causes, Policy Responses, and Outcomes.

Bhalla, S. S. (2012). Devaluing to Prosperity: Misaligned Currencies and Their Growth Consequence. Peterson Institute.

Bolt, J., & van Zanden, J. L. (2020). Maddison Project Database 2020 [dataset]. https://www.rug.nl/ggdc/historicaldevelopment/maddison/releases/maddison-project-database-2020

Boorman, J. T., & Icard, A. (2011). Reform of the International Monetary System: The Palais Royal Initiative. SAGE Publications India.

Campbell, P., Clover, C., & McGee, P. (2018, February 28). Is Chinese state behind Geely's Daimler swoop? Financial Times. https://www.ft.com/content/a9fcd724-1bbc-11e8-aaca-4574d7dabfb6

CEIC. (n.d.-a). China Electricity Production, 1986 – 2023 | CEIC Data. Retrieved October 17, 2023, from https://www.ceicdata.com/en/indicator/china/electricity-production

CEIC. (n.d.-b). Taiwan General Government Net Expenditure | Economic Indicators. Retrieved October 16, 2023, from https://www.ceicdata.com/en/taiwan/general-government-revenue-and-expenditure-ministry-of-finance/general-government-net-expenditure

CEIC. (n.d.-c). Taiwan General Govt Net Expenditure: Education, Science & Culture (ES) | Economic Indicators. Retrieved October 16, 2023, from https://www.ceicdata.com/en/taiwan/general-government-revenue-and-expenditure-ministry-of-finance/general-govt-net-expenditure-education-science--culture-es

Chaudhuri, S. (1996). Government and Economic Development in South Korea, 1961-79. Social Scientist, 24(11/12), 18–35. https://doi.org/10.2307/3520100

Chhibber, A., & Soz, S. A. (2021). Unshackling India: Hard Truths and Clear Choices for Economic Revival. HarperCollins.

Chong, G. (2020). Huawei—Chinese Telecommunications Giant Strategies To Success. Nanyang Technological University. https://www.ntu.edu.sg/ntupreneur/news-events/news/detail/huawei---chinese-telecommunications-giant-strategies-to-success

Choudhry, S., Khosla, M., & Mehta, P. B. (2016). *The Oxford Handbook of the Indian Constitution*. Oxford University Press.

Clark, D. (2016). Alibaba: The House That Jack Ma Built. HarperCollins.

Cohn, S. (2015). The State and Development. In Emerging Trends in the Social and Behavioral Sciences (pp. 1–15). John Wiley & Sons, Ltd. https://doi.org/10.1002/9781118900772.etrds0353

Corak, M. (2016). Inequality from Generation to Generation: The United States in Comparison. IZA Discussion Papers, Article 9929. https://ideas.repec.org//p/iza/izadps/dp9929.html

Doner, R. F., Ritchie, B. K., & Slater, D. (2005). Systemic Vulnerability and the Origins of Developmental States: Northeast and Southeast Asia in Comparative Perspective. International Organization, 59(2), 327–361.

Durlauf, S. N., & Seshadri, A. (2018). Understanding the Great Gatsby Curve. NBER Macroeconomics Annual, 32, 333–393. https://doi.org/10.1086/696058

Ewans, M. (2002). European Atrocity, African Catastrophe: Leopold II, the Congo Free State and Its Aftermath. Psychology Press.

Fafunwa, A. B. (2018). History of Education in Nigeria. Routledge.

Federal Reserve Bank of St. Louis. (1948). Postwar Drain on Foreign Gold and Dollar Reserves. Federal Reserve Bulletin, 34(4). https://fraser.stlouisfed.org/files/docs/publications/FRB/pages/1945-1949/30033_1945-1949.pdf

Federico, G., & Tena-Junguito, A. (2017). A tale of two globalizations: Gains from trade and openness 1800–2010. Review of World Economics (Weltwirtschaftliches Archiv), 153(3), 601–626.

Fouquin, M., & Hugot, J. (2016). Back to the Future: International Trade Costs and the Two Globalizations. http://www.cepii.fr/CEPII/en/publications/wp/abstract.asp?NoDoc=9133

Fraser Institute. (2019). Economic Freedom of the World: 2019 Annual Report. https://bit.ly/3WtLn98

Fukuyama, F. (1989). The End of History? The National Interest, 16, 3–18.

Fukuyama, F. (2014). Political Order and Political Decay: From the Industrial Revolution to the Globalization of Democracy. Profile Books.

Gerhaeusser, K., Iwasaki, Y., & Tulasidhar, V. B. (2010). Resurging Asian Giants: Lessons from the People's Republic of China and India. Asian Development Bank.

Gerschenkron, A. (1962). Economic Backwardness in Historical Perspective: A Book of Essays. Belknap Press of Harvard University Press.

Gorokhovskaia, Y., Shahbaz, A., & Slipowitz, A. (2023). Freedom in the World. Freedom House. https://freedomhouse.org/report/freedom-world/2023/marking-50-years

He, Z., & Wei, W. (2023). China's Financial System and Economy: A Review. Annual Review of Economics, 15(1), 451–483. https://doi.org/10.1146/annurev-economics-072622-095926

Herbst, J. (2014). States and Power in Africa: Comparative Lessons in Authority and Control - Second Edition. Princeton University Press.

Heritage Foundation. (2023). Index of Economic Freedom. //www.heritage.org/index/

Hsieh, C.-T., & Song, Z. (Michael). (2015). Grasp the Large, Let Go of the Small: The Transformation of the State Sector in China (Working Paper 21006). National Bureau of Economic Research. https://doi.org/10.3386/w21006

Huchhanavar, S. (2022, June 27). Is the system of self-regulation among India's judges fit for purpose? U4 Anti-Corruption Resource Centre. https://www.u4.no/blog/self-regulation-indias-judges-fit-for-purpose

Huntington, S. P. (2012). The Third Wave: Democratization in the Late 20th Century. University of Oklahoma Press.

Hut, K. (n.d.). Subject Guides: International Trade Data: Historic Data. Retrieved October 17, 2023, from https://subjectguides.library.american.edu/c.php?g=175035&p=1153717

International Monetary Fund. (2020). The World Economic Outlook Database [dataset]. https://www.imf.org/en/Publications/SPROLLS/world-economic-outlook-databases#sort=%40imfdate%20descending

International Monetary Fund. (2023). IMF Data [dataset]. https://data.imf.org/?sk=388dfa60-1d26-4ade-b505-a05a558d9a42&sid=1479331931186

Johnson, C. (1982). MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975. Stanford University Press.

Kaganova, O. (2006). Managing Government Property Assets: International Experiences. The Urban Insitute.

Kähkönen, J. (n.d.). III Japan's Capital Flows. In Saving Behavior and the Asset Price "Bubble" in Japan. International Monetary Fund. Retrieved October 17, 2023, from https://www.elibrary.imf.org/display/book/9781557754622/ch03.xml

Kapur, D. (2020). Why Does the Indian State Both Fail and Succeed? The Journal of Economic Perspectives, 34(1), 31–54.

Kawagoe, T. (1999). Agricultural land reform in postwar Japan: Experiences and issues (Policy Research Working Paper Series 2111). The World Bank. https://econpapers.repec.org/paper/wbkwbrwps/2111.htm

Kose, M. A., Prasad, E., Rogoff, K., & Wei, S.-J. (n.d.). Financial Globalization: A Reappraisal.

Krugman, P. (1994). The Myth of Asia's Miracle. Foreign Affairs, 73(6), 62–78. https://doi.org/10.2307/20046929

Kuznets, S. (1955). Economic Growth and Income Inequality. The American Economic Review, 45(1), 1–28.

Kuznets, S. (1957). Quantitative Aspects of the Economic Growth of Nations: II. Industrial Distribution of National Product and Labor Force. Economic Development and Cultural Change, 5(4), 1–111.

Lall, R. (2023, October). State, Democracy and Markets: Perspectives on the Global Experience and Implications for India. Artha Retreat 2023.

Lee, T., Kim, H., Cho, S., You, M., Chung, W., & Moon, J. (2022). Country Case Study: The Republic of Korea. http://hdl.handle.net/10986/38372

Lloyd, W. F. (1833). Two Lectures on the Checks to Population. S. Collingwood.

Lührmann, A., Tannenberg, M., & Lindberg, S. I. (2018). Regimes of the World (RoW): Opening New Avenues for the Comparative Study of Political Regimes. Politics and Governance, 6(1), 60–77. https://doi.org/10.17645/pag.v6i1.1214

Maddison, A. (2004). The World Economy. OECD Publishing.

Mazzocco, I. (2022). How Inequality Is Undermining China's Prosperity. https://www.csis.org/analysis/how-inequality-undermining-chinas-prosperity

Meissner, L. (2013). How Finance Is Shaping the Economies of China, Japan, and Korea. Columbia University Press. https://doi.org/10.7312/park16526

Moore, B. (2015). Social Origins of Dictatorship and Democracy: Lord and Peasant in the Making of the Modern World. Beacon Press.

Murphy, L. (2022). Leaving lockdown [Computer software]. https://www.resolutionfoundation.org/publications/leaving-lockdown/

Nielsen, I. (2022). Public Perceptions of Corruption in East Asia: A Comparative Study of Japan, Singapore, and South Korea. Scholarly Horizons: University of Minnesota, Morris Undergraduate Journal, 9(1). https://doi.org/10.61366/2576-2176.1102

Obstfeld, M., & Taylor, A. M. (2004). Global Capital Markets: Integration, Crisis, and Growth. Cambridge University Press.

OECD. (2010). A Family Affair: Intergenerational Social Mobility across OECD Countries (pp. 181–198). OECD. https://doi.org/10.1787/growth-2010-38-en

OECD. (2021). How Was Life? Volume II: New Perspectives on Well-being and Global Inequality since 1820. Organisation for Economic Co-operation and Development. https://www.oecd-ilibrary.org/social-issues-migration-health/how-was-life-volume-ii_3d96efc5-en

Ornston, D., & Vail, M. I. (2016). The Developmental State in Developed Societies: Power, Partnership, and Divergent Patterns of Intervention in France and Finland. Comparative Politics, 49(1), 1–21. https://doi.org/10.5129/001041516819582964

Perkins, D. H., & Tang, J. P. (2017). East Asian Industrial Pioneers: Japan, Korea, and Taiwan. In K. H. O'Rourke & J. G. Williamson (Eds.), The Spread of Modern Industry to the Periphery since 1871 (p. 0). Oxford University Press. https://doi.org/10.1093/acprof:oso/9780198753643.003.0008

Pop-Eleches, G. (2008). From Economic Crisis to Reform: IMF Programs in Latin America and Eastern Europe. Princeton University Press.

Pradhan, B., & Kumaresan, S. (2019, June 3). India's 2019 Election Becomes the World's Most Expensive—Bloomberg. https://www.bloomberg.com/news/articles/2019-06-03/india-s-bitterly-fought-poll-becomes-the-world-s-most-expensive?embedded-checkout=true

Pritchett, L., Woolcock, M., & Andrews, M. (2013). Looking Like a State: Techniques of Persistent Failure in State Capability for Implementation. The Journal of Development Studies, 49(1), 1–18. https://doi.org/10.1080/00220388.2012.709614

Pufendorf, S. F. von. (1703). Of the Law of Nature and Nations: Eight Books. L. Litchfield.

Putnam, R. D., Leonardi, R., & Nanetti, R. Y. (1994). Making Democracy Work: Civic Traditions in Modern Italy. Princeton University Press.

Rajan, R. G. (2017). Fault Lines: How Hidden Fractures Still Threaten The World Economy. HarperCollins.

Rajan, R. G., Prasad, E., & Subramanian, A. (2007, March). The Paradox of Capital. Finance & Development, 44(1). https://www.imf.org/external/pubs/ft/fandd/2007/03/prasad.htm

Rajan, R. G., & Zingales, L. (1998). Financial Dependence and Growth. The American Economic Review, 88(3), 559–586.

Rapoza, K. (n.d.). President-Elect Bolsonaro To Brazil's Bureaucrats: "You're Fired." Forbes. Retrieved October 17, 2023, from https://www.forbes.com/sites/kenrapoza/2018/11/01/president-elect-bolsonaro-to-brazils-bureaucrats-youre-fired/

Reinhart, C. M., & Rogoff, K. S. (2009). This Time Is Different: Eight Centuries of Financial Folly. In This Time Is Different. Princeton University Press. https://doi.org/10.1515/9781400831722

Rodrik, D., Subramanian, A., & Trebbi, F. (2002). Institutions Rule: The Primacy of Institutions over Integration and Geography in Economic Development. https://www.imf.org/external/pubs/ft/wp/2002/wp02189.pdf

Sandel, M. J. (2012). What Money Can't Buy: The Moral Limits of Markets. Penguin UK.

Saxena, V. C., Sweta Chaman. (2003). Did Output Recover From the Asian Crisis? https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Did-Output-Recover-From-the-Asian-Crisis-16355

Shan, W. (2019). Out of the Gobi: My Story of China and America. John Wiley & Sons.

Smith, A. (2021). The Wealth of Nations. True Sign Publishing House.

Solow, R. M. (1956). A Contribution to the Theory of Economic Growth. The Quarterly Journal of Economics, 70(1), 65–94. https://doi.org/10.2307/1884513

Stiglitz, J. E. (1996). Some Lessons from the East Asian Miracle. The World Bank Research Observer, 11(2), 151–177.

Thurbon, E. (2001). Two paths to financial liberalization: South Korea and Taiwan. The Pacific Review. https://doi.org/10.1080/09512740110037370

Thurbon, E. (2002). Two Paths to Financial Liberalisation: South Korea and Taiwan. Department of Government and International Relations, Faculty of Economics and Business, University of Sydney.

Turner, G., Tan, N., & Sadeghian, D. (2012). The Chinese Banking System. RBA Bulletin (Print Copy Discontinued), 53–64.

Vogel, E. F. (1991). The Four Little Dragons: The Spread of Industrialization in East Asia. Harvard University Press.

Wade, R. (1990). Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization. Princeton University Press.

Weber's Rationalism and Modern Society: New Translations on Politics, Bureaucracy, and Social Stratification. (2015). Springer.

World Bank. (n.d.). South Korea Tariff Rates 1988-2023. Retrieved October 16, 2023, from https://www.macrotrends.net/countries/KOR/south-korea/tariff-rates

World Bank. (1987). Korea—Managing the industrial transition. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/759121468041456632/Main-report

World Bank. (1991). World Development Report 1991: The Challenge of Development. New York: Oxford University Press. https://doi.org/10.1596/978-0-1952-0868-9

World Bank. (1992). Program Completion Report: Republic of Benin, First Structural Adjustment Credit. World Bank. https://documents1.worldbank.org/curated/en/580291468227104937/pdf/multi0page.pdf

World Bank. (1994). China—Foreign trade reform [Text/HTML]. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/422061468770445653/China-Foreign-trade-reform

World Bank. (1995). China—Macroeconomic stability in a decentralized economy [Text/HTML]. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/748321468770440758/China-Macroeconomic-stability-in-a-decentralized-economy

World Bank. (2022). Government expenditure on education, total (% of GDP) [dataset]. https://genderdata.worldbank.org/indicators/se-xpd-totl-gd-zs/

World Bank. (2023). World Development Indicators (Version 23) [dataset]. https://datacatalog.worldbank.org/search/dataset/0037712/World-Development-Indicators

World Bank, & Maddison, A. (2017). World GDP over the last two millennia. Our World in Data. https://ourworldindata.org/grapher/world-gdp-over-the-last-two-millennia

World Inequality Database. (2023). World Inequality Database [dataset]. https://wid.world/

World Trade Organisation. (n.d.). Understanding the WTO - The Uruguay Round. Retrieved October 17, 2023, from https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact5_e.htm

World Trade Organisation. (2023). WTO STATS [dataset]. https://stats.wto.org/en

You, J. (2014). Land Reform, Inequality, and Corruption: A Comparative Historical Study of Korea, Taiwan, and the Philippines. The Korean Journal of International Studies, 12(1), 191–224. https://doi.org/10.14731/kjis.2014.06.12.1.191

Young, A. (1994). The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience (Working Paper 4680). National Bureau of Economic Research. https://doi.org/10.3386/w4680

Zhong, R. (2019, April 25). Who Owns Huawei? The Company Tried to Explain. It Got Complicated. The New York Times. https://www.nytimes.com/2019/04/25/technology/who-owns-huawei.html