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Chapter 3

Do we need new development models?

The impact of neo-liberal policies

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3.1 INTRODUCTION

From 1982 onwards the neo-liberal model dominated the policies of most developing countries, led by the International Financial Institutions (IFIs). The debt crisis of the 1980s provided the opening that gave the IFIs the power to insist on their policy package in most African and Latin American countries. Asian countries managed to retain more autonomy, and although they moved in the direction of a more market-oriented system, generally speaking they retained an important role for the state. The fall of communism in the late 1980s provided a further opening, and the former socialist countries joined developing countries in adopt non-interventionist market-oriented policies. Consequently, the 1980s and 1990s saw a widespread and growing adoption of neo-liberal policies (figure 3.1).

The agreement on the Millennium Development Goals (MDGs) might have interrupted this policy path by changing the objectives of development and monitoring policy outcomes in relation to the goals. Yet for the most part, macroeconomic policies and market-oriented mesoeconomic policies went unchallenged, and the MDGs (and the Poverty Reduction Strategy Papers, or PRSPs, which supported them) were interpreted as involving only social sector policy and not economic policy. This was encouraged by the fact that while the MDGs included a poverty objective they

contained nothing about inequality or indeed about economic growth. Consequently, until the crisis of 2008, the 2000s were also a liberalizing era for much of the world. This was, however, greatly modified by the fact that many African countries (because of rising commodity prices), and Latin American countries (because accumulated reserves allowed them to become much more independent of IFI policy advice) were able to steer more independent courses (see Cornia, 2011). Moreover, in addition to promoting the acceptance of human development as the overriding objective of development, the MDGs provided a nudge towards a different approach to *assessing* development: clearly, neither stabilization nor economic growth in and of themselves are adequate criteria.

Figure 3.1
Trends in trade openness, 1960-2000

Source: Wacziarg and Welch (2008). Openness is defined by the Sachs-Warner conditions. Sample includes 141 countries.

The neo-liberal policy package

The package is well known, brilliantly presented by Williamson in his aptly named Washington Consensus (Williamson, 1990). The macro- (and meso-) package includes a balanced budget; elimination of import quotas and reduction of import tariffs to a uniform low level; elimination of controls over investment or the allocation of domestic credit; financial market liberalization with market-determined interest rates; tax reform away from direct taxation to indirect; and a change in indirect taxes from taxes on trade

to taxes on consumption in the form of a uniform (or near uniform) value-added tax; privatization of publicly owned assets; institution of western-style private property rights; and liberalization of capital markets, removing restrictions on international flows of capital. Without being explicitly acknowledged in the Washington Consensus, a fundamental underlying assumption was that the role of the state should be greatly restricted, in terms of economic planning, of ownership of industry and provision of services. In all these areas, it was argued that the market would perform much better (Krueger, 1978; Lal, 1983; Little, 1982; Little and others, 1970).

This chapter will (i) briefly review actual policy changes in different parts of the world; (ii) present a summary of major criticisms that have been made of the neo-liberal policy package; and (iii) indicate through some descriptive data how countries fared on different indicators, how the policy reforms affected major economic and social indicators, looking both at data “before and after” policy reform and comparing countries with differing degrees of policy reform; and (iv) review some of the empirical econometric assessments that have been made of the model.

3.2 POLICY REFORMS TOWARDS THE WASHINGTON CONSENSUS, 1980S AND 1990S

From 1980–2000, the neo-liberal policy consensus had a major effect in most parts of the world, especially Africa and Latin America where the IFIs were most dominant. There were changes elsewhere, but they tended to be more selective. Here we confine our attention to the period up to 2000 because after that, many countries, notably in Latin America, modified the package (Cornia, 2011). In addition, a commodity price boom up to 2007, due to the rapid growth of demand in India and China together with a sustained boom in the rest of the world, supported African economic growth and allowed African economies more freedom from the constraining influence of the IFIs. Below we list some major changes in policy adopted in the 1980s and 1990s.

Exchange rate regimes

As shown in table 3.1, there has been a pervasive move from fixed to managed or free-floating exchange rates as documented by Ghosh and others (2002; reproduced by Cornia, 2011). Easterly shows that this change in regime was associated with a depreciation in the real exchange rate (figure 3.2).

Table 3.1
Exchange rate regimes from 1970 to 1999

Percentage of countries			
	1970–1979	1980–1989	1990–1999
A. Pegged regimes ^a	84.8	68.4	46.6
B. Intermediate regimes ^b	11.0	22.5	26.4
C. Free floating ^c	4.3	9.1	27.0

Source: Cornia 2011 derived from Ghosh, Gulde et al. (2002).

Note: a includes hard pegs, and single currency and basket pegs; b floats with ruled-based or discretionary interventions; c floats with light or no interventions.

Based on data for 167 countries.

Tariff reforms

A major aspect of the reform package was a move towards liberalizing imports, reducing and then abolishing quantitative restrictions (QRs) where they were prevalent, and reducing the average tariff rate, while on the export side, there were steps to reduce the taxation of exports.

Investigating trade liberalization in 32 countries in four regions between 1985 and 1992, Dean and others conclude that “[t]rade liberalization has indeed occurred extensively and sometimes dramatically” (Dean

Figure 3.2
Median real exchange rate, developing countries, 1960–2000

Source: derived from Easterly (2001).

and others, 2004: 95). In Latin America, tariffs fell most sharply with an average reduction of 35 per cent between the late 1980s and early 1990s in eight major Latin American countries, from 44.0 per cent to 14.7 per cent. In Sub-Saharan Africa, over the same period, QRs were abolished or reduced, falling dramatically in half the countries investigated (Ghana, Kenya, Madagascar, Mali, Nigeria and South Africa), while tariffs also fell but less markedly. In East Asia, QRs' coverage fell where they had been high (Philippines and Korea) and remained low elsewhere. In four South Asian countries, both QRs and tariffs fell.

Table 3.2 shows the change in average tariff rates for the countries studied by Dean and others (2004) and Cornia (2011) between 1982-90 and 1998-2002.

Fiscal reforms

A critical component of the reform package was to reduce the large budget deficits prevalent in the early 1980s to not more than 1 or 2 per cent of GDP. The emphasis was placed on achieving this through reductions in government expenditure, rather than increases in taxation.

As shown in figure 3.3, on average the budget deficit was reduced from the high of the early 1980s, but did not fall as much as had been hoped.

Taking developing countries as a whole, tax revenue as a percentage of GDP rose slightly from the 1970s to the 1980s (from 16.2 per cent to 17.3 per cent), and fell marginally in the 1990s (to 17 per cent). As a result, increasing taxes did not contribute to the improved fiscal position (Bahl

Table 3.2
Average tariff rates on imports, 1982-1990 and 1998-2002

<i>Region</i>	<i>Average tariff rate</i>		<i>Ratio of 1998-2002 to 1982-1990</i>
	<i>1982-1990</i>	<i>1998-2002</i>	
South America	40.0	12.2	0.31
Central America and Mexico	46.6	8.8	0.19
Sub-Saharan Africa	26.7	14.5	0.54
MENA	29.7	17.3	0.58
South Asia	62.9	20.8	0.33
East and Southeast Asia	20.3	15.5	0.76

Source: Cornia (2011) derived from Ghosh, Gulde et al. (2002), and Dean, Desai and Riedel (1994).

Figure 3.3
Median budget balance, 1972-1997

Source: derived from Easterly (2001).

and Bird, 2008). Regional analysis indicates some rise in the tax ratio in both the 1980s and 1990s in Asia, a fall in the ratio in Africa both in the 1980s and 1990s, and a big fall in the ratio in Latin America in the 1980s with a recovery in the 1990s (Cornia, 2011 on the basis of Martarano, 2011). As the package demanded, there was a move from direct to indirect taxation and away from taxes on international trade (table 3.3).

Changes in government expenditure as a percentage of GDP are shown in table 3.4. In the 1980s, expenditure fell by over two percentage points in Africa, on average, though more individual countries saw rises than falls. There was a small recovery in the 1990s. Asia too saw a big decrease

Table 3.3
Trends in the composition of taxation in developing countries, 1980-2000

Percentage share of total tax revenues			
	<i>Income taxes</i>	<i>Indirect taxes</i>	<i>Taxes on international trade</i>
1980	28.6	29.3	30.7
1990	27.6	34.9	25.6
2000 ^a	28.3	40.1	19.0

Source: Bird and Bahl (2008), derived from IMF Government Financial Statistics (2003).

a Limited data.

Table 3.4
Government expenditure, 1980-1998

Per cent of GDP			
Region	Government Expenditure as % GDP		
	1980	1990	1998
Africa	28.5	26.3	27.6
No. of countries increasing	..	10.0	10.0
No. of countries decreasing	..	7.0	7.0
Asia	19.1	16.8	15.2
No. of countries increasing	..	6.0	5.0
No. of countries decreasing	..	5.0	6.0
LAC	16.8	15.5	16.6
No. of countries increasing	..	7.0	12.0
No. of countries decreasing	..	8.0	3.0

Source: Bird and Bahl (2008), derived from IMF Government Financial Statistics (2003).

between 1980 and 1990 and a further decrease in the 1990s to the very low rate of 15 per cent. Latin America showed the same pattern as Africa, with a smallish decrease in the 1980s and a smallish rise in the 1990s. Latin American countries had very low ratios, with 9 countries having ratios of expenditure to GDP of less than 20 per cent.

Financial and capital account liberalization

Typically, reforms to liberalize the domestic financial markets occurred first and subsequently reforms of external capital accounts were introduced. Easterly (2001) shows the degree of financial deepening (rising M2/GDP ratio; see figure 3.4a) and rising real interest rates (figure 3.4b) that occurred.

Financial liberalization reforms (domestic and international) were documented by Adam (1999) for some African economies; by (Morley and others, 1999) for Latin America; and (Williamson and Mahar, 1998) for nine industrial and twenty-five developing countries. (Escaith and Paunovic, 2004) give an index of the extent of capital account liberalisation in Latin American countries, showing variation among countries and over time (figure 3.5).

Figure 3.4a
Median of M2/GDP, developing countries, 1961-1999

Source: derived from Easterly (2001).

Figure 3.4b
Median real interest rate in developing countries, 1961-1996

Source: derived from Easterly (2001).

Figure 3.5
Trends in capital account liberalization in Latin America, 1980-2000

Source: Escaith and Paunovic (2004).

Note: Not comparable across countries. Countries are listed in alphabetical order. It reflects trends in individual economies.

Privatization

Privatization formed part of the policy package from an early date, but only really got underway from the 1990s (figure 3.6).

To summarize: the 1980s and 1990s saw a major move towards the adoption of each element of the Washington Consensus model, though, obviously, the pace of change and the details varied across countries.

3.3 GENERAL CRITICISMS OF THE NEO-LIBERAL PACKAGE

The neo-liberal model is justified by the assumption that a free market maximizes efficiency, produces a welfare optimum, raises savings, investment and technology change, and consequently leads to a higher rate of growth. As is well known, there are huge theoretical flaws in this view leading to many market failures. Consequently, the model has to be defended pragmatically—i.e. on the argument that it works better than alternatives—rather than on the basis of theory. Here, I will briefly consider some of the theoretical flaws in the model; and then some of the more pragmatic arguments.

Figure 3.6
Estimates of amounts raised by privatization among developing countries, 1990-1999

Source: OECD (2000).

The most important theoretical flaws concern (i) the neglect of externalities; (ii) the assumption of perfect and complete information; (iii) the assumption that there are no significant scale economies, either static or dynamic; and (iv) the view that income growth is the single objective of development and consequently income distribution and other objectives, including sustainability, can be ignored.

As is well known, the view that the market leads to a welfare optimum ignores externalities (Stewart and Ghani, 1991). A Coasian-type bargain in which private agents make deals concerning externalities such that they are effectively internalized rarely occurs because of heavy transaction costs and imperfect information. Consequently, the market tends to result in underinvestment in goods with high externalities (such as health, education and infrastructure) which are essential for economic growth as well as for well-being. It is therefore generally accepted that the state should support the production of goods with high externalities. Yet the model, as adopted, involved tight control of state expenditure and thus limited countries' capacity to offset underinvestment in vital sectors with government expenditure. The significance of externalities has become even greater with the increasing importance of environmental issues.

A critical assumption behind the model predicting that the market will maximize efficiency is that of perfect information. Yet, as Stiglitz has shown, this assumption is fundamentally incorrect, and once one allows for imperfect, and generally asymmetrical, information, the market model does not lead to an efficiency optimum. (Greenwald and Stiglitz, 1986; Stiglitz, 1994; Stiglitz, 2002).

Another assumption is the absence of relevant-scale economies, including learning economies as well as pure-scale economies. Yet the existence of such economies means that there can be corner solutions, implying that the marginal conditions which lead to a welfare optimum do not apply. While in countries with large markets (such as the economies of many of the advanced countries) such economies of scale and learning may not be sufficient to prevent competitive equilibrium or inhibit development, in the small economies of many developing countries there are serious implications, especially given their huge learning gap compared with developed countries: a market model may lead to monopoly or oligopoly and also keep economies in the activities where they have a static comparative advantage and prevent them catching up in sectoral terms or in productivity relative to more advanced countries (Chang, 2002; Lall, 1987).

If we combine any of these flaws in the assumptions underlying the basic model with the theory of the second best, which shows that if one of the conditions for an optimum equilibrium does not apply, then we cannot assume that meeting the other conditions will improve the situation (Lipsey and Lancaster, 1956-1957). Thus, the theoretical foundations of the model, which underlie the Washington Consensus policy prescriptions, are not valid.

Although not explicitly stated, it appears that maximizing the level (or growth) of aggregate income is the single assumed objective of development, given that the focus of the model is on market efficiency and neglects income distribution. Let us first consider income distribution before moving to wider objectives. It is clear that maximizing incomes irrespective of distribution could lead to a highly undesirable situation, with high and even rising levels of poverty despite market efficiency. The usual response to this criticism of the model is that one should leave the market to maximize output, and the state can then redistribute to achieve the desired income distribution. There are clearly strong political economy reasons for viewing this as an implausible scenario, since those who initially benefit from the productive system are likely to put up strong resistance to having their gains removed from them and distributed to those who have not benefitted. Moreover, most redistributory mechanisms involve marginal

taxation which acts as a disincentive for efficient allocation of resources. Even though, in theory, lump sum taxes can be devised which do not act as disincentives at the margin, these are too complex even for developed countries and have nowhere been fully adopted. Moreover, apart from political and efficiency constraints on redistribution, the model, as adopted, includes a shift *away* from more progressive taxes (i.e. from direct to indirect taxes) and thus involves a likely *reduction* in any redistributory activity by the state. However, in most economies the redistribution brought about by taxes alone is very small, and it is through public expenditure that the state influences income distribution (Chu and others, 2000; Goñi and others, 2008). However, in many cases, the model included policies restraining public expenditure, which frequently benefit the poor more than the rich relative to their original income (Cornia, 2004). Consequently, we cannot assume that the state can be left to correct any undesirable distribution effects of the market model.

In addition to the effects on income distribution among households (vertical distribution), there can also be unequalizing effects on horizontal inequality (distribution among groups). This includes ethnic and religious groups—indigenous peoples, in particular, are often bypassed by the market (Langer and Stewart, 2012; Thorp and Paredes, 2010)—and also across genders. The neo-liberal model has often been criticized for ignoring the care economy, resource distribution and power relations. One consequence is that the market often increases rewards to activities controlled by men (“cash” crops in many African economies), while increasing the burden on women (by cutting social spending) (Cornia *et al.*, 1986; Elson, 1991, 1995; Gladwin, 1991; Haddad and others, 1995).

In addition, the view that development should be solely concerned with maximizing income (even if appropriately distributed) has been widely criticized for neglecting human objectives, including health, education, leisure, security and the environment (Sen, 1980; Sen, 1999; UNDP, 1990). If we accept that the aim of development is to expand capabilities or freedoms, there may be only a weak link between achieving a market optimum and promoting development.

These are fundamental flaws in the welfare theory underlying the model. But it might be argued that the reason for introducing the model was not because anyone believed it would actually maximize welfare, but because it was thought that it would work better than the previous more state-oriented strategy (often known by market aficionados as “dirigisme”). If that is so, we need to judge the model in more pragmatic ways. This section

will provide an overview of more pragmatic criticisms of the various policy reforms embodied in the model. The subsequent sections will review some empirical findings.

Here the argument starts with deficiencies of the state-oriented model about which critics made the following points:

- The large budget deficits led to high rates of inflation which in turn were bad for growth (by causing uncertainty and hence lowering investment) and poverty.
- Overvalued exchange rates combined with heavy protection discouraged exports and led to inefficient production, because of protection from competition.
- Planning, protection and public ownership of industry led to rent-seeking and inefficiency.
- Repressed financial markets kept interest rates too low with the consequence that savings were discouraged and were inefficiently allocated, and choice of technique was too capital-intensive, leading to unemployment and underemployment.
- Controls over the international movement of capital prevented capital flowing to where it would have highest returns, which was presumed to be the developing countries, given their capital scarcity.

In addition, it was accepted that while the model did focus on incomes to the neglect of income distribution and of wider social objectives, in practice, trickle down would occur because 'growth is good for the poor' (Dollar and others, 2001) and 'wealthier is healthier' (Pritchett and others, 1993).

There is, of course, something in most of these criticisms of the pre-reform model; hence, the need for careful empirical appraisal of the consequences of the neo-liberal model in comparison with pre-reform policies. But there are also important pragmatic defects in the model (and in the above arguments).

The adverse impact of fiscal deficits and of inflation has been much exaggerated by critics: there is very little evidence that inflation below a quite high rate (around 40 per cent) has an adverse impact on growth (Bruno and Easterly 1998) (Ghosh *and others*, 1996; Khan and Senhadji, 2000; Templar, 2000), while the frequently expressed view that inflation is especially bad for the poor (who are ignored for the most part but enter this part of the argument) has little empirical backing. The connexion clearly depends on who the poor are and which prices rise most, which varies across societies. Any costs must also be considered in relation to the counterfactual – i.e. policies

taken to rein in inflation may be more damaging to the poor than inflation itself. Nonetheless, large budget deficits weaken domestic control over the economy, are associated with large trade deficits and high indebtedness, and hence can lead to periodic crises and heavy dependence on foreign loans and assistance.

Yet accepting the need for lower fiscal deficits than in the pre-reform era does not mean these need be achieved via *expenditure cuts*. Public expenditure plays a vital role in supporting economic infrastructure and in “crowding in” private investment, and in supporting social expenditure which contributes to meeting social objectives as well as to long-run growth through enhancing human capital (Ahmed and Miller, 1999). The major criticism of the fiscal part of the neo-liberal model, therefore, is its emphasis on expenditure cutting rather than revenue-raising and in many cases, the *speed* of the adjustment demanded.

With respect to resource allocation (domestic and for trade), the model assumes that resources would flow freely and painlessly from one use to another. While this might plausibly work within a large and well-established manufacturing sector, because of infrastructural needs, learning economies and economics of scale, such movement would be likely to be slow and costly in low-income countries—and, in particular, require high rates of infrastructural and other investment, especially where the shift in resource allocation involved a movement into new industries. Yet without such a shift, the policies are likely to lead to unemployment the underutilization of capital equipment rather than an increase in output via an improvement in the efficiency of resource use. For countries with an undeveloped manufacturing sector, import protection of some sort may well be essential to enable industrialization to occur, as argued in the nineteenth century by List (1841) and in recent years by Chang (2002) among others.

The arguments concerning the implications of financial repression assume that savings are responsive to interest rates, which has often been questioned; while the argument that international capital is likely to flow towards the poorer capital-deficient countries if global capital markets are freed does not work for low-income countries, which do not offer high rates of return because of their deficiencies in infrastructure and human capital, and weak industrial and service linkages. Moreover, free capital movements may threaten the macroeconomic stability of middle-income countries.

Finally, the assumption that poverty reduction and broader societal objectives are best achieved via maximizing growth is not consonant with many other findings. While, on average, the poor may benefit somewhat from

higher growth, the relationship is uneven across countries. Where income distribution is highly unequal and worsening, the poor may not benefit at all; conversely, countries can reduce poverty with low growth if it is accompanied by low inequality and appropriate policies. Moreover, rising inequality is undesirable even if accompanied by falling poverty, since evidence suggests that it increases criminality, reduces life satisfaction, and increases political instability, and, where horizontal inequality increases, it raises the chance of civil war (Alesina and Perotti, 1996; Fajnzylber and others, 2002; Graham and Felton, 2005; Stewart, 2008). Similar arguments apply with respect to the “wealthier is healthier argument” (UNDP, 2010) has shown the very low correlation between rising income per capita and improvements in health, for example (UNDP, 2010). Research into achievements on different dimensions of human development shows low correlations across country between income per capita and many other dimensions (Ranis and others, 2006).

Thus there are flaws both in the theoretical underpinnings of the model and in the more pragmatic arguments that have been advanced in its defence. At the end of the day, however, the actual consequences of the reforms for growth, distribution and stability determine the desirability of the neo-liberal reforms.

3.4 HOW DID COUNTRIES FARE?

This section provides an aggregate picture of what happened in the “liberalizing era” compared with the more state-oriented and interventionist era. For this purpose we take data from 1960-1980 for the interventionist era; and from 1980-2000 for the liberalizing era. We stop at 2000 for two reasons: first because quite a number of countries after that date modified the model, as shown by Cornia for Latin America (Cornia and Martorano, 2011); and, secondly, because the boom in commodity prices, largely due to the expansion of Chinese demand, altered conditions radically for many countries, including relaxing the pressures for reform in many African countries. Nonetheless, we include data for post-2000, but focus on it less in interpretation.

In addition, we attempt to compare countries that have adopted more extensive and deeper neo-liberal reforms, compared with those with few or no reforms. For this purpose, we draw on the work of Sachs and Warner (1995) and Wacziarg and Welch (2008). Sachs and Warner classified countries as “open” if they met all of the following conditions:

- Average rates of tariff of less than 40 per cent;
- Non-tariff barriers of less than 40 per cent coverage;
- Black market exchange rate not more than 20 per cent lower than the official rate;
- No state monopoly on major exports;
- No socialist economic system.

Clearly, these criteria are arbitrary and Rodriguez and Rodrik (1999) have shown that conclusions about associations with openness (e.g. growth rates) depend on the particular definition of openness adopted and changes of the definition, as the definition indeed changes. Wacziarg and Welch (2008), using their own definition, showed how the Sachs/Warner conclusion—that more open economies have higher growth rates—does not hold for the 1990s. Wacziarg and Welch updated the Sachs/Warner classification to account for factors relevant to the 1990s, but the fundamental criticism of arbitrariness, made by Rodriguez and Rodrik, remains valid. Nonetheless, lacking an alternative, below we use a modified version of the classification, putting countries into four categories:

Category 1: “Early liberalizers” (pre-1980) of which there are 12 countries, including well-known cases such as Chile, Hong Kong SAR, and the Republic of Korea.

Category 2: “Forced liberalizers”, which includes 47 countries that enacted reforms in the 1980s and 1990s under pressure from the IFIs. Some liberalized selectively and others bought the whole package (or had it imposed on them) differing in terms of the pace with which they introduced reforms and the extent to which the state acted as a strategic planner. This group is far the largest (as would be expected given the prevalence of reforms in the 1980s and 1990s noted above). As it is difficult to differentiate these subcategories without more information, there is some arbitrariness to this category.

Category 3: The “selective reformers”, including China, India and Vietnam, all of which maintained a strong state role and were highly selective in terms of which reforms they implemented.

Category 4: The “non-liberalizers” (or post-2000 liberalizers) of which there are 27 countries.

Appendix table A3.1 details the classification. The transition countries have been excluded. Going beyond the usual criteria, we used the following to assess performance:

- Growth rate of GDP and employment
- Investment ratio
- Diversification measured by industrial value-added as a per cent of GDP and the share of primary exports in total exports
- Inequality
- Life expectancy
- Expenditure on education as a per cent of GDP
- Carbon emissions per person.

As can be seen from figure 3.7, growth in output and employment slowed down everywhere, except for the selective liberalizers (in this case data are only available for China), during the liberalizing era (i.e. 1981-2000 compared with the previous decades). The sharpest falls were in the most open category (1), followed by the least open (4). The investment ratio also fell in the second period (while it rose in the first) everywhere except among the selective liberalizers (figure 3.8). Diversification increased everywhere between 1960 and 1980, measured by industry value-added as a per cent of GDP. In the liberalizing era, it remained unchanged in the early liberalizers and the selective liberalizers, rose quite sharply in the non-liberalizers, but fell slightly in the forced liberalizers (figure 3.9).

Figure 3.7
Annual growth in employment and GDP, 1960-2007

Source: World Development Indicators.

The Gini coefficient fell on average in every category during the interventionist era, but rose sharply in the very open economies and the selective liberalizers during the liberalizing era (figure 3.10). However, it remained more or less stable on average for category 2 and category 4 countries (forced liberalizers and non-liberalizers). Life expectancy improved in both eras (figure 3.11), but the rate of improvement slowed down in the liberalizing period, especially among the forced and non-liberalizers. Education expenditure as a percentage of GDP continued to increase in the liberalizing era, at a slower rate in categories 1 and 3, and a faster rate in categories 2 and 4 (figure 3.12). In absolute terms, by 1999, the most open economies had the highest rate, followed by the closed economies. As may be expected, increases in CO₂ emissions reflected growth rates, with the highest increase in the open economies and among the selective liberalizers (figure 3.13).

Figure 3.8
Investment by country category, 1960-2008

Source: World Development Indicators.

Table 5 summarizes the above information by showing how the various country categories rank on different criteria. On economic criteria, the selective liberalizers do the best and the non-liberalizers do the worst. On social criteria, the forced liberalizers seem to do the worst, although the

Figure 3.9
Industry value-added by country category, 1960-2008

Source: World Development Indicators.

others are similar. On environmental criteria, the open economies do the worst. If we do a crude combined index (by averaging), selective liberalizers come out on top and non-liberalizers at the bottom.

The early liberalizers' poor showing on the environment and inequality suggests that we do need an alternative model; but the poor performance of the closed economies in terms of growth and improving life expectancy suggests that the closed-economy alternative is not satisfactory, and that *a selective liberalization combined with policies to protect the environment and limit inequality may be optimal*.

The comments above relate to the pre-liberalizing (1960-1980) and liberalizing (1980-2000) eras, and not to post-2000 developments, when conditions changed as the terms of trade improved for commodity exporters and policy stances changed in many developing countries. Nonetheless, post-2000 developments are of interest. Growth of output improved considerably in the period 2001-2007 compared with the previous two decades in each except for the early liberalizers where it fell (figure 3.7). The investment ratio also increased, but only marginally among the early liberalizers and by a small amount among the late and non-liberalizers (figure 3.8). Improved investment and growth is likely to have been due to a combination of the good external

Figure 3.10
Gini coefficient, 1960-2005

Source: WIDER.

Figure 3.11
Life expectancy at birth, 1960-2009

Source: World Development Indicators.

Figure 3.12
Education expenditure, 1960-2007

Source: World Development Indicators.

Figure 3.13
CO₂ emissions per capita, 1960-2007

Source: World Development Indicators.

Table 3.5
A summary of performance

Category	Ranks by category			
	Early liberalisers	Forced liberalisers	Selective liberalisers	Non-liberalisers
Economic				
Growth rate, 1981-2000	2	3	1	4
Employment growth, 1981-2000	3	1	2	4
Investment ratio, 2000	2	3	1	4
Diversification increase: industry value-added as % GDP	2	4	2	1
Social				
Inequality, 2000	4	3	2	1
Education expenditure, 2000	1	3	4	2
Life expectancy, 2000	1	4	2	3
Improvement in life expectancy, 1980-2000	2	2	1	4
Environmental				
CO ₂ emissions, 2000	4	2	1	3
Change in CO ₂ emissions, 1960-1980-1980-2000	4	2	3	1
Average rank	2.0	2.7	1.9	2.5

conditions and the policy combinations adopted. But it should be noted that the improved growth was not reflected in increased employment expansion, apart from among the late and non-liberalizing group. Diversification towards industry occurred in each group, reversing the small drop previously experienced by the forced liberalizers. However, primary product exports increased as a proportion of total exports in each category apart from the selective liberalizers, probably due to the improved prices received.

The data are rather partial for the Gini coefficient, but what there are suggest that inequality fell in the early liberalizer group, rose very slightly among the forced and selective liberalizers, and significantly among the late or non-liberalizers (figure 3.10). Improvements in life expectancy continued everywhere, but slowed down in all but the forced liberalizers, although

among this group life expectancy was still much lower than among the early and selective liberalizers (figure 3.11). Education expenditure continued to rise as a proportion of GDP in all countries apart from the early liberalizers, where it fell slightly 2000-2007 (figure 3.12). CO₂ emissions continued to rise, especially sharply among the selective liberalizers, but remained much the highest in the early liberalizer group. In terms of ranking, in the economic sphere, the selective liberalizers do best. In the social sphere, the early liberalizers continue to outperform the others with little difference among the other three categories. The non-liberalizers do best in terms of containing CO₂ emissions, while the early and selective liberalizers score the worst. The aggregate ranking remains the same as for the earlier period, with the selective liberalizers outperforming the rest and the forced liberalizers still ranked lowest.

We must emphasise that the exercise carried out in this section is very crude. Weaknesses include: arbitrary categorization of countries; the endogeneity of policy change to initial conditions, which may then influence what happens over time; variations in policy choice and performance within each category; and lack of (or inaccurate) data in quite a number of cases. Therefore, we now turn to summarizing some econometric approaches that have been adopted to assess the liberalizing reforms.

3.5 ASSESSMENT: FINDINGS FROM EMPIRICAL STUDIES

Section 3.3 presented some general arguments concerning defects of the neo-liberal model. But, as noted there, there were also defects in the pre-reform state-oriented model. To get a balanced assessment therefore one needs an empirical assessment of the neo-liberal model in comparison with the prior model. In this section, we review some studies that have made such a comparison, pre and post-reform, and with and without reform. However, the pre-reform situation is *not* the only, or, almost certainly, the most desirable alternative policy package, so in principal one should also consider whether the neo-liberal reform model compares positively or not with other potential alternatives. This, however, is clearly difficult to do, as there are many alternative possibilities, often with unknown effects.

The standard model and economic growth

Easterly sums up a dilemma for adherents of the neo-liberal model: “In 1960-79, the median per capita growth in developing countries was 2.5 per

cent. In 1980-98, the median per capita growth of developing countries was 0.0 per cent. In contrast, the standard determinants of growth in growth regressions like financial development, black market premiums, real overvaluation, educational attainment, life expectancy, fertility, and infrastructure got steadily more favorable for growth from the 60s through the 90s.” (Easterly, 2001: 3). He concludes: “The fact remains that many, even stationary, country characteristics widely thought to be favorable for growth (or at least favorable for level of income) have improved, yet developing countries on average have stagnated. This in itself is a blow to the optimism surrounding the ‘Washington Consensus’ prior to the experience of the last two decades.” (Ibid.: 21-22).

The conclusion that the model, as introduced by the IMF, did not speed up growth, and indeed may have reduced it, is confirmed by many assessments of IMF programmes, which examine the main elements of the reform programme. For example, a survey by Ul Haque and Khan (1998) of 18 evaluations undertaken between 1978 and 1997 showed mixed evaluations. The “before-after” evaluations produced three positive assessments and four zero ones; the with-without assessments gave one positive, one negative and two zeros; the “generalized evaluations” produced two negative, two positive and one negative in the short-term and positive in the longer term, while simulation exercises showed one negative, and one negative in the short term, positive in the longer term. The summary by Bird is broadly similar:

On economic growth, although many early studies found little connection, Goldstein and Montiel (1986) found IMF programs to have a significantly negative effect. Simulation tests by Khan and Knight (1982) also predicted that demand management programs similar to those supported by the IMF will have negative short-run effects on growth, although subsequent research by them suggests that these effects can be ameliorated by incorporating supply-side measures to protect investment (Khan and Knight, 1985). Conway (1994) finds significant differences between the short-run and long-run effects of IMF programs on economic growth and investment, as contemporary reductions are followed by lagged increases. Killick (1995) finds a largely neutral association with economic growth, although over a longer time-frame the association is positive (albeit of only limited statistical significance).... While Hutchison (2001) discovers a significant adverse effect on output growth over one to two years, Przeworski and Vreeland (2000) claim that IMF programs have an enduring adverse effect on economic growth. (Bird 2001: 1851)

More recent assessments have used instrumental variables in order to separate the impact of the programmes from the economic conditions of the country which led to the need for a programme. Barro and Lee (2005: 1245) conclude that “a higher IMF loan-participation rate reduces economic growth” and it also has a small negative impact on democracy and the rule of law, which may further impact negatively on growth. Dreher (2005), also allowing for endogeneity, comes to similar conclusions.

Beyond economic growth, studies of IMF programmes generally find that they have a negative impact on investment (Bird, 2001) while improving the current account and the fiscal balance (Atoyan and Conway, 2005). The effects on inflation appear to be small and ambiguous in direction (Bird, 2001).

The consequences of particular elements in the model

There have also been many studies of the effects of particular elements in the package. A major element is *import liberalization*. Here Sachs and Warner famously argue that more-open economies grew faster, based on cross-sectional evidence correlating degrees of openness, as defined above, with growth. Similar results have been produced by others (e.g. Dollar, 1992; Harrison 1996; Edwards 1998). But as noted earlier, the way openness is measured may determine these results (Rodrik and Rodriguez 2000). Wacziarg and Welch (2003) argue that before-after studies of liberalization avoid this problem and show that import liberalization is associated with a speed up in growth. However, Slaughter (2001) compared before-after results of trade liberalizers with non-liberalizers among OECD countries, and found little difference in growth. Kneller (2002: non-technical summary) came to similar conclusions examining developing countries: “The increase in growth that took place in liberalizing countries also took place in non-liberalizing countries i.e. trade liberalisation did not cause growth rates to increase.”

Moreover, adverse effects of trade liberalization have been noted. Shafaeddin (2005) argues that in 40 per cent of countries, trade liberalization had the effect of speeding up the growth of manufactures, but in many of the remainder, including many least developed countries, it led to deindustrialization. Mosley and others (1991) argue that in Africa, trade liberalization reduces growth.

Studies of the impact of trade liberalization on income distribution, which had been expected to be egalitarian for developing countries, again show ambiguous results with some liberalizing countries becoming more equal but in many cases trade appears to have been unequalizing.

Several studies point to the equalizing effect of free trade. In the nineteenth century, trade liberalization led to an increase in domestic inequality in rich New World countries, but reduced it in the poor Old World countries. Likewise, in an analysis of 35 small developing countries, Bourguignon and Morisson (1990) conclude that the removal of trade protection in manufacturing reduced the income share of the richest 20 per cent of the population and raised that of the bottom 60 per cent. While Wood (1994) arrives at a similar conclusion for East Asian exporters of labour-intensive manufactured goods, he has argued further that the unskilled to skilled age ratio improved in East Asia following liberalization but worsened in Latin America, and attributes this to the differing dates at which liberalization occurred, with Latin America facing severe competition from China in the 1980s and 1990s (Wood, 1997). Michaely and others (1991) present some cases of improving and others of worsening income distribution in a nineteen-country study of trade liberalization. According to Lindert and Williamson (2001) wage inequality was found to have increased in six out of seven Latin American countries that had liberalized trade, as well as in the Philippines and Eastern Europe. And an analysis of 38 developing countries for the years 1965-1992 found that trade liberalization benefited the richest 40 per cent, while negatively affecting the bottom 40 per cent, who were hurt by greater fluctuations in the terms of trade following the opening of the economy (Lundberg and Squire, 2000). Savvides (1999) showed that the most open developing countries experienced a rise in inequality between the 1980s and the early 1990s, and a positive correlation between trade protection and the income share of the poorest quintile (Cornia, 2005: 3-4).

In general, while the liberalizing era was accompanied by worsening income distribution in many countries, this did not occur everywhere (figure 3.10) and since there were many simultaneous changes, it is not possible to attribute this to any single measure.

Financial sector reforms do not consistently increase savings as assumed by its advocates, and can deter investment. Although Fry (1988) indicates that national savings increase with higher real interest rates brought about by financial sector reform, there is evidence of declining savings following liberalization in number of countries (Williamson and Mahar, 1998). Savings fell following liberalization episodes in Chile, Argentina, Colombia and the Philippines, Kenya and Malawi, but rose in Egypt, Lesotho and Uganda, according to a range of studies (Cobham, 2002). Warmana and Thirlwall (1994) show that in Mexico financial reforms did result in a rise in the real interest rates, but this did not lead to an increase in total savings and was a

deterrent to investment. Demetriades and Devereux (1992) find a negative impact on investment from higher real interest rates in a panel study of 63 developing countries from 1961 to 1990, while Günçavdia and others (1998) show that in Turkey financial liberalization did not relax credit constraints. But Siddharthana and others (1998) found that in three industries in India, MNC behaviour changed, with market share post-reform being determined by factors related to innovation, as against the ability to secure licenses in the pre-reform era.

More broadly, financial sector liberalization has been attributed with encouraging speculation in future markets, which is likely to have contributed to high and volatile food prices, pushing many millions into poverty (Gilbert, 2008; United Nations, 2011; World Bank, 2011).

The evidence on *capital account liberalization* is also ambiguous. According to Cobham's survey: "It may be concluded on the basis of this literature survey that the growth-related benefits of capital account liberalisation for developing countries have not been established" (Cobham, 2002: 19). While Klein and Olivei (1999) find a positive impact on financial deepening and growth for developed countries, they do not find this for developing countries, which they attribute to a lack of appropriate institutions. Kraay (1998: 19) confirms "the absence of evidence of the growth benefits of capital account liberalization". Capital account liberalization can have negative effects – first, because some flows are highly volatile and can result in acute crises and, second, because high inflows of foreign capital can lead to an exchange rate appreciation. The volatility has been exhibited in the series of financial crises experienced by highly liberalized countries, such as Mexico; South East Asia in the late 1990s and a number of countries during the 2008-2009 global financial crisis, in which countries with limited private capital flows were relatively unaffected (Stewart, 2011).

These crises have had heavy economic and social costs. As Stiglitz writes:

One of the most controversial aspects of globalization is capital market liberalization; not so much the liberalization of rules governing foreign direct investment, but those affecting short-term capital flows, speculative hot capital that can come into and out of a country. In the 1980s and 1990s, the IMF and the US Treasury tried to push capital market liberalization around the world, encountering enormous opposition, not only from developing countries, but from economists who were less enamoured of the doctrines of free and unfettered markets, of market fundamentalism, that were at that time being preached by the international economic institutions. The economic crises of the late

1990s and early years of the new millennium, which were partly, or even largely, attributable to capital-market liberalization, reinforced those reservations. (Stiglitz, 2004: 57).

With respect to *privatization*, in a study of 63 countries, Cook and Uchida (2003) find that privatisation is robustly *negatively* related to economic growth, although Filipovic (2005) gets more ambiguous results when introducing a number of other policy variables simultaneously.

In summary, empirical assessments of the reform packages, and of individual elements, produce differing results, depending on methods and time period. On balance, the IMF packages seem to have a negative impact on economic growth and privatization has also been associated with negative growth impact. No systematic growth effects can be detected from import liberalization or financial liberalization, while capital account liberalization increases the risks of costly crises without necessarily raising savings and investment. Income distribution worsened in many countries during liberalization (Cornia, 2004), but no clear-cut relationships can be found between particular measures and distributional outcomes.

3.6 CONCLUSIONS

The review of the basic neo-liberal model showed that there were deep flaws in the theoretical foundations. The more pragmatic arguments for liberalizing were also shown to be inconclusive. But the proof of the pudding is in the outcomes. Here we find that the Washington Consensus model has not delivered its promised acceleration in growth. Indeed, on balance it seems to have been associated with reductions in growth and often with worsening income distribution. Financial liberalization does not seem to have raised investment, as predicted, nor has privatization been associated with increased growth. Capital account liberalization has shown very few benefits and high costs in terms of instability and exchange rate effects.

Yet this does not mean that all liberalizing policies should be reversed: indeed, the survey of outcomes of countries categorized according to the extent of liberalization found that the non-liberalizers did worst. Countries which liberalized selectively *and retained a strong role for the state* in steering the economy—in this review just a small subset, notably India, China and Vietnam—seemed to do best. The conclusion then is that we do need a new macroeconomic model, but this is not likely to consist of a total reversal of all liberalizing policies, but a careful selection and modification

of these policies, supported by complementary policies towards investment, human resources, taxation and social transfers. Moreover, the best policy mix is likely to differ across countries according to level of development and economic structure, while international conditions are also relevant.

APPENDIX

Table A3.1

Trends in the composition of taxation in developing countries

<i>Country</i>	<i>Year uninterrupted openness began</i>		<i>Category</i>
	Sachs & Warner	Wacziarg & Welch	
Barbados	1966	1966	1
Bolivia	1985	1985	1
Botswana	1979	1979	1
Chile	1976	1976	1
Hong Kong SAR, China	always open	always open	1
Indonesia	1970	1970	1
Jordan	1965	1965	1
Korea, Rep.	1968	1968	1
Malaysia	1963	1963	1
Singapore	1965	1965	1
Thailand	always open	always open	1
Yemen, Rep.	always open	always open	1
Argentina	1991	1991	2
Bangladesh	closed	1996	2
Benin	1990	1990	2
Brazil	1991	1991	2
Burkina Faso	closed	1998	2
Burundi	closed	1999	2
Cameroon	1993	1993	2
Cape Verde	n.a.	1991	2
Colombia	1986	1986	2
Costa Rica	1986	1986	2
Cote d'Ivoire	closed	1994	2
Dominican Republic	closed	1992	2
Ecuador	1991	1991	2
Egypt, Arab Rep.	closed	1995	2
El Salvador	1989	1989	2
Ethiopia	closed	1986	2

(cont'd)

Table A3.1 (cont'd)

<i>Country</i>	<i>Year uninterrupted openness began</i>		<i>Category</i>
	Sachs & Warner	Wacziarg & Welch	
Gambia, The	1985	1985	2
Ghana	1985	1985	2
Guatemala	1988	1988	2
Guinea	1986	1986	2
Guinea-Bissau	1987	1987	2
Guyana	1988	1988	2
Honduras	1991	1991	2
Jamaica	1989	1989	2
Kenya	1993	1993	2
Madagascar	closed	1996	2
Mali	1988	1988	2
Mauritania	1992	1995	2
Mexico	1986	1986	2
Morocco	1984	1984	2
Mozambique	closed	1995	2
Nepal	1991	1991	2
Nicaragua	1991	1991	2
Niger	closed	1994	2
Panama	n.a.	1996	2
Paraguay	1989	1989	2
Peru	1991	1991	2
Philippines	1988	1988	2
South Africa	1991	1991	2
Sri Lanka	1991	1991	2
Tanzania	closed	1995	2
Trinidad and Tobago	closed	1992	2
Tunisia	1989	1989	2
Turkey	1989	1989	2
Uganda	1988	1988	2
Uruguay	1990	1990	2
Venezuela, RB	closed	1996	2
Zambia	1993	1993	2

(cont'd)

Table A3.1 (cont'd)			
Country	Year uninterrupted openness began		Category
	Sachs & Warner	Wacziarg & Welch	
China	closed	closed	3
India	1994	closed	3
Vietnam	n.a.	n.a.	3
Algeria	closed	closed	4
Angola	closed	closed	4
Central African Republic	closed	closed	4
Chad	closed	closed	4
Congo, Dem. Rep.	closed	closed	4
Congo, Rep.	closed	closed	4
Cuba	n.a.	n.a.	4
Gabon	closed	closed	4
Haiti	closed	closed	4
Iran, Islamic Rep.	closed	closed	4
Iraq	closed	closed	4
Korea, Dem. Rep.	n.a.	n.a.	4
Lesotho	n.a.	closed	4
Liberia	n.a.	closed	4
Malawi	closed	closed	4
Myanmar	closed	closed	4
Nigeria	closed	closed	4
Pakistan	closed	2001	4
Papua New Guinea	closed	closed	4
Rwanda	closed	closed	4
Senegal	closed	closed	4
Sierra Leone	closed	2001	4
Somalia	closed	closed	4
Swaziland	n.a.	closed	4
Syrian Arab Republic	closed	closed	4
Togo	closed	closed	4
Zimbabwe	closed	closed	4

NOTES

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