Chapter 1. Introduction:

How did the Rich Countries *Really* Become Rich?

1.1. Introduction

There is currently great pressure on developing countries from the developed world, and the international development policy establishment that it controls, to adopt a set of "good policies" and "good institutions" to foster their economic development.[1] According to this agenda, "good policies" are broadly those prescribed by the so-called Washington Consensus, which include restrictive macroeconomic policy, liberalisation of international trade and investment, privatisation, and deregulation.[2] The "good institutions" are essentially those that are to be found in developed countries, especially the Anglo-American ones. The key institutions include democracy, "good" bureaucracy, an independent judiciary, strongly protected private property rights (including intellectual property rights), transparent and market-oriented corporate governance and financial institutions (including a politically independent central bank).

As we shall see later in the book, there have been heated debates on whether these recommended policies and institutions are appropriate for developing countries. However, curiously, even many of those who are sceptical of the applicability of these policies and institutions to the developing countries take it for granted that these were

[1] So in addition to the conventional "economic conditionalities" attached to multilateral and bilateral financial assistance to developing countries, now we have "governance-related conditionalities" (see Kapur & Webber, 2000).
[2] Williamson (1990) is the classic statement of this. For some recent criticisms see Stiglitz (2001a) and Ocampo (2001).

the policies and the institutions that were used by the developed countries when they themselves were developing countries.

For example, it is supposed to be common knowledge that Britain became the world's first industrial superpower because of its *laissez faire* policy, while France fell behind because of its interventionist policies. Similarly, it is widely believed that that the USA's abandonment of free trade in favour the protectionist Smoot-Hawley Tariff at the outset of the Great Depression (1930) was, according to the famous free-trader economist Bhagwati (1985), "the most visible and dramatic act of anti-trade folly" (p. 22, f.n. 10). Yet another example is the frequent claim that without patents and other private intellectual property rights the developed countries would not have been able to generate the technologies that made them prosperous. The US-based National Law Center for Inter-American Free Trade (1997) claims that "[t]he historical record in the industrialized countries, which began as developing countries, demonstrates that intellectual property protection has been one of the most powerful instruments for economic development, export growth, and the diffusion of new technologies, art and culture" (p. 1). And so on.

But is it really true that the policies and institutions currently recommended to the developing countries are those that were adopted by the developed countries when they were developing countries themselves? Even at a superficial level, there seem to be bits and pieces of history that suggest otherwise. Some of us may know that unlike its 18^{th} or 20^{th} century nature, the French state was quite conservative and non-interventionist in the 19^{th} century. We may also have read about the high tariffs in the USA, at least after the Civil War. A few of us have heard somewhere that the US central bank, the Federal Reserve Board, was set up in as late as 1913. One or two of us may even know that Switzerland became one of the world's technological leaders in the 19th century without a patent law.

If these kinds of counter-evidence to the orthodox view of capitalism's history are indeed true, it is fair to ask whether the developed countries are somehow trying to hide the "secrets of their success". This book is an attempt to piece together the bits of historical information scattered around which contradict the orthodox view of the history of capitalism, and to provide a comprehensive but concise picture of the policies and institutions that the developed countries used when they themselves were developing countries. In other words, the book is asking: "How did the rich countries *really* become rich?"

The short answer to this question that emerges from this book is that the developed countries did *not* get where they are now through the policies and the institutions that they recommend to the developing countries today. Most of them actively used "bad" trade and industrial policies, such as infant industry protection and export subsidies – practices that are frowned upon, if not actively banned, by the WTO (World Trade Organisation) these days. Until they were quite developed (that is, until the late 19th to early 20th century), they had very few of the institutions deemed essential by developing countries today, including such "basic" institutions as central banks and limited liability companies.

If this is the case, aren't the developed countries, under the guise of recommending "good" policies and institutions, actually making it difficult for the developing countries to use policies and institutions that had allowed them to develop economically in earlier times? This is the question that this book hopes to address.

1.2. Some Methodological Issues: Drawing Lessons from History

The 19th century German economist Friedrich List (1789 – 1846) is commonly known as the father of the infant industry argument, namely the view that, in the presence of more developed countries, backward countries cannot develop new industries without state intervention, especially tariff protection. His masterpiece, *The National System of Political Economy,* was originally published in1841.[3]

List starts the book with a lengthy historical discussion. In fact he devotes the first 115 pages of his 435-page text to a review of trade and industrial policies in the major countries of the Western world up to his time. Included in his survey were the experiences of Venice (and other Italian states), the Hanseatic cities (led by Hamburg and Lübeck), the Netherlands, England, Spain and Portugal, France, Germany, and the USA.

Many of these accounts go almost completely against what most of us know (or think we know) about the economic histories of these countries.[4] Particularly striking to the contemporary reader are List's analyses of Britain and the USA – the supposed homes of "liberal" economic policy.

List argues that Britain was actually the first country to perfect the art of infant industry promotion, which in his view is the principle behind most countries' journey

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[3] The book was translated in the USA as early as 1856 (Henderson, 1983, p. 214), reflecting the then close intellectual affinity between the USA and Germany as the two centres of "nationalistic" economics (on this affinity, see below; also see Dorfman, 1955; Balabkins, 1988; Hodgson, 2001). However, its British translation, the version that I have used for this book, did not appear until 1885, reflecting the dominance of free trade doctrine in Britain during the middle of the 19th century.

[4] They are also interesting for the amazing degree of sophistication in understanding the role of public policy and institutions in economic development. For example, List states: "However industrious, thrifty, inventive, and intelligent individual citizens might be, they could not make up for the lack of free institutions. History also teaches

to prosperity. He goes as far as saying that we should "let [whoever is not convinced of the infant industry argument] first study the history of English industry" (p. 39). His summary of the British road to industrial success is worth quoting at length.

> "[H]aving attained to a certain grade of development by means of free trade, the great monarchies [of Britain] perceived that the highest degree of civilisation, power, and wealth can only be attained by a combination of manufactures and commerce with agriculture. They perceived that their newly established native manufactures could never hope to succeed in free competition with the old and long-established manufactures of foreigners [the Italians, the Hansards, the Belgians, and the Dutch]…. Hence they sought, by a system of restrictions, privileges, and encouragements, to transplant on to their native soil the wealth, the talents, and the spirit of enterprise of foreigners" (p. 111).[5]

This is a characterisation of British industrial development which is fundamentally at odds with the prevailing view of Britain as a valiant free-trade, free-market economy fighting against the *dirigiste* countries on the Continent, eventually proving the superiority of its policies with an industrial success unprecedented in human history.

List then goes on to argue that free trade is beneficial among countries at similar levels of industrial development (which is why he strongly advocated a

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that individuals derive the greater part of their productive powers from the social institutions and conditions under which they are placed" (p. 107).

[5] Then he goes on to argue: "This policy was pursued with greater or lesser, with speedier or more tardy success, just in proportion as the measures adopted were more

customs union among the German states – *Zollverein*) but not between those at different levels of development. Like many of his contemporaries in countries that were trying to catch up with Britain, he argued that free trade benefits Britain but not the less developed economies. To be sure, he acknowledges that free trade benefits agricultural exporters in these economies, but this is to the detriment of their national manufacturers and thus of their national economic prosperity in the long run. To him, therefore, the preachings on the virtues of free trade by British politicians and economists of his time were done for nationalistic purposes, even though they were cast in the generalistic languages of what he calls "cosmopolitical doctrine". He is worth quoting at length on this point.[6]

> "It is a very common clever device that when anyone has attained the summit of greatness, he *kicks away the ladder* by which he has climbed up, in order to deprive others of the means of climbing up after him. In this lies the secret of the cosmopolitical doctrine of Adam Smith, and of the cosmopolitical tendencies of his great contemporary William Pitt, and of all his successors in the British Government administrations.
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> Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than *to throw away these ladders* of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in

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or less judiciously adapted to the object in view, and applied and pursued with more or less energy and perseverance" (p. 111).

> the paths of error, and has now for the first time succeeded in discovering the truth [italics added]" (pp. 295-6).

As for the USA, List points out that the country had previously been misjudged by great economic theorists Adam Smith and Jean Baptiste Say as being "like Poland", namely, destined to rely on agriculture (p. 99). Indeed, Adam Smith in his *Wealth of Nations* (1937 [1776]) sternly warned the Americans against any attempt at infant industry promotion:

> "Were the Americans, either by combination or by any other sort of violence, to stop the importation of European manufactures, and, by thus giving a monopoly to such of their own countrymen as could manufacture the like goods, divert any considerable part of their capital into this employment, they would retard instead of accelerating the further increase in the value of their annual produce, and would obstruct instead of promoting the progress of their country towards real wealth and greatness" (pp. 347-8).

Two generations later, when List was writing his book, many Europeans still shared Smith's view. Fortunately for them, List argues, the Americans firmly rejected Smith's analysis in favour of "common sense" and "the instinct of what was necessary for the nation", proceeding to protect their infant industries with great success after 1816 (pp. 99-100).

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[6] I thank Charles Kindleberger for drawing my attention to these passages in a personal correspondence.

List's observation was more than vindicated subsequently, as the USA remained the most ardent practitioner (and the intellectual home) of protectionism for a century after he wrote those passages but also became the world's industrial leader by the end of that period (see section 2.2.2 of chapter 2). List was also proven right by subsequent historical events with regard to his comment on "kicking away the ladder". When its industrial supremacy became absolutely clear after the Second World War, the USA was no different from 19th-century Britain in promoting free trade despite the fact that it acquired such supremacy through the nationalistic use of heavy protectionism.

These are important historical "facts" that we will establish in greater detail in the next chapter. For the moment, however, I would like to draw the reader's attention to List's methodology, that is, his "historical" approach to economics.

This approach, if applied appropriately, does not limit itself to the collection and cataloguing of historical "facts" in the hope that some "pattern" will naturally emerge. Rather, it involves searching for persistent historical patterns (which may not easily reveal themselves), finding explanations behind them, distilling theories from them, and finally applying the theories thus constructed to contemporary problems *taking into account changes in technological, institutional, and political circumstances*. This approach is concrete and inductive, and contrasts with the currently dominant Neoclassical approach based on abstract and deductive methods.

This sort of methodology was in fact the staple of the German Historical School, which was the dominant school of economics in many Continental European countries before the Second World War, and can be found in works written in English by authors like Polanyi (1957[1944]) and Shonfield (1965).[7] The School included among its leading members names like Wilhelm Roscher, Bruno Hildebrand, Karl Knies, Adolph Wagner (of Wagner's Law fame)[8], Gustav Schmoller, Werner Sombart, and (contentiously) Max Weber, who is these days mistakenly known only as a sociologist but was actually a professor of economics in the Universities of Freiburg and Heidelberg (Balabkins, 1988. ch. 6; Tribe, 1995; Hodgson, 2001).

Although it is not well known today, the German Historical School's influence before the Second World War went well beyond Continental Europe. It strongly impressed one of the founding fathers of Neoclassical economics, Alfred Marshall, who remarked that its work has "done more than almost anything else to broaden our ideas, to increase our knowledge of ourselves, and to help us to understand the central plan, as it were, of the Divine government of the world" (*Principles of Economics,* 8th edition, p. 768; as cited in Hutchison, 1988, p. 529).

In the late 19th century and the early 20th century, many leading American economists were directly and indirectly influenced by this School (Balabkins, 1988, ch. 6; Hodgson, 2001; Dorfman, 1955).[9] The patron saint of American Neoclassical economics, John Bates Clark, in whose name the most prestigious award for young (under 40) American economists is given today, went to Germany in 1873 and studied under Roscher and Knies (Balabkins, 1988, p. 95), although he gradually drifted away from it (Conkin, 1980, p. 311). Richard Ely, one of the leading American economists of the time, also studied under Knies (Balabkins, 1988, p. 95) and influenced the American Institutionalist School through his disciple, John Commons (Cochran &

[7] It is also found in certain strands in Marxism – for example, in Marx's theory of history rather than in his labour theory of value.
[8] Wagner's Law states that there is a natural tendency for the relative size of the government to grow with the development of human society.

Miller, 1942, p. 260; Conkin, 1980, p. 311; Garraty & Carnes, 2000, p. 562). Ely was one of the founding fathers of the American Economic Association; to this day, the biggest public lecture at the Association's annual meeting is given in Ely's name, although few of the present AEA members would know who he was.

After the Second World War, when the development of post-colonial developing countries became a major issue, the historical approach was deployed very successfully by many founding fathers of "development economics" (for a selection of the early key works in the field, see Agarwala & Singh (eds.), 1958).

Economists like Arthur Lewis (1955), Walt Rostow (1960), and Simon Kuznets (1965 and 1973) formulated their theories of the "stages" of economic development (whatever the limitations of such theories may be) on the basis of their extensive knowledge of the history of industrialisation in developed countries.

Also influential was the "late development" thesis of the Russian-born American economic historian, Alexander Gerschenkron (1962), who, drawing on the European industrialisation experiences, argued that the continuously increasing scale of technology will make it necessary for countries embarking on industrialisation to deploy more powerful institutional vehicles in order to mobilise industrial financing. For example, his work provides an important backdrop to Hirschman's pioneering work in development economics (Hirschman, 1958). Kindleberger's classic textbook on development economics (Kindleberger, 1958) makes extensive reference to historical experiences of the developed countries, once again with numerous references to Gerschenkron.

In the 1960s, the heyday of development economics, there were even some collections of essays whose explicit purpose was to draw lessons for developing

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[9] Bablakins (1988) cites a survey conducted in 1906 that shows that half of the

countries from the historical experiences of the developed countries (Supple (ed.), 1963, and Falkus (ed.), 1968). Even as late as 1969, Gustav Ranis, a leading Neoclassical development economist of our time (although of an older, gentler vintage), was writing an article entitled "Economic Development in Historical Perspective" in the key mainstream journal, *American Economic Review* (Fei & Ranis, 1969).

Unfortunately, during the last couple of decades, even development economics and economic history – two sub-fields of economics for which the historical approach is most relevant – have been dominated by mainstream Neoclassical economics, which categorically rejects this sort of inductive reasoning. The unfortunate result of this has been that the contemporary discussion on economic development policy-making has been peculiarly ahistorical.

The development literature is certainly full of theoretically-based propositions (e.g., free trade benefits all countries) and may also draw extensively on contemporary experiences (e.g., the literature on the East Asian "developmental state"). Rarely do we now see, however, discussions that are based on the historical experiences of the now-developed countries. To be sure, there are scattered references to history here and there. However, they are often based on higly stylised characterisations of the historical experiences, and tend to refer only to Britain and the USA. The supposed free-trade, free-market histories of the countries are held up as examples for developing countries. Yet these discussions of the British and US experiences are highly selective and thus misleading, as will become clearer later in this book.

Americans who studied social sciences in Europe studied in Germany (p. 95).

The upshot is that, unfortunately, with a few notable exceptions such as Senghaas (1985), Bairoch (1993), Weiss & Hobson (1995), and Amsden (2001), there have been few serious studies over the last few decades which deploy the historical approach in the study of economic development.[10]

This is why one of the aims of this book is to re-affirm the usefulness of the historical approach by applying it to the critique of the current popular discourses on "good policies" and "good governance". Saying this may, however, give the reader the mistaken impression that the book's main aim is to prove the validity of an approach, using a policy issue as the raw material. This is not the main aim of this book. It is rather to discuss a contemporary problem with the help of history. And I argue that, given current debates on "good" policies and institutions, this approach is particularly relevant at the moment.

The book will naturally focus on the 19th century and the early 20th century – say, between the end of the Napoleonic War (1815) and the beginning of the First World War (1914). This was when most of the now-developed countries were going through their Industrial Revolutions. However, in some cases, we will extend our time horizon. Britain, for example, deserves attention from the 14th century onwards, given its pioneer status in many areas of economic policy and of institutional development. 18th-century Prussia is another special case that deserves attention for its bureaucratic

[10] However, the studies by Senghaas, Bairoch, and Weiss & Hobson are not as comprehensive as this book. Bairoch, while covering a wider range of countries, mainly focuses on trade policy. Senghaas looks at even a wider range of countries, but his discussion is rather brief except for the Scandinavian countries. Weiss and Hobson cover a wider range of policies – industrial, trade, and fiscal – but cover a relatively limited range of countries – Britain, France, Prussia, Japan, Russia, and the USA. The study by Amsden has many spot-on references to the historical experiences of the developed countries, but its main focus is actually on the historical experience of the developing countries.

reform and for developing new methods of state-led industrial promotion. Yet another exception is found in the post-Second-World-War experiences of countries like Japan and France, as these countries were able to generate most impressive economic growths on the basis of radical institutional transformation following the War and therefore merit discussion here.

An effort has been made to cover as many countries as possible. Although this attempt to bring in a wide range of evidence reinforces our main findings, it also necessarily invites criticism from specialists in the economic histories of these countries. This is to be expected and is very welcome. For not only do we hope to encourage development economists to reconsider the historical basis of their theories, we would also like to see economic historians take greater cognizance of the theoretical implications of their work. If this book succeeds in generating debate over the generalisation and particulars discussed in the pages that follow, then it will have achieved its main aim.

Special effort is made to bring into the book examples from outside the more "important", and thus better-known, countries (that is, Britain, the USA, Germany, France, and Japan) so that we can draw more general lessons. However, the coverage of the other countries necessarily remains less extensive due to the sheer paucity of English-language studies of these countries. I have tried in part to overcome this problem with the help of research assistants who speak other languages, but the limitations of such methods are patent. In addition, it should be pointed out that there is still great value in looking at the experiences of the supposedly better-known countries, as there exist *especially* many myths and misconceptions about their histories.

The distinction between "policies" and "institutions" that I adopt in the book (and the chapter titles of the two substantial chapters that follow) is necessarily arbitrary. In common sense usage, we might say that institutions are more permanent arrangements while policies are more easily changeable. For example, raising tariffs for certain industries would constitute a "policy", whereas the tariff itself could be regarded as an "institution". However, such simple distinctions quickly break down. For example, patent law can be regarded as an "institution", but a country could adopt a "policy" of not recognising patents – as indeed Switzerland and the Netherlands did until the early 20th century. Similarly, when we examine competition law we will do so in the context of corporate governance institutions, but also as a part of industrial policy.

1.3. The Chapters

Chapter 2 deals mainly with what these days are called industrial, trade, and technology policies (or ITT policies for short). This is because, for one thing, differences in these policies, in my view, separate the countries that have been more successful in generating growth and structural change from the others. The policies have for a few hundred years stood at the centre of controversies in the theory of economic development. This does not imply, of course, that other policies are unimportant for development.[11] Nor does it imply that economic growth (still less

[11] For example, few people will dispute that achieving macroeconomic stability through appropriate budgetary and monetary policies is a pre-condition for development, although I object to defining it narrowly as merely achieving very low rates of inflation (say, below 5%), as in the current orthodoxy (also see Stiglitz, 2001a, pp. 23-5).

industrial growth) is all that matters, although I do believe that growth is a key to more broadly-defined economic development.

The chapter focuses on a smaller number of countries than the following chapter on institutions. This is, above all, because policies are more difficult to characterise than institutions, given that they are, at least as I defined them, more variable. For example, we can easily date the formal legislation of, say, limited liability or central banking (although it may be more difficult to say exactly from when the institution in question has become widely accepted and effective), but it is much more difficult to establish that, say, France had a free trade policy during the late 19th century. Because of the difficulty involved in clearly identifying the existence and the intensity of particular policies, I felt that more country-based narratives were necessary, which in turn meant that I could not cover as many countries in the “policies” chapter as in the “institutions” chapter (chapter 3).

Chapter 3 ranges more widely both geographically and conceptually. Because it is often easier to identify when a particular institution was introduced than to characterise a country’s policy regime, more countries could be covered than in Chapter 2. Partly because of the institutional complexity of modern societies, but also because we understand only poorly which institutions are really critical for economic development, Chapter 3 examines quite a large number of institutions. They include: democracy; bureaucracy; judiciary; property rights (especially intellectual property rights); corporate governance institutions (limited liability, bankruptcy law, auditing/disclosure requirements, competition law); financial institutions (banking, central banking, securities regulation, public finance institutions); social welfare and labour institutions (social welfare institutions, child labour laws, institutions regulating adult working hours and conditions). As far as I am aware, this book is unique in providing information on such a wide range of institutions over a large number of countries.

Chapter 4, the final chapter of the book, returns to the central question: Are the developed countries trying to “kick away the ladder” by which they have climbed up to the top, as List put it, by preventing developing countries from adopting policies and institutions that they themselves used?

I will argue that the current policy orthodoxy does amount to “kicking away the ladder”. Infant industry promotion (but not just tariff protection, I hasten to add) has been the key to the development of most nations, and the exceptions have been limited to small countries on, or very close to, the world’s technological frontiers, such as the Netherlands and Switzerland. Preventing the developing countries from adopting these policies constitutes a serious constraint on their capacity to generate economic development.

In the case of institutions, the situation is more complex. My main conclusion is that many of the institutions that are regarded as “necessary” for economic development these days were actually in large part the outcome, rather than the cause, of economic development in the now-developed countries. This is *not* to say that developing countries should not adopt the institutions prevailing in the more developed countries now (although, in contrast, they should *not* adopt the industrial and trade policies that the latter countries have now). Some of these institutions may even be beneficial for most, if not necessarily all, developing countries, although the exact forms that they should take is a matter of controversy. For example, central banking is necessary to manage systemic financial risk, but it is debatable whether the central bank should have near-absolute political independence and exclusively focus on inflation control, as the current orthodoxy has it. Indeed, given that many potentially beneficial institutions have only developed after painful economic lessons and political struggle, it would be foolish for developing countries to forego the advantages of being the late-comer which stem from the possibility of "institutional catching-up".

However, the benefits of institutional catch-up should not be exaggerated, as not all "global standard" institutions are beneficial or necessary for all developing countries. To give some examples that I will discuss in depth later, stringent intellectual property rights may not be beneficial for most developing countries. Some other institutions, such as anti-trust regulations, may not be all that necessary for them, which means that the net benefit of adopting such institutions may even be negative, given that establishing and running these institutions demand resources, in particular scarce skilled human resources. There is also the question of whether introducing "advanced" institutions in countries that are not ready for them implies that these institutions will not function as well as they should. Moreover, we should not lose sight of the fact that the currently developing countries actually have much higher levels of institutional development when compared to the NDCs when they were at equivalent stages of development (see section 3.3.3 of Chapter 3). If this is indeed the case, there may actually be relatively little room for effective improvement in institutions for these countries in the short run.

From this perspective, in so far as some of the institutions demanded of the developing countries are irrelevant or harmful given their stage of development, and to the extent that they are costly to run, we could also say there is an element of "kicking away the ladder" in the dominant development discourse on institutional upgrading.

1.4. A "Health Warning"

What the book is about to say will undoubtedly disturb many people, both intellectually and morally. Many of the myths that they have taken for granted or even passionately believed in will be challenged, as many of my own assumptions were challenged in the process of researching it. Some of the conclusions may be morally uncomfortable for some readers. Of course, I claim no moral superiority of the arguments put forward. I hope, however, to reveal some of the complexity surrounding these issues that has long been obscured by ahistorical and often moralistic arguments.