

# Tides in Economic Theories from Classical To Post-Washington Consensus: A Critical Review

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**Abstract:** Economic theories have changed over the last two hundred years on the basis of thinkers' partial and biased 'truths' about the world; distortion in insights, advance in science and technology, and changes in social, economic, cultural, and environmental conditions. The idea of free market was started against mercantile policy that provided ideological and intellectual background for the Industrial Revolution, with remarkable results on the human well-being. However, early days of IR were marred by appalling conditions for large numbers of workers. Following the swigs of the idea of free market, the state-favored theories legitimized state intervention into markets with the aim of achieving growth. The result was fascinating; many countries grew at unprecedented rates. On the other side, the apparent success of the anti-market ideology of national governing elites resulted in heavily state-centric development strategies in 1950s and 1960s. A balanced view began to emerge during the closing years of the 20<sup>th</sup> century as the Washington Consensus (WC) failed to deliver its promises. From these swigs one can notice that by 21<sup>st</sup> century, there is a fair understanding of the complementarities between markets and the state. A 'one size fits all' kind of economic policy has been condemned and scholars realized the malfunction of the WC. The evaluation of development experiences suggests the combination of state and market and most people inclined to agree with state intervention. The question is, however, in what areas should/not the state intervene and how to fashion the new models suited to the nation's local circumstances.

**Keywords:** Classical, Economic theories, Pessimists, Radicals, Post Washington Consensus, State, Tides.

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## I. INTRODUCTION

Economic development refers to promotion of more intensive and more advanced economic activity through such means as education, health care facilities, improved tools and techniques, more available financing, better transportation facilities, and creation of new economic sectors. In the past economic development was also seen as the planned alteration of the structure of production and employment from agriculture to manufacturing and service sectors. Development strategies and practices have usually focused on rapid industrialization often at the expense of agriculture and rural development measured with different criteria. Of which, the GDP and per capita income are the universal measures of how a country's economy is doing (Willis, 2005; Peer & Hartwich, 2009; Todaro & Smith, 2009).

Economic theories of growth and development that are guiding policy directions have various histories, trajectories, philosophical basis, typical kinds of practice, and offered different analysis, often with diversity in economic growth from place to place and from time to time (Miller, 2008; peet & Hartwick, 2009). Moreover, the views on which policy directions are good for economic growth have changed depending on changing circumstances of the national and international political environments (Nugent, 2004). For instance, since the end of mercantilist political policy classical theorists invented the concept of self-regulating market and then in the course of 19<sup>th</sup> century neoclassical economists in conjunction with the rise of industrial capitalism, further refined the idea of the market as decision-maker. Both of these

approaches advocate minimal state intervention letting the economy organize and grow in accordance with institution of the market. By this approach the state is only allowed to uphold private contracts and the ownership of property. While some others prefer more controlled markets, in which the state regulates how goods, services and labor may be used, priced, or distributed. Still others favor mixed economic development approach with a more state intervention. In this economic system, some key economic sectors are in state ownership and others in private using dual economies. The nations of Western Europe and Asian Miracle countries are typical examples of this type (Meier & Rauch, 2000; Kohsaka, 2004; Pierson, 2005; Bowles, 2007; Peet & Hartwich, 2009; Todaro & Smith, 2009).

The views on the relationship between states, market and the achievements of economic development have passed through different phases. As Meier and Rauch (2000) states, thinking about the particular economic approach have gone through three phases beginning from the origin of modern development economics in the 1950s. The first most optimistic phase viewed the state as a benevolent leader of the development process and sufficient social welfare maximizing unit. Early writers on development, governments of recently independent developing countries, and many western countries facing reconstruction after World War II saw a major role of the state in the production process. The second most pessimistic phase viewed the state as a major obstacle to development working for narrow interest groups or politicians and bureaucrats rather than for the greater good. Pessimistic views emphasize on market's superior qualities as a decision-making mechanism to deliver economic change in key dimensions. The third phase identifies wide variations in state performance and seeks to explain them focusing in particular on institutional determinants of state capacity, meaning the ability of the state to formulate policy independent of corrupting influences and to implement development policies effectively (Meier & Rauch, 2000; Kohsaka, 2004; Miller, 2008).

Putting all these views together, economic development can be considered as a contentious issue around which swirl better arguments and fierce discussions. Particularly the 21<sup>st</sup> century is considered as a period of transformation in the global economy, a period of new international division of labor entered a middle-age crisis and the global economy entered financial crisis, which collectively calls for new consensus with new development strategies (Peet & Hartwick, 2009).

Based on stated background, this paper reviewed the achievements of economic development policy directions that are translated from competing development theories in temporal and spatial context and explained the current trend in policy directions. In preparing this paper, a review of the relevant literature was undertaken with the objective of identifying various theories and achievements. In order to achieve the objectives, the era of economic views were divided into four phases on the basis of shifts in emphasis. The first phase is the period of classical economics starting from Adam Smith (1776) to 1920-30s. The second phase is the rise of the Keynesian and dependency theories from 1920-30s to the end of 1970s; the third phase is the time of neoclassical counterrevolution from 1980s and 1990s, and the fourth phase is the current shift towards new development strategies starting from the Santiago consensus.

## **II. CLASSICAL VIEWS ON STATE-MARKET-ECONOMY RELATIONSHIPS**

### **1. PESSIMISTS' VIEW:**

Classical economics refers to a period of British economic thought stretching from 1776 to 1848 (a year marked by liberal revolutions throughout Western Europe). In the light of this theory, most economists believed that laissez faire was the best vehicle for achieving sustainable growth in an economy (Willis, 2005; Lin, 2010). One of the first and most important scholars in this endeavor was Adam Smith (1723–1790), whose book, *The Wealth of Nations*, would become the foundation for a whole new field of knowledge and influence later ideas of economic development. Since more of his ideas have lasted than those of any other economist, some regard Adam Smith as the alpha and the omega of economic science. He tried to show the existence of a 'natural' economic order, one that would function most efficiently if the state played a highly limited role. He saw the division of labor in improving production and the extension of markets to expand wealth through manufacture and trade (Willis, 2005; Miller, 2008). One of his great contributions was his explication of the self-regulating market. He argued that a competitive, demand-and-supply-driven market could make decisions for a nation's economy without the intrusions of government guidance or business control. He called this market-organized

decision-making system the “invisible hand.” and considered the competitive market an exceptionally positive mechanism. To underline his laissez-faire convictions, Smith argued that state and personal efforts to promote social good are ineffectual compared to free market forces (Miller, 2008; John, 2010).

Following his belief in competitive markets that Adam Smith opposed to the state-franchised trading-company monopolies of mercantilism practiced in Western Europe. In addition, he opposed the state protection of local producers via taxes (high import tariffs) on imports of cheaper products from other countries (Miller, 2008). In order to safeguard their interests, merchants supported protectionist measures which allowed them to carry out their activities without what they saw as unnecessary competition. He argued for greater attention to be paid to production, rather than trade and gold accumulation as an indicator of economic development or a measure of wealth status (Wills, 2005; Bowles, 200; Peet & Hartwick, 2009). In line with this, Justin Yifu Lin (2008) also argued in his marshal Lectures that trade should not be considered as a fundamental determinant of long-term growth in a country.

Over the course of the nineteenth century Adam Smith was followed by a number of great classical thinkers. The first who is of special interest to this matter is David Ricardo (1772–1823) (Miller 2008). He was a great advocate of free trade and developed the theory of ‘comparative advantage’. According to this theory, countries should concentrate on producing and then selling the goods that they had an advantage in producing because of their assets, such as land, mineral resource, labor, and technical or scientific expertise. This meant a global division of labor. Ricardo argued that it made more sense for countries to specialize, rather than trying to produce everything, because through specializing, production would be more challenged in the early twentieth century by significant economic events, in particular the 1929 Stock Market Crash and the Great Depression of the 1930s in the USA. But in contrast to Smith, David Ricardo was pessimist about equitable distribution of growing income from the market-industrial society. He thought that those who own a scarce and limited resource, land in his day would reap unequal benefits while others would suffer. It is based on his insight that the market does not necessarily create a fair and equitable distribution of income (Kohsaka, 2004; Willis, 2005; Miller, 2008; Peet & Hartwick, 2009).

## **2. THE RADICAL VIEWS:**

After Adam Smith and David Ricardo, the third great classical political economist who is of special interest to this topic is Karl Marx (1818–1883). Because he lived later than Smith and Ricardo, he observed more of the development of the Industrial Revolution and its spread around the world than either of his predecessors. He was critical of what he called “vulgar economics.” He saw the market as a mechanism of exploitation and not a liberator, as Smith and his followers saw it. However, Marx agreed with his fellow classical political economists that it was foolish to separate politics from economics analytically because societies can be understood only in their holistic interconnectedness and in their historical context. The historical context on which he focused was capitalism. Marx developed his own model of how capitalism works, what was wrong with it, and what was going to happen to it (Miller 2008).

## **3. ECONOMIC IMPLICATIONS OF CLASSICAL VIEWS:**

The ideas of Smith provided the ideological and intellectual background for the Industrial Revolution. The fundamental characteristic of the industrialization process was the introduction of mechanical power (originally steam) to replace human and animal power in the production of goods and services. As the mechanization of production gained momentum in England and gradually spread to other parts of the world, several fundamental changes occurred. London became the center of the most powerful production system in the world. Production became more specialized and concentrated in larger units, called factories (Miller 2008). Artisans and small shops of the 18th century were relegated to the periphery of economic activity in the leading nations, especially in England, the United States, and Germany. The modern working class began to emerge; workers no longer owned their tools, they had little property and they had to exchange their labor for a money wage. The application of mechanical power to production brought a great increase in worker efficiency, which made goods abundant and cheap. Thus, the real standard of living rose throughout much of the world during the 19<sup>th</sup> C (Willis, 2005; Pierson, 2005; Bowles, 2007; Rostow 1990a cited in Lin, 2010).

In the late 19<sup>th</sup> Century, especially in the United States, the modern corporation, with its limited liability and immense financial power, began to emerge as the dominant form of business organization. The tendency toward corporate control of manufacturing led to many attempts to create combines, monopolies, or trusts that could control an entire industry (Bowles, 2007; Miller, 2008; Peterson, 2008).

Despite the remarkable economic achievements, the development of industrial capitalism had serious human costs. The early days of the Industrial Revolution were marred by harsh conditions for large numbers of workers, especially in England. Abusive child labor, long working hours, and dangerous and unhealthy workplaces were common. These conditions led Karl Marx to blame the capitalistic system. Marx struck private ownership of the means of production and believed that land and capital should be owned collectively and that the products of the system should be distributed according to need (Bowles, 2007; Miller, 2008).

Capitalism was also troubled by periods of expansion followed by economic collapse and waves of unemployment. The ups and downs of economic life resulted from such cycles are the inevitable price that society had to pay for the material progress experienced. Marxian criticisms, along with frequent depressions in the major capitalist nations, helped establish vigorous trade-union movements that fought to raise wages, shorten working hours, and improve working conditions. Despite such difficulties, capitalism continued to expand and prosper almost without limit throughout the 19<sup>th</sup> century. It was successful because it demonstrated an enormous ability to create new wealth and raise real standard of living for nearly everyone touched by it. As the century closed, capitalism was dominant economic and social system (Pierson, 2005; Bowles, 2007).

To conclude, three different and competing world views are descended from Smith, Ricardo, and Marx, respectively. They compose the analytical core of the field of international political economy. Though all three scholars were a part of classical political economy, they had three quite different perspectives. Smith is associated with the market model of neoclassical economics. Ricardo is associated with comparative advantage- the organizational power model of institutional political economy. Marx is associated with his critical model of capitalism and subsequent elaborations. The three views differ on many dimensions. For instance, on the dimension of who are the central actors in the political economy, the market school sees them as individuals; the institutional school sees them as organizations; and the Marxist school sees them as classes.

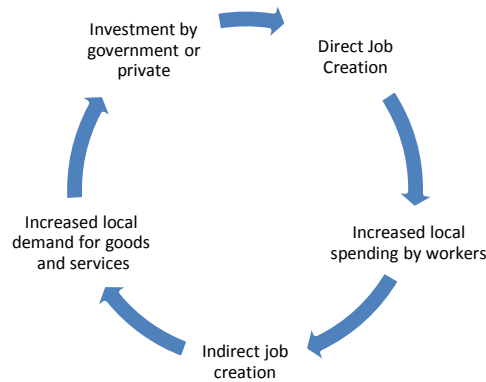
### **III. OPTIMISTS' VIEWS ON STATE-MARKET-ECONOMY RELATIONSHIP**

#### **1. THE KEYNESIAN AND DEPENDENCY THEORIES:**

Many people have come to understand that capitalist economies are not necessarily self-stabilizing. Keynes and his followers worried about shortfalls in aggregate demand and the resulting unemployment. Keynesian economics was raised following the extreme depressions resulted from the free-market approach. The Stock Market Crash (1929) and the Great Depression that haunts most Western Europe, United States, and much of the capitalist world (1930s) could be mentioned. Thus, economists and governments began develop new understandings of the national economies. Among these was John Maynard Keynes, who published *The General Theory of Employment, Interest and Money* in 1936 (Rodrik, 2004; Pierson, 2005; Willis, 2005).

The Keynesian economic theory legitimized state intervention into market economies with the aim of achieving growth rates decided on the basis of social policy. Hence, some degree of state intervention became more or less accepted in mainstream economics and in conventional politics. Similarly, in Latin America a structuralist school of thought emerged that was critical of certain aspects of classical economic doctrine and urged the need for greater state intervention in the growth process as Keynes did (Guinnes & Nagle, 2002; Peet & Hartwick, 2009).

Keynes's argument was that the free market was not necessarily the positive force that many, following Adam Smith, believed. He argued that the key to growth was real investment in new infrastructure projects which would have a positive effect on job creation and wealth generation through the multiplier effect (See fig 1).



Source: Modified from Willis, 2005

**Figure 1 Multiplier Effect of Government investments on infrastructure**

For example, if a government funds a road-building scheme, this will create jobs not only for the road builders, but also for suppliers of road-building materials and tools. The workers will spend money so supporting other people's jobs and companies will make profits which can be invested further in productive capital (Kohsaka, 2004; Willis, 2005). The state also had to intervene through monetary policies, mainly the manipulation of interest rates and fiscal policies, in order to influence national income and employment through central banks (Pierson, 2005; Peet & Hartwick, 2009).

Another influential supporter of state intervention in economic development was the Swedish economist Gunnar Myrdal (1957). He highlighted the spatial inequalities inherent in free market economic development in his book *Economic Theory and Underdeveloped Regions*. He argued that the only way to reduce the exacerbation of spatial inequalities could be through state intervention; and if state planning was efficient, there was no need for the regional variations in economic growth rates. However, he had awareness that in many situations the government departments have no capacity in many countries. He termed weak states as 'soft states' and advocated a move to 'strong states' to ensure the implementation of the planning mechanisms. Myrdal's faith in planning as a solution to development problems fits with what post-development theorists would call a Eurocentric technocratic approach (Willis, 2005).

There were also less Marxist but still radical views known as "dependency" theories, which were particularly prominent in Latin America. These schools of thoughts emerged as critical of certain aspects of classical economic doctrine and that often advocated state intervention in the growth process. Dependency theorists argued that markets favored industrialized countries through providing raw materials cheaply from the developing world. In addition, industrialized countries owned the technology that developing countries needed and had the economic power to admit exports from developing countries only when it suited them. Such views gave a strong bias in the developing world to a belief in the virtues of autonomous development. According to the dependency theorists, developing countries could only grow behind protective trade barriers that kept out exports from the industrialized world (Guinness & Nagle, 2002; Peet & Hartwick, 2009). These theorists also believed that investment by Western multinational corporations would mainly harm developing countries and so regarded such investment with suspicion. Since free markets alone could not generate adequate growth, and structural change, governments had to have a major hand in planning and promoting the economy, including public sector enterprises to undertake the investments that the market would not provide. For some dependency thinkers even foreign aid was seen as a "neocolonial" instrument to protect the dominance of the industrial countries and make the world safe for capitalism. Even after independence, it was the developed countries that had colonized the developing world, and they appeared to have kept the developing world in an inferior position by pressuring them to produce raw materials needed by the industrial world, thus hindering their attempts to become manufacturing economies (Guinness & Nagle, 2002; Bowles, 2007; Todaro & Smith, 2003, 2009).

In line with the rise of state-favored economic development theories, many governments and multilateral and bilateral international agencies have taken significant measures in response to market failures and Great Depression. Of which, the vital ones were the New Deal, the Marshal Plan, and other social welfare maximizing interventions (Bowles, 2007).



**i. The New Deal :**

The New Deal, a US Social and Economic Reform Program, was introduced in the United States in 1930s under the Presidency of Franklin Delano Roosevelt. It was a program undertaken between 1933 and 1938 to counteract the effects of the Great Depression through expanding government intervention into new areas of social and economic concerns and creating social-assistance measures on the national level. It produced a wide variety of programs to reduce unemployment, assist businesses and agriculture, regulate banking and the stock market, and provide security for the needy, elderly, and disabled and then to restore prosperity (Willis, 2005; McElvaine, 2008).

The Great Depression fundamentally changed the relationship between the government and the people, who came to expect and accept a larger federal role in their lives and the economy. The programs of the New Deal brought together a new, liberal political alliance in the United States. Roosevelt's policies won the support of labor unions, blacks, people who received government relief, ethnic and religious minorities, intellectuals, and some farmers, forming a coalition that would be the backbone of the Democratic Party for decades to come (McElvaine 2008).

While Keynesian economics was available from 1936 onward, the Depression of the 1930s was ended by pragmatic governmental intervention, as with New Deal employment-generating programs in the United States, and supporting all the Western economies involved in World War II. During the postwar period, Keynesian economics became the basis of growth theories promulgated by economists other than Keynes. Full employment, economic revival and production increment and the resultant better life were promises of the theory and program interventions.

**ii. The Marshal Plan :**

The post World War II period gave Western nations the opportunity to consider the most appropriate forms of international organization and intervention to ensure that the economic crises of the 1930s could never happen again. In addition, they wanted to promote a more peaceful world where warfare could be replaced with diplomacy and negotiation. In the sphere of economics, the 1944 Breton Woods Conference in New Hampshire, USA, led to the creation of three key international institutions aimed at promoting stable economic growth within a capitalist system; the International Monetary Fund (IMF), the World Bank and the General Agreement on Tariffs and Trade (GATT). Decisions were made to influence the whole of the non-communist world, but the countries represented were from the industrialized world (Willis, 2005).

The important role of government, or in the case of the Breton Woods institutions, multilateral organizations, in economic intervention for development was clearly reflected in the Marshall Plan, officially titled the 'European Recovery Program' and was announced on 5 June 1947 by the US Secretary of State George C. Marshall. This was a program through which aid was channeled from the USA to fund reconstruction in Europe. The program was ran from 1948–52 and reflected Keynesian theory in that investment into infrastructure programs was not just to recreate physical capital in Europe; it was also meant to contribute to recover the national economies of the region quickly. Restored European economies would provide markets for US products and would also contribute to the maintenance of a viable trading system. In addition, given the concerns about the communist threat, the US administration felt that providing this assistance would reduce the likelihood of shifts towards communism within Western Europe. To administer the Program, the Organization for European Economic Cooperation was set up. In 1961 this organization became the Organization for Economic Cooperation and Development (Willis, 2005; Bowles, 2007).

**2. ECONOMIC IMPLICATION OF OPTIMIST THEORIES:**

The result of these policies and intervention programs was that in the 1950s and 1960s capitalist countries in the core grew at historically unprecedented rates, secured levels of employment which had never previously been achieved for such a long period and had institutional mechanisms in place, such as the welfare state and progressive taxation, which ensured that income inequality generally decreased over the period (Willis, 2005; Bowles, 2007).

The United States was assumed as unrivalled leadership of the capitalist bloc in the time. It is also estimated that the US accounted all about half of the world industrial output in 1945 and continued up to 1970s until the country faced recession. Economic development was also high in large part of the capitalist developing countries though many of the benefits did not reach the poor due to unequal income or wealth distribution. Capitalism with free market

economic model showed expansion in geographical reach and more countries were integrated into empires and trade relations. But in the 20<sup>th</sup> C there was diminution of its geographical scope as many Eastern European, Asian and African countries were joining the socialist block (Bowles, 2007). Finally, as the tension between the two big blocks (capitalist and socialist) ended with the victory of the capitalist block by the end of 1980s, another market fundamentalist view—neoclassical counter revolution, flourished in 1980s and 1990s (Bowles, 2007).

#### **IV. NEOCLASSICAL COUNTERREVOLUTION**

##### **1. THEORETICAL AND PRACTICAL FOUNDATIONS:**

Neoclassical counterrevolution sometimes called Neoliberalism (Market Model) emerged in the 1980s in the United States, Canada, Britain and West Germany as economic theory and policy. In the developed nations, this counterrevolution favored supply-side macroeconomic policies, rational expectations theories, and the privatization of public corporations. In the developing countries, it called for freer markets, dismantling of public ownership, and government regulation of economic activities (Willis, 2005; Todaro & Smith, 2009).

The inventors of the market model believed that they were improving upon Adam Smith's original formulations. Since they modified a number of elements of classical political economy, they have been called neoclassical economists. The "neo" before classical recognizes that this new disciplinary perspective notably differs from the broader classical tradition. The neoclassical economists developed a tightly deductive model of how a market makes decisions. They relied on more mathematically precise formulations; and they went beyond the classical political economists, who identified labor as the essential source of value in the production process, by adding capital and natural resources as independent creators of value. These economists share Smith's belief in the market's superior qualities as a decision-making mechanism (Miller, 2008).

The central argument of the neoclassical counterrevolution is that underdevelopment results from poor resource allocation due to incorrect pricing policies and too much state intervention by overly active developing-nation governments experienced in 1970s. Jagdish Bhagwati, Anne Krueger and Bela Balassa, Lord peter Bauer, Deepak Lal, Ian Little, Milton Friedman, and Harry Johnson, argue that it is this very state intervention in economic activity that slows the pace of economic growth. For neoclassical theorists, the route to greater economic growth and then greater levels of well-being for all was through reducing state intervention and letting the market set prices and wages.

The neoliberals argue that permitting competitive free markets to flourish, privatizing state owned enterprises, promoting free trade and export expansion, welcoming investors from developed countries and eliminating the plethora of government regulations and price distortions in factor, product, and financial markets will stimulate both economic efficiency and economic growth. The new neoclassical counterrevolutionaries argue that the third world is underdeveloped not because of the predatory activities of the First World and the international agencies that it controls but rather because of the heavy hand of the state and the corruption, inefficiency, and lack of economic incentives that permeate the economies of developing nations (Willis, 2005; Todaro & Smith; 2009).

As to this view, what is needed is simply a matter of promoting free markets and laissez-fair economics within the context of liberal governments that allow the "magic of marketplace" and the "invisible hand" of market price to guide resource allocation and stimulate economic development. They point both to the success of countries like South Korea, Taiwan, and Singapore as "free market" examples and to the failures of the public interventionist economies of Africa and Latin America (Miller, 2008; Todaro & Smith, 2009).

Some of the problems attributed to state intervention in developing countries as stated by (Todaro & Smith, 2009; Meier & Rauch, 2000) are: (1) the state may know less on preferences and circumstances of individuals; (2) state planning may increase risks by leading everyone in the same direction; (3) state planning may be more rigid than private decision-making as complex decisions may be made in government; (4) states may be incapable of administering detailed plans and state controls may prevent private sector initiative through many bureaucratic obstacles (5) since organizations and individuals require incentives to work, innovate, control costs, and efficient allocation, and rewards of the market cannot easily be replicated within public enterprises and organizations as they are often inefficient and wasteful; (6) different levels and parts of government may be poorly coordinated in the absence of balancing signals provided by the market;

particularly the groups or regions with different interests are involved; (7) markets place constraints on what can be achieved by government, for example, resale of commodities on black markets and activities in the informal sector can disrupt rationing or other non-linear pricing of taxation schemes; (8) controls create resources using activities to influence those controls through lobbying and corruption-often called rent-seeking or directly unproductive activities in the literature (9) planning may be manipulated by privileged and powerful groups that act in their own interests, and further planning creates groups with a vested interest in planning, for example, bureaucrats or industrialists who obtain protected positions; and (10) states may be dominated by narrow interest groups focused on their own welfare and sometimes actively hostile to large sections of the population through intensifying their power.

## **2. THE RISE OF THE WASHINGTON CONSENSUS:**

The Washington Consensus was coined by John Williamson, an economist from the Institute for International Economics. It is used to describe the implementation of neo-liberal policies throughout the world and as a synonym for ‘market fundamentalism’ (Williamson, 2004; Todaro & Smith, 2009). The Washington Consensus contains ten points, such as: (1) fiscal discipline;(2) redirection of public expenditure priorities toward health, education, and infrastructure; tax reform, including the broadening of the tax bases and cutting marginal tax rates;(3)unified and competitive exchange rates; (4) secure property rights; (5) deregulation: dismantling of legal and governmental restrictions on the operation of certain businesses;(6)trade Liberalization;(7) privatization (taking economic enterprises out of state control and transfer to private ownership);(8) elimination of barriers to direct foreign investment (DFI); and (9) financial liberalization (Willis, 2005; Todaro & Smith, 2009).

The ten points of Washington Consensus were aimed at bringing shared growth, eliminating absolute poverty, achieving meaningful development, and reducing inequality across nations and individuals (Todaro & Smith, 2009). The Consensus was becoming more dominant, consequently in 1989 the Berlin Wall failed, and the Soviet Union was collapsed in 1991; countries in Central and Southeastern Europe and the Baltic nations (CSB), as well as the Commonwealth of Independent States (CIS) have been striving to create market economies; and China and other socialist countries began the transition to a same approach. Some Latin American countries including Chile, Uruguay, and Argentina, were among the early converts to market economy though the state retained an active economic role. Others have since jumped on the free market ranging from traditionally more market oriented countries such as Kenya, Peru, the Philippines and Cote’D Ivoire to formerly socialist-inclined countries such as India, Sri Lanka Tanzania, Jamaica and Turkey (Todaro & Smith, 2009).

As part of market liberalization programs, these countries have reduced the role of the public sector, encourage greater private sector activity, and eliminate distortion in interest rates, wages, and the prices of consumer goods, and more productive allocation of investments. In addition, these countries have sought to improve their comparative advantage in the international economy by lowering exchange rates, promoting exports and eliminating trade barriers (Todaro & Smith, 2009).

## **3. OUTCOMES OF NEOCLASSICAL COUNTERREVOLUTION:**

The outcome of the neoclassical market fundamentalist model and Washington Consensus policy was mostly a failure except few countries. South Korea and Taiwan achieved the highest rates of economic growth over the past half century and exemplary for shared growth, in which absolute poverty was eliminated early, and the lower income groups have become beneficiary from the development process, despite increase in inequality since the late 1990s (Todaro & Smith, 2009).

Bowles (2007) also argues that the highest rates of economic success of East Asian countries such as Singapore, Hong Kong, Taiwan, Thailand, South Korea and Malaysia, the so-called “East Asian miracle” prove that market fundamentalism is the best system for achieving economic advancement in developing countries. Latin American countries such as Chile, Peru, Uruguay, and Brazil have in practice maintained a high degree of continuity with the economic policies of the Washington Consensus. Chile has been offered as an example of a Consensus success story, and countries such as El Salvador and Uruguay have also shown some positive signs of economic growth. Brazil, despite relatively modest rates of aggregate growth, has seen important progress in recent years in the reduction of poverty. However, numerous authors stressed that many of the East Asian countries had at least partially achieved their economic success through government



interventions in the region. Joseph Stiglitz also argued that the Chilean success story owes a lot to state ownership of key industries, particularly its copper industry, and currency interventions stabilizing capital flows.

Many other economists argue that Chile's economic success is largely due to its combination of sound macroeconomics and market-oriented policies and fairly strong public institutions, including better public school systems (Centeno and Portes, 2003). In fact, some countries for example, Hong-Kong and Singapore, have achieved success through different policy directions: Hong-Kong with more free market approach and Singapore with more state intervention with frequent shift in focus over time. Hence, it is easy to see that the market cannot work without government involvement. With the recent trend towards globalization, collective action by governments or states is needed (Lam, 2000; Kohsaka, 2004; Bowles, 2007).

Transition from socialism to market economy also brought rapid economic growth in China and Vietnam for more than two decades, while the result was a failure in most transition countries. The transitions that began in the early 1990s in Soviet Union and Eastern European countries led to dramatic declines in their economies and deterioration in most aspects of social development. As Nishikimi (2004) and Lin (2008) using a survey conducted in 2006 by the European Bank for Reconstruction and Development state that only 30% of the surveyed people believed that their lives were better than in 1989. Most developing countries followed the IMF and the World Bank advice to reduce government intervention and enhance the role of the market but the result was disappointing—economic performance deteriorated, substantial magnitude in GDP dropped, production and income declined in sharp contrast with the perpetual double-digit growth in China and Vietnam. Indeed, 21 of the 25 countries in question had lower GDPs in 1999 than in 1989; in the most serious cases, real GDP plummeted by more than 50% during the decade (Mishikimi, 2004; Lin, 2008).

The World Bank's 1990s report also asserts that there was a deep and prolonged collapse in output in some transition countries. More than a decade into the transition, some of the former communist countries, especially parts of the Soviet Union, had still not caught up to their 1990 levels of output. Many Sub-Sahara African economies failed to take-off during the 1990s, in spite of efforts at policy reform, changes in the political and external environments, and continued heavy influx of foreign aid. Uganda, Tanzania, and Mozambique were among countries showed some success, but they remained fragile (Mishikimi, 2004; Bowles, 2007; Lin, 2008).

There were several painful financial crises in Latin America, East Asia, Russia, and Turkey following the neoclassical counterrevolution and the Washington Consensus policy. The Latin American recovery in the first half of the 1990s was interrupted by crises later in the decade and there was less growth in per capita GDP than in the period 1950-80. Argentina, depicted by some as "the poster boy of Latin American economic revolution", came crashing down from 1999 to 2002. The main reason may attributed to limited institutional capacity of governments, disorganized effects of economic liberalization, and policy-makers' shallow perception of the dynamics treating free-market in the developing countries (Centeno & Portes, 2003; Nishikimi, 2004). The Washington consensus was much criticized. Some critics focus on claims that the reforms led to destabilization and for particular economic crises such as the Argentine economic crisis, Asian economic turmoil, and for exacerbating economic inequalities. A US scholar Dani Rodrik, Professor at Harvard University, in his paper *Goodbye Washington Consensus, Hello Washington Confusion*, and Joseph Stiglitz have joined the criticisms. He pointed out that China and India increased their economies' reliance on free market forces to a limited extent, their general economic policies remained the exact opposite to the Washington Consensus recommendations. Both had high levels of protectionism, no privatization, extensive industrial policies planning, and lax fiscal and financial policies through the 1990s. According to Rodrik "while the lessons drawn by proponents and skeptics differ, it is fair to say that nobody really believes in the Washington Consensus anymore. The question now is not whether the Consensus is dead or alive, it is what will replace it" (Kohsaka, 2004; Willis, 2005).

Joseph Stiglitz has challenged the 'fundamentalist' policies for what he calls a 'one size fits all' treatment of individual economies. According to him the treatment suggested by the IMF is simply to stabilize, liberalize and privatize without prioritizing or watching for side effects. Following the 2009 G-20 London summit, British Prime Minister Gordon Brown also declared "the old Washington Consensus is over". Some socialist political leaders in Latin America are well-known critics of the Washington Consensus policies. A new policy frame has emerged since the crisis which relies on a more active state in the promotion of growth (Grugel & Riggirozzi, 2007). Argentina under former President Nestor Kirchner also made a break with the Consensus and that this led to a significant improvement in its economy. Argentina's

immediate recovery from crisis was aided by abrogating its debts and a fortuitous boom in prices of primary commodities (Grugel & Riggiozzi, 2007). In 2003, Argentina's then-President Nestor Kirchner and Brazilian President Lula de Silva signed the "Buenos Aires Consensus," a manifesto in opposition to the policies of the Washington Consensus. On the other hand Lula de Silva has paid the whole of the Brazilian debt with the IMF two years in advance to free his government from the IMF's advice, as did Nestor Kirchner's government in 2005 (Grugel & Riggiozzi, 2007).

## **V. TOWARDS THE NEW CONSENSUS AND NEW DEVELOPMENT STRATEGIES**

### **1. RATIONAL FOR THE NEED TO STATE INTERVENTION:**

A significant body of economists and policy-makers strongly agree that the Washington Consensus lacked socio-cultural preconditions and economic requirements and which makes it incomplete (Chang, 2003). In the Americas, the new views referred to as the new Consensus, or the Santiago Consensus, began to take shape at the April 1998 Summit of the Americas in the Santiago, Chile. The broad elements of the new consensus are: (1) development must be market-based, but there are large market failures that cannot be ignored (2) government should not be in the business of direct production as a rule. The consensus identified a broad, eclectic role for government in the following areas: (a) providing stable macroeconomic environment (b) infrastructure, though in fewer sectors than thought necessary in the past (c) public health, education and training (d) technology transfer (e) ensuring environmentally sustainable development and ecological protection (e) providing export incentives to improve investment climate (f) helping the private sector overcome coordination failures (g) ensuring "shared growth" by acting to reduce poverty and inequality assuming that as the economy grows, the poor share substantial benefits (h) continued more moderate regulation and support in financial sectors (i) provision of fundamental public goods, such as legal structure, including the protection of property rights.

An important dimension of the new Consensus is the emphasis on government's responsibility to focus on poverty alleviation. But the focus on market-based development and limiting government's role in direct production continues to be the views of the Consensus. A sober view continues emphasizing on the value of building state capacity and responsiveness with judiciously designed reforms and encouraging the development of NGOs and civil society (Todaro & Smith, 2009). The new Consensus also appears to reflect a growing sentiment that the goal of poverty eradication is achievable by giving attention in human capital through provision of health, education and other areas vital for successful development.

The ability of a society to make effective use of the market depends on the capabilities of its citizens. People who are ill or illiterate have limited capacity to take advantage of market opportunities when these emerge. India and China provide valuable illustrations having restraints on the market in the past. But as China invested heavily in basic education and health, its liberalization in 1978 was started with a literate, numerate, and relatively healthy adult population resulting in higher growth. When India liberalized around 1991 nearly half of the adults were illiterate and many were still lacking in nutrition and basic health care. This may be one rational for China's better growth after market liberalization than of India's (Todaro & Smith, 2009).

The new view represents in part renewed recognition that markets do fail that at times these failures cannot be addressed without a significant and ongoing role of government. Indeed, key part of governments' role is to help secure the foundation for economic development by ensuring that the requirements for effective market-based economy are met. However, few would contend that government reform is easy or that government should revert to the sort of full and direct control of state that prevailed prior to 1980s (Todaro & Smith, 2009).

There have been no successful developments without government intervention while there has been no case of economic development being accomplished without a market system. With regard to the relative roles played by the market and by government policy during the process of economic development, five arguments for state intervention in the economy may be distinguished (Meier & Rauch, 2000): (i) Market Failure, which may arise from many possible sources including externalities, missing markets, increasing returns, public goods and imperfect information; (ii) a concern to reduce poverty and/or to improve income distribution; (iii) the assertion of rights to certain facilities or goods such as education, health and housing; (iv) paternalism (relating to education, pension, and drugs); and (v) the rights of future generations including concerns to the environment. Taking these into consideration, developing countries need to move beyond 'first

generation' macroeconomic and trade reforms to a stronger focus on productivity-boosting reforms and direct programs to support the poor, human and social capital development, infrastructure provision, legal and institutional environments, and boosting countries' effectiveness at innovating and absorbing technology (Chang, 2003; Kohsaka, 2004).

Along with a large swing in development strategy valuable lessons are gained about the complementarities between state and market. For example, the industrial development in Korea after the 1960s was characterized by dual industrial growth – labor-intensive industries and capital-intensive producers of intermediate products – contributed to Korea's rapid industrial growth (Ohno, 2004). With these complementarities in mind, Dani Rodrik tries to build a ground work for designing new development strategies for the twenty-first century. Particularly, he focuses on the role of public institutions, which is inadequately treated by the Washington Consensus. In order to enable markets work properly, public institutions must play specific roles with the support of capable governments (Kohsaka, 2004).

## 2. SOCIO-CULTURAL PRECONDITIONS FOR MARKET ECONOMY:

Well-functioning market economy requires special social, institutional, legal, and cultural preconditions often absent in developing nations. Fraud, corruption, and monopoly do not disappear with the wave of a magic neoclassical wand. About 14 socio-cultural and institutional requirements for the operation of effective market were identified such as (1) trust (in banks, insurance companies, suppliers, etc); (2) law and order (enforcement of contracts); (3) security of persons and of property; (4) balancing competition with cooperation; (5) division of responsibility and diffusion of power; (6) community altruism; (7) social mobility, legitimization of ambition and toleration of competitiveness; (8) materialistic values as a stimulus to greater production; (9) differing gratification to generate private saving; (10) rationality unconstrained by tradition; (11) honesty in government; (12) efficient form of competition opposed to monopolistic control; (13) freedom of information along with protection of privacy; (14) flows of information without restriction or favoritism (Todaro & Smith, 2009).

The present mixed economies have successfully developed in quite different ways over extended periods. As Kohsaka (2004) states that market incentives need to be underpinned by strong public institutions that could function in various arrangements fitted to local practices and needs.

## 3. AREAS OF STATE INTERVENTION:

The day-to-day activity of the state is among other things, about the making and implementing of policy, the management of consent, the processing of societal pressures, the provision of welfare services, the maintenance of law and order and so on. All of these activities have an economic dimension; they cost money which the state has to raise (Pierson, 2005; Bowles, 2007). The economic activity of the state is divided into two. The first are areas in which the state is directly involved as an economic actor and the second are policy and strategies through which the state influences the economic process. This second category is further divided between those state policies which are directly addressed to the economy (economic and monetary policies) and those which have indirect impact on economic activity (social policy). Of course, these several areas of state activity almost overlap (Pierson, 2005). The ways state can act on the economy include: state as owner, owner-producer, employer, producer, distributor, economic and non-economic policy maker.

**State as Owner:** the state has an impact as an economic actor as the owner of land and capital. Modern states, at both the national and local level, are often society's largest landowners. Much of a nation's underdeveloped or common land are usually in the ownership of the state and large numbers of valuable public buildings, government offices, schools, hospitals, universities, army establishments and so on are often owned by states. Furthermore, in the last instance, most states, in claiming to be sovereign, retain certain special rights of ownership throughout their jurisdiction, which they may evoke in times of national emergency (Pierson, 2005; Bowles, 2007).

**State as Owner-producer:** more prominent role of state in the economy has been its function as the owner of public enterprises. In the socialist societies, state ownership was the greater form while in the developed West State ownership tended to focus upon the public utilities such as basic services which are essential to everyone (gas, electricity, water, etc.). But public ownership was also extended more into larger corporations or key industries (energy supply, banking) and/or industries that faced particular competitive difficulties (e.g. the car industry in France and the UK). This reflected the fact that state ownership was initiated not only to transfer rights of ownership to the public, but also the absence of

effective competition as private management had failed to deliver services efficiently and effectively or that particular strategic industries should not be available for foreign ownership (Pierson, 2005; Bowles, 2007).

**State as Employer:** the huge growth of the public sector throughout the twentieth century especially since 1945 led to a remarkable increase in public-sector employment. Employment within the states' industrial sector had risen by the 1970s on average between 6% and 8% with varied magnitude across countries and regions (Meier & Rauch, 2000; Pierson, 2005).

In judging the economic role of the state as an employer, the following generalizations seem to be in order: first, to a quite varying degree (contrast say Japan and Sweden), the state has grown through the twentieth century to become a major employer. Average public sector employment in the OECD stands at something close to 15–20%. Again, in a rather varying pattern, these levels of employment have tended to stabilize in the period since about 1980. In the European Union, growth in employment through the 1990s was fairly evenly divided between public and private sectors. Levels of employment in the industrial public sector have tended to fall more steeply than general employment in the government service (Pierson, 2005).

**State as Regulator:** the state intervenes administratively or legislatively to control the behavior of market actors. In this sense, states have always regulated markets and forbid or controls markets in all sorts of goods and services (certified drugs, firearms, body parts, endangered species, sexual services, etc.). It sets the framework of ownership, contract, exchange and laws without which a market economy could not operate; provides legal tender, controls the rates of interest at which money may be lent, sets limits on the age of workers and working hours. It registers certain forms of employment, prohibiting work by unregistered persons and placing certain statutory obligations upon those who practice these professions. It controls the provision of credit by financial institutions, protects the quality of imports, and establishes controls upon pollution. To this end, the state has to establish public agency with a statutory responsibility to see that the regulations are upheld (Pierson, 2005; Bowles, 2007).

**State as Redistributors:** the modern state is a tax state and the process of taxing and spending is one in which governments redistribute wealth. Governments' tax and spending behavior may be progressive - taking from the rich to give to the poor or regressive-taking from the poor to give to the rich. It may shift resources between other groups, from men to women, from those in work to the unemployed, from those of working age to those who are retired, from adults to children. In modern times, the scale of governments' taxing and spending activity and redistribution of resources has been enormous. Citizens pay some forms of taxation and receive benefit from state services. In market economies, the effect of state policies on tax raising and service provision is to reduce inequality in the final distribution of income as compared to the original market-generated incomes (Pierson, 2005).

**State as Economic Policy-Maker:** the state has extremely important role as an economic *policy-maker*. In the post-war world, governments set a series of economic targets to maximize economic growth, to maintain full employment, to secure price stability, and to maintain a favorable balance of payments on international trade. To this end, they have pursued a series of policies which they believed would deliver these essential desires. As circumstances and priorities have changed over time, governments strive to maximize overall economic growth consistent with reasonable price stability. In the state's taxation policy, governments may reduce levels of corporation tax to encourage inward investment or other states may take policy action of vice-versa to increase government revenue and in turn public utilities. Governments make similar use of monetary policy to encourage particular forms of economic behavior. Interest rates are varied so as to slow down or to speed up levels of economic activity (Pierson, 2005).

Governments have also set the terms and conditions upon which banks and other financial institutions may lend to private borrowers. One ambition of such policies was to achieve greater equality of wage-earners' incomes. States have also made more particularistic industrial policy interventions in the economy.

**State as Non-economic Policy Maker:** the state can also impact on the economy through its non-economic policies involving the spending of money. For example, the governments' transport policy has an active part in the provision of transport infrastructure with a significant economic effect. Similarly, the state's environmental policy impacts directly upon industrial producers and their customers. But the most economically significant of the state's 'non-economic' policies is a social policy that is the main areas of activities of welfare-state: education, health, housing, social security

(income maintenance) and personal social services. These intervention areas have an economic effect in their redistribution of resources and opportunities. States have come to recognize the impact social security system has upon patterns of employment (Pierson, 2005).

## VI. CONCLUSIONS

This paper reviewed the tides in economic theories and development achievements over time. Contending economic thoughts that are divided into four phases beginning from Adam Smith to recent post-Keynesian theories are selected to evaluate economic outcomes. The review reveals that economic theories have changed over the last two hundred years. This may be attributed to formulating theories on the basis of thinkers' partial and biased 'truths' about the world; distortion, institutional strength, and advance in science and technology. Social, economic, cultural, and environmental change may also be taken as important attributes.

Literatures indicate that the idea of free market was started in conflict with mercantile policy which provided ideological and intellectual background for the Industrial Revolution (IR), which increased production, started specialization, and improved real standard of living throughout much of the world during 19<sup>th</sup> century. However, early days of IR were marred by appalling conditions for large numbers of workers. Abusive child labor, long working hours, dangerous and unhealthy workplace had led to criticisms of the capitalist system, finally faced with frequent depressions and widespread unemployment in USA, Western Europe and other capitalist world.

The state-favored theories stood for legitimizing state intervention into markets with the aim of achieving growth. To this end, the New Deal, the Marshal Plan and other European social welfare services were employed to alleviate the impact of the Depression and Second World War. Moreover, monetary and fiscal policies were issued and enforced to influence national income and employment. The result was fascinating, capitalist countries grew at historically unprecedented rates, secured levels of employment and income inequality decreased.

During 1950s and 1960s, the Soviet Union and the anti-market ideology of national governing elites resulted in heavily state-centric development strategies. In Latin America, the dominant 'structuralist' view was that market incentives would fail to elicit much of a supply response. Throughout the developing world the private sector was regarded as difficult and private initiatives were severely restricted. These views underwent a radical transformation during the 1980s under the joint influence of a protracted debt crisis and the teachings of the Breton Woods institutions. The 'Washington Consensus', which emphasizes privatization, deregulation and trade liberalization, was embraced enthusiastically by policy makers in Latin America and post-socialist Eastern Europe. The reception was more cautious in Africa and Asia, but policies took swing towards markets. These market-oriented reforms at first paid very little attention to institutions and the complementarities between the private and public spheres of the economy.

A more 'balanced' view began to emerge during the closing years of the twentieth century as the Washington Consensus failed to deliver its promises. The talk in Washington turned towards 'second-generation reforms', 'governance' and 'reinvigorating the state's capability'. Three developments added fuel to the discontent about the orthodoxy. The first of these was the depressing failure in Russia of price reform and privatization in the absence of a supportive legal, regulatory and political apparatus. The second was the widespread dissatisfaction with market-oriented reforms in Latin America and the growing realization that these reforms had paid too little attention to social insurance and safety nets. The third and most recent was the Asian financial crisis, which revealed the danger of allowing financial liberalization to run ahead of adequate regulation.

By this 21<sup>st</sup> century, there is relatively a better understanding of the complementarities between markets and the state, and a greater appreciation of the virtues of the mixed economy. A 'one size fits all' kind of economic policy, like the Washington Consensus policy is not needed. The evaluation of development experiences suggests the need for combinations of state and market in different sociopolitical contexts and historical phases.

In the developed countries there are efficient institutions, human and social capital, democratic system, sophisticated technology, 'good' cultural values, high economic capacity, low fraud, social security, up-to-date information, and so on. Therefore, in these countries free market economy with minimal state guidance could be effectual. In the developing countries where the aforementioned systems are so weak and imperfections are widespread, letting the economy for the



market alone may result in devastation, and frequent economic and financial crises as experienced in Asia and Latin America in 1990s.

The tides in economic theories have passed through successes stories, failures and criticism. Many evidences reveal that most Southeast Asian countries achieved their success with strong state intervention though some attribute it to the market system. In addition, Argentina's economy has started to flourish again from crisis of 1999 to 2002 after refrain from Washington Consensus policy and Latin American countries started to shift towards more state intervention in their economy. Criticisms on the Washington Consensus by anti-globalists, Neo-Keynesians, the Latin America governments, the Dani Rodrik's paper, the opposition of Joseph Stiglitz; the declaration of Gordon Brown in his words 'the old Washington Consensus is over' in 2009, and the New Santiago Consensus are important indicators of shifting to state intervention in the achievements of economic development. However, there are paradoxical arguments given by scholars about countries' success stories emanated from thinkers' ideological and political inclinations. Market fundamentalists argue that the growth success of Asian miracle countries have resulted from the free market system, while those who are in favor of state intervention the miracle has derived from strong state intervention. The neutral view the attributed the East Asian success to both strong state intervention and market mechanisms. This view coincides with the new development strategy that recognizes the broader role of state as observed in most successful development experiences than encapsulated by the Washington Consensus.

The other paradox is that the growth success of Hong-Kong and Singapore. They have followed different political, social, and economic changes but bear more similarities in economic status than differences. From this one can conclude that economic approach alone may not matter economic growth rather institutional capability, human and social capital, information, and socio-cultural conditions may matter it. In order for markets to work properly, public institutions must play specific roles with the support of capable governments. Hence, most scholars inclined to agree with the need for state intervention, but the question is in what areas should the state intervene and in what do not and how to fashion the versions of new models suited to the nation's local circumstances. This is a big issue that would continue to be a home-work for many scholars and governments.

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