

HARVARD UNIVERSITY  
John F. Kennedy School of Government  
Course Materials Office  
Spring Semester 2009



COURSE CODE:

**PAL110 D #2**

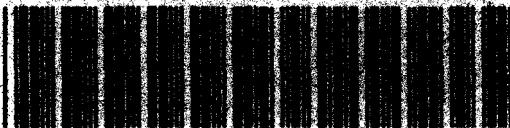
PACKET SEQUENCE #:

COURSE TITLE:

***Political Institutions and Public Policy: Comparative Politics***

INSTRUCTOR(S):

***Anthony Saich & Tarek Masoud***



PAL110 D, #2

0000014928

CLASS DATES FROM:

***February 9, 2009***

TO:

***February 25, 2009***

DESCRIPTION:

NOTE TO CLASS:

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# Governing the Market

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ECONOMIC THEORY AND  
THE ROLE OF GOVERNMENT  
IN EAST ASIAN INDUSTRIALIZATION

*Robert Wade*

PRINCETON UNIVERSITY PRESS  
PRINCETON, NEW JERSEY

Copyright © 1990 by Princeton University Press  
Published by Princeton University Press, 41 William Street,  
Princeton, New Jersey 08540  
In the United Kingdom: Princeton University Press, Oxford

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*Library of Congress Cataloging-in-Publication Data*

Wade, Robert.

Governing the market : economic theory and the role of  
government in East Asian industrialization / Robert Wade.  
p. cm.

Includes bibliographical references.

1. Industry and state—East Asia. 2. East Asia—Industries
3. East Asia—Economic policy. I. Title.

HD3616.E183W33 1990 338.95—dc20 90-8236

ISBN 0-691-04242-X (alk. paper)

This book has been composed in Linotron Times Roman

Princeton University Press books are printed on acid-free paper,  
and meet the guidelines for permanence and durability of the  
Committee on Production Guidelines for Book Longevity of the  
Council on Library Resources

Printed in the United States of America

3 5 7 9 10 8 6 4 2

## *Chapter 1*

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### STATES, MARKETS, AND INDUSTRIAL POLICY

The economic role of the state has managed to hold the attention of scholars for over two centuries without arousing their curiosity. . . . The chief instrument of empirical demonstration on the economic competence of the state has been the telling anecdote.

—George Stigler

THE PREDOMINANT approach to economic policy in the 1950s and 1960s assigned the state<sup>1</sup> a substantial role in repairing market failures. In the industrialized countries the experience of the Great Depression and wartime *dirigisme*<sup>2</sup> provided the impetus. The approach was also taken up by economists dealing with “underdeveloped countries” and made the basis of a newly emerging discipline of development economics. The early contributions to development economics concentrated on showing how the special circumstances of underdeveloped countries—low private saving, dependence on primary product exports, declining prices of exports in relation to imports, small internal markets, limited skills, few entrepreneurs adept at large-scale organization, and pervasive underemployment—required an even bigger role for the state than in the more developed countries.

These circumstances meant that underdeveloped countries could not expect to achieve full employment or earn enough foreign exchange to meet unrestrained demand in the context of an open economy, according to development economists. Almost regardless of the exchange rate and even with wages no higher than physical subsistence level, a shortage would remain of activities producing goods or services saleable on the international market. Reliance on the free market would perpetuate what was variously called dualism, marginalization, or the coexistence of precapitalist with capitalist forms of production. Hence the state should not only maintain macroeconomic balance and supply “public” goods and services, but it should also undertake direct re-

<sup>1</sup> I use “government” to mean the executive branch and “state” to mean the wider structure of governance institutions, but in practice the two words are often used interchangeably—less serious a confusion for Taiwan and Korea than for many other countries.

<sup>2</sup> *Dirigisme* in the French sense contains the idea of directional thrust, or orienting power, in the hands of government (*Petit Larousse* 1975). I use *dirigisme*, guided market and governed market more or less interchangeably, to mean strongly influenced rather than tightly controlled.

sponsibility both for augmenting the economy's investable resources and for establishing a mechanism to transfer those resources into productive investment. Capital formation, in this view, was the engine of development. By leaving significant amounts of an economy's resources underutilized, free markets in less developed country (LDC) conditions, would generate less investment than was socially desirable and allocate it in less than socially desirable ways. Development economics thus restored capital formation to prominence, which having been at the heart of economic theory from the eighteenth century to the First World War had then been displaced by issues of efficient resource allocation. But it combined capital formation with an activist view of the state in a way that classical economics had not.<sup>3</sup>

The late 1960s and early 1970s saw a downgrading of the role of the state in both developed and less developed countries. In the LDC context economists presented three main kinds of evidence:

1. the use of the state to promote import-substituting industrialization during the 1950s and the 1960s had resulted in inefficient industries requiring permanent subsidization, with little prospect of achieving international competitiveness
2. extensive government intervention tended to generate "rent-seeking" on a significant scale, that is, to divert the energies of economic agents away from production and into lobbying for increased allocations of government subsidies and protection
3. some of the most successful LDCs—including Taiwan, South Korea, Hong Kong, and Singapore—had achieved extraordinary industrial growth by using an outward-oriented model driven by market incentives and a strong private sector<sup>4</sup>

The generally favorable effects that followed the gradual liberalization of trade and capital flows among the developed countries during the 1960s pointed to the same conclusion. And immediate fiscal conditions necessitated smaller government; the 1973 energy price rise put acute pressure on state budgets in most oil-importing countries, so that public expenditures had to be curtailed.

Even where some form of government intervention could be justified by market failure the actual effects of such interventions are often perverse, it was said. Indeed, "government failure" is as pervasive and serious as market failure, if not more so. A small but lively band of economists developed gen-

<sup>3</sup> This approach was sometimes called "structuralism" because it emphasized the structural impediments to the working of markets seen, for example, in large differences between sectors in real product per worker. For the evolution of postwar thinking about the role of the state, I draw on Brett 1985; Bienefeld 1982; Lewis 1989. For early views which emphasize the employment problem and/or the foreign exchange gap in underdeveloped countries, see Nurkse 1953; Rosenstein-Rodan 1943; Lewis 1955; Myrdal 1957; Chenery 1959; Singer 1949; Streeten 1964.

<sup>4</sup> See in particular the seminal book by Little, Scitovsky, and Scott 1970; also Krueger 1974 on "rent-seeking."

eral arguments to show why such failure is an inherent tendency of all governments.<sup>5</sup> Other economists working on developing countries said that the governments of these countries were even more likely to fail than those in developed countries, because, in Deepak Lal's words, "many developing countries are closer in their official workings to the rapacious and inefficient nation-states of 17th or 18th-century Europe, governed as much for the personal aggrandizement of their rulers as for the welfare of the ruled" (1983:108). In these circumstances, he continued, it is the height of folly to urge upon developing countries that "enlightened discrimination" toward foreign trade, transnational companies, technology, and the meeting of basic needs prescribed by traditional development economics; discrimination is seldom enlightened.

The upshot of these new circumstances and arguments was that by the second half of the 1970s, if not earlier, the mainstream of thinking about development policy (especially in the English-speaking academic community and international development agencies) had decisively shifted from the prescriptions of the 1950s and 1960s toward a "neoclassical" view of the appropriate roles of markets and governments. The need for a special economics of development was denied (Lal 1983).

In the neoclassical view, the engine of development is not so much capital formation as efficient allocation of resources. Once institutional arrangements are in place to generate an efficient allocation of resources investment can be left to take care of itself. Whatever investment is generated by these arrangements constitutes—with some small exceptions—the social optimum. The necessary institutional arrangements for generating efficient resource use are competitive markets, particularly domestic markets integrated with international markets. Hence government should leave private producers operating through market mechanisms to supply all but certain "public" goods. It should limit its own activities to improving the functioning of markets and to providing only those goods and services where the government has a clear comparative advantage relative to private agents. The resources so released can either be transferred to the private sector or used to improve the performance of the state's essential functions.

If prices reflect social opportunity costs, the underlying argument runs, profit incentives will drive the economy to its maximum production potential. So in a labor-abundant economy profit maximization by private producers will lead to the choice of labor-intensive production techniques. In the absence of trade distortions, exports of labor-intensive products will grow, generating beneficial second-round effects on the rate of aggregate growth. As labor demand increases faster than the supply, labor surpluses will be absorbed, leading to a rise in real wages and a change in comparative advantage guided by the changes in factor scarcities.

<sup>5</sup> For example, Wolf 1979; Buchanan and Tullock 1962.

The key development policy is therefore an outward-oriented trade regime, characterized by low or negligible impediments to imports, relatively uniform incentives for different production activities, and incentives for export sale equal to the incentives for domestic market sale. These conditions will maximize the economy's income and growth (in world prices) by concentrating resources on those activities in which the economy has a comparative advantage, leaving other forms of production to other nations. In addition, by expanding the proportion of the economy which is directly subject to international competitive pressures, the government's own ability to impose "political" prices is weakened; hence producers' uncertainty about government policy is reduced.

Other poorer nations also benefit. For as a country experiences increases in costs and improvements in technological capacity, so it exits light-manufactured exports—textiles, clothing, shoes, and simple consumer electronics—leaving them for the next tier, itself moving into more sophisticated products. As Bela Balassa describes the sequence, the newly industrializing countries (NICS) would "upgrade and . . . diversify their exports in line with their changing comparative advantage," leaving "countries at lower stages of industrial development to replace exports of unskilled-labor-intensive commodities from the newly-industrializing countries to industrial country markets" (1980:25–26).

#### THE PROPER ROLE OF GOVERNMENT

In the neoclassical view, the essential economic functions of government are to:

1. maintain macroeconomic stability
2. provide physical infrastructure, especially that which has high fixed costs in relation to variable costs, such as harbors, railways, irrigation canals, and sewers
3. supply "public goods," including defense and national security, education, basic research, market information, the legal system, and environmental protection
4. contribute to the development of institutions for improving the markets for labor, finance, technology, etc.
5. offset or eliminate price distortions which arise in cases of demonstrable market failure
6. redistribute income to the poorest in sufficient measure for them to meet basic needs

This list of functions is uncontroversial as far as it goes. The controversy comes at the step of recognizing market failures<sup>6</sup> in practice and deciding what to do about them.

<sup>6</sup> Market failure is defined as a situation in which the market system produces an allocation of resources which is not Pareto-efficient—it is possible to find ways of changing resource allocation

For example, many neoclassical economists would accept that markets for technology development, manpower training, and credit to small firms and exporters may fail seriously enough to warrant some offsetting government intervention.<sup>7</sup> With respect to technology development market failure may occur because knowledge leaks. If a firm invests in acquiring technological mastery over new processes it will have trouble keeping the benefits to itself. Other producers can "reverse-engineer" products. Employees can leave their firm and apply on the new job what they learned on the old. So while the firm bears the cost of the innovation it does not capture the full social benefit, and hence underinvests in technological effort. Also, some forms of technological development may require a minimum scale of effort, which a single firm acting on its own may not be able to mount. In cases where technology investments are suboptimal, tax incentives may be used to increase the implicit private rates of return on investment, while in cases where private scale is too small, government coordination of public and private technology development activities may be justified. The government also has a role in formulating and enforcing intellectual property rights, in the form of patents and copyrights.

With respect to manpower development market failure may occur if the benefits to society of having an educated population exceed the benefits which educated individuals can capture in the form of higher incomes. These benefits may include a healthier population, lower fertility, and a better informed citizenry. Education and training are generally difficult to finance privately because of the absence of nonfamily institutions that lend to individuals against uncertain and distant future income returns. Hence market forces generally lead to underinvestment in human capital, which a government may correct by a variety of subsidies.

With respect to credit allocation to small firms, market failure may occur if large firms have control over credit markets and apply bargaining power to obtain loans on privileged terms. Also, large firms may get privileged terms if they have an implicit government guarantee, in the sense that they are more likely to be rescued by government than small firms. These cases can provide a rationale for compensating government intervention to increase small firms' access to credit. Likewise, if action to remove exchange rate overvaluation and protection is ruled out, cheap export credit may be justified to offset higher private profitability of domestic market sales.

Such arguments can be used to provide a justification for a *functional* or horizontal industrial policy which is consistent with the principles of neoclas-

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so as to make some consumer(s) better off and none worse off. Hence individual self-seeking behavior by consumers and firms will not achieve the highest level of welfare for society as a whole insofar as market failure is prevalent. It is predicted to occur in the presence of monopoly and oligopoly, externalities, public goods, and common property resources, in each of which individualistic behavior leads to suboptimal results. See Bannock, Baxter, and Rees 1978:287.

<sup>7</sup> See World Bank 1987b.

sical economics. It is difficult to use those principles to justify a *sectoral* or industry-specific industrial policy, however. A sectoral industrial policy aims to direct resources into selected industries so as to give producers in those industries a competitive advantage. It therefore aims to produce a different profile of industries compared to what would result from the decisions of unguided, unstimulated market agents on their own.

In the case of "sunrise" or "infant" industries such justification must rest, in economic terms, on positive side-effects between firms or on economies of scale. Positive interfirm side-effects, or "externalities," may take the form of benefits created by a firm, in the form of goods, services, or technological capacity, for which it is not fully compensated in market transactions. Or they may take the form of benefits from an investment activity carried out by one firm which are dependent upon complementary investments by other firms, in which case present market prices are unlikely adequately to signal the interdependence that exists among these investment decisions. Externalities may provide a *prima facie* case for intervention to offset suboptimal private investment through government coordination of investment decisions or incentives for additional investment. Economies of scale, as distinct from externalities, occur when costs per unit fall as output expands, generating an imperfectly competitive industrial structure as those with lower costs are able to drive others out of business. Here the *prima facie* case might call for government ownership, or price regulation, or measures to help firms travel down their declining cost curves. In "sunset" industries the justification has to rest on a demonstration that the pace or patterns of decline generated by the market are in some way socially inefficient or unacceptably disruptive, for example, with respect to employment.

However, neoclassical economics teaches that market failure of a kind that could be improved upon by a sectoral industrial policy is rare. Indeed, some economists think that there are few inherent market failures and that existing market imperfections are often due to government actions which distort markets. They are pessimistic about politicians' willingness to resist the temptation to misuse economic powers, and still more pessimistic about the ability of governments to detect opportunities which private entrepreneurs have missed. Other neoclassical economists are more impressed by the infant industry case, but see the proper role of government as being confined to the provision of nondiscriminatory and nondiscretionary industrial promotion policies for the set of infant industries. All would agree with Assar Lindbeck that "in market-oriented economies, the role of government planning and public finance is largely to 'plan' the physical, social and psychological *environment* of private agents rather than to plan what these agents are supposed to do" (1986:8). In most LDCs application of this principle would mean a shrinkage in the size of government and a concentration of public attention on a much

more limited set of tasks than at present. It would mean substantial economic liberalization and privatization.

### WHAT DOES the NEOCLASSICAL CONFIDENCE REST ON?

#### *Theory*

The source of these policy prescriptions can be traced to the theory of comparative advantage. This theory shows that any one nation will be better off, in the sense of enjoying more output, if it concentrates on those activities in which its costs are relatively cheapest. Resources will be so allocated provided that international market forces are allowed to determine the relative prices of internationally tradable goods in the domestic economy. And that requirement, in turn, calls for free trade, or a close approximation to it, with low or no impediments to imports and with relative prices that give no more incentive to sell on the domestic market than to sell abroad.

However, the theory of comparative advantage covers only the effects of once-and-for-all changes in trade restrictions. It does not specify a causal mechanism linking realization of comparative advantage to higher growth. A leading proponent admits that "in its present state, trade theory provides little guidance as to the role of trade policy and trade strategy in promoting growth. . . . There is nothing in theory to indicate why a deviation from the optimum should affect the rate of economic growth" (Krueger 1980:288). Attempts to make the theory more dynamic, as in the stages of growth approach (Balassa 1981), show how changes in a country's educational and capital stocks produce changes in comparative advantage; but the changes in the stocks are taken as independent of the changes in the pattern of industrial specialization. Neoclassical economists instead rely on ad hoc factors to make the link between freer markets and higher growth. Some have suggested that opening the economy to international competitive pressures assists technical change, economies of scale, and indigenous entrepreneurship. Others say that a free trade regime is an important component of the task of confining government to its proper place, by making it more difficult for the government to go beyond the bounds of providing those public goods essential for civil life (Lal and Rajapatirana 1987; Krueger 1980). But these explanations shift the burden of argument well beyond the theory of comparative advantage to issues of government failure and technological change which have received little theoretical attention within the neoclassical framework (Fransman 1986).<sup>8</sup>

Some economists, indeed, have recently provided theoretical arguments which suggest that in certain conditions with real world analogues freer trade may not promote faster growth. In conditions of *increasing* returns to scale

<sup>8</sup> For a seminal attempt to theorize the connection between "dynamic comparative advantage" and growth from a non-neoclassical perspective, see Chenery 1961.

and imperfect world markets, a country's growth can be faster if it restricts trade to some degree. Paul Krugman concludes that "the new thinking about trade . . . makes one thing clear: the idealized theoretical model on which the classical case for free trade is based will not serve us anymore. The world is more complex than that, and there is no question that the complexities do open, in principle, the possibility of successful activist trade or industrial policy" (1986:15). One could still argue that the qualifications only apply in conditions not found in most developing countries, so that for them the classical case for free trade still holds. But to repeat, the classical case for free trade as a means to higher growth is shaky.

### *Evidence*

Yet even if the causal mechanisms linking nearly free trade with higher growth are not well understood, neoclassical proponents claim that the record overwhelmingly supports such a connection. For example:

- “The evidence is quite conclusive: countries applying outward-oriented development strategies had a superior performance in terms of exports, economic growth, and employment whereas countries with continued inward orientation encountered increasing economic difficulties.” (Balassa 1981:16–17)
- “Detailed and historical studies . . . have provided an impressive empirical validation of the theoretical case for the view that . . . free trade remains the best policy for developing (and developed) countries.” (Lal 1983:27–28)
- “It seems to be as firm a stylized fact as any in the economics of developing countries: a sustained movement to an outward-oriented trade regime leads to faster growth of both exports and income.” (Lal and Rajapatirana 1987:208)
- “The case for liberalizing financial and trade control systems and moving back to a nearly free trade regime is now incontrovertible.” (Lal 1983:32)
- “Experience has been that growth performance has been more satisfactory under export promotion strategies . . . than under import substitution strategies. . . . There is little doubt about the link between export performance and growth rates.” (Krueger 1980:288–89)

Jagdish Bhagwati is probably correct to claim that belief in the superiority of what he terms the “export promotion” strategy over the “import substitution” strategy is all but universal among economists, “insofar as any kind of consensus can ever be found in our tribe” (1986:93). What Bhagwati calls export promotion, and others call outward orientation, is close to, though not identical with, free trade, a point to which we return.

The consensus among economists has become the standard recipe of the multilateral lending agencies, notably the International Monetary Fund (IMF) and the World Bank. In a recent survey of the world economy, the IMF said:

Another noteworthy element of policies in developing countries has been an increasing emphasis on a wide range of structural adjustment measures intended to improve the allocation of resources and enhance growth prospects. For the most part, these measures have involved restructuring prices and price-setting procedures towards a more market oriented approach. . . . These measures are already leading to more robust development in some countries, and should bring further benefits as their efforts become more widely felt. (1985:66)

The World Bank, speaking of the same reforms, goes on to assure its clients that, "however difficult the policy reforms may have been to adopt, in due course they will create much easier conditions for developing countries than would prevail if the reforms were diluted or abandoned" (1985:146). Both statements express a ringing confidence in the force of the evidence.

Two kinds of evidence are involved. One is the cross-sectional study of the relationship between "inward" and "outward" orientation, on the one hand, and growth on the other, or some more disaggregated specification thereof. The other kind is the in-depth study of one or more key cases, the key cases being the East Asian NICs, including South Korea, Taiwan, Hong Kong, and Singapore. These are judged to have been the most successful developing countries of the postwar era, and therefore to show what policies and other conditions make for superior development performance. Most of the rest of this book relates to the second kind of evidence. Here I discuss the first. The question is whether the cross-sectional evidence provides good grounds for confidence in the neoclassical prescriptions. I do not attempt to appraise a vast literature, but merely to indicate grounds for doubt.

Bela Balassa has carried out much research on trade regimes which all seems to support the neoclassical position. But Colin Bradford has applied to one of Balassa's studies a simple test (1987). Taking Balassa's eight inward-oriented and six outward-oriented countries over the 1970s, Bradford found their price distortion scores as calculated by the World Bank (1983). For the overall price distortion index, as well as for the two most important components of the overall index (exchange rate distortion and interest rate distortion), he found virtually no difference between the averages for the outward- and the inward-oriented countries. There are also virtually no differences in savings rate and growth of gross domestic product (GDP). To compare averages for such a small sample is admittedly a crude test. But the failure of Balassa's argument to pass it is reason to reject his own conclusion that "the evidence is quite conclusive: countries applying outward-oriented development strategies had a superior performance in terms of exports, economic growth, and employment whereas countries with continued inward orientation encountered increasing economic difficulties" (1981:16-17).

Other studies have also found only a weak connection between export (or outward) orientation and growth. Studies by Rostam Kavoussi (1985) and by

Hans Singer and Patricia Gray (1988) find export orientation to be positively correlated with growth performance only when world demand is growing fast (as in 1967–73). When world demand is growing slowly (as in 1973–77 and 1977–83) the correlation is slight, suggesting that in such conditions the gains from export orientation are offset by negative effects. In all conditions of world demand, the correlation is weaker for poorer countries than for richer countries.<sup>9</sup>

Howard Pack examines the connection between trade regimes and technical efficiency to see whether export-oriented trade regimes go with faster growth in technical efficiency, as some neoclassical economists have said. He concludes that, “there is no clear confirmation of the hypothesis that countries with an external orientation benefit from greater growth in technical efficiency in the component sectors of manufacturing” (1986:33). Even Jagdish Bhagwati, a long-time proponent of outward-orientation, has recently concluded that there is little systematic evidence to support an outward orientation (which he calls “export promotion”) over import substitution on grounds of scale economies, innovation, savings, or technical efficiency (1988:38–40).

The World Bank’s 1987 *World Development Report* makes a more ambitious attempt to demonstrate the virtues of outward orientation. Going beyond the dichotomy, it classifies forty-one developing countries into strongly outward-, moderately outward-, moderately inward-, and strongly inward-oriented categories for 1963–73 and 1973–85. It measures each category against six criteria of macroeconomic performance for both periods, or twelve indicators in all. The theory predicts an even progression in performance, the strongly inward doing worst, the strongly outward doing best.

The results show that the moderately inward-oriented countries do better than the moderately outward-oriented countries on six out of twelve indicators.<sup>10</sup> The moderately inward-oriented countries do better on inflation and savings in both periods, and better on the rate of growth of GDP and of gross

<sup>9</sup> See also Jung and Marshall 1985, who use a performance-based rather than incentive-based measure of “export led.” They find that at the level of individual industries in thirty-seven countries output growth tends to cause export growth more frequently than the other way around, including in Taiwan, Korea, and Brazil. On the export growth link, see also Havrylshyn and Ali-khani (1982:661): “the link between rapid growth of manufactured exports and rapid growth of income is by no means automatic”; and Michaely (1977:52): “growth is affected by export performance only once countries achieve some minimum level of development”—perhaps under “bad” import substitution policies. Presumably the effects of exports on overall growth in Taiwan, Korea, and Japan depended on their being manufactured exports, a point which is obscured when countries are asked to adopt an export orientation per se.

<sup>10</sup> The moderately outward-oriented countries include Brazil, Israel, Malaysia, Thailand, and others. The moderately inward-oriented countries include El Salvador, Honduras, Kenya, Mexico, Nicaragua, the Philippines, Senegal, Yugoslavia, and others. The strongly inward-oriented countries include Argentina, Bangladesh, the Dominican Republic, Ethiopia, Ghana, India, Peru, Sudan, Tanzania, Zambia, and others. The named countries are all those which appear in their category in both periods.

national product (GNP) per capita in the more recent period. They do worse on incremental capital output ratio and growth of manufactured exports in both periods. For the more recent period, 1979–85, the moderately inward-oriented do better on four indicators out of six, which is striking because the world economy over the next ten to fifteen years will probably be more like the 1973–85 period than the 1963–73 period in terms of instability and low growth of demand.

It is true that the averages for the strongly and moderately outward-oriented cases combined are substantially better than those for the combined inward-oriented categories. But the strongly outward-oriented cases include only Korea, Hong Kong, and Singapore. (Taiwan was not in the sample because the World Bank does not recognize Taiwan as a separate entity.) Since weighted averages are used and since the size of the Korean economy swamps the other two, the results from the strongly outward-oriented category are largely the results from one country (except for export growth). Only anthropologists are allowed to draw sweeping conclusions from a sample of less than two.

Besides which, it is striking that all the strongly outward-oriented cases happen to be East Asian. This raises the possibility that the causes of exceptional macroeconomic performance have more to do with East Asianness, or (absent Hong Kong) with industrial policies and managed trade, than with the attributes of strongly outward orientation.

The results do appear to support the neoclassical/World Bank position with respect to the strongly inward-oriented countries, which performed worse than the moderately inward-oriented countries on all twelve indicators. But as Hans Singer has shown, it cannot be concluded that they performed worse *because of* their strongly inward orientation (1988). They are much poorer than the moderately inward-oriented countries, with weighted average incomes little more than half. Indeed, over the whole sample per capita income is a better discriminator with respect to growth performance than trade regime. The results are consistent with the proposition that the poorer countries find it more difficult and less beneficial to maintain an outward orientation, especially because of the negative effect on growth of greater instability of exports and imports.

There is a further problem concerning the very meaning of the terms. Outward and inward orientation are taken to be near synonyms for free trade and controlled trade, respectively. The *World Development Report 1987* defines strongly outward-oriented countries as those where “trade controls are either nonexistent or very low. . . . There is little or no use of direct controls and licensing arrangements. . . .” Defining the moderately outward-oriented category the report adds another criterion, namely, that the range of effective protection rates to different sectors of the economy is low. By contrast, the moderately inward-oriented category is defined to include countries where “the overall incentive structure distinctly favors production for the domestic

market. The average rate of effective protection for home markets is relatively high and the range of effective protection rates relatively wide. The use of direct import controls and licensing is extensive . . ." (1987a:82). The definitions make a sharp distinction between moderately outward- and moderately inward-oriented cases, which makes the lack of difference in performance all the more striking.

Korea is the prime example of a strongly outward-oriented country. But does Korea really meet the criteria for a strongly outward-oriented case? Anticipating chapter 10, we can say here that several studies provide detailed evidence of selective trade controls in Korea. The rate of effective protection for manufacturing was 49 percent in both 1978 and 1982, according to Young (1984), which is by no means low. The locus classicus of the view that Korea has had a relatively free trade regime, the study by Larry Westphal and Kwang Suk Kim (1982), suffers from serious methodological problems and uses data from only one year, as long ago as 1968. And even if we take their findings at face value, it turns out that Korea had nearly as much variation in effective protection to different manufacturing sectors as Colombia, and more than Argentina; Korea had the second highest amount of interindustry dispersion in a six-country comparison (Balassa, et al. 1982).<sup>11</sup> This would preclude Korea's classification as even a moderately outward-oriented country in the World Bank study, because even moderately outward-oriented countries are defined to have little variation in effective protection rates to different industries. Without Korea the strongly outward-oriented category contains only the Hong Kong and Singapore minnows.

Another source of cross-sectional evidence is the direct correlation between price distortions and economic growth. The neoclassical argument says that lower price distortions cause higher growth, while higher price distortions have an adverse effect on growth. This argument was given prominence in the World Bank's *World Development Report 1983*, which presents the results of a correlation between price distortion scores and growth rates for a sample of developing countries. The key finding is that "the average growth rate of those developing countries with low distortions in the 1970s was about 7 percent a year—2 percentage points higher than the overall average. Countries with high distortions averaged growth of about 3 percent a year, 2 percentage points lower than the overall average" (1983:61). This conclusion does not survive even casual scrutiny. By far the most influential component of the overall distortion index is the exchange rate. If exchange rate distortion is an important cause of poor growth performance, it should make its effect felt through lagging export volume. But there is no statistically significant relationship between the growth of export volume and the exchange rate distortion index.

<sup>11</sup> The Korean study shows much the same problems as the companion Taiwan study by Lee and Liang (1982), discussed in chapter 5. See also tables 3.2 and 3.3; and chapter 10.

The same holds for the relationship between agricultural growth and the measured distortion of agricultural prices. "It is difficult to argue that one is measuring one's distortions right if they fail to exert an influence where they are most relevant," Albert Fishlow observes. He concludes that "the widely publicized World Bank results are inadequately founded on a distortion index that has limited analytic content" (1985:140).

Indeed, some evidence suggests that deliberate "distortion" of some prices may *help* growth. Colin Bradford compares the price of investment goods relative to consumption and government goods in a number of countries, and finds that the newly industrialized countries are distinguished from other developing countries and from some of the poorer industrialized countries (such as Hungary, Italy, and Spain) by a relatively low price of investment goods. He concludes:

These patterns suggest the possibility that NIC growth and export performance in manufactures have been accelerated by public policies that have lowered the cost of investment goods. These policies could have been in the form of domestic monetary policy affecting interest rates and credit allocations to industrial investors and borrowers or in the form of direct subsidies affecting the price of domestically produced investment goods. Such monetary and fiscal policies would have the effect of stimulating greater demand and supply of investment goods, which in turn spurs capital accumulation, industrialization and structural change.

(1987:309)

What about the effects of trade liberalization, of a change in trade regime toward free trade? Recall the claim that this relationship—of a sustained change generating faster export and income growth—"seems to be as firm a stylized fact as any in the economics of developing countries" (Lal and Rajapatirana 1987:208). But the evidence in support of the claim conflates the effects of trade policy changes with the effects of commonly associated changes, such as macroeconomic stabilization. One study which attempts to identify the impact of trade liberalization alone concludes that "if truth-in-advertising were to apply to policy advice, each prescription for trade liberalization should be accompanied with a disclaimer: 'Warning! Trade Liberalization cannot be shown on theoretical grounds to enhance technical efficiency; nor has it been empirically demonstrated to do so'" (Rodrik 1988b:28).

Even where individual countries improve their performance after a trade liberalization (and certainly some do), this does not provide firm grounds for recommending trade liberalization as a general prescription. For one thing, the direction of causation is unclear. The liberalization of trade may itself be facilitated by the circumstances conducive to rapid growth, and even though under such conditions it helps to reinforce that growth, this beneficial consequence of freer trade cannot be considered universal. Indeed, when the conditions for rapid growth are no longer given, the social and political conse-

quences of entering further liberalization could become destabilizing (Bienefeld 1982:34). In conditions of widespread unemployment, trade tends to become more adversarial than in full employment conditions. It becomes a means of allocating unemployment across countries, as well as the more familiar means to balance the commodity bundle in each economy (Drucker 1986).

There is also the fallacy of composition. Even the present very low levels of developing country penetration of industrial country markets for manufactured goods have triggered protectionist reactions. Presumably these reactions are part of the reason why the share of imports from developing countries in relation to total consumption of manufactured goods in industrial countries has remained roughly constant over the past decade, at just over 1.5 percent (*North-South* 1980:176; UNCTAD 1988:4; Cline 1982b). If many more countries increased their share of industrial country markets without displacing existing suppliers—which is the implication of a generalized export orientation strategy for developing countries—the protectionist reaction could be expected to be much stronger.

So the cross-country evidence relevant to neoclassical trade and industrial policy prescriptions is by no means unambiguous.<sup>12</sup> It supports instead a cautious assessment of what a free trade approach can be expected to achieve for a broad cross-section of developing countries. The state of the evidence is no better than that on the effects of IMF stabilization programs, about which a recent in-house survey concludes: ‘‘Little empirical evidence exists on the long-run effects of Fund programs, and *none at all* on the effects of various combinations of stabilization policies on economic development. . . . Even the informal evidence that is available is ambivalent on the relationship between financial stability and economic development’’ (Khan and Knight 1985:7, emphasis added)—this after nearly forty years of Fund stabilization programs. The paper was published by the IMF in the same year as the earlier-quoted IMF report on the world economy, which avowed that ‘‘these [market-oriented] measures are already leading to more robust development in some

<sup>12</sup> Rati Ram (1986), using a very large sample of 115 countries, finds that government size is positively correlated with growth in almost all cases; that the externality effect of government size is generally positive; that the positive effect of government size on growth may be stronger in lower-income contexts; and several more relationships which confute for the neoclassical argument. I do not give much weight to these results, however, because I cannot specify a mechanism by which such an aggregate variable as government size might have a positive impact on growth. One needs to specify government activity in line with a theoretical reason why the specified activity might be important for growth. The difficulties of trying to base policy generalizations on empirical evidence are seen in the fact that Ram (1986) and Landau (1986) published papers within a few months of each other with diametrically opposed econometric findings about the correlation between size of government in GNP and growth (Helleiner 1988). In formulating the argument set out in the text, I have benefited from discussions with Manfred Bienefeld (see Bienefeld 1988).

countries and should bring further benefits as their efforts become more widely felt.”

### THE FREE MARKET (FM) THEORY OF EAST ASIAN SUCCESS

We turn now to the East Asian NICs. With some stretching of the category, pre-1970 Japan can be included as well. An abundant literature attributes the industrial success of the five NICs—Japan, Taiwan, Korea, Hong Kong, and Singapore—to their reliance on free markets. For example, Hugh Patrick declares himself to be “of the school which interprets Japanese economic performance as due primarily to the actions and efforts of private individuals and enterprises responding to the opportunities provided in *quite free markets for commodities and labor*. While the government has been supportive and indeed has done much to create the environment of growth, its role has often been exaggerated” (1977:239, emphasis added).<sup>13</sup> Referring to the five, Edward Chen asserts that “*state intervention is largely absent. What the state provided is simply a suitable environment for the entrepreneurs to perform their functions.*” Such practices as “directing resources to the desired channels by state intervention” are part of central planning and have no part in the development of the East Asian five (1979:41, emphasis added). Hence, according to Chen, the hypergrowth of the five demonstrates that “the free market environment provides the necessary mechanism to gear the economies towards their optimal points on the production possibilities frontier” (1979:185). Shifting into even higher rhetorical gear, David Aikman claims that Taiwan and Hong Kong “demonstrate just how faithful, consciously or not, the rulers of these two countries have been to American conceptions of free enterprise” (1986:116). Milton and Rose Friedman, in *Free to Choose*, make the same point on a still grander scale: “Malaysia, Singapore, Korea, Taiwan, Hong Kong and Japan—relying extensively on private markets—are thriving. . . . By contrast, India, Indonesia, and Communist China, all relying heavily on central planning, have experienced economic stagnation” (1980:57).

According to this “free market” (FM) theory, East Asia does better than other newly industrializing countries because the East Asian state interferes hardly at all in the working of the market. The other countries have been held back from the development they would have achieved in the “normal” course of events by excessive state intervention, especially in foreign trade. Or in a slightly different version of the argument, John Fei claims that “the basic causation of success of the [East Asian] NICs on the policy front, can be traced to the *lessening of government interferences* in the market economy during the

<sup>13</sup> David Henderson (1983:114) claims that “the real explanation for the Japanese economic miracle is the country’s laissez-faire policies on taxes, antitrust, banking and labor,” which prompts Chalmers Johnson to wonder whether Henderson understands French (1985:3). See also Hosomi and Okumura 1982:150.

E-O [Export-Oriented] phase. In Taiwan and Korea, interference with the market was considerably less as compared to other worse offenders in the near NICS and the Latin American countries . . . (1983:34, emphasis added).

#### THE SIMULATED FREE MARKET (SM) THEORY OF EAST ASIAN SUCCESS

Some neoclassical economists conclude that the governments of East Asia did more than just liberalize markets and lower distortions. In their view the governments also intervened more positively to offset other distortions, both those caused by other policies (e.g., import controls) and those remaining from government failure to change distortion-inducing institutions directly (e.g., segmented financial markets). Frederick Berger states the argument as follows: “I believe that the crux of the Korean example is that the *active interventionist attitude of the State has been aimed at applying moderate incentives which are very close to the relative prices of products and factors that would prevail in a situation of free trade*. . . . It is as though the government were ‘simulating’ a free market” (1979:64, emphasis added).

This is similar to Gary Saxonhouse’s argument (1985) that Japan’s peculiar institutional features are merely the functional equivalent of different arrangements in other countries. Its industrial policy, for example, is but a substitute for information which is provided by better-developed capital markets in the West.

Jagdish Bhagwati endorses a further type of government intervention in support of what he calls the “export promotion” (EP) strategy. An EP strategy is a set of policies which results in the average effective exchange rate for importables being approximately equal to that for exportables. The most important thing the government of an underdeveloped country can do to promote growth, he implies, is to maintain an EP strategy, and this requires government intervention. “The Far Eastern economies (with the exception of Hong Kong) and others that have come close to the EP strategy have been characterized by considerable government activity in the economic system. In my judgement, such intervention can be of great value, and almost certainly has been so, in making the EP strategy work successfully” (1988:33). However, Bhagwati’s desirable interventions are restricted to those which increase producers’ confidence in the government’s commitment to the EP strategy. “By publicly supporting the outward-oriented strategy, by even bending in some cases towards ultra-export promotion, and by gearing the credit institutions to supporting export activities in an overt fashion, governments in these [Far Eastern] countries appear to have established the necessary confidence that their commitment to the EP strategy is serious, thus inducing firms to undertake costly investments and programs to take advantage of the EP strategy” (p. 34). He mentions in passing that the EP strategy does not preclude import substitution in selected sectors but gives no attention to this combination.

This “simulated free market” (SM) theory differs from the FM theory in terms of the distinction between a free (or liberal) trade regime and a neutral trade regime. The former is one with no or few impediments to imports; the latter is one where any incentive for domestic producers to sell on the domestic market rather than export, because of protection, is offset by export subsidies. This means that, overall, a U.S. dollar of exports fetches, in local currency, the same as a U.S. dollar of imports, when all export subsidies and tax credits and all import premia resulting from quantitative restrictions and tariffs are included. So a neutral trade regime may go with some government intervention, including protection of the domestic market. The important point, according to this theory, is that the incentive effect of such protection in biasing sales toward the domestic market should be offset, in aggregate, by export promotion measures. The Far Eastern countries have managed to do this, according to Bhagwati, which is a large part of the reason why they have been so successful compared to others which have not.

However, the proponents of the SM view have shown little interest in analyzing the nature of government intervention in East Asia, though they recognize its existence. And they also place primary causal weight on the character of the trade regime for explaining economic performance. For both reasons, the SM theory can be considered a variant of the core neoclassical theory, which links economic success to self-adjusting markets.

#### THE GOVERNED MARKET (GM) THEORY OF EAST ASIAN SUCCESS

Over the past decade or so, another stream of literature has emphasized the directive role of the state in East Asia. Parvez Hasan,<sup>14</sup> for example, writing of South Korea, draws attention to an “apparent paradox”:

[T]he Korean economy depends in large measure on private enterprise operating under highly centralized government guidance. In Korea the government's role is considerably more direct than that of merely setting the broad rules of the game and in influencing the economy indirectly through market forces. In fact, the government seems to be a participant and often the determining influence in nearly all business decisions. (1976:29)

Edward Mason and associates come to a similar conclusion in their study of government-business relations:

The rapid economic growth that began in South Korea in the early 1960s and has accelerated since then has been a government-directed development in which the principal engine has been private enterprise. The relationship between a government committed to a central direction of economic development and a highly dynamic private sector that confronts the planning machinery with a continually changing structure of economic activities presents a set of interconnections diffi-

<sup>14</sup> A World Bank staff member.

cult to penetrate and describe. Planning in South Korea, if it is interpreted to include not only policy formulation but also the techniques of policy implementation, is substantially more than "indicative." *The hand of government reaches down rather far into the activities of individual firms with its manipulation of incentives and disincentives.* At the same time, the situation can in no sense be described in terms of a command economy. (1980:254, emphasis added)

Much the same has been said of Japan. According to this interpretation, the Japanese were the first to recognize that international competitive advantage could be deliberately created by government not just to nurture a few infant industries to supply the domestic market but to push broad sets of industries toward areas of growth and technological change in the world economy. In the words of a vice-minister of MITI (Ministry of International Trade and Industry):

The MITI decided to establish in Japan industries which require intensive employment of capital and technology, industries that in consideration of comparative cost of production should be the most inappropriate for Japan, industries such as steel, oil-refining, industrial machinery of all sorts, and electronics. . . . From a short-run, static viewpoint, encouragement of such industries would seem to conflict with economic rationalism. But, from a long-range viewpoint, these are precisely the industries where *income elasticity of demand is high, technological progress is rapid, and labor productivity rises fast*. It was clear that without these industries it would be difficult to employ a population of 100 million and raise their standard of living to that of Europe and America with light industries; whether right or wrong, Japan had to have these heavy and chemical industries. . . . Fortunately, owing to good luck and wisdom spawned by necessity, Japan has been able to *concentrate its scant capital in strategic industries*.

(OECD 1972:15, emphasis added)

Henry Rosovsky went so far as to say of Japan that it "must be the only capitalist country in the world in which the Government decides how many firms should be in a given industry and sets out to arrange the desired number" (1972:244).

Chalmers Johnson has sketched a model of the "capitalist developmental state," based on the institutional arrangements common to the high-growth East Asian capitalist countries (1981, 1982, 1983). These arrangements are characterized, he says, by the following features:<sup>15</sup>

1. The top priority of state action, consistently maintained, is economic development, defined for policy purposes in terms of growth, productivity, and competitiveness rather than in terms of welfare. The substance of growth/competitive-

<sup>15</sup> I have slightly revised the presentation of Johnson's model and have omitted one of his points, that the state supervises a heavy and consistent investment in education for all the people (which relates to investment allocation rather than to organizational arrangements).

ness goals is derived from comparisons with external reference economies which provide the state managers with models for emulation.

2. The state is committed to private property and the market and limits its interventions to conform with this commitment.
3. The state guides the market with instruments formulated by an elite economic bureaucracy, led by a pilot agency or "economic general staff."
4. The state is engaged in numerous institutions for consultation and coordination with the private sector, and these consultations are an essential part of the process of policy formulation and implementation.
5. While state bureaucrats "rule," politicians "reign." Their function is not to make policy but to create space for the bureaucracy to maneuver in while also acting as a "safety valve" by forcing the bureaucrats to respond to the needs of groups upon which the stability of the system rests: that is, to maintain the relative autonomy of the state while preserving political stability. This separation of "ruling" and "reigning" goes with a "soft authoritarianism" when it comes to maintaining the needs of economic development vis-à-vis other claims, and with a virtual monopoly of political power in a single political party or institution over a long period of time.

This picture of a centralized state interacting with the private sector from a position of preeminence so as to secure development objectives has been called the "developmental state" theory of East Asian industrial success (Johnson 1982; White 1988). It is not, however, much of a theory. Its specification of institutional arrangements is descriptive rather than comparative-analytic, so what the developmental state is contrasted with is not clear. It also says little about the nature of policies and their impact on industrial performance. Indeed, Johnson's institutional arrangements are for the most part as consistent with simulated free market policies as with more directive ones. I now propose a "governed market" theory which builds on both the idea of the developmental state and on the older development economics' understanding of the nature of the development problem.

The governed market (GM) theory says that the superiority of East Asian economic performance is due in large measure to a combination of: (1) very high levels of productive investment, making for fast transfer of newer techniques into actual production; (2) more investment in certain key industries than would have occurred in the absence of government intervention; and (3) exposure of many industries to international competition, in foreign markets if not at home. These are the proximate causes. At a second level of causation, they are themselves the result, in important degree, of a set of government economic policies. Using incentives, controls, and mechanisms to spread risk, these policies enabled the government to guide—or govern—market processes of resource allocation so as to produce different production and investment outcomes than would have occurred with either free market or simulated free

market policies. At the third level of explanation, the policies have been permitted or supported by a certain kind of organization of the state and the private sector. Let us specify the policies and the organizational arrangements in more detail.

Johnson's picture of the developmental state can be recast to fit with concepts developed elsewhere in political science for comparing political regimes. The relevant distinctions are "democratic versus authoritarian" and "pluralist vs. corporatist." The first refers to the rules by which rulers are chosen. In democratic regimes the rulers are chosen by a process much influenced by popular preferences, while in authoritarian regimes they are selected by methods which give relatively little scope for the expression of popular sentiment. The second distinction refers to relations between interest groups and the state. In pluralist regimes, interest groups are voluntary associations, free to organize and gain influence over state policy corresponding to their economic or political resources. The process of government consists of the competition between interest groups, with government bureaucracies playing an important but not generally dominant role. In corporatist systems the state charters or creates a small number of interest groups, giving them a monopoly of representation of occupational interests in return for which it claims the right to monitor them in order to discourage the expression of "narrow," conflictual demands. The state is therefore able to shape the demands that are made upon it, and hence—in intention—maximize compliance and cooperation (Schmitter 1974; Stepan 1978; Zeigler 1988).

In these terms, the United States is the example par excellence of a pluralist democracy; Korea and Taiwan are examples of authoritarian corporatism; Austria and Switzerland illustrate democratic corporatism; and Japan illustrates corporatism combined with arrangements for selecting rulers which are intermediate between democratic and authoritarian, or what Johnson calls "soft authoritarian."

The corporatist and authoritarian political arrangements of East Asia have provided the basis for market guidance. Market guidance was effected by augmenting the supply of investible resources, spreading or "socializing" the risks attached to long-term investment, and steering the allocation of investment by methods which combine government and entrepreneurial preferences. In particular, the governments guided the market by: (1) redistributing agricultural land in the early postwar period; (2) controlling the financial system and making private financial capital subordinate to industrial capital; (3) maintaining stability in some of the main economic parameters that affect the viability of long-term investment, especially the exchange rate, the interest rate, and the general price level; (4) modulating the impact of foreign competition in the domestic economy and prioritizing the use of scarce foreign exchange; (5) promoting exports; (6) promoting technology acquisition from multinational companies and building a national technology system; and (7) assisting

particular industries. (For Japan post-1970/73 we would also have to include industry-specific policies to ease decline. Throughout the reference is to Japan before this time.<sup>16</sup>)

I am especially interested in the policies to assist particular industries. This is not because I think that industry-specific policies were causally more important than the others. But they were important enough, and yet have been almost completely ignored in most of the economics literature about the Taiwanese and Korean “economic miracles.” Neglect of these policies matters particularly because it is in the histories of specific industries that one can most clearly see the government in action.

However, the existence of sectoral policies does not in itself mean that they produced significantly different outcomes from free market or simulated free market policies. They might merely put the government’s seal of approval on some private sector projects by way of mild assistance for something that private firms would have done anyway in response to price signals alone. In that case we could dismiss sectoral policies as mere “hand-waving” or “window-dressing.”

To clarify the issue, let us distinguish between leading the market and following the market. Sectoral policies lead the market when the government takes initiatives about what products or technologies should be encouraged, and puts public resources or public influence behind these initiatives. A clear case is where the government proposes a project to private firms, the private firms decline, and the government goes ahead through a public enterprise. On the other hand, sectoral policies follow the market when the government adopts the proposals of private firms about new products and new technologies. If private firms propose to make the quantum jump from fabrication of 16K to 64K DRAM chips and ask for government assistance, then government assistance follows the market.

Leading and following should be qualified by the degree of additionality. When government helps firms to do what they would have done anyway, this is—with apologies to the English language—“small followership.” When government assists firms significantly to extend the margin of their investments, this is “big followership.” We can use “big leadership” to refer to government initiatives on a large enough scale to make a real difference to investment and production patterns in an industry, and “small leadership” to refer to government initiatives which on their own carry too few resources or too little influence to make a difference.

The FM and SM theories of East Asian industrial success can accommodate the fact of sectoral policies by saying or implying that they constitute merely “small followership.” The GM theory says that the governments’ industry-

<sup>16</sup> By 1970–73 Japan’s protection-promotion system began to be substantially dismantled. These years mark the end of an era—the end of catch-up, the beginning of large balance-of-payment surpluses, and a shift in industrial policy from growth, industrial investment, and export objectives, toward freer trade and social-overhead investment.

specific policies went beyond "small followership," to either or both "big leadership" and "big followership." Interventions of these types suggest that the production and investment outcomes were different from what would have occurred with free market or simulated free market policies, the difference being greater for big leadership than for big followership. The fact of a difference does not in itself imply that the difference helped or hindered development. Whether it helped or hindered has to be established independently.

Let us now summarize the main differences between the GM theory and the other two. The FM and SM theories emphasize efficient resource allocation as the principal general force for growth, and therefore interpret superior East Asian performance as the result of more efficient resource allocation than in other LDCS or NICS. This more efficient resource allocation comes from more freely functioning markets, including closer integration of domestic product markets into international markets. Hence these countries show the virtues of "getting the prices right," where "right" means domestic prices in line with international prices. The GM theory, on the other hand, emphasizes capital accumulation as the principal general force for growth, and interprets superior East Asian performance as the result of a level and composition of investment different from what FM or SM policies would have produced, and different, too, from what the "interventionist" economic policies pursued by many other LDCS would have produced. Government policies deliberately got some prices "wrong," so as to change the signals to which decentralized market agents responded, and also used nonprice means to alter the behavior of market agents. The resulting high level of investment generated fast turnover of machinery, and hence fast transfer of newer technology into actual production.

The FM and SM theories are silent on the political arrangements needed to support their policies. The GM theory emphasizes the developmental virtues of a hard or soft authoritarian state in corporatist relations with the private sector, able to confer enough autonomy on a centralized bureaucracy for it to influence resource allocation in line with a long-term national interest<sup>17</sup>—which sometimes conflicts with short-run profit maximizing. The state's steering of resource allocation is the economic counterpart to its political restrictions on "free trade" in interest groups.

#### THE QUESTION OF EVIDENCE

There is an unavoidable ideological loading in debate about the role of the state, for the issues lie uncomfortably close to the heart of the ideological

<sup>17</sup> Many writers in the tradition of political pluralism deny any meaning to the notion of the general good or the national interest, other than whatever happens to be the balance of demands between competing interest groups. I use "national economic objectives" or "the national interest" to refer to interests or objectives that are broadly rather than narrowly shared and enduring rather than short-term. Cf. Dahl and Lindblom 1963:501.

dispute in which the superpowers have clothed their global rivalry. There are also disciplinary interests at stake, as each discipline or subdiscipline tries to emphasize the importance of that factor—free markets, the state, culture, or something else—in which it can claim a comparative analytical advantage. But serious differences of opinion among scholars remain, which reflect the methodological difficulties with any theory which posits government steerage of the market as an independent variable. In part, the difficulties stem from the absence of an economic theory of sufficient credibility to provide a legitimate base from which technical economic analysis can act as a constraint on admissible arguments. In part, also, the difficulties stem from the same problem as with virtually all interesting social science questions: the absence of a counterfactual. The question of whether measures designed by a well-meaning bureaucracy can achieve results superior to those which a more liberal market system would produce is impossible to answer conclusively; what would have happened in the absence of the intervention is always unknown. Nonetheless, economists from Adam Smith onwards have not hesitated to make strong assertions, both positive and negative, about the effectiveness of government intervention without offering serious evidence to support their claims.

Serious direct evidence would have to separate out the impact of industrial policies from that of macroeconomic and other policies. Macroeconomic policies affect aggregate demand, but they also affect different industries differently although not intended to produce such differential effects. Industrial policies, on the other hand, are intended to affect production and investment decisions of decentralized producers. And industrial policies, as we have seen, come in two broad kinds—functional and sectoral—whose respective impacts also need to be distinguished. In addition to macroeconomic and industrial policies, there are also public goods policies, or what Adam Smith called the three “duties of the sovereign”—defense, law and order, and physical infrastructure. We should further distinguish policies aimed at changing income and asset distributions, whose results then affect the political feasibility of different macropolicies, especially ones for adjusting to economic austerity. The relationships among macroeconomic, industrial, public goods, and distributional policies is best thought of in terms of overlapping circles. The effects of one set are highly contingent upon the effects of the others. In particular, macroeconomic fiscal and monetary policies affect the general thrust of government economic actions toward growth and competitiveness vis-à-vis consumption and redistribution, and so have an important bearing on both the speed and composition of industrial growth.<sup>18</sup>

To assess the impact of industry-specific policies, one obvious method would be to take a number of industries and examine case by case the connection between promotion measures and subsequent growth. But the problems

<sup>18</sup> For example, Scott 1985.

include holding other things constant between high-assistance and low-assistance industries; commensurating different types of assistance (e.g., subsidies, protection, antitrust exemptions); and obtaining information on promotional measures which are not contained in financial disbursements or legal directives (such as the "announcement effect" of loans from the Japan Development Bank on the direction of commercial bank lending, which enables the Japan Development Bank to influence credit allocation with only a small amount of lending). Then there is the problem of interpretation: if industries which receive a lot of assistance grow more slowly than those which do not, does this indicate the failure of assistance or does it indicate targeting of industries that need assistance as a condition of subsequent fast growth? And always one needs to make an assumption about what would have happened in the absence of government help. Even for as nicely specific a policy as performance requirements on foreign direct investment (such as export ratios, local content conditions, requirements for ownership, and employment based on national origin) it has proved impossible to answer the question of how the requirements affect trade and investment. Assumptions have to be made about what other countries do when one country raises or lowers its performance requirements. The requirements may be redundant in that investors would meet them anyway or they may not be enforced.<sup>19</sup>

Again, take selective credit policies, used by many governments to steer resources into certain uses. In order to be effective, selective credit policies have to cause a net increase in credit to the priority use, and this net increase has to bring about a reallocation of real resources. To cause a net increase, the government or the central bank has either effectively to control and monitor the behavior of financial institutions or provide them with incentives to raise lending for the priority use. To bring about a change in resource allocation, the priority borrowers should not simply substitute cheap credit through the concessional scheme for more expensive credit which they would have obtained without the scheme, without altering their production plans. Finally, the effectiveness of selective credit needs to be weighed against the costs, in terms of the effects on other participants in financial markets of raising the extra revenue needed to pay for the subsidy. Obtaining information on these three sets of conditions for success is difficult, to put it mildly.<sup>20</sup>

Even if studies of selective intervention showed effectiveness at the industry level, they would still leave open the question of whether the population as a whole would have been better off in welfare terms developing industries other than those particular ones. There is a cost to selective promotion, which is the cost of diverting resources from currently profitable production (e.g., textiles) to production that *might* be profitable in the future (e.g., sophisticated elec-

<sup>19</sup> See Guisinger 1986:170.

<sup>20</sup> See Ghamen and Rajaram 1987, for Korea and Tunisia.

tronics). Industry optimality does not establish national optimality, and national optimality may be defined not only in terms of present or future consumption but also in terms of the competitive strength of national industries in relation to other countries. It is tempting to use aggregate production function analysis to estimate the extent of "national" optimality, with the size of the residuals indicating the maximum possible extent of the government's contribution. The problem is that the size of the residuals depends on how the production function is specified, which is a matter of very subjective judgment. The "national" issue can be got at another way, by comparing countries which in many important respects are similar but where the role of government has been significantly different (Japan and Italy in the postwar period, for example [Boltho 1981]). The hazards are obvious.

Faced with the manifold difficulties in determining the economic effects of government attempts to steer the market, we can use more indirect evidence to take the debate forward.

First, we can establish the extent to which the key neoclassical growth conditions have been present over time: to what extent trade has been free, the exchange rate in equilibrium, the labor market competitive, and interest rates high enough to reflect the real scarcity of capital. In other words, we can assess the degree of price "distortions" in different product and factor markets. The neoclassical (both FM and SM) presumption is that the lower these distortions, the faster the growth; so high-growth East Asia should show low distortions.

Second, we can get evidence of sectoral industrial policies by examining the histories of particular industries to see what kinds of activity the government was undertaking. We need to know how much control it exercised over investment decisions, and to what extent it was responsible for taking initiatives about products or production processes that private firms would not have undertaken at about the same time without assistance. The GM theory leads us to expect big followership or big leadership in some important industries.

Third, if the government is to exercise leadership it must have instruments for affecting investment decisions. The instruments might include trade controls, foreign exchange controls, export incentives, selective credit allocation, tax incentives, public enterprises, as well as other means of punishing firms that do not comply. Such instruments are needed for getting prices "wrong" and in other ways altering market behavior. If we do not find such instruments we can discount claims that the government has an important role. Of course it is not enough to establish that the instruments exist; they may exist on paper only, or they may dedicate only a trivial amount of resources, or they may entail too little change in costs and prices to have a resource-pulling effect. By looking at the "input" side we can get some sense of whether it is plausible to say that the policies have significant effects on the "output" side. The GM theory leads us to expect substantial variation between industries in the effects

of government policies on relative prices, corresponding to the objectives of government promotional activity.

Fourth, we also have to be able to identify the institutional locus of the instruments—one or more central agencies vested with the powers to plan and coordinate within parts of the economy and with some responsibility for industrial success. Likewise we should find evidence of national goal-setting, going beyond the practice of Anglo-American economies and the principles of neoclassical economics, with goals relating substantively to industrial structure and international competitiveness as well as to macroeconomic balance, adequate market infrastructure, and “fair” competition.

Finally, the configuration of agencies, national goals, and industrial policy instruments is likely to be more effective where political power is relatively unified, and unified around groups of people who are committed to industrialization. This is what the GM theory predicts. If instead we find that political power is distributed in a pluralistic or fragmented way, with different constellations of domestic and foreign interest groups exerting pressure on different public policy issues, *or* if we find that political power is unified around groups of people whose interests are hostile to industrialization, then whatever the government claims to be the case we can discount the argument that its planning and coordination have helped industrialization. Relatedly, the evidence for the GM theory is stronger insofar as we can show why the “needs of political survival” are in line with the “needs of productive investment” rather than opposed—or why the political leaders do *not* adopt a Marcos- or Mobutu-like strategy of plundering the Treasury and pulverizing state-implementing agencies in disregard of the consequences for economic development. This involves the political calculations that shape industrial policies.

And that, roughly, is the sequence of chapters 3 to 9. Chapter 10 then brings information and argument from these earlier chapters together with material from Korea, Japan, and Hong Kong to address the question of how important governing the market has been in capitalist East Asia. Chapter 11 goes on to ask what lessons might be drawn from the East Asian experience for development strategy in other developing countries.

But before all this, we need to examine economic performance in East Asia, particularly Taiwan’s. How good has it been?

RETHINKING  
THE  
EAST ASIA  
MIRACLE

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A copublication of the World Bank  
and Oxford University Press

*Oxford University Press*

Oxford • New York • Athens • Auckland • Bangkok • Bogotá • Buenos Aires • Calcutta • Cape Town • Chennai • Dar es Salaam • Delhi • Florence • Hong Kong • Istanbul • Karachi • Kuala Lumpur • Madrid • Melbourne • Mexico City • Mumbai • Nairobi • Paris • São Paulo • Singapore • Taipei • Tokyo • Toronto • Warsaw

*and associated companies in*  
Berlin • Ibadan

© 2001 The International Bank for Reconstruction  
and Development / The World Bank  
1818 H Street, N.W., Washington, D.C. 20433, USA

Published by Oxford University Press, Inc.  
198 Madison Avenue, New York, N.Y. 10016

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Cover design and interior design by Naylor Design, Washington, D.C.

Manufactured in the United States of America  
First printing June 2001  
1 2 3 4 04 03 02 01

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*Library of Congress Cataloging-in-Publication Data*  
Rethinking the East Asian miracle/edited by Joseph Stiglitz and Shahid Yusuf.

p. cm.

Includes bibliographical references.

ISBN 0-19-521600-8

1. East Asia—Economic conditions. 2. Finance—East Asia. I. Stiglitz, Joseph E. II. Yusuf, Shahid, 1949-

HC460.5 .R48 2000

330.95'0429—dc21

00-051329

## CHAPTER 1

# THE EAST ASIAN MIRACLE AT THE MILLENNIUM

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**Shahid Yusuf**

The 1990s were interesting times for East Asia in the literal sense of the term and in the more ominous sense conveyed by the famous Chinese saying. The decade started on a positive note, with most countries in the region registering high rates of growth. Rapid growth persisted for five years and then began to flag in 1996, with a slowing of exports, the emergence of excess capacity in many industries, and a decline in earnings (see tables 1.1 and 1.2). Questions surfaced about the vigor of the “tiger” economies, and these doubts turned serious in 1997, with the failure of several *chaebol* in the Republic of Korea, signs of stress in Thailand’s real estate and financial sectors, and the persistent debilitating stagnation of the Japanese economy.<sup>1</sup>

By the year’s end, the region was in the grip of a full-blown crisis, which started in Thailand and then spread to Korea, Malaysia, and Indonesia. The Philippines, Hong Kong (China), and Singapore were affected, but to a lesser degree. Growth also slowed in China and in Taiwan (China), but these two economies were the least hard-hit.<sup>2</sup> Earlier doubts about the future of the so-called East Asian miracle congealed into a deep gloom.

Observers who had worried about the lack of technical progress in the region; who had noted the fragility of the banking systems; who had pointed to widening current account deficits, eroding export competitiveness, meager corporate profitability, and the exposure to short-term debt; and who had criticized the pell-mell investment in real estate felt vindicated (see, for instance, Reinhardt 2000; Easterly and

Table 1.1 Annual Growth Rates of Real Gross Domestic Product Per Capita, 1973–96

Economy	Initial gross domestic product per capita (U.S. dollars)	Annual growth (percent)
United Kingdom	17,953	0.5
France	12,940	1.5
West Germany	13,152	1.8
Austria	11,308	2.0
Italy	10,409	2.1
Spain	8,739	1.8
Greece	7,779	1.5
Singapore	5,412	6.1
Hong Kong, China	6,768	5.1
Japan	11,017	2.5
Malaysia	3,167	4.0
Philippines	1,956	0.8
Korea, Rep. of	2,840	6.8
Indonesia	1,538	3.6
Thailand	1,750	5.6
China	839	5.4
United States	16,607	1.6

Source: Crafts 1999.

others 1993; and Bello and Rosenfeld 1990 for an earlier voicing of concerns). For researchers, who viewed as an anomaly the persistence of high growth in the region over three decades, the downturn and regression to an international mean seemed a natural reassertion of the force of gravity (Easterly and others 1993).

As the crisis deepened in late 1997, concern was voiced that this regional downturn could have much wider consequences. In a lead editorial, the *Economist* noted that a sharp economic slowdown affecting the Korea and Japan “took on a new seriousness. These are two of the world’s largest economies which are also two of the world’s largest importers as well as sending their investment all over the globe. A financial calamity there could bring on a worldwide slowdown or even a slump” (*Economist*, December 20, 1997, p. 15; on the lead up to the crisis and the aftermath, see World Bank 1999a).

Once the true magnitude of financial fragility, inadequate regulatory oversight, corporate indebtedness, failed management, and overcapacity in key manufacturing subsectors in East Asia became apparent, other countries—such as Brazil and the Russian Federation—were subjected to speculative attacks and had to cope with capital flight

**Table 1.2 Percentage Change in Gross Domestic Product in East Asia, 1996–2001**

Region	1996	1997	1998	1999	2000 <sup>a</sup>	2001 <sup>b</sup>
<i>East Asia Five</i>						
Indonesia	8.0	4.5	-13.7	0.5	3.0	5.0
Korea, Rep. of	6.8	5.0	-5.8	10.2	6.0	6.1
Malaysia	8.6	7.5	-7.5	5.4	6.0	6.1
Philippines	5.8	5.2	-0.5	3.2	4.0	4.8
Thailand	5.5	-1.3	-10.0	4.0	5.0	5.5
<i>Transition economies</i>						
China	9.6	8.8	7.8	7.1	7.0	7.2
Vietnam	9.3	8.2	5.8	4.7	4.6	4.5
<i>Small economies</i>						
Cambodia	7.0	1.0	1.0	4.0	5.5	6.0
Lao People's Democratic Republic	6.8	6.9	4.0	4.0	4.5	5.0
Papua New Guinea	3.5	-4.6	2.5	3.9	4.7	4.5
Fiji	3.4	-1.8	-1.3	7.8	3.5	3.0
Mongolia	2.4	4.0	3.5	3.3	4.3	4.5
Solomon Islands	0.6	-0.5	-7.0	1.0	2.0	3.0
<i>East Asia newly industrializing economies (excluding Korea)</i>						
Hong Kong, China	4.5	5.3	-5.1	2.0	5.2	4.4
Singapore	7.6	8.4	0.4	5.4	5.7	5.8
Taiwan, China	5.7	6.8	4.8	5.5	6.5	6.1
<i>Industrial countries</i>						
Japan	5.0	1.6	-2.5	0.3	0.9	1.6
United States	3.7	4.5	4.3	4.1	4.3	—

— Not available.

a. Estimate.

b. Projection.

Source: World Bank 2000a.

(Clifford and Engardio 1999; Gilpin 2000).<sup>3</sup> The world economy walked a tightrope through most of 1998, with the United States and some of the European economies providing much of the momentum for growth, and with the U.S. absorbing much of the capital which fled East Asia (Van Wincoop and Yi 2000). However, by early 1999 the worst was behind. Even though the Japanese economy remained weak, other East Asian countries began to rebound on the basis of export demand from the United States and Western Europe, especially for electronics, and higher domestic fiscal spending.

The pace of recovery quickened in the latter part of 1999 because of increasing intraregional trade, higher oil prices that aided the pe-

troleum producers, and appreciation of the yen ("Southeast Asia Export Recovery," *Oxford Analytica*, December 10, 1999). In early 2000, the doubts voiced about the future of economic development in East Asia had largely dissipated.<sup>4</sup> Writing in the *Financial Times* (February 23, 2000), Martin Wolf saw "Asia's future burning bright." He extolled "Asia's astounding comeback" and observed that "the most important economic story of the past two decades—that of the convergence of the income levels of the advanced economies by a rising proportion of the peoples of emerging Asia—has regained its credibility." Stock market recovery throughout the region, propelled by exuberant views regarding Internet and technology stocks, provided additional impetus ("The Fear of the Internet," *Far Eastern Economic Review*, December 30–January 6, 2000).<sup>5</sup>

With the economies of East Asia growing by close to 6 percent in 2000, after attaining a growth rate of 4.1 percent in 1999, is there any need to rethink the East Asian miracle? Can we treat the one year of low growth—that is, 1998, when the East Asian economies expanded just 1.6 percent—as an inevitable bump on the road to globalization? Or does the crisis of 1997–98 and what it revealed about macroeconomic policy, institutions, business practices, and regulatory capability in East Asia call for a reappraisal of the East Asian model and of its underlying dynamics? Have fundamental weaknesses persisting in the East Asian economies been obscured by their undeniable strengths and by close to three decades of rapid growth?

### WHY RETHINK AND WHAT?

The purpose of this volume is to cast just such a searching eye over a landscape rendered less familiar by an unforeseen event of the utmost severity. The chapters reexamine the major determinants of East Asian performance from country or regional perspectives and indicate how the experience of the 1990s has either modified or reaffirmed the mainstream views of the early 1990s, which were expressed in the *East Asian Miracle* (World Bank 1993) and many other publications (for a critical assessment of the East Asian miracle, its commissioning, and the crafting of its recommendations, especially on industrial policy, see Wade 1996).

The kind of questions motivating our inquiry were expressed with characteristic bluntness by Paul Krugman in August 1997, soon after the crisis erupted in Thailand. Krugman took as his point of departure the work of Young (1992, 1994a and b) and Kim and Lau (1994), which suggested to him that Asian growth was "mainly a matter of perspiration rather than inspiration—of working harder, not smarter." He went on to add:

If there is one thing that believers in an Asian system admire, it is the way Asian governments promote specific industries and technologies; this is supposed to explain their economies' soaring efficiency. But if you conclude that it is mainly perspiration—that efficiency is not soaring—then the brilliance of Asian industrial policies becomes a lot less obvious. The other unwelcome implication of the perspiration theory was that the pace of Asia's growth was likely to slow. You can get a lot of economic growth by increasing labor force participation, giving everyone a basic education and tripling the investment share of GDP [gross domestic product], but these are one-time unrepeatable changes.

The biggest lesson from Asia's [recent] troubles is not about economics, it is about government. When Asian economies delivered nothing but good news, it was possible to convince yourself that the alleged planners of these knew what they were doing. Now the truth is revealed, they do not have a clue. [Paul Krugman, "What Ever Happened to the Asian Miracle?" *Fortune*, August 18, 1997, p. 27.]

## KEYS TO THE EAST ASIAN MIRACLE

Before rethinking the causes and dynamics of the East Asian approach to development, I summarize its main elements as perceived at the beginning of the decade of the 1990s and presented in the *East Asian Miracle* and other publications (World Bank 1993; Ohno 1998). Each country pursued its own customized variant, but a convenient stylization included four main strands.

First was the adherence to the fundamentals of macroeconomic management. This called for:

- A stable business environment with relatively low inflation that encouraged investment in long-gestation, fixed assets
- Prudent and sustainable fiscal policies to actively complement other measures aimed at equitably sharing the rewards from higher growth

- Exchange rate policies to underpin export competitiveness
- Financial development and the progressive liberalization of the sector so as to maximize domestic savings (stimulated, initially, by rapid growth) and promote efficient allocation and integration with the global financial system
- Efforts to minimize price distortions
- Actions to support the spread of primary and secondary schooling as well as the creation of a hierarchy of skills to buttress an outward-looking development push.

A second strand of the strategy stressed the need for a bureaucracy able to conceive and implement the designs of a “strong state” (meaning an authoritarian, centralized developmental state) and to make a credible commitment to long-run development. This element of the strategy, which drew selectively on the experience of Singapore, Korea, Japan, and Taiwan, called for able and well-paid administrators who were insulated to a significant degree from political pressures and empowered to take development initiatives aimed at maximizing the growth of output and employment (Campos and Root 1996; Root 1996; Ohno 1998). In this context, insulation had a particular meaning: such bureaucrats, while being embedded within the system, were less likely to be diverted from the pursuit of long-run goals by political demands that were frequently myopic (Evans 1995). It did not mean distancing government from business. In fact, the World Bank study attached much importance to the interaction between administrators and businesspeople through means such as deliberation councils so as to forge national priorities, induce an exchange of market information, and promote networking as well as coordination.<sup>6</sup> But the study went beyond coordination and information pooling to underscore the role of strong bureaucracies in stimulating “contests” between business groups to ensure that competition in the marketplace did not flag (Stiglitz 1996). Businessmen met with government administrators to reach an understanding on strategy and, where possible, to coordinate their activities. This did not blunt the incentives to compete against one another. On the contrary, East Asian governments adroitly employed carrots and sticks to prevent a slackening of domestic competition.

A third strand was governments' activist policies to quicken the pace of industrialization and export an increasing proportion of industrial output. Outward-oriented development, in conjunction with exchange rate policy, was a means of achieving viable external balances and generating the demand needed to accelerate GDP growth, force producers to absorb technology, and strive after competitiveness. In their efforts to industrialize, East Asian governments made selective use of tariff protection and export incentives, ranging from moral suasion to subsidies and mild financial repression, so as to provide industry with financing at lower cost. The World Bank study notes that these measures were applied sparingly and is cautious in recommending their use by other countries.

The reason for the qualified support extended to government activism was made clear by the fourth strand of the East Asian development strategy: the approach was pragmatic, and the measures were applied flexibly and abandoned if their purpose was not being fulfilled (Ohno 1998; for an East Asian perspective on industrial policy, which underscores the significance of a vision and a long-term strategy, see Yamada and Kuchiki 1997). In other words, a circumscribed dirigisme yielded good results on balance because of an overriding commitment to rapid and efficient development, combined with the ability of a strong state to abandon initiatives that were seen to be failing. The record of East Asian countries in applying this exacting pragmatic calculus was by no means perfect, and some Southeast Asian countries deviated more often than others (however, see Jomo, chapter 12 of this volume). But when certain (demanding) conditions were met, market outcomes for late developers could be improved through a clear-headed manipulation of incentives by the visible hand (see the concluding chapter of this volume, by Joseph Stiglitz; Wade 1990; Amsden 1989; and Root 1996).

### QUESTIONING THE EARLIER CONSENSUS

The experience of the 1990s and research results from around the world have strongly reaffirmed the appropriateness of sound macroeconomic and sectoral policies. Nevertheless, questions have arisen regarding their execution. In particular, East Asian countries were slow

to implement prudential regulations, induce banks to adopt risk management systems, strengthen banking supervision, and sharpen incentives supporting allocative efficiency prior to dismantling some of the restraints on capital flows (McKinnon 1991; Chow 2000; Flatters 2000). As a result, the authorities and banks were ill prepared to cope with the huge influx of capital or with the abrupt outflow in 1997 (Wong 1999; Furman and Stiglitz 1998; Hellman, Murdock, and Stiglitz 2000).<sup>7</sup> In particular, banks were guilty of currency and term mismatching, which greatly exacerbated the severity of the financial crisis (see chapter 2, by Ito, in this volume). The use of exchange rate and fiscal policies has also aroused debate, with some observers claiming that the severity of the currency crises could have been ameliorated by a different approach. Fiscal policy tended to be excessively conservative, which worsened the deflationary pressure in the immediate aftermath of the crisis.<sup>8</sup> The crisis underlined the advantages of public bureaucracies skilled at managing the economy and responding to shocks. But the experience of Korea and Thailand also revealed how difficult it is to sustain a meritocratic culture and insulate bureaucracies from political pressures (Haggard 2000, Heo and Kim 2000).

Moreover, the earlier “consensus” appears least settled in six areas. First, by the end of the 1980s, East Asia was rapidly converging toward the industrial countries. Growth was driven by increasing factor inputs, with total factor productivity (TFP) on an upward trend. But research during the 1990s has rendered the story much more complex. Although technical efficiency is rising, the productivity gap between middle-income East Asian countries and industrial economies is as wide as before. More seriously, the apparent contribution of technical progress to TFP remains small. This calls into question policies pertaining to industrialization, the service sector, the development of human resources, and the gains from building research capacity.

Second, the advantages of an activist and pragmatic industrial policy, which used directed credit and subsidies to build new subsectors, are far from clear. “Getting the prices wrong” and subsidizing industry for lengthy periods in an attempt to create viable exporters have entailed high costs, and they seem increasingly inappropriate in an integrated world subject to World Trade Organization (WTO) disciplines (Amsden 1989, 1991).

Third, close symbiotic relations between banks and industrial corporations, encouraged by governments, induced investment and a long-term business perspective in some East Asian countries but also resulted in misallocation of bank lending (often into real estate), the accumulation of nonperforming assets, and high corporate gearing ratios (Cho and Kim 1995, Hutchcroft 1999).<sup>9</sup> Moreover, even in Japan, the close links between banks and companies did not strengthen corporate governance, insulated companies from market pressures, and impeded the emergence of a competitive market for corporate control (Hall and Weinstein 2000).<sup>10</sup> The dominance of the banking system also may have impeded the widening of financial markets.

Fourth, the efficacy of exports as an engine of productivity and growth in East Asia has been questioned. Recent research casts doubt on the proposition that “in subsidy-dependent industrialization, growth will be faster the greater the degree to which the subsidy allocation process is disciplined and tied to performance standards—exports possibly being the most efficient monitoring device” (Amsden 1991: 285). In fact, Amsden came to view growth in Northeast Asian economies as driven more by investment and the sectoral reallocation of resources than by exports (Amsden and Singh 1994). Other researchers have also focused on investment and imports (Rodrik 1995; Lawrence and Weinstein in chapter 10 of this volume).

Fifth, the approach to governance in East Asia deserves a fresh look. Governance is about how institutions, organizations, and processes mediate relationships between principals and agents (Dyck 2000; Haggard 1999). It seeks to explain the making and implementing of collective decisions (Burki and Perry 1998). Four aspects of governance in East Asia attracted attention in the 1990s: the nature of government-business interaction to coordinate decisions, internalize externalities, and manage the market; the degree to which individual families exercised control over large business empires; the autonomy and effectiveness of regulatory agencies, especially those mandated to oversee the financial sector and shareholders; and the discipline exerted by strict rules of corporate governance on the managers of firms. East Asia’s brand of governance, while occasionally criticized, was generally praised for promoting cooperation and contests that delivered good economic results (see Woo-Cumings, chapter 9 of this volume). The deterioration in performance after 1996 and the under-

lying problems uncovered by the crisis suggest that relationship-based governance structures, and family ownership through holding companies or complex interlocking shareholdings, must adapt as countries multiply their links with the global economy (Li 1998). By “governing the market” (Wade 1990) and relying on administrative rulings to achieve results, East Asian governments slowed the growth of legal and regulatory institutions that would strengthen the market and remedy certain types of market failure, although they promoted human resource development and the acquisition of comparative advantage in some areas (see Jomo, chapter 12 of this volume; Haggard 2000; and Heo and Kim 2000). In the East Asian institutional milieu, rules of corporate governance to solve problems of agency made little headway.

A sixth development of consequence is the progressive integration of the region as well as of the world economy because of trade and factor flows.<sup>11</sup> The contiguity of the crisis revealed just how far this has progressed and the degree to which foreign investors perceive East Asia as an entity sharing certain common attributes. A decade ago, East Asian countries could pursue macroeconomic and trade policies more or less independently of their neighbors. Now they must recognize some degree of interdependence and coordinate their actions (Gilpin 2000).

The balance of this introductory chapter examines in more detail each of these facets of the East Asian miracle, indicating how an eventful decade and the latest research have qualified or altered our thinking.

## **MACROECONOMIC POLICY AND STABLE GROWTH**

The advantages of a stable environment and low inflation remain unchallenged. Moderate rates of inflation are not necessarily harmful to growth (Bruno and Easterly 1995; Barro 1997) or to savings (Hussein and Thirlwall 1999), but business confidence, and with it investment, including foreign direct investment, thrives best under conditions of political and economic stability (Fischer 1993).<sup>12</sup> As East Asia becomes more closely integrated with the global economy, conducive business conditions will become even more important.

Economic stability rests on a coordinated application of fiscal, mon-

etary, and exchange rate policies. Throughout the 1990s most East Asian countries—except Thailand—attempted to contain the growth of monetary aggregates and keep fiscal deficits to sustainable levels. When hit by the crisis, the affected countries were persuaded to follow the orthodox policy of raising interest rates to stem the outflow of capital and cut budgetary outlay so as to rebuild confidence in their finances. This proved to be harsh medicine and was diluted. However, because of policy actions, the launching of institutional reform, and strong export performance, interest rates declined, currencies subsequently strengthened, stock markets rebounded, and countries regained much of their earlier momentum. But the crisis and its aftermath indicated that in the event of a shock, which calls for a sharp rise in interest rates to restore confidence and prevent further weakening of the currency, fiscal spending may need to be increased to offset a drop in private spending and ameliorate the deflationary impact of tighter monetary policy on consumers and businesses. The desirability of such action and moderation in the use of monetary tightness become even more important when companies are highly leveraged.<sup>13</sup> The relatively low ratio of public debt to GDP in most East Asian countries also reduced the risks of running larger budget deficits over the medium term.<sup>14</sup>

The responses to the East Asian crisis indicate that the rules for dealing with shocks need to be broadened to take account of country circumstances and the possibility of contagion. Should governments continue to adhere to the fiscal fundamentals but respond to a banking-cum-currency crisis by mobilizing contingent spending plans to maintain aggregate demand, recognizing that such a move could worsen the outflow of capital? Is it the case that restricting capital movement through taxes or administrative measures may not always be suboptimal? What is the appropriate exchange rate policy for medium-sized and highly trade-oriented economies to follow? One thing is clear: a dogmatic line on either monetary or fiscal or exchange rate policies is not desirable. As Clarida, Calf, and Gertler (1999: 1703) observe, in the face of severe monetary shocks, monetary policy should not adhere to a simple rule. But on this point there is little theoretical or empirical work to guide policymakers, and it is “a fertile area for research.” Furthermore, while in normal times, prudent budgetary management with low sustainable deficits is desirable, if a crisis strikes,

policymakers need to examine their options carefully and weigh the tradeoff so as to avoid an unnecessary loss of output.

Fiscal action to control a deflationary spiral when the corporate sector is highly geared needs to be coordinated with monetary policy to limit interest rate spikes. In some cases, taxes on capital flows might be necessary to ensure that such policies lead to the least costly results and do not exacerbate the effects of the shock or delay adjustment.

Although the policy response to a shock has certainly become more nuanced, the East Asian crisis has not significantly altered our views on openness or on the steps toward achieving it. Banks should be well regulated. Financial management and the regulation of banks are now seen as much more critical to both growth and stability (Levine 1997). At the same time, the emergence of new products and new activities, the consolidation of financial entities, and the greater geographic scope of their activities have also confronted regulators with tougher challenges on how to attain efficiency while preserving the soundness of the financial system (Mishkin and Strahan 1999).

Banks, long accustomed to a comfortable and sheltered world of relationship banking, need to adjust to a more competitive environment in which foreign banks are a growing presence and higher-margin, consumer-oriented lending emphasizing service and new products will determine success (Wade 1998). In addition, banking cultures throughout much of East Asia are being pushed to adopt the practice of disclosure, to improve their system of evaluating credit risk, to pay greater attention to customer cash flow than collateral, to make branch offices more accountable to the head office, and to rely more on arm's-length dealing rather than on trust.<sup>15</sup> While the weaknesses of banks were one part of the problem, the deficiencies of non-bank financial institutions were even greater, and they exacerbated the effects of the shock (see Woo-Cumings, chapter 9 of this volume). In Japan, the housing loan corporations, or *jusen*, 70 percent of whose loans were collateralized by real estate, were at the heart of the financial crisis.

The crisis certainly revealed East Asia's deficiencies in these critical areas. But where countries achieved these objectives, an opening of the capital account did not increase the volatility of growth (Easterly, Islam, and Stiglitz 2000) and over time could promote financial development with its attendant allocative benefits.<sup>16</sup> Moreover, as fi-

nancial sophistication rises, preventing capital outflows becomes increasingly difficult (Dooley 1995), and derivatives make it problematic for even the most skilled regulators to contain inflows of short-term capital (Garber 1998).<sup>17</sup> China experienced large outflows during 1998–2000, and in spite of capital controls, the restrictions imposed by Malaysia were decreasingly effective by 2000 (“Funds Leave Malaysia Despite Capital Controls,” *International Herald Tribune*, December 5, 2000).

The crisis also focused attention on exchange rate policies. First it highlighted the dynamic triggered by the movements in the yen-dollar rate since the mid-1980s—the yen “carry trade” (McKinnon 2000). By putting upward pressure on the yen rate, the trading relationships between the United States and Japan pushed down interest rates in Japan and encouraged Japanese banks to seek higher—and riskier—returns in East Asia. It also encouraged other investors to borrow on the Japanese market and to place these funds in neighboring countries. The likelihood of being bailed out in the event of a crisis further emboldened banks and others and funneled large amounts of capital in what proved to be unwise investments in manufacturing as well as real estate (Overholt 1999). One lesson to be drawn is that in an integrated world, exchange rate coordination between key currencies may avoid conditions that can lead to a crisis. Unfortunately, pushing down the yen rate to enable Japan to run a large current account surplus, which accommodates its high saving and moderate investment rate, is likely to pose a serious challenge to attempts at coordination.<sup>18</sup>

A second and equally important lesson is that a policy regime based on a soft exchange rate peg coupled with sterilized interventions has serious drawbacks.<sup>19</sup> The former ultimately lacked credibility. The latter pushed up interest rates and stimulated further inflows. The crisis underscored once again the difficulties that can arise from a compromise between a fixed-rate regime—or monetary unification through dollarization or via a monetary board system with a key currency—or a freely floating exchange rate. Theory suggests that the choice of an exchange rate should be determined by the nature of expected shocks. If they are real, then a system of floating rates is advisable. If they are not, then fixed rates are more appropriate. When shocks come through the capital account and contain both real and nominal elements, the choice is unclear (Calvo and Reinhart 1999).

Recent experience has also lent weak support to theories suggesting that the likelihood of a currency crisis increases when the real exchange rate is overvalued relative to trend, credit growth is high, the ratio of M2 to GDP has risen (Berg and Pattillo 1999), the banking system is weak and undercapitalized, and countries have financed current account deficits with short-term borrowing (Dornbusch 2000).<sup>20</sup>

However, neither the East Asian crisis nor other currency crises in the 1990s have established the superiority of fixed or flexible rates. Although many commentators have pointed to the risks of pegging to the U.S. dollar, estimates of real appreciation of key East Asian currencies do not suggest much change in the years preceding the crisis. Only in Thailand was there any significant real appreciation. Even there, the change from peak to trough was 13 percent, and from the base value of 100, it was just 8 percent (McKibbin and Martin 1999). Moreover, some East Asian countries, notably Korea, registered a strong increase in the volume of exports.

The optimal regime ultimately depends on a range of factors peculiar to a country: size, openness, labor mobility, fiscal capacity, the size of reserves, the strength of the banking system, the credibility of legal rules and property rights, the willingness to integrate with trading partners, and, where the option is to adopt a monetary board, the political readiness to surrender control over key policy levers (Frankel 1999). For some countries, the lesson from the East Asian crisis is that a credible policy stance under conditions of openness, when much of their trade is denominated in dollars, is to opt for a fixed peg through a monetary board type of arrangement (Calvo and Reinhart 1999; McKinnon in chapter 5 of this volume). For others, the recent experience points to the advantages of greater exchange rate flexibility with an inflation target (Mishkin 1999). But exchange rate flexibility cannot be adopted after a crisis has already hit—Thailand's approach—or just before a crisis and after financial weakness is already apparent—the tack followed by Korea and Malaysia (Eichengreen 1999). It must entail a full-fledged shift to floating rates along the lines of Mexico, Brazil, and Colombia.

The future course of exchange rate policies in East Asia and other industrializing countries remains unclear, and there is bound to be a period of experimentation determined by progress with reform and the direction of political change. But the lesson emerging from

the second half of the 1990s is that currency management in the region was inconsistent with the increasing vulnerability of individual countries.

## PERSPECTIVES ON GROWTH IN EAST ASIA

In the early 1990s, our understanding of the determinants of growth in East Asia was assailed by contrarian evidence questioning the contribution of total factor productivity. At the start of the decade, human capital, physical capital, and labor inputs contributed about 60 percent to the growth of high-performing Asian economies (HPAEs).<sup>21</sup> Primary and secondary education were the largest contributors, followed by physical capital. Approximately a third of growth was derived from rising TFP. Productivity change in the East Asian countries was higher than that in other developing countries, although it was still lower than that occurring in the industrial countries. "All the HPAEs, except Singapore, [stood] up well in their ability to keep pace with the world's shifting technological frontier" (World Bank 1993: 57).

Shortly after publication of the World Bank study (1993), Young (1994b) and Kim and Lau (1994) challenged this position, finding that TFP made a negligible contribution to growth in much of industrializing East Asia. The principal drivers of growth were primarily physical capital followed by human capital, Krugman's perspiration variables.

These findings radically undermined the orthodox position and unleashed a torrent of econometric investigation (for a review of the recent literature on the sources of East Asian growth, see Crafts 1998; Felipe 1999). The results of the key research are summarized below.

This body of research has asserted the primacy of physical capital among the various sources of growth in East Asia, with labor and human capital second and TFP a distant third. Most of the East Asian economies still lag well behind the non-Asian G-7 countries (Canada, France, Germany, Italy, the United Kingdom, and the United States) and Japan in terms of TFP. Nevertheless, they do far better than other developing countries, in large part because of greater openness, better policies, and stronger institutions (Hahn and Kim 1999). They also relate to the scale economies achieved by East Asian coun-

tries through better management of capital (see Perkins in chapter 6 of this volume).

The variance in the econometric findings and the difficulty of reconciling the low TFP scores with the apparent success of East Asian countries in assimilating industrial technology have aroused a measure of skepticism and a search for other explanations (see tables 1.3 and 1.4). The skepticism derives from a resurgence of long-standing doubts about the robustness of concepts and techniques used to measure the sources of growth and about the quality of both the data as well as the deflators used to arrive at "adjusted" series (see Pack in chapter 3 of this volume).

To start with, there is the long-standing theoretical concern about finding a measure for capital as an index independent of relative prices and distribution. Growth accounting assumes that the interaction term between inputs such as physical and human capital is insignificant, whereas in practice this is unlikely to be the case.

In some cases, estimates are biased because constant returns and perfect competition are incorrectly assumed. In addition, because right-hand-side variables are measured with error, ordinary least squares

**Table 1.3 Sources of Growth in Europe and Japan, 1950–73, and in East Asia, 1960–94 (percent a year)**

Period and economy	Capital	Labor	Total factor productivity	Output
<b>1950–73</b>				
France	1.6	0.3	3.1	5.0
Italy	1.6	0.2	3.2	5.0
Japan	3.1	2.5	3.6	9.2
United Kingdom	1.6	0.2	1.2	3.0
West Germany	2.2	0.5	3.3	6.0
<b>1960–94</b>				
China	3.1	2.7	1.7	7.5
Hong Kong, China	2.8	2.1	2.4	7.3
Indonesia	2.9	1.9	0.8	5.6
Korea, Rep. of	4.3	2.5	1.5	8.3
Malaysia	3.4	2.5	0.9	6.8
Philippines	2.1	2.1	-0.4	3.8
Singapore	4.4	2.2	1.5	8.1
Taiwan, China	4.1	2.4	2.0	8.5
Thailand	3.7	2.0	1.8	7.5

Source: Crafts 1998.

**Table 1.4 Alternative Estimates of East Asian Total Factor Productivity Growth  
(percent a year)**

Economy	Young (1994a and b, 1995), 1966–90	Collins and Bosworth (1996), 1960–94	Sarel (1997), 1978–96	Adjusted (Young), 1966–90 <sup>a</sup>
China		4.6 <sup>c</sup>		
Hong Kong, China	2.3			2.4 <sup>d</sup>
Indonesia	1.2 <sup>b</sup>	0.8	1.2	
Korea, Rep. of	1.7	1.5		1.3
Malaysia	1.1 <sup>b</sup>	0.9	2.0	
Philippines		-0.4	-0.8	
Singapore	0.2	1.5	2.2	1.0
Taiwan, China	2.6	2.0		1.9
Thailand	1.5 <sup>b</sup>	1.8	2.0	

a. Adjusted (Young) uses revised factor share weights with capital assumed to have a weight of 0.35.

b. 1970–85

c. 1984–94.

d. 1966–91.

Source: Crafts 1998.

give biased and inconsistent results, and these can be exacerbated by the choice of countries and particular data sets. Last, it is argued that unless the elasticity of substitution is known, it is not possible to assign growth accurately to changes in capital intensity as against biased technical change. In other words, “Growth accounting exercises cannot distinguish between two different explanations of growth decomposition equally consistent with the time-series data: one arising from a production function with unitary elasticity and Hicks neutral technical change and another with an elasticity of less than one and labor-using technical change” (Felipe 1999: 30).

The attempt to find additional evidence to qualify or strengthen the aggregate analysis has led to microeconomic investigations of individual industrial subsectors, R&D in East Asian countries, the national innovation systems in place, and the role of trade and foreign direct investment. Howard Pack (chapter 3 of this volume) builds on his earlier work to show how East Asian economies have successfully tackled the assimilation of technology and begun contributing fresh technological insights of their own, insights that have resulted in a stream of patents, most notably from Korea and Taiwan.<sup>22</sup> Pack discusses the limits of the aggregative approach and then explores, in more qualitative terms, the avenues through which technology was

transferred to East Asia and absorbed by companies large and small across the region. Pack emphasizes the domestic effort that mediated the process of absorption and illuminates the enormous gains made by the East Asian countries, gains not registered by other developing countries with respectable rates of investment and stocks of human capital.

Pack also touches on the innovation systems taking root in several East Asian countries. These systems are positioning countries to contribute more actively to technical advance in a number of industries and to derive the full rents from commercially successful innovations, rents they cannot extract from borrowed technologies.

Even though the neoclassical revival in the 1990s shifted attention briefly back to capital accumulation as the primary source of growth in East Asia, the research it stimulated has again focused attention on TFP (Easterly and Levine 2000). While the industrializing countries of East Asia will continue to derive a large part of their growth from factor accumulation, over the longer term their convergence to the incomes of the advanced countries will depend on the speed of movement toward the technological frontier and eventually their ability to push this frontier outward in select areas. Thus assimilating and generating technological advances by creating the appropriate physical and institutional infrastructure will be necessary adjuncts to accumulation.<sup>23</sup>

How countries succeed in harnessing available technologies and then moving to the cutting edge of technological change is one of the most exciting areas of current and future research. The experience of those industrial countries that are among the most prolific producers of industrial innovation points to the intertwining of policies, institutions, industrial organization, size of market, and first-mover advantages. Although no single recipe emerges from this wealth of experience, certain common elements are also becoming sources of dynamism in some of the leading East Asian countries.

A strong, research-oriented university system, which complements vigorous research activities in corporations and other public or private institutes, appears to be a necessary condition for moving up the ladder of technology. Government policy and financial support for research activities have often proved crucial, but so has the commitment of the private sector, sharpened by competition policies pushing companies to retain or enlarge market share by way of innovation. Intellectual property rights instituted by the state have supported in-

novation in some sectors, as have regulatory policies in industries such as pharmaceuticals. In the United States, access to venture capital has promoted the growth of electronics and biotech industries, which derived their initial impetus from research funded by the Department of Defense and the National Institutes of Health. This abundance of venture capital arose out of institutional deepening in the financial markets, guided by a succession of government policy actions. In other countries, the banking system, vertically integrated corporations (some supporting intrapreneurial activities), or subcontracting networks have substituted for the lack of venture capital.

A large, sophisticated, and demanding market has been an asset for the United States, Japan, and some of the European countries. Such a market facilitates the launch of new products and is frequently the basis for first-mover advantages, which are responsible for the stability of firms in the chemical, pharmaceutical, and automobile industries. However, with the decline of barriers to trade, even firms in smaller countries are not overly constrained by market size if they have accumulated skills in marketing products worldwide (see Mowery and Rosenberg 1999; the papers in Mowery and Nelson 1999; Scherer 1999).

All of these lessons are being absorbed piecemeal by the East Asian countries. But the hardest step is the creation of the fundamental building block—a base of research-oriented universities and research institutes that induce creative work.<sup>24</sup> The importance of this has been formally recognized throughout the region and underscored by research on the role of TFP in growth. The difficult step for even the leading East Asian economies, such as Korea, Taiwan, Hong Kong, and Singapore, is to shift basic schooling away from rote learning without sacrificing their strengths in science and math. Next there is the need to encourage competition between universities and, through this, to instill a culture of excellence in research and develop the infrastructure for refereeing and disseminating research findings and strengthening the links between universities and the business sector (Lim 1999, Branscomb, Kodama, and Florida 1999). This could maximize the commercial utility of research, thereby encouraging the two-way flow of resources and talent, which has been critical to the success of Silicon Valley and the high-tech industrial networks around the Universities of Chicago and Cambridge.

## INDUSTRIAL POLICY IN THE 1990S

This rethinking of the role of technology in the context of growth points to the evolution of industrial policy in an integrated world. The 1980s closed with the literature emphasizing the drawbacks of “picking winners,” supporting them with directed credit from the banking system, and protecting them with trade barriers. Nevertheless, even some of the critics recognized the efficacy of industrial policy in a few East Asian countries at an early stage of their development, under special circumstances, external as well as internal. These included dynamic strategies to advance the prospects of individual sectors by enabling them to exploit economies of scale, technological spillovers, and possibilities of learning, and to coordinate their own investment with downstream producers (Stiglitz 1996).<sup>25</sup>

The decade of the 1990s saw the continuing retreat of industrial policy in East Asia, as countries came to recognize the advantages of openness and accepted the disciplines of the World Trade Organization.<sup>26</sup> Research into the merits of industrial policy, as practiced in East Asia, also focused attention on costs, in the rare instances where the presence of externalities argued for preferential treatment—as with the development of high-technology industries such as electronics and semiconductors in Malaysia, Taiwan, and Korea and auto parts in Thailand (Mathews and Cho 2000; and Jomo, chapter 12 in this volume)—and highlighted the diminished relevance of such policies in the new global environment.<sup>27</sup> In a world where the trend is for companies to spread the burden of R&D and gain access to markets through joint ventures, mergers, and alliances, the role of industrial policy is increasingly limited to those few cases in which countries, through skill development and research, build competitive sectors able to produce high-technology products for a global market (Jomo, chapter 12; Smith 1995; Krugman 1986).<sup>28</sup>

Some notable findings from the research on Japan are that subsidies had, on balance, shifted resources from high- to low-productivity uses (Noland and Bergsten 1993), and the bulk of the assistance provided through favorable tax treatment, subsidized credit, and protection had gone not to the fastest-growing subsectors, but to declining industries or mature industries with modest future prospects, such as coal, petroleum, and textiles (Beason and Weinstein 1996).<sup>29</sup> Indus-

trial policies successfully assisted the growth of industries such as household sewing machines (1970s) and semiconductors and information technology (1980s). But government support was of little relevance to Japan's consumer electronics industry in the 1950s and 1960s—and at times was obstructive (Partner 1999). It was ineffective in the case of biotechnology and played a small role in the development of motorcycles, audio equipment, autos, game software, office equipment, robotics, and soy sauce (Porter and Takeuchi 1999; Porter, Takeuchi and Sakakibara 2000; Okimoto 1986; Imai 1986). Market incentives, the capacity to identify and exploit opportunities, research skills, and networking enabled these industries to thrive. They are also the ingredients that matter most in today's globalizing environment.

Research on East and Southeast Asian economies during the 1980s and 1990s has drawn attention to wasteful investment in metallurgical, chemical, and transport subsectors.<sup>30</sup> Such investment was made possible by directed credit to select business groups, and some of the plant was put up on the government's instruction. Directed credit and tax privileges that specifically nurtured large industrial conglomerates (called *chaebol* in Korea) also brought into existence an industrial structure where control over assets—directly or indirectly—was concentrated in the hands of a few wealthy and politically influential families (see Woo-Cumings, chapter 9 of this volume). In fact, such concentration was not peculiar to Korea. Claessens, Djankov, and Lang (2000) point out that most of East Asia's corporate assets, other than in Japan and the transition economies, are controlled by a small number of families.

By 1995, 41 percent of industrial value added and 16 percent of gross national product (GNP) were in the hands of the top 30 Korean *chaebol*. This had implications for productive efficiency, governance, and the political economy of decisionmaking, the full consequences of which became apparent at the time of the crisis in 1997 (see Woo-Cumings in chapter 9 of this volume). A study of Korean industry by McKinsey and Company (Baily and Zitzewitz 1998) shows that although Korea's ratio of capital to labor was only a third of the U.S. level, capital productivity was declining and in 1995 was only 5 percent above that of the United States. Prior to the crisis, profitability of the top 30 *chaebol* was less than the cost of debt. This story was further elaborated through an analysis of individual subsectors. For instance,

food processing, with capital intensity and technology equal to that of American companies, could only achieve 50 percent of the productivity levels attained by firms in the United States. Similar results were obtained for autos, semiconductors—where Korean productivity is half that of the leading U.S. firms—and confectionery, where a poor product mix, overcapacity, and concern for sales over profits result in TFP of 42 percent, even though capital intensity exceeds that of the United States.

In part this is the outcome of rapid growth fueled by cheap credit in a protected environment. Borensztein and Lee (1999) find a negative relationship between lending and loan size, on the one hand, and average profit rates, on the other, during 1970–90. Industries with large firms were also more likely to receive credit. For example, industries with low profit rates and a few large firms, such as aircraft and shipbuilding, had good access to credit. In other words, industrial policy was instrumental in directing credit to the less efficient parts of the economy, in retarding the maturation of the financial sector, and in bringing about a steady accumulation of nonperforming assets. In 1986, the nonperforming loans on the books of the five largest commercial banks amounted to 11 percent of credit and were three times their net worth. Although the provision of directed credit began to taper off in the 1990s, the influence of the Ministry of Finance over banks remained strong (on industrial policy and the rise of the *chaebol*, see Woo-Cumings in chapter 9 of this volume).

Cho and Kim (1995) observe that the use of directed credit by the Korean government, over an extended period of time, was damaging for a number of reasons.<sup>31</sup> In an oligopolistic market environment, the implicit coinsurance of bank lending by the government induced banks to lend for and encouraged firms to invest in risky projects. Commercial banks in Korea functioned almost like development banks and ended up being saddled with huge nonperforming loans equal to almost 20 percent of GDP, the cost of which will be borne largely by the taxpayer. Problems faced by banks were mirrored in deteriorating industrial performance, starting with the bankruptcy of Hanbo, the 14th largest *chaebol*, in January 1997. Five others followed in quick succession—Sammi, Jinro, Dainong, Ssangyoung, and Kia (Lee 1999).<sup>32</sup> In 1998 Daewoo, the second-largest *chaebol*, became a victim of corporate excess and in spite of determined efforts to rescue the firm by the government and its creditors, went into liquidation in 2000. In spite

of the economic rebound in 1999–2000, parts of the Hyundai and LG *chaebol* also experienced severe distress, with Hyundai Engineering and Construction teetering on the verge of bankruptcy in the last quarter of 2000.

Although Thai governments did not use directed credit to the same extent, implicit guarantees extended to the banking system because of close government-business-banking relations gave rise to almost equally serious moral hazard problems. Dollar and Hallward-Driemeier (1998) find that the financial institutions routinely extended loans without bothering about the creditworthiness of the borrower.

Southeast Asian countries used industrial policy more sparingly, but, if anything, they were even less successful in achieving desired outcomes. Indonesian agencies were unable to monitor subsidies and were susceptible to capture by business interests. Their attempts to promote the auto, aircraft, and plywood industries were expensive failures. This experience was repeated in Malaysia, where state-owned industries—basic metals, machinery, petrochemicals, paper, and building materials—did poorly (Smith 1995). And the survival of the two Malaysian car companies Proton and Perodua has depended on tariffs of 140 to 300 percent on vehicles and 42 to 70 percent on imported kits and components (“Moment of Truth,” *Far Eastern Economic Review*, November 23, 2000; “Proton’s Dilemma,” *Oxford Analytica*, Malaysia , October 29, 2000). Thailand largely directed assistance to industries whose export performance was deteriorating.<sup>33</sup> And in the Philippines, preferential credit as well as other public policies were annexed by well-connected elites with the state—and the country—receiving nothing in return (Hutchcroft 1999).

The capture of industrial policy by elites is perceived more clearly now than in the past and has inflicted costs in excess of the budgetary outlays. Crony capitalism was not just a problem in the Philippines. Non-*pribumi* businesses in Indonesia (mainly owned by ethnic Chinese) connected with the Suharto family imposed large burdens on the economy (Hill 1997; Emmerson 1998). Even in Korea, the discretion enjoyed by government officials gave rise to rent-seeking opportunities that proved irresistible. For instance, the \$37 billion Yulgok defense procurement program was also used as a vehicle for technology transfers to local companies being groomed as suppliers to the Korean military. As these companies evolved during the 1970s and 1980s, some of

their profits found their way to defense officials managing the industrial policy. When these payments were investigated in 1993, two former defense ministers were convicted of accepting kickbacks, and 39 generals were sacked, reprimanded, or jailed (Ades and Di Tella 1997: 1024).

The power of major corporations, banks, and individual businessmen in East Asia and the close links that developed between the corporate sector and banks also affected the governments' ability to take quick and decisive action to restructure or close companies and financial entities after the crisis (Overholt 1999; Lincoln 1999).<sup>34</sup> The slow pace of reform is traceable, in part, to the corporate structure created by industrial policy. It has contributed to the difficulty of introducing disclosure rules, bankruptcy laws, and measures that would result in a more competitive market for corporate control, and lower the barriers to foreign direct investment in certain sectors.

Arguably, the policies introduced since 1998 reflect a widespread realization that in all but a narrow set of cases, the costs of subsidies significantly outweigh the benefits. With the exception of exports from Korea, exports of countries using export subsidies have grown no faster than those of countries that have not, and in fact subsidies can be welfare reducing (Panagariya 2000). Acceptance of WTO disciplines by East Asian countries—to be joined by China—indicates that industrial policy, as practiced prior to the mid-1980s, is seen to have outlived its usefulness, and a more market-based approach should guide future development. Such rethinking is also related to a more realistic assessment of bureaucratic capability.

The emergence and growth of a large nonstate and private industrial sector in China, starting in the late 1970s, reveal the power of market incentives to galvanize entrepreneurial initiatives and spur exports without any guidance from the central government ("Private Sector," *Oxford Analytica*, China, December 18, 2000). The share of the nonstate sector in industrial output rose from 22.4 percent in 1978 to 73.5 percent in 2000, while that of the private sector went from 2 percent in 1985 to 16 percent in 1998. Moreover, this blooming of industry in rural areas, townships, and small cities has occurred in the absence of clearly defined property rights and the still-embryonic state of infrastructure for enforcing business contracts. As Justin Lin and Yang Yao, Dwight Perkins, and Yingyi Qian show in chapters 4, 6, and 7, the dismantling of price and regulatory controls was the trigger and

set the stage for the development of collective and private enterprises. The building of a market system was sustained by a succession of reforms, by investment in infrastructure, and by the easing of access to capital. What is remarkable is how the share of nonstate enterprises rose, in the face of benign neglect on the part of the government and the continuance of credit policies that direct more than 70 percent of bank lending to state enterprises. This is very much of a piece with the East Asian miracle during its later phase, beginning in the 1980s, when the emphasis on market forces was on the increase.

China was not included in the earlier World Bank study, but in many respects its performance was comparable to that of some of the other leading economies of the region. In addition, the continuing liberalization of China's economy during the 1990s is a major input in the rethinking of the East Asian experience.

### THE CHANGING AUTONOMY AND ROLE OF BUREAUCRACY

Earlier views on industrial policy linked its utility to the existence of a bureaucratic apparatus committed to long-term development, yet shielded from the full force of political and corporate pressures.<sup>35</sup> A tiny number of countries were able to both build and use economic bureaucracies effectively. But in the majority of cases, the capacity to insulate technocrats from such pressures proved difficult. This became even more apparent in the 1990s. As democratic forces gathered momentum in East Asia, much evidence of corruption was uncovered, and the exigencies of short-term political calculation began to outweigh longer-term strategic concerns. The nature of the response of key government agencies throughout the region prior to, during, and in the aftermath of the crisis points to their susceptibility to pressure from powerful interest groups. Furthermore, the difficulty that even East Asian bureaucracies have experienced in attracting and retaining individuals of high technical caliber, as, for example, in Malaysia, indicates that in a market environment talent gravitates, as it should, to the private sector. Only Singapore, at considerable cost, has sustained a meritocratic public bureaucracy.

Clearly the circumstances have changed, and what Park Chung Hee could achieve in the 1960s and 1970s is difficult to replicate.<sup>36</sup>

The disarray in Korean policymaking circles during 1996–98, the tension between agencies, and the pressures impinging on regulatory bodies attempting to design and implement reforms in the postcrisis years all point to a changing political environment in which bureaucratic autonomy is neither desirable nor achievable (“Corporate Difficulties,” *Oxford Analytica*, South Korea; November 3, 2000; “Lessons Unlearned,” *Far Eastern Economic Review*, September 21, 2000). Similarly, as Okazaki notes in chapter 8 of this volume, deliberation councils were an effective two-way transmission mechanism in Japan from the 1940s through the early postwar decades. But in the 1980s and 1990s, both the need for such coordinating bodies and their capacity to fulfill their earlier role have diminished, and micromanaging by public agencies is dysfunctional (see Woo-Cumings, chapter 9 of this volume).<sup>37</sup> The trend in Southeast Asia also suggests that the heyday of the technocratic bureaucracy at the helm of a developmental state may be past. Hal Hill described the policy inertia in Indonesia starting from the early 1990s: “The public policy agenda [was] captured by debates over irrelevant, trivial, or misleading issues—serious reform initiatives [were] hampered by these debates” (Hill 1997: 257). The governments that have come to power since 1999 are less cohesive and cannot muster a core of highly trained individuals such as the Widjojo Group, which provided economic leadership in the 1970s and 1980s. In addition, BAPENAS, the National Planning Agency, much like its Korean counterpart, has lost its influence to a political body, the National Economic Council (Hill 1999). Thai policymaking and regulatory agencies also have had to come to terms with the realities of democratic politics, which involve greater sensitivity to political concerns and more arm’s-length dealings with business (Unger 1998).<sup>38</sup>

#### NATURE OF GOVERNANCE AND DEVELOPMENT OF THE LEGAL SYSTEM

A decade ago, governance was not a major concern for the East Asian region. The region was moving, along with other parts of the world, toward greater democratization and the building of legal institutions.<sup>39</sup> These were seen as normal accompaniments to the growing role of

the market economy and increased openness. Throughout the 1990s, these developments focused attention on governance at many levels. Improved communications, the Internet, the consciousness-raising activities of many international nongovernmental organizations, and the widening acceptance of rules appropriate for democracies further underscored the significance of good governance. As a consequence, researchers began to take greater interest in the effects of corruption, nepotism, crony capitalism, and weak corporate governance and to empirically estimate their influence on development (Mauro 1995). A series of high-profile trials of past Korean presidents, of former President Ferdinand Marcos in the Philippines, the impeachment of President Estrada of the Philippines in 2000, and scandals involving politicians in Japan highlighted the magnitude of corruption in countries with apparently high standards of governance. They also revealed how a systematic pattern of bribery could seriously undermine policymaking where the rules for transparency and accountability were not in place or, even if they were, tended not to be enforced (on the relationship between banks and government in Japan, see Lincoln 1999).

Senior policymakers, specialists, and professionals questioned by David Hitchcock in June 1996 all put political problems near the top of their concerns. "Governance was a central issue everywhere. In Singapore, Malaysia, Indonesia, and China, some intellectuals, cultural figures, and activists believed governments must become more responsive to people. . . . In Thailand . . . respondents reported widespread disillusionment with politics . . . we have the form but not the substance of democracy. In the [other countries] maintaining political stability was a prime government objective, but some thought it was being overused to keep the lid on freedom of expression and to stay in power" (Hitchcock 1997: 123–24). As Stephen Haggard observes, "Indonesia's difficulties can be attributed in part to a highly centralized regime accountable to relatively narrow constituencies and lacking both effective checks on executive authority and a succession mechanism." In many countries in the region, "close political relationships between politicians and business constituencies and particular firms have also been responsible for the crisis." Because of misguided industry policies, the moral hazard created by government intervention, "weak financial regulation, and poor systems of corporate governance were important precursors to the crisis" (Haggard 1999: 35, 37).<sup>40</sup>

A better understanding of governance at the key interstices of the economic system is now viewed as being at least as important as factor accumulation. It has a significant bearing on the nature of the industrial-financial policies discussed above as well as the legal system. Although a strong empirical link between democracy and growth has not been identified (Helliwell 1994; Barro 1997), prosperous countries are more likely to be democratic (with some of the effect coming from education). In addition, the vast political science literature suggests that democracy promotes good governance, especially if certain procedural and constitutional rules are in place: rules for the division of responsibility between central and subnational entities, rules for relations between the different branches of the state, rules determining representation by different groups and regions of the country on legislative bodies, and rules inducing the formation of disciplined parties and determining the timing of elections. Adapting these rules to East Asian conditions in order to raise accountability within the existing democratic frameworks calls for fresh thinking and research.

Protecting the rights of investors is a second facet of governance that acquired more prominence in the 1990s. With the majority of large companies in East Asia being closely held or controlled by families, minority shareholders have difficulty expressing themselves and safeguarding their interests. Problems of agency are serious, and the crisis showed that there is little by way of legal redress for shareholders dissatisfied with the performance of corporate managers who respond mainly to the principal owners. Corporate governance in East Asia has avoided external monitoring as well as internal oversight. "It has been characterized by ineffective boards of directors, weak internal control, unreliable financial reporting, lack of adequate disclosures, lax enforcement to ensure compliance, and poor audits" (World Bank 1999a: 67–68).

The absence of adequate investor protection through legal channels has impeded financial broadening, constrained the dispersal of share ownership, and sacrificed efficiency in the allocation of capital across firms (La Porta and others 1997, 1999). Weak minority shareholder rights are also a feature of some of the European countries, but these countries have created substitute mechanisms to counterbalance the power of managers or dominant private shareholders. These con-

sist of banks or other institutional investors that are represented on boards of directors and wield significant power, aside from exercising surveillance over companies in which they hold a stake. Such institutional investors provide a partial solution to the agency problem and the weakness of minority investors.

East Asian countries have not yet evolved toward this model, although in the precrisis period, there was considerable interest in the Japanese main bank model.<sup>41</sup> Most financial or nonfinancial institutions are controlled either by the state or by corporate interests and generally have not attempted to enhance accountability and the voice of minority shareholders. The role of foreign financial entities is quite small, but it is growing in spite of domestic opposition in Thailand and Korea, and over time could affect the role of banks in corporate governance. However, until reforms and foreign investment begin to transform governance, dominant shareholders will be encouraged to seek even tighter control through direct ownership of shares and cross-shareholdings (Zingales 1994).

The crisis brought the situation to a head and exposed the true extent of mismanagement, poor investment decisions, and risk taking by enterprises. Subsequent attempts to restructure, revive, or liquidate companies in whole or in part have shown both the extent to which the rules favored the principal owners and the difficulty of changing the rules so as to give due recognition to the interests of other shareholders. The existing system, with its powerful and entrenched interests, is strongly resistant to reform that would distribute rights more fairly. However, as the East Asian economies revived in 1999–2000, the realization that lack of transparency, weak standards of accounting and auditing, and unenforceable bankruptcy laws are damaging is leading to change albeit at a slow pace (Overholt 1999).

Reform of the legal system that complements the effort to improve corporate governance has been equally sluggish and is related to the concentration of corporate ownership.<sup>42</sup> But change is ongoing in most East Asian countries, alongside the trend toward democracy and the increasing openness to trade as well as foreign direct investment (FDI).<sup>43</sup> The importance ascribed to governance in the 1990s has brought legal institutions into the mainstream of development thinking. Starting with proxy variables for institutional characteristics, economists have begun delving into the making of laws, the costs of

assigning rights, legal procedures, the infrastructure for implementing laws, the willingness to observe the law, and the legal tradition guiding evolution in individual countries.<sup>44</sup> One widely noted finding is that countries adopting the civil law tradition from continental Europe offer weaker protection to investors than those conforming to the English common law tradition, made by judges and subsequently incorporated into legislation. This is reflected in financial market development and the quality of corporate governance, both of which tend to lag behind when investor protection derives from law that is defined by scholars or legislators and is anchored in ancient Roman law (La Porta and others 1997 and 1999).

When viewed over the span of two decades, the legal systems in most East Asian countries have become more supportive of market-based rules for contracting, property, and other rights. Bankruptcy laws also are being pushed closer to the norms of industrial countries.<sup>45</sup> The crisis lent urgency to this process, and some of the momentum gained has persisted, although the opposition to corporate and financial restructuring has mounted steadily (World Bank 2000b; "South-east Asia's Problem Trio," *Economist*, December 2, 2000; "Foreigner Friendly," *Economist Intelligence Unit*, Business Asia: October 16, 2000).

In Korea legal institutions have increasingly circumscribed government discretion since the mid-1980s. For example, enforcement of the competition law shifted from the Ministry of Finance and Economy to a legally independent agency in 1991. Following the onset of the crisis in 1997 and the election of a new government later in the year, this agency acquired greater autonomy, political clout, and ability to challenge the state in court (Pistor and Wellons 1999: 78). By comparison, the influence of the Ministry of Finance waned, and some of its regulatory functions were transferred to the Financial Supervisory Commission, which has taken the lead in introducing corporate and financial sector reform ("Power Fades at Korea's Finance Ministry," *Wall Street Journal*, June 25, 1999).<sup>46</sup> A measure of the change in protection afforded to investors was the aggressive stance taken by the government against Hyundai, the largest *chaebol*, for not protecting shareholder rights while the founder's two sons feuded over who would control the vast conglomerate. The Ministry of Finance claimed that Hyundai had seriously damaged transparency, responsibility, and credibility in business practices by treating management control as an in-

heritance ("Hyundai May Be Censured for Ignoring Shareholders," *Financial Times*, March 28, 2000). This came on the heels of a landmark decision by the government, Korean banks, and foreign creditors to break up Daewoo, Korea's second-biggest conglomerate.

These are major developments. Whether they will speed up Korea's convergence toward western legal systems and promote the restructuring of businesses and systems of governance will depend on domestic political and economic trends, the pressures exerted by globalization, and the greater penetration of foreign economic interests.

Such factors also will determine the direction taken by three other countries in the region: Indonesia, Malaysia, and China. The first two have no tradition of judicial autonomy. In Indonesia the Justice Ministry administers the civil and criminal courts and decides on judicial appointments, promotions, and salaries. Moreover, because of the judiciary's connections with military and business elites, there is little demand from the bench for greater autonomy. Most disputes are settled out of court, usually under the supervision of the police, whose role until recently has been larger than that of the judiciary.

The longer-run effects of the crisis, pressures to decentralize, and the declining influence of both Golkar (the former ruling party) and the military could lead to institutional changes that strengthen the judiciary. Attempts to augment the bankruptcy law in order to cope with businesses and banks hit by the crisis are a step in that direction. Academics are also calling for judicial independence. But much will depend on the government's support and a spreading demand for rules that safeguard rights. Either way this will be a live issue for some time, especially if power is dispersed away from the center through demands for greater regional autonomy ("Indonesia: Judicial Independence," *Oxford Analytica*, March 11, 2000).

Relative to Indonesia, Malaysia, with its common law system and its rule-based market economy, has a deeper-rooted and more effective judicial system. In fact, on commercial matters and on the protection of private property, the courts apply the law firmly and with little evidence of corruption. But the appearance of an independent judiciary is deceptive, and executive powers were growing in the late 1990s. Undergirding the power of the executive is the Internal Security Act, which permits a suspension of constitutionally guaranteed freedoms, as well as other statutes such as the Sedition Act and the Securi-

ties Act, giving the state latitude to charge individuals with specific political offences. In the economic sphere, the state has become increasingly assertive in allocating resources and embarking on sweeping changes, such as the move announced in September 1999 to merge the country's 58 banks initially into six groups ("Malaysia: Bank Controversy," *Oxford Analytica*, March 24, 2000). This was subsequently relaxed in the face of opposition from the banking community to permit the formation of ten groups. Although the government's actions can be subjected to judicial review, "courts seem to invoke self-restraint over cases involving the alleged executive abuses of power" (Pistor and Wellons 1999: 91) and are apparently reluctant to take an independent line when dealing with cases involving state or UMNO (United Malays National Organization)—the ruling party-managed enterprises ("Malaysia: Judicial Autonomy," *Oxford Analytica*, March 29, 2000). More troubling is the weakening protection of intellectual property rights and the use of the Internal Security Act to arrest brokers and currency traders on charges of financial sabotage.

Shifts in Malaysian politics might lend weight to the still-muted demands for judicial autonomy. Many elements of an effective judicial system are in place, but the future is still uncertain. The judiciary could emerge as a pillar of good governance, but that would require readiness on the part of the government to exercise restraint.

Whereas by the 1960s and 1970s, other East Asian countries already had the rudiments of a legal system geared to the market, China had to commence building one from scratch. In a little more than 15 years, the Chinese have greatly increased the pool of lawyers, assimilated laws, and instituted legal procedures. But the unfinished agenda of legal reform to support radical changes in governance remains vast. Rules and judicial practice still differ markedly from those of industrial countries. The state must approve all foreign investments in local business. When administrative power is misused, individuals can seek redress, but not when the Communist Party is involved. Furthermore, judges are inadequately trained, and many are drawn from a military background and susceptible to influence by the political authorities. Moreover, the courts cannot challenge the right of the police to impose administrative punishments and send people to jail ("China: Rule of Law," *Oxford Analytica*, October 25, 1999; "China: The Legal En-

vironment," *Oxford Analytica*, July 29, 1998). There are, in addition, many areas where transparency is lacking and mechanisms of enforcement are poorly specified. Thus the absence of judicial independence and the rule of law partly vitiates the solid progress made in formulating civil and criminal laws and in engendering a social consensus on the significance of law in society ("A Slow Move to Justice," *Economist*, February 5, 2000).

From the late 1990s onward, most East Asian countries have enlarged the role of the market, pursued economic openness, adopted a more liberal political regime, and in some instances decentralized fiscal and economic decisionmaking. All these have raised the salience of governance and brought to the forefront issues pertaining to institutional development, especially in the context of the legal system. Hence, when we rethink the East Asian miracle and consider the priorities for the region, the mechanisms of governance and the assignment and enforcement of rights are among the ones deserving the closest attention.

### TRADE RATHER THAN EXPORT-LED GROWTH

Earlier views on East Asia's success have frequently stressed export orientation as a major source of growth competitiveness and technology absorption. This was one of the chief lessons communicated to other countries attempting to imitate the region's performance. In fact, some recent research continues to link growth with exports.<sup>47</sup> But a closer look at the dynamics of growth in East Asia and changes in industrial productivity is finding that exports might have played a smaller role than was previously thought.<sup>48</sup>

Two kinds of results have challenged the primacy of exports. One is the finding, based on data for the United States and a handful of developing countries, that high productivity in certain industries is what leads to exports and that causation does not generally run in the other direction. Second is the finding, based on empirical tests using data for Japan and Korea and presented by Lawrence and Weinstein in chapter 10 of this volume, that imports have a stronger effect on productivity than do exports. It is also borne out by data on U.S. industries. This can be explained by the competitive pressure that imports im-

pose on local producers, which drives some of the weakest out of business and forces the survivors to become more efficient. Imports can also influence productivity through another channel. By embodying technological gains achieved by the country of origin and other countries contributing to the product, imports are an effective vehicle for assimilating new technology (Bayoumi, Coe, and Helpman 1996). Capital investment has become a more important vehicle for technological advance because of major gains embodied in equipment—computers, telecommunications systems, and automated assembly lines. By one estimate, nearly 60 percent of recent gains in output in the United States can be traced to such investment (Greenwood, Hercowitz, and Krusell 1997). Continued protection of producers in East Asian countries has contributed to their inefficiency and is likely to be a key factor behind the slow increase in TFP (McGuire and Schuele 1999).

The relationship between openness and growth appears to be fairly robust (Sachs and Warner 1995, Edwards 1999, Frankel and Romer 1999, Irwin and Tervio 2000), and this aspect of the miracle does not need to be reconsidered. However, the balance has shifted between exports and imports as sources of growth, with imports seeming to contribute more to productivity than exports. The lowering of trade barriers during the 1990s is likely to have bolstered East Asia's performance, and future commitments to reduce tariffs should be equally advantageous, especially for countries such as China. But East Asian economies will have to cope with some transient dislocation and unemployment as a result of increased imports.

## **REGIONAL INTEGRATION AND POLICY**

The East Asian region became more integrated in the 1990s because of intraregional trade, FDI, and labor flows in Southeast Asia. Exports among East Asian countries rose from 32 percent of total exports in 1990 to 40 percent in 1996. If Japan is included, they amounted to more than 50 percent. Nearly 78 percent of the capital inflow into China through the mid-1990s was from Hong Kong, Taiwan, and Macao. Although Southeast Asia's share was just 5 percent, it is growing steadily. Rising incomes and improvements in the quality of the goods produced are contributing to the integration. But other forces

are at work as well. One is the increased migration of some Japanese industries to China and the Southeast Asian economies as the yen becomes stronger. This is enlarging Japan's FDI in the region. In the past, Japanese firms that established subsidiaries in other East Asian countries mainly sold their products on local markets or exported them to third countries. Now a rising percentage is being exported back to Japan. These changes in the pattern of FDI and associated trade flows are described by Urata in chapter 11 of this volume.

Another facet of integration is in the financial sphere, abetted by the regional Chinese network. Chinese businesses have traditionally invested a sizable part of their capital in the region, and to contain risk they have attempted to maintain a diversified portfolio of assets across countries. This has been facilitated by the opening of capital markets and the easing of regulatory controls on FDI. In fact, the volume of intraregional FDI, excluding flows from Japan, is sizable.

Apart from the intraregional circulation of capital, East Asia is the recipient of FDI, portfolio investment, and short-term capital from outside the region. Reputation, and the promise of large returns, has been a significant factor pulling in the non-FDI flows, but as the crisis of 1997–98 showed, reputation can be a two-edged sword. When the strength of one East Asian economy came under suspicion, investors poorly informed about the fundamental resilience of other economies began withdrawing funds from across East Asia. The speed and extent of the contagion revealed another side of regional integration: outsiders increasingly perceive East Asian countries as sharing many common attributes, both strengths and weaknesses.

The process of integration, real and assumed, also has implications for the conduct of policy and for institutional infrastructure. If the possibility of contagion in the event of a crisis afflicting one country is here to stay, then the advantages of undertaking regional coordination of policy and harmonizing regulatory institutions need to be explored. Continuing globalization and the greater integration of East Asian countries, both regionally and with the world economy, can enhance their development prospects. The increase in trade and capital flows during the 1990s was a source of demand, resources, and technology, fueling growth in all the regional economies. But integration also increases the risk from speculative attack under a regime of managed exchange rates.

Clearly past arrangements, which were adequate through the early 1990s, will need to be modified. One direction is to take a different approach to exchange rate policy, as discussed above. Another approach, which can be pursued in parallel, is to improve policy coordination and rely more on regional mechanisms for monitoring performance, reporting, benchmarking, and pooling resources for use in a crisis, subject to criteria that minimize moral hazard.<sup>49</sup> A third step, which complements the others, is to scale back trade barriers progressively, a process that was slowed by the onset of the crisis and the attendant increase in unemployment. A fourth is to harmonize key rules of business, such as auditing, accounting, and disclosure practices.

Policy coordination has a checkered and uncertain history. To yield the desired results, it must be preceded by a long spell of institution building. Some building blocks, such as the Association of Southeast Asian Nations (ASEAN) and the Asian Free Trade Area (AFTA), are in place, and bilateral negotiations are ongoing between Korea and Japan for a further easing of trade barriers in some sectors. But to make these building blocks into effective bulwarks against shocks will require converting ASEAN, for instance, from a forum of quiet and unobtrusive diplomacy based on consensus into a body capable of negotiating a coordinated set of policies and inducing members to implement them. A freeze on the membership of ASEAN to the current 10 could be the start of a process toward institutional deepening. However, ASEAN must overcome a variety of tensions before the regional approach to decisionmaking can contribute to economic management in a globalizing world. The gap between the richer and poorer countries in ASEAN is a source of friction and conflicting demands. Several members are reluctant to press ahead with tariff reduction agreed upon under the AFTA. And centrifugal pressures in Indonesia are influencing the government's ability to participate in or to make commitments on regional issues.

Other forces, such as competition with China, which may soon become a member of the WTO, are forging greater cohesion among ASEAN members, but such competition can also make it harder for all the major East Asian countries to find common ground on critical intersecting areas of policy ("ASEAN Membership Moratorium," *Oxford Analytica*, March 23, 2000).

The big shift from the late 1980s, accelerated by the crisis, is that all of East Asia is looking at the European Union, exploring the benefits of regionalization, assessing harmonization, and analyzing the benefits of adopting a single currency (Nicolas 1999). East Asian economies are also discussing the possibility of creating an Asian Monetary Fund and considering whether there might be some utility in sacrificing a degree of sovereignty on policymaking so as to buy insurance against external shocks (Sakakibara 2000).

## CONCLUDING OBSERVATIONS

It would not be far-fetched to say that rethinking the East Asian miracle has been ongoing since the publication of *Asia's Next Giant* (Amsden 1989), *Governing the Market* (Wade 1990), and "A Tale of Two Cities" (Young 1992). The tempo quickened following the launch of the *East Asian Miracle* (World Bank 1993). It received a further boost when the "tigers" began slowing in the mid-1990s. The East Asian crisis confirmed the fears of the critics. But it also nudged the true believers toward a revival of the faith and a yearning for the days when authoritarian regimes with enlightened bureaucracies could pursue long-term goals through industrial policy and a tightly sequenced opening of the economy. Nineteen ninety-eight was a difficult year, when irrational pessimism, laced with glee over the humbling of the seemingly irrepressible East Asian economies, threatened a self-fulfilling prophecy that could substantially erode close to 50 years of hard-won prosperity for the entire world.

The three years of breathing room provided by the recovery in East Asia and continuing expansion in the industrial countries restored a degree of calm. We are now in a position to weigh a decade of experience more dispassionately and to marshal a wealth of research to arrive at a measured assessment of the key policies and institutions responsible for East Asia's performance.

The chapters in this volume take stock of what is arguably the most exciting development experience available to us. Measured in terms of GDP growth per capita, gains in welfare, and poverty reduction, East Asia has certainly outpaced other developing regions. Viewed from the perspective of macroeconomic policy management, most East Asian

economies have successfully pursued openness, fiscal and current account balance, and stability. A few countries effectively used industrial policy in the early stages of development to promote the growth of key subsectors or coordinate industrial change as shown by Okazaki. Others deployed trade and incentive policies to attract FDI and to build a base of export-oriented industry. In China's case, reforms created a vast rural and township industry that presently accounts for close to half of the country's industrial product.

In other respects, East Asia's record has been mixed, with uneven policies and gaps in institution building becoming apparent in the 1990s. In particular, the crisis of 1997–98 forced observers and policymakers to reevaluate the approach to development that had been broadly accepted as workable until shown to be problematic in a globalizing world.

The chapters in this volume draw attention to the revealed weakness of exchange rate policies based on a weak peg and sterilization. They discuss the drawbacks of partial capital account liberalization in the absence of regulatory measures ensuring financial strength and the ability to absorb and mediate capital inflows efficiently.

Although East Asian economies gradually dismantled industrial policies during the 1990s, the effects of close government, finance, and business relationships linger and are examined by several authors in this volume. By inducing the accumulation of nonperforming assets in banks and a concentration of corporate ownership, these relationships slowed financial development, impeded robust corporate governance, and hampered the emergence of legal institutions. The issue of weak corporate governance is clearly of vital importance and is analyzed by several contributors to this volume. However, as Joseph Stiglitz notes in the concluding chapter, we must not lose sight of the counterfactual: Could East Asia without industrial policy have done much better than it actually did? The experience of the 1990s and the intense debate on the sources of East Asian growth highlighted not only the region's continued dependence on factor inputs but also the urgency of building capacity to participate more actively in technological advance. Research by Lawrence and Weinstein as well as others suggests that East Asia could enhance technological inflow by matching the long-standing reliance on export growth with an equal emphasis on import liberalization. But efforts to acquire dynamic com-

parative advantage through the accumulation of R&D capital and skills will continue to be important, at least for the Southeast Asian countries, as noted by K. S. Jomo.

Greater openness and international integration have many advantages, but they also increase risks. To manage these risks, countries will need to act on three fronts: domestic, regional, and international (Stiglitz 2000). East Asia has a good record of domestic policy, and the crisis has triggered a round of reforms that if resolutely implemented could further strengthen such policy. However, globalization may require more effort at coordinating policies and institutions at the regional and international levels, so that the gains from an integrated world can be fully realized.

#### NOTES

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The  
*Developmental*  
State

*Edited by*

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CORNELL UNIVERSITY PRESS

*Ithaca and London*

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First published 1999 by Cornell University Press  
First printing, Cornell Paperbacks, 1999

Printed in the United States of America

Library of Congress Cataloging-in-Publication Data

The developmental state / Meredith Woo-Cumings, editor.  
p. cm. — (Cornell studies in political economy)  
Includes index.  
ISBN 0-8014-3585-4 (alk. paper). — ISBN 0-8014-8566-5  
(pbk. : alk. paper)  
1. Economic development. 2. Economic policy. 3. Capitalism.  
4. State, The. I. Woo-Cumings, Meredith. II. Series.  
HD75.D499 1999  
338.9—dc21 98-50072

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Cloth printing 10 9 8 7 6 5 4 3 2 1  
Paperback printing 10 9 8 7 6 5 4 3 2 1

## CHAPTER TWO

### *The Developmental State: Odyssey of a Concept*

Chalmers Johnson

One of my main purposes in introducing the idea of the “capitalist developmental state” into a history of modern Japanese industrial policy was to go beyond the contrast between the American and Soviet economies. The American-Soviet comparison had become a feature of virtually all the canonical works of the American side during the cold war—such as Samuelson’s *Economics* textbook. I wanted, instead, to call attention to the differences, not the similarities, between the capitalist economies of the United States and Britain, on the one hand, and Japan and its emulators elsewhere in East Asia, on the other. During the 1970s, when I was doing the research for *MITI and the Japanese Miracle* (1982), these differences were beginning to show, even though there was, and is today, enormous ideological resistance in the English-speaking countries to any attempt to take them seriously.<sup>1</sup>

Looking back on the era of the 1970s, Ronald Dore, in *Flexible Rigidities: Industrial Policy and Structural Adjustment in the Japanese Economy, 1970–1980*, noted in the second paragraph of his introduction that “they [the Japanese] don’t believe in the invisible hand.” “Why on earth, then,” Dore asks, “should Japan, an economy which almost flaunts its rigidities as a matter of principle, be the most successful among the OECD [Organization for Economic Cooperation and Development] countries at dy-

1. Compare David Williams, “Beyond Political Economy: A Critique of Issues Raised in Chalmers Johnson’s *MITI and the Japanese Miracle*,” in *East Asia: International Review of Economic, Political, and Social Development* (Frankfurt: Campus, 1985), 3:231–47. See also David Williams, *Japan: Beyond the End of History* (London: Routledge, 1994). Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford: Stanford University Press, 1982); page references will be given parenthetically in the text.

namically adjusting to these challenges—absorbing the oil-price rises, controlling inflation at a low figure, and shifting the weight of its industrial structure away from declining to competitive industries?”<sup>2</sup>

Japan’s “flagrantly flouting all received principles of capitalist rationality,” to use Dore’s words (p. 18), was turning it into one of the world’s richest big nations and the model for all the other countries of East Asia, including China. The cases of the so-called East Asian NICs (newly industrialized countries) were also calling into question the lectures of scores of American “dependency theorists” and World Bank officials who droned on about why Latin America was doomed to underdevelopment. At the same time, the Americans and the British, the exemplars of the “principles of capitalist rationality,” were being repaid for their orthodoxy with stagflation, high rates of unemployment, and a hollowed-out manufacturing base. Their decline was checked only marginally during the succeeding decade by Ronald Reagan’s credit card binge, which left the United States as the world’s largest debtor, and Margaret Thatcher’s determination to let the market rule, which only made Britain surly.

During the 1990s, as a result of overconfidence and arrogance, Japan allowed a speculative bubble to develop in its domestic economy. The spiral upward in prices was based primarily on overinvestment in productive capacity and unrestricted bank lending using inflated real estate prices as collateral. When the inevitable collapse came, instead of reforming its banking practices and holding its companies responsible for bad investment decisions, Japan exported the bubble to South Korea and Southeast Asia, thereby precipitating the East Asian economic crisis that started in 1997. Many writers in the United States concluded from these events that the Asian “miracle” was a flash in the pan and that the “end of history,” that is, the elimination of all alternatives to the American way of life, had finally and definitively arrived. Unfortunately for them, these American writers have seen only those aspects of the Asian economic crisis that neoclassical economics illuminates for them. They have refused to notice the cold war context in which the Asian economies flourished or how overextended they themselves are as the economic and military guarantors of the Asian system. In any case, my history of the Ministry of International Trade and Industry (MITI) was devoted to an explicit period of twentieth-century history, as its subtitle indicates: *The Growth of Industrial Policy, 1925–1975*.

I invoked the concept of “developmental state” to characterize the role the Japanese state played in Japan’s extraordinary and unexpected post-

2. Ronald Dore, *Flexible Rigidities: Industrial Policy and Structural Adjustment in the Japanese Economy, 1970–1980* (Stanford: Stanford University Press, 1986), pp. 1, 6.

war enrichment. I never said or implied that the state was *solely* responsible for Japan's economic achievements or that it behaved like the state in command economies in assigning tasks and duties to the Japanese people. Nonetheless, many reviewers, usually self-identified as "economists," allege that I did. Thus began one major stream of response to the concept: it was heretical. Anglo-American "theory" taught that there were only two possible explanations for Japan's wealth—it must be an extreme instance of "getting the prices right," or Japan was toying with socialism and would soon begin to show signs of Soviet-type misallocation of resources and structural rigidities. It could not exemplify the role of the state in a market economy, because even what Adam Smith had to say on that subject was no longer credited in the extreme, "rational choice" version of Western economic individualism.<sup>3</sup>

This line of attack on the concept "developmental state" came as a surprise to me. When I wrote the history of MITI, I did not realize the extent to which economics had become the doctrinaire orthodoxy of the "West" during the cold war and economists the censors of social science deviancy within the English-speaking university establishment. My book was not even consciously directed at the world of academic economics but rather at such issues as the uses of the state in the setting and achievement of social goals, the failures of Soviet-type socialist displacement of the market, comparative state bureaucracies, and public-private cooperation. Thus, I tended at first not to pay too much attention to reviewers who noted that "economists . . . will quibble with some of Johnson's formulations" (*Journal of Asian Studies*) and "I am afraid that Johnson has unnecessarily alienated many economists" (*Journal of Japanese Studies*).<sup>4</sup> I came to realize, however, that my book was an ideological red flag to the bull of Anglo-American cold war orthodoxy about economic correctness. That is to say, MITI, industrial policy, Japan's economic growth, and above all the idea of a "developmental state" continue to threaten people on both sides of the Pacific with deep vested interests in the cold war relationships.

Thus, without ever contradicting or even confronting the historical evidence I had presented from both prewar and postwar Japan, critics developed several standard ploys for dealing with my book. These and variations on them have been repeated over and over again. One, suggested for example, by Kuroda Makoto, MITI's chief negotiator with the United States over trade in semiconductors, is that my history is accurate enough

3. See Chalmers Johnson and E. B. Keehn, "A Disaster in the Making: Rational Choice and Asian Studies," *The National Interest* 36 (Summer 1994): 14–22.

4. Leon Hollerman, review of *MITI and the Japanese Miracle*, by Chalmers Johnson, *Journal of Asian Studies* 42, no. 2 (February 1983): 414–15; Kozo Yamamura, review of *MITI and the Japanese Miracle*, by C. Johnson, *Journal of Japanese Studies* 9, no. 2 (1983): 211. Henceforth untitled reviews of my book will be given as "review."

but no longer relevant because Japan has changed and no longer does industrial policy in the old way. Another (compare Karl Zinsmeister for the Heritage Foundation) invites readers to imagine how mind-blowingly rich the Japanese would be if the state had *not* intervened. Or I am taxed with “understat[ing] the economic activities of the private sector” (Nakamura Takafusa), without ever specifying what “private” might mean in Japan as opposed to the United States or how and by whom the incentives the Japanese private actors faced were changed over time.<sup>5</sup>

Since my book was published in the early 1980s, several other writers have taken up the same broad subject—the role of the state in the Asian market economies—and analyzed it in contexts different from the Japanese and with attention to other aspects of Japan’s activities than industrial policy. The most important of these works are Alice Amsden, *Asia’s Next Giant*, on the fundamentally different microeconomics of the Korean developmental state from those recommended by the English-language economics textbooks; Robert Wade, *Governing the Market*, on many aspects of Taiwan’s economic growth but particularly on the corporatist politics that sustain the developmental state; and Jung-en Woo (Meredith Woo-Cumings), *Race to the Swift*, on how the single most important tool of industrial policy in the growth of South Korea was control of finance. Another critically important work that theoretically distinguishes the capitalist developmental state from the Soviet-type command economy, market socialism, and laissez-faire is Yu-Shan Wu, *Comparative Economic Transformations: Mainland China, Hungary, the Soviet Union, and Taiwan*.<sup>6</sup>

In a sense, these works led to the World Bank’s unintended paean to economic success: *The East Asian Miracle: Economic Growth and Public Policy* (1993). The Japanese aid-giving authorities forced the ideological conservatives of the bank to write this study as a condition for further Japanese funding. The study does not actually say anything new and is intentionally misleading on fundamentals, but in the foreword the president of the World Bank, Lewis T. Preston, writes, “This diversity of experience

5. Kuroda Makoto, “Myths about MITI,” *Tokyo Business Today* (April 1988): 64; Karl Zinsmeister, “MITI Mouse: Japan’s Industrial Policy Doesn’t Work,” *Policy Review* (Spring 1993): 28–35; Nakamura Takafusa, review, *Japan Quarterly* (October–December 1982): 484–86. Compare James Fallows et al., “Up against the Wall Street Journal,” *The American Prospect* (Summer 1993): 21–27.

6. Alice H. Amsden, *Asia’s Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990); Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991); Yu-Shan Wu, *Comparative Economic Transformations: Mainland China, Hungary, the Soviet Union, and Taiwan* (Stanford: Stanford University Press, 1994).

[in East Asia] reinforces the view that economic policies and policy-advice must be country-specific, if they are to be effective.<sup>7</sup> If Jeffrey Sachs and similar advisers in Russia and Eastern Europe had taken this stricture seriously when they were asked to help restructure the command economies there, the outcomes might be much less vexed and politically volatile.

I do not here feel the need to review the theory of the developmental state. That has already been done quite brilliantly in the works cited above, as well as in the articles collected in this volume. Before leaving the subject, however, I would like to mention two articles that in my view make major contributions to synthesizing the different aspects of the developmental state and solving noteworthy East Asian puzzles (for example, was Hong Kong before its return to China an example of laissez-faire? Answer: no). These are Ziya Onis, "The Logic of the Developmental State," and Manuel Castells, "Four Asian Tigers with a Dragon Head: A Comparative Analysis of the State, Economy, and Society in the Asian Pacific Rim."<sup>8</sup> These works deserve to be better known. For my own thoughts on the developmental state after *MITI and the Japanese Miracle*, see the collection of my essays entitled *Japan, Who Governs? The Rise of the Developmental State*.<sup>9</sup>

The developmental state exists and is in the process of altering the world balance of power, whether or not the Anglo-American academic and journalistic establishments recognize it.<sup>10</sup> My purpose here is not to restate what has already been well said but to undertake three lesser tasks: first, to summarize what *MITI and the Japanese Miracle* actually said, which has often gotten lost in the ideological disputation about its possible implications; second, to reveal for the first time the editorial debate that preceded publication of the book over whether the Japanese case constituted a model; and, third, to consider the reviews under four broad headings: (1) What was more important, the market or industrial policy? (2) Is Japan a democracy, and is the capitalist developmental state compatible with democracy? (3) Did Japan's success depend on the period in which it occurred? and (4) What is the nature of bureaucratic-civilian relations (these terms are preferable to public-private) in the capitalist develop-

7. World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993), p. vi.

8. Ziya Onis, "The Logic of the Developmental State," *Comparative Politics* 24, no. 1 (October 1991): 109–26, and Manuel Castells, "Four Asian Tigers with a Dragon Head: a Comparative Analysis of the State, Economy, and Society in the Asian Pacific Rim," in Richard P. Appelbaum and Jeffrey Henderson, eds., *States and Development in the Asian Pacific Rim* (Newbury Park, Calif.: Sage, 1992), pp. 33–70.

9. Chalmers Johnson, *Japan, Who Governs? The Rise of the Developmental State* (New York: Norton, 1995).

10. Chalmers Johnson, "The Empowerment of Asia," *Australian Quarterly* 67, no. 2 (Winter 1995): 11–27.

mental state? These four areas cover all the serious controversies surrounding *MITI and the Japanese Miracle*.

### THE THESIS

In the immediate paragraphs below, I quote extensively from *MITI and the Japanese Miracle* in order to provide a synopsis of the argument it contains. The essence of the argument is that credit for the postwar Japanese economic "miracle" should go primarily to conscious and consistent governmental policies dating from at least the 1920s:

[A] state's first priority will define its essence. . . . For more than 50 years the Japanese state has given its first priority to economic development. Some of the Japanese state's priorities for economic development, such as the imperialism of the Pacific War, were disastrous, but that does not alter the fact that its priorities have been consistent. (Pp. 305-6)

Overcoming the depression required economic development, war preparation and war fighting required economic development, postwar reconstruction required economic development, and independence from U.S. aid required economic development. The means to achieve development for one cause ultimately proved to be equally good for the other causes. There are striking continuities among the state's various policy tools over the prewar and postwar years. (P. 308)

The issue is not one of state intervention in the economy. All states intervene in their economies for various reasons. . . . The United States is a good example of a state in which the regulatory orientation predominates, whereas Japan is a good example of a state in which the developmental orientation predominates. A regulatory, or market-rational, state concerns itself with the forms and procedures—the rules, if you will—of economic competition, but it does not concern itself with substantive matters. (Pp. 17, 19)

A state attempting to match the economic achievements of Japan must adopt the same priorities as Japan. It must first of all be a developmental state—and only then a regulatory state, a welfare state, an equality state, or whatever other kind of functional state a society may wish to adopt. (P. 306)

The fundamental problem of the state-guided, high-growth system is that of the relationship between the state bureaucracy and privately owned business. This problem erupted at the very outset of industrial policy. . . . Over the past 50 years Japan developed and attempted to implement three different solutions to this problem—namely, self-control, state control, and cooperation. None of them is perfect, but each is preferable to either pure laissez faire or state socialism as long as forced development remains the top priority of the state. (Pp. 309-10)

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The Supreme Commander for the Allied Powers (SCAP) never singled out the civilian bureaucracy as needing basic reform. However, SCAP eliminated completely from political life one major rival of the economic bureaucracy, the military; and it transformed and severely weakened another, the zaibatsu. . . . The purge had little effect on the economic ministries. . . . Even more important was SCAP's insistence that the economic functions previously shared between the government and the zaibatsu should now be placed exclusively in governmental hands. (Pp. 41, 44)

The Enterprises Bureau's next big initiative was the enactment of the Foreign Capital Law (1950). The Foreign Exchange and Foreign Trade Control Law of 1949 had already given the government power to concentrate all foreign exchange earned from exports (by law such foreign exchange had to be sold to a foreign exchange bank within 10 days of its acquisition), and this power made possible the control of imports through the use of a foreign exchange budget. MITI made every effort to suppress imports of finished goods, particularly those that competed with domestic products, but it urgently sought imports of modern technology and machinery. The problem was to keep the price down and to "untie the package" in which such foreign technology normally came wrapped—to separate the foreign technology from its foreign ownership, patent rights, know-how agreements, proposals for joint ventures, capital participation, voting rights, and foreign managers on boards of directors. The Foreign Capital Law dealt with this problem. It established a Foreign Investment Committee and stipulated that foreign investors wanting to license technology, acquire stock, share patents, or enter into any kind of contract that provided them with assets in Japan had first to be licensed by the committee. (P. 217)

Specialists on modern Japan will differ as to the precise elements and the weight to be attached to each element in such a model, but the following, based on the history of MITI, is my own estimation of the essential features of the Japanese developmental state. . . . The first element of the model is the existence of a small, inexpensive, but elite state bureaucracy staffed by the best managerial talent available in the system. . . . The duties of this bureaucracy would be first, to identify and choose the industries to be developed (industrial structure policy); second, to identify and choose the best means of rapidly developing the chosen industries (industrial rationalization policy); and third, to supervise competition in the designated strategic sectors in order to guarantee their economic health and effectiveness. These duties would be performed using market-conforming methods of state intervention. (Pp. 314-15)

The second element . . . is a political system in which the bureaucracy is given sufficient scope to take initiative and operate effectively. This means . . . that the legislative and judicial branches of government must be restricted to "safety valve" functions. . . . A non-Japanese example would be something like the American legislative branch's relationship to the wartime Manhattan Project or to the postwar nuclear submarine development program. (Pp. 315-16)

The third element of the model is the perfection of market-conforming methods of state intervention in the economy. . . . [Japanese methods include] creation of governmental financial institutions, whose influence is as much indicative as it is monetary; the extensive use, narrow targeting, and timely revision of tax incentives; the use of indicative plans to set goals and guidelines for the entire economy; the creation of numerous, formal, and continuously operating forums for exchanging views, revising policies, obtaining feedback, and resolving differences; the assignment of some governmental functions to various private and semiprivate associations (JETRO [Japan External Trade Organization], Keidanren); an extensive reliance on public corporations, particularly the mixed public-private variety, to implement policy in high-risk or otherwise refractory areas; the creation and use by the government of an unconsolidated "investment budget" separate from and not funded by the general account budget; the orientation of antitrust policy to developmental and international competitive goals rather than strictly to the maintenance of domestic competition; government-conducted and government-sponsored research and development (the computer industry); and the use of the government's licensing and approval authority to achieve developmental goals. Perhaps the most important market-conforming method of intervention is administrative guidance. . . . It is necessary to avoid overly detailed laws that . . . put a strait jacket on creative administration. . . . Highly detailed statutes serve the interests primarily of lawyers, not of development. . . . At its best Japanese administrative guidance is comparable to the discretionary authority entrusted to a diplomat negotiating an international agreement. Success depends upon his skill, good sense, and integrity, and not on a set of legal requirements that no matter how well crafted can never truly tell a negotiator what to do. (Pp. 317-19)

The fourth and final element of the model is a pilot organization like MITI. . . . MITI's experience suggests that the agency that controls industrial policy needs to combine at least planning, energy, domestic production, international trade, and a share of finance (particularly capital supply and tax policy). . . . The key characteristics of MITI are its small size . . . , its indirect control of government funds (thereby freeing it of subservience to the Finance Ministry's Bureau of the Budget), its "think tank" functions, its vertical bureaus for the implementation of industrial policy at the micro level, and its internal democracy. It has no precise equivalent in any other advanced industrial democracy. (Pp. 319-20)

#### THE TAKE-HOME MESSAGE

Many of these quotations, particularly the four-part model, come from the final chapter of *MITI and the Japanese Miracle*, titled "A Japanese Model?" This chapter did not exist in the original manuscript but was added at the insistence of the chief editor of Stanford University Press. Although usually such editorial decisions are of no great importance, ex-

cept perhaps to the author, in this instance they relate to what is perhaps the single most important question concerning the *Japanese* developmental state. Is it duplicable? Is there really a Japanese model? What are the general, culture-free lessons to be learned from the Japanese case?

There is no longer any question that the Japanese use of market mechanisms for developmental purposes has been successfully emulated in other countries. The most important examples, in descending order of their distance from the Japanese precedent, are South Korea, Taiwan, Singapore, and Hong Kong. The growth of these five capitalist developmental states has also tended to promote growth in the surrounding areas—through trade, investment, emulation, and other influences. During the 1990s, the People's Republic of China also began to adapt the institutions of Japan's developmental state to its own Leninist heritage, a command economy it was attempting to dismantle. Beyond Japan and the NICs, this growth has often occurred without an explicit pilot agency such as MITI and has produced severe economic and environmental dislocations together with high levels of structural corruption. These were the primary reasons why Thailand and Indonesia were the countries first affected by the economic crisis that began in 1997. None of the Asian cases is a clone of the Japanese experience. Some followers improved on the Japanese model (for example, state control of *chaebol*—that is, *zaibatsu*—banks in Korea), and others ignored Japanese-type controls on unchecked growth and paid the consequences (for example, repeated bouts of inflation in mainland China). Nonetheless, as is made clear below and in other papers in this volume, all the East Asian cases reflect particular forms of state guidance that were first demonstrated to be effective by Japan.

That was not, however, the take-home message I had in mind when I was writing the history of MITI. I never doubted that Japan was a better model for both the second and third worlds than Anglo-American capitalism, but I was trying to signal by way of a broader conclusion a different point—namely, that the “learn-from-Japan” craze then sweeping the United States was dangerously ahistorical and simple-minded. I conceived the book in terms of eight chapters: an introduction to the Japanese developmental state, an analysis of the functions and status of the Japanese state bureaucracy, and six chapters on the history of Japanese industrial policy from 1925 to 1975. My primary focus was the prewar and postwar continuities, both institutionally and in terms of personnel, that my research had revealed. To the extent that I had a didactic purpose at all, it was to stress that Japan's case would be hard to emulate. If nothing more, it depended to a large extent on losing a big war to the right people at the right time.

The only reviewer who ever divined this message from the published book was Walter Goldfrank. He accepted that “the structures and practices of MITI (Ministry of International Trade and Industry) and its pre-

decessor ministries particularly, bear primary causal responsibility for the growth and diversification of postoccupation Japanese industry."<sup>11</sup> He then asked, Is this history generalizable? His answer (and mine) is, Yes, but only if a nation is similarly committed to the mobilization of industry.

The Japanese case is actually one of an economy mobilized for war but never demobilized during peacetime. The political costs of running an economy in this fashion were not ones that Americans under Ronald Reagan were about to pay. "Although he does not put it so baldly," wrote Goldfrank, "Johnson argues that the Japanese model is not transferable: its economic bureaucrats enjoy a scope and initiative unthinkable in U.S. politics, while its planning and control mechanisms have evolved through a sequence of conjunctures and state interventions that together have amounted to a long and nonrepeatable learning process." That is certainly one of the conclusions that I drew from my research while I was in the process of doing it. I had no doubt that other Asian, African, and Latin American nations would try to emulate Japan, but I did not recommend that the United States try it. I instead stressed that the United States would have to match Japan—just as it had matched, not copied, the USSR—when Japan's enrichment started to turn to empowerment. In doing so, the Americans would have to draw on and perhaps reform their own particular national heritage, not copy that of a country fifteen hundred years older than they were.

I wrote my history of MITI during the summer and autumn of 1980, after some eight years of research on the subject. I then submitted it to Stanford University Press, which had already published three earlier books of mine. Its chief editor, J. G. Bell, was one of the most talented academic publishers of the time. He had extraordinary knowledge of trends in scholarly publishing about Asia and an almost perfect ear as an editor. I trusted his advice about the structure of my manuscript. On December 29, 1980, Bell wrote to me, in part:

A strong last chapter seems to me absolutely necessary. Such a chapter might go over some of the same ground as Chapter 1, and would surely make the same basic point that you make in Chapter 1, but would be very different from Chapter 1 by reason of its references to specifics now known to the reader. Without such a chapter the reader is baffled. Which of the various elements of MITI's success are to be considered central, and how do they relate to the others? The fact that they get the brightest guys from Todai? The fact that so many high-level bureaucrats go on from MITI to become high executives in industry? The fact that MITI operates in some terrain between state socialism and *laissez-faire* capitalism that is free of the major drawbacks

11. Walter Goldfrank, review, *Contemporary Sociology* 12, no. 6 (November 1983): 722-23.

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of both extremes? The fact that MITI somehow has a mandate to anticipate difficulties, plan accordingly, and get its plans embodied in legislation? What does MITI's 50-year experience add up to? What is the take-home message?

On January 3, 1981, I replied:

In the case of MITI, I tried to write a narrative history about how the Japanese state economic apparatus grew (something that I believe is quite original since histories of bureaucracies are rare), combined with two chapters on, respectively, the Japanese economy and the Japanese bureaucratic polity. Your comment that the "effect [of the narrative history] is one of accident, expediency, chance" leads me to think that I have succeeded, even though you don't like it, since that is precisely the message I wanted to convey to any country thinking of setting up its own MITI. The narrative is what's original about this book—it is really hidden history. Most books on Japan do not even mention MITI, let alone the Ministry of Munitions. All books that do mention MITI do nothing more than that—because nobody knows anything about it, and the ministry—like all bureaucracies—prefers to remain confidential. What I consider original about the book is not chapter one but (a) the time frame, and why the external observer must take this larger time frame into consideration; (b) the identification of some key political actors in Japan who are normally overlooked—*because they are bureaucrats* (i.e., Yoshino, Shiina, Kishi, Sahashi, etc.); and (c) the detailed analysis of the ways in which an effective state bureaucracy works. . . . I certainly could write a last chapter, but some of my conclusions would be distinctly downbeat and perhaps unnecessarily harsh on the Japanese. I do not think, for example, it would be nice to say that fascism may be good for a nation, or to call the final chapter—as at one time I was thinking of doing—"From the Wonderful Folks Who Brought You Pearl Harbor."

Bell's reply of January 7 was unyielding:

Now, then, whether argument or narrative, there can be no serious doubt that the book needs a Conclusion. . . . You should set forth your conclusions without regard to whether some readers might regard them as downbeat, pro-fascist, unnecessarily hard on the Japanese, mean to Eldridge Cleaver, etc., so only that you say as courteously as possible exactly what you think the facts warrant saying. . . . You should let all us chickens in on the take-home message, whether this be that "accident, expediency, chance" is the name of the game as opposed to the various forms of economic, racial, and historical determinism, . . . or whatever. Because us chickens can read what you *wrote*, but us can't read what you *think* about what you wrote unless you *write* it. Dig? OK if it's not socko, better if it is.

There it was. I had asked his advice and he had given it. He once commented that the original manuscript ended the way bagpipe music usu

ally ends: it sounded like the piper had walked off a cliff. The book needed a chapter that set forth a Japanese model, regardless of whether I thought creating such a model was a good idea. When Gary Allinson later wrote in a review for the *American Political Science Review* that chapter 9 was "a tour de force, an exemplary model in its own right," Bell never let me forget that it was written at his insistence and that such advice is what good editing is all about.<sup>12</sup>

Today I agree with him. But, analytically speaking, the issue still remains that it is hard to abstract a "model" from historical reality. This is one of the errors of both the Marxists and the neoclassical economists: they overgeneralize the histories of Germany and France, on the one hand, and of England and the United States, on the other. These kinds of errors are not new in what are called the social sciences—Bentham believed he could draft a system of laws for any country from China to Peru, and Rousseau actually drafted a constitution for Poland without ever going there.<sup>13</sup> But any social science worthy of the name, it seems to me, must deal with both the generalizable and the particular without ruling one or the other out of court. The current fad for "rational-choice theory" and other forms of extreme economic reductionism are simply the latest examples of attempts at social science that fail this elementary test. They are combinations of sterility and hubris that resemble Scholasticism. I believe that the "developmental state" actually exists in time and space in East Asia and also exists as an abstract generalization about the essence of the East Asian examples. It is both particular and generalizable.

#### THE TRANSLATION

Even before *MITI and the Japanese Miracle* was published, officials of MITI had heard about my research and approached me for permission to do a translation. The JETRO officer in San Francisco, who reported to Tokyo on activities at the University of California, Berkeley, where I was then teaching, had written back to his ministry about what I was doing. Nonetheless, the ministry did not know much about me; I had not spent a lot of time interviewing at MITI, and most of my research was documentary, except for a major interview with former vice-minister Sahashi Shigeru. Each of us should probably have been more cautious about the other before agreeing to work together.

12. Gary Allinson, review, *American Political Science Review* 77 (March 1983): 242–43.

13. My thanks to Professor Leslie Lipson for reminding me of these early examples of misplaced universalism, in a letter dated September 8, 1994.

A Senior MITI officer, Yamada Katsuhisa, the former secretary of Miyazawa Kiichi when he was MITI minister and in 1980 head of the Planning Office in the Ministerial Secretariat, flew to California to say that the ministry itself wanted to translate my book as a way of instructing new officers about the difficulties of Japan's postwar high-speed growth. I agreed, and he arranged for a group of bright, young MITI officials, each partly educated in an English or an American university, to do the translation. They were unpaid and did the work after hours. I met with them on several occasions in Tokyo to resolve problems. They did a good job, and the terms *hatten-shiko-kata kokka* (developmental state) and *kisei-shiko-kata kokka* (regulatory state) became better known in Japan than their English equivalents did in the United States.<sup>14</sup>

MITI also used the translation to promote the political career of Yano Toshihiko, who retired in 1981 as vice minister and the following year ran successfully for the upper house of the Diet. He is the listed "supervising translator" (*kanyakusha*), even though he did not actually participate in the work, and with each copy of the book the ministry included a long dialogue between me and Yano in which he repeatedly says that I got the history right but did not pay enough attention to the ways Japan and the ministry were opening up to the outside world. My book thus helped both Yano's political campaign and MITI's public relations effort to convince the outside world that MITI had changed. Yamada suggested to me that if I would write a sequel about MITI after 1975, stressing Japan's commitment to "internationalization" (*kokusaika*), he would arrange interviews with all the then living ministers and vice ministers. I declined on grounds that it is impossible to have perspective on a governmental agency while it is actually making and implementing policy. But it also occurred to me that I was being set up to become the ministry's captive propagandist. There is no doubt in retrospect that it would probably have been better if I had entrusted the translation to a scholar (as I did with the Korean and Chinese translations). But having the book published with MITI's blessing ensured extensive reviews in Japanese—it was briefly on the business books best-seller list in September 1982—and that it would be widely read.<sup>15</sup>

Looking back on it, MITI may have more regrets about translating my book than I do about not ensuring a scholarly translation. The ministry has always been ambivalent about its own history and industrial policy, depending on whether it was writing in Japanese or in English. In Japanese, MITI officers reviewed the book lavishly. In the official house organ of

14. Chalmers Johnson, *Tsusansho to Nihon no kiseki*, trans. Yano Toshihiko (Tokyo: TBS Britannica, 1982), pp. 20–25.

15. *Nikkei Business*, September 20, 1982, p. 211.

the ministry, Iwatake Teruhiko (MITI, 1934–59) wrote, “The value of this book lies in showing the great contributions of MITI officials to high-speed growth,” which was of course precisely why the ministry translated it.<sup>16</sup> In a rather hostile interview with Bernard Krisher, the then MITI minister, Abe Shintaro, used my book to defend the ministry. “At one point in the interview,” wrote Krisher, “Abe came close to boasting about this protectionism. He rose from his desk to fetch a copy of Chalmers Johnson’s new book, *MITI and the Japanese Miracle*, which describes the origins and operations of the system.” This system was “the MITI way, a quiet protectionism that never acknowledges its name.”<sup>17</sup>

In English, on the other hand, the ministry has consistently argued that its role and that of industrial policy have been overstated by foreign observers. In the early 1980s, Japanese propaganda organs emphasized the “special circumstances surrounding the 1950s–1960s” when MITI was hyperactive, and they listed “ways in which Americans exaggerate Japan’s industrial policy.”<sup>18</sup> A decade later, they were still at it: “There are even those who argue that Japan is fundamentally different with a set of rules that are [*sic*] incompatible with those generally accepted elsewhere. . . . In Japan, we use the term ‘industrial policy’ to mean those government strategies that are put in place to supplement the market mechanism only when and where necessary.”<sup>19</sup>

The point is obvious. MITI is emphatically not an academic research organ. It has always taken shelter in secrecy and likes to confuse its competitors with disinformation. In 1973, when the ministry changed the name of the Enterprises Bureau to the Industrial Policy Bureau, some officers complained that it was not a good idea to say too publicly exactly what that key bureau actually does. In Kozo Yamamura’s review of *MITI and the Japanese Miracle*, he goes out of his way to reassure an unknown MITI official who, he says, wanted to issue a denial that the ministry was as powerful as I had described it. Not to worry, writes Yamamura, “There are many of us outside Japan who do not believe MITI in effect ‘runs’ the Japanese economy or that MITI has ‘perfected’ the art of industrial poli-

16. Iwatake Teruhiko, in *Tsusai Jyanaru*, September 1982, pp. 148–49.

17. Bernard Krisher, interview of Abe Shintaro, *Fortune*, October 4, 1982, pp. 91–92, 96.

18. Japan Economic Institute (JEI) of America, *Japan’s Industrial Policies* (Washington, D.C.: JEI, 1984). The JEI is “registered under the Foreign Agents Registration Act as an agent of the Japanese Government.” See also *Japan’s Postwar Industrial Policy* (Tokyo: JETRO, January 1985), which acknowledges that “industrial policies have made a considerable contribution to the rapid expansion of the Japanese economy,” in combination with favorable international factors and high levels of education, Japanese-style employment practices, and weak shareholder control of companies.

19. Japan Economic Foundation (JEF), *Japan: A Perspective on Industrial Policy* (Tokyo: Acorn, June 1994), pp. 1, 2. The JEF is a MITI-created foundation.

cymaking.”<sup>20</sup> I think Yamamura misunderstood his informant, who was merely trying to prevent foreigners from finding out too much. Much the same worry was expressed by Kuroda Makoto, MITI’s best-known hard-line negotiator, after Sony’s Morita Akio wrote about how Japanese capitalism differs from Anglo-American capitalism: “We must not provide a dangerous basis for the argument that says Japan conducts itself by a different set of rules and must be treated differently. . . . For some time I have repeatedly stated that we should avoid expressions such as ‘Japanese-style practices.’”<sup>21</sup> Just a few years after his review, even Yamamura was asking, “Will Japan’s economic structure change? Confessions of a former optimist.”<sup>22</sup>

MITI is not interested in abstract analysis of the Japanese economic system, and while its translation of my book may have served its interests at one time, it no longer did so a few years later. Nonetheless, because of its prompt translation, my book was widely read and reviewed in Japan as well as the United States. Hiraiwa Gaishi, then head of Tokyo Electric Power and later president of Keidanren, concluded his review by saying that Japan needed a “new MITI” for the period after 1975. A leading automotive journal castigated MITI as industry’s “overprotective mama” and as a bureaucratic *sokaiya* (“corporate extortionist”). Takemura Ken’ichi, a journalist of the pulp magazines, used his review to tell Ronald Reagan to provide some real incentives for people in the United States to save, to stop protecting declining industries and the lawyers who represent them, and to create modern trading companies that can compete anywhere in the world.<sup>23</sup>

In this varied context, I received my most comprehensive review in any language. A doctoral candidate at Keio University, Oyama Kosuke, writing in the obscure *Kikan Gyosei Kanri Kenkyu* (Administrative management research quarterly), presented the book’s argument, reviewed major foreign reviews, and concluded that my book raised four fundamental issues of continuing controversy.<sup>24</sup> I agree with him. In the pages that follow I want to analyze each of Oyama’s four categories, laying out what is at issue, what is often misunderstood or obscured, and where the controversies stand nearly two decades after the book was published. It goes without saying that this categorization is somewhat artificial and that some is-

20. Yamamura, review, p. 215.

21. *Bungei shunju*, April 1992, pp. 176–93. Kuroda Makoto quoted in Chalmers Johnson, “Comparative Capitalism: The Japanese Difference,” *California Management Review*, Summer 1993, p. 59.

22. Kozo Yamamura, ed., *Japan’s Economic Structure: Should It Change?* (Seattle: Society for Japanese Studies, 1990), p. 13.

23. Hiraiwa Gaishi, review, *Zaikai*, September 21, 1982, p. 100; *Jidoshsha Hambai*, October 1982, p. 58; Takemura Ken’ichi, review, *Shukan Post*, September 10, 1982.

24. Oyama Kosuke, review, *Kikan Gyosei Kanri Kenkyu*, no. 29 (March 1985): 68–72.

sues, such as the compatibility of the developmental state with democracy and relations among bureaucrats and civilians, clearly overlap. Nonetheless, Oyama's framework is useful so long as it is not pushed too far.

#### INDUSTRIAL POLICY VERSUS THE MARKET

Oyama's first point concerns the question of how influential the Japanese state's industrial policy was and how much of Japan's high-speed economic growth was actually the result of market forces. He cites as specific representatives of the market forces school Kozo Yamamura in his review of *MITI and the Japanese Miracle* in the *Journal of Japanese Studies* and Komiya Ryutaro, who during the 1980s was Japan's best-known exponent of Anglo-American economics and a critic of MITI but who subsequently retired as a professor and went to work for MITI as head of its research institute. Yamamura indeed poses the question directly in his review: "To what extent has the postwar economic performance been due to the policies of a 'developmental state' and to what extent to 'market forces?'"<sup>25</sup>

Yamamura's alternative explanation to the developmental state is that "Japan was still 'catching up' with the West and was 'lucky' in many ways." He also throws in the old canard about how Japan was about to undergo fundamental structural change that would reveal MITI's accomplishments to be meaningless: "I have the distinct feeling that Johnson will come to regret all this discussion concerning MITI's 'effectiveness' and some of the other laudatory remarks he made about MITI. Because when Japan too begins to have its economic woes, as it clearly has begun to have, MITI's batting average is going to decline awfully quickly. In this sense, I think Johnson's book came out ten years too late."<sup>26</sup>

I do not know whether Yamamura came to regret his prediction, but Japan went on in the decade after he wrote these words to extract a cool trillion dollars from the rest of the world while racking up the greatest trade surpluses ever recorded. Even when the Japanese economy fell into a self-induced recession in the 1990s, its households continued to save close to a fifth of their income, it became the creditor nation to the rest of the world, including the United States, and each year the government invested several hundred billion dollars in infrastructure. Are these the "economic woes" Yamamura had in mind?

As for Yamamura's own explanation for Japan's high-speed economic growth, it boils down to good luck. Yamamura believes that industrial policy was not important in Japan's catching up with and overtaking external

25. Yamamura, review, pp. 212-13.

26. Ibid., pp. 214.

reference economies because "the 'winners' had been in effect 'pre-selected' by the Western nations."<sup>27</sup> All Japan had to do was emulate them. He does not go into why, among all the nations allied with the United States, Japan was the only one that carried this catch-up strategy to the point of altering the world balance of power. As far as he is concerned, Japan was just lucky.

I would argue that the very contrast between industrial policy and market forces is false and probably ideological. Industrial policy is not an alternative to the market but what the state does when it intentionally alters incentives within markets in order to influence the behavior of civilian producers, consumers, and investors. Americans are perfectly familiar with the state's structuring the domestic real estate market to favor family ownership of houses. American industrial policy allows its citizens to deduct mortgage interest payments in calculating their taxable income, and they respond by obtaining and carrying large mortgages. As Richard E. Caves concludes from the same evidence that Yamamura dealt with, the analytical issue is "the overall pattern of business incentives created by MITI's policies. . . . MITI has enough instruments to create substantial positive inducements for many types of conforming decisions by the private sector; it can also make life thoroughly miserable for any company that defies its wishes. . . . MITI has been able to guarantee a fat price-cost margin and easy access to needed inputs for any sector it chose to encourage."<sup>28</sup> Altering market incentives, reducing risks, offering entrepreneurial visions, and managing conflict are some of the functions of the developmental state, as I have demonstrated historically and as some economists have started to demonstrate theoretically.<sup>29</sup>

There is a powerful argument that can be made against industrial policy, but Yamamura does not make it. The real objection is not to its use as an alternative to or a displacement of market forces but that it is more commonly used to protect vested interests than to achieve national development. The state *can* structure market incentives to achieve developmental goals, as the Japanese case clearly illustrates, but it can also structure them to enrich itself and its friends at the expense of consumers, good jobs, and development. Several reviewers of *MITI and the Japanese Miracle* made this point. Robert Reich, for example, stressed that Japan's private business strategies depended on its public industrial policies—"Neither could exist without the other." But because the United States has an easily lobbied government, its industrial policies serve primarily

27. *Ibid.*, p. 213.

28. Richard E. Caves, review, *Journal of Economic Literature* 21 (March 1983): 102-4.

29. See, for example, Ha-Joon Chang, *The Political Economy of Industrial Policy* (New York: St. Martin's Press, 1994).

the interests of politically well-connected, declining industries, not the goal of high value-added jobs for Americans. "Rapid industrial change," writes Reich, "is relatively easy to achieve when the leaders who plan it have no serious worries about politics. . . . [This was] Herbert Hoover's dream of an associationist state—a dream which came to brief fruition in Franklin Delano Roosevelt's National Recovery Association. Neither provides for direct review by, or accountability to, the people in the factories, towns, or regions that will be affected."<sup>30</sup> This was even more true in the case of contemporary Japan from 1925 to 1975, a point to which I will return in the next section.

Before leaving the issue of the economists and their views on industrial policy, I would like to raise the question of why arguments like those of Yamamura, although logically flawed, recur so often and with such vehemence in English-language discourse. I believe it is because they are ideological. Although there is a contemporary impulse in academic social science to overlook or discount ideology, Martin Malia reminds us of the costs of doing so in the case of the former USSR. One of the most embarrassing failures of "revisionist" Sovietologists was their inability to see the strains within the USSR that led to its collapse. The key variable that they consistently discounted or misconstrued during the last three decades of the Soviet Union's existence was ideology.<sup>31</sup>

In dealing with Japan, Western ideologists want to defend Western laissez-faire capitalism against Soviet-style displacement of the market. A central ideological dimension of the cold war was to posit a "free" market system in which the state served only as referee over and against the socialist displacement of the market for state ends. The achievements of the Japanese developmental state were inconvenient for both sides in this debate. They illustrated to the West what the state could do to improve the outcomes of market forces, and they illustrated to the Leninists that their big mistake was the displacement of the market rather than using it for developmental purposes.

Western ideologists sensitive to these issues are quick to intervene in discussions of Japanese capitalism. David Williams has noticed an interesting instance in the book edited by Ezra Vogel, *Modern Japanese Organization and Decision-Making* (1975). Williams observes:

[Peter] Drucker, the dean of American business experts, wrote an article for the volume titled "Economic Realities and Enterprise Strategy." A unique case in Vogel's collection, Drucker's article is immediately followed by a set of dissenting comments by Hugh Patrick. Why, we must ask, should the argu-

30. Robert B. Reich, review, *New York Review of Books*, June 24, 1982.

31. Martin Malia, *The Soviet Tragedy: A History of Socialism in Russia, 1917–1991* (New York: Free Press, 1994).

ments of one of the most influential students of world business trends require immediate correction by an economist? The reason is actually quite bold: Drucker's conclusion, that Japanese firms pursue financial ends other than short term profits, denies one of the key tenets of mainstream economic analysis. The universal reach of classical political economy requires stiff rejection of the very idea that Japanese economic practice could differ in any substantial way from Anglo-American economic practice by definition. It was because the issue was so fundamental to all theoretically aware economic discussion that Patrick was forced to attack Drucker's conclusions, as it were, on the spot.<sup>32</sup>

Given these ideological considerations, the subject of Japan as a "developmental state" arouses resistance to its dispassionate study that has grown only more intense since my history of industrial policy was published.

#### DEMOCRACY AND THE DEVELOPMENTAL STATE

In his review, Oyama stresses and agrees with my contention that in the Japanese developmental state "the politicians reign and the bureaucrats rule" (*seijika wa kunrin-shi, kanryo ga tochi-suru*).<sup>33</sup> He also notes, however, that even though Japan is ruled by bureaucrats, it is more "democratic" than the military and/or bureaucratic authoritarianism that prevailed in all East Asia and many regimes in Latin America at the time. Yet, he is also concerned that MITI's policies have strengthened the abstract entity called Japan but have not done much to enrich the lives of Japanese consumers and city dwellers. The Japanese people's standard of living did not change anywhere near as much as the change in the Japanese gross national product. Furthermore, because I stressed that after MITI officials failed in the 1960s to enact specific new legislation authorizing their orders to industry, they continued their oversight anyway under the cover of "administrative guidance," the question naturally arises: Is Japan a democracy under the rule of law, or is it merely administered through law when convenient?

These critically important questions lie at the heart of the study of the Japanese polity and, by extension, of the developmental state. In addressing this subject, American political science has squandered at least a decade trying to force Japan into various versions of American pluralist, constitutional, and rational choice theory, while avoiding empirical re-

32. Williams, "Beyond Political Economy," p. 245.

33. Johnson, *Tsusansho to Nihon no kiseki*, p. 356.

search on the Japanese state itself. Many political scientists in Japan contributed to this obfuscation by agreeing that Japan was really just a late-blooming version of American democracy and a proper place to apply the usual voting studies, game-theoretic electoral rules, and principal-agent theories of bureaucracy. Even to suggest otherwise was "revisionism" and "Japan-bashing."

The result is that there is still not even an elementary mapping of the Japanese government in English. There is no history of the prewar Ministry of Home Affairs (Naimusho), the pinnacle of the developmental state until it was dismembered into many other agencies by the American occupation. There are also no histories of the Ministries of Finance, Justice, Construction, Transportation, and so forth; no analysis of the thousands of nonprofit foundations (*zaidan hojin* and *shadan hojin*) created in the 1980s and 1990s for bureaucratic purposes; and no understanding of what, if anything, changed when during 1993–94 Japan changed parties and prime ministers four times. Writing in 1994 in the newsletter of the Institute of Social Science of the University of Tokyo, Professor Hiwatari Nobuhiro confesses, "Political studies of Japan have not yet fully addressed either the symbiotic relationship between the bureaucracy and politicians or the role of political parties. We still need an understanding of the Japanese state."<sup>34</sup>

One persistent theme in the reviews of *MITI and the Japanese Miracle* is that the book came dangerously close to a defense of fascism. For example, in an insightful review of the book, Christopher Howe says: "One may question whether in his [Johnson's] comparisons with systems such as that in the U.S., he has adequately weighed the political implications of the existence of such a powerful, semi-autonomous group in society. For as the author shows, from 1936 the same group that devised the post-war 'miracle' worked hard for one of the most despicable political regimes experienced in the twentieth century." Murray Sayle echoes this point: "In his magisterial *MITI and the Japanese Miracle*, Chalmers Johnson credits the capitalist developmental state with being 'a genuine Japanese invention.' With respect I believe that Mussolini holds the patent, although he never got his model to fly." Richard Nielson adds: "There are severe political difficulties in a democracy to effectively implement an industrial policy. . . . [Johnson treats] the political issue as a constraint. . . . Industrial policy was an important component of fascist ideology." And even the distinguished theorist of technology policy Kodama Fumio worries many Japanese and foreigners (notably E. O. Reischauer, former Ameri-

34. Hiwatari Nobuhiro, "After the Earthquake Election: Rethinking the Role of the Bureaucracy," *Social Science Japan*, July 1994, p. 14.

can ambassador to Japan) when he praises MITI for its commitment to "social engineering."<sup>35</sup>

My position on this controversy is to deny any necessary connection between authoritarianism and the developmental state but to acknowledge that authoritarianism can sometimes inadvertently solve the main political problem of economic development using market forces—namely, how to mobilize the overwhelming majority of the population to work and sacrifice for developmental projects. An authoritarian government can achieve this mobilization artificially and temporarily, but it is also likely to misuse such mobilization, thereby making it harder to achieve in the future. In the true developmental state, on the other hand, the bureaucratic rulers possess a particular kind of legitimacy that allows them to be much more experimental and undoctrinaire than in the typical authoritarian regime. This is the legitimacy that comes from devotion to a widely believed-in revolutionary project.<sup>36</sup> Korean public anger at the rules the International Monetary Fund tried to impose on South Korea in 1997 is a good example of public support for a developmental state. The leaders of a developmental state do not enjoy legitimacy in the sense of a mandate bestowed on them by civil society. The concept of civil society (or its absence) has, in any case, been invoked much too facilely by foreign "experts" trying to explain the failure of such revolutionary regimes after the fact.<sup>37</sup> The legitimacy of developmental states cannot be explained using the usual state-society categories of Anglo-American civics.

The successful capitalist developmental states have been quasi-revolutionary regimes, in which whatever legitimacy their rulers possessed did not come from external sanctification or some formal rules whereby they gained office but from the overarching social projects their societies endorsed and they carried out. As Ha-Joon Chang and Robert Rowthorn note, "Even central planning works better than the market for situations where there is one overriding objective, as in wartime or in a space program."<sup>38</sup> This one overriding objective—economic development—was present among the Japanese people after the war, among the Korean people after Syngman Rhee, among the Chinese exiles and the Taiwanese

35. Christopher Howe, review, *Bulletin of the School of Oriental and African Studies* 47, no. 1 (1984); Murray Sayle, "Japan Victorious," *New York Review of Books*, March 28, 1985, p. 40 n. 3; Richard Nielson, review, *Sloan Management Review* (Winter 1983): 84; and Kodama Fumio, "Tsusansho ni yoru kiseki wa futatabi kano ka" (Is the MITI-produced miracle possible a second time?), *Chuo Koron*, March 1983, pp. 139–47.

36. On this point, see Castells, "Four Asian Tigers with a Dragon Head."

37. See, in particular, X. L. Ding, "Institutional Amphibiousness and the Transition from Communism: The Case of China," *British Journal of Political Science* 24, no. 3 (July 1994): 293–318.

38. Ha-Joon Chang and Robert Rowthorn, "Introduction," in Chang and Rowthorn, eds., *Role of the State in Economic Change* (Oxford:Oxford University Press, 1995), p. 18.

after Chiang Kai-shek acknowledged that he was not going home again, among the Singaporeans after the Malayan Emergency and their expulsion from Malaysia, among the residents of Hong Kong after they fled communism, and among Chinese city dwellers after the Cultural Revolution. What distinguishes these revolutionaries from those in the Leninist states is the insight that the market is a better mechanism for achieving their objectives than central planning. The market includes people who want to work for a common goal; central planning excludes them.

Can such revolutionary legitimacy in a developmental state ever be democratic? One must first note, in the words of John Schaar, "Democracy is almost the most prostituted word of our age, and anyone who employs it in reference to any modern state should be suspect of either ignorance or bad motives."<sup>39</sup> With that stricture in mind, if one means by democracy some form of state accountability to the representatives of the majority of citizens combined with respect for the rights of minorities, the answer is probably no. At the same time, the leaders of the developmental state do enjoy legitimacy in the sense that their claim to political power is based on some source of authority above and beyond themselves. They differ in this sense from authoritarian rulers whose continued rule depends on their monopoly of force remaining a genuine monopoly. The source of authority in the developmental state is not one of Weber's "holy trinity" of traditional, rational-legal, and charismatic sources of authority. It is, rather, revolutionary authority: the authority of a people committed to the transformation of their social, political, or economic order. Legitimation occurs from the state's achievements, not from the way it came to power.

Such legitimacy based on projects or goals is, of course, fragile in that it normally cannot withstand failure. Equally serious, it cannot adjust to victory and the loss of mission. The legitimacy of the leaders of a developmental state is like that of field commanders in a major military engagement. It comes from people working together, and it probably cannot long survive either defeat or victory. This problem is an abiding source of instability in such regimes, one that often leads to severe crises, such as after Japan's defeat in World War II or the Korean revolution of 1987.<sup>40</sup>

To the extent that a developmental state possesses legitimacy and is not just a dictatorship of development, its leaders are somewhat akin to those of revolutionary mass movements. It goes without saying that they manip-

39. John Schaar, *Legitimacy in the Modern State* (New Brunswick, N.J.: Transaction Books, 1981), p. 23.

40. For further discussion of this issue, see Chalmers Johnson, "What Is the Best System of National Economic Management for Korea?" in Lee-Jay Cho and Yoon Hyung Kim, eds., *Korea's Political Economy: An Institutional Perspective* (Boulder, Colo.: Westview, 1994), pp. 63-85.

ulate their followers through propaganda, have enormous difficulty in being held responsible for failures, and often misuse the state for private purposes. But they can also alter the balance of power. The postwar bureaucratically led movement to enrich Japan was a revolutionary project, one that enjoyed legitimacy among the Japanese people for what it promised rather than for how its leaders got there. To think of such a regime as authoritarian is to both miss the point and fail to recognize real authoritarianism when it occurs.

### THE TIME FRAME

Oyama's strictures on the time frame of my study—1925 to 1975—can be dealt with speedily. He makes two points, with both of which I agree. The issue here is not a difference but a clarification of views. Oyama's first point is that 1925 to 1975 is an arbitrary time frame and that there are several other ways of periodizing modern Japanese history. He specifically mentions Bernard Silberman's division of Japan's modern century into a period of bureaucratic absolutism, 1868–1900, and a period of limited pluralism, 1900–1936.<sup>41</sup> Although I believe Silberman's division mislocates the periods of absolutism and does not deal with the prewar and postwar continuities surrounding World War II, I accept Oyama's basic point that there are other possibilities.

Hidaka Rokuro's three cycles of democracy and bureaucracy seem to me more accurate in identifying periods of relative absolutism. His cycles—each of which has two parts, democratization followed by bureaucratization—are cycle one, Meiji Restoration to the constitution, followed by 1890 to the end of Meiji (1912); cycle two, Taisho democracy, 1912 to 1931, followed by militarism, 1931 to 1945; and cycle three, postwar democratization, 1945 to 1960, followed by high-speed growth and single-party rule, 1960 to 1989.<sup>42</sup> This schema is obviously quite different from that of Silberman. But not evident in either of them is the fact that Japan's preoccupation with industrial policy coincides with the greatest periods of both militarism and democracy. The high tide of state influence over the economy occurred during the war and the occupation. One of my purposes in stressing the era 1925 to 1975—from the founding of the Ministry of Commerce and Industry to the aftermath of the "oil

41. Bernard S. Silberman, "The Bureaucratic State in Japan: The Problem of Authority and Legitimacy," in Tetsuo Najita and J. Victor Koschmann, eds., *Conflict in Modern Japanese History* (Princeton: Princeton University Press, 1982), pp. 226–57.

42. For Hidaka's periodization, see Chalmers Johnson, "The People Who Invented the Mechanical Nightingale," in Carol Gluck and Stephen R. Graubard, eds., *Showa: The Japan of Hirohito* (New York: Norton, 1992), pp. 71–90.

shock"—was precisely to see Japan in a different light than that shed by the usual "victor's history."

Japan was working on and implementing industrial policy before 1925, of course, and I agree with Arthur Tiedemann in his review for the *American Historical Review*. "Many of the concerns, attitudes, practices and policies that he [Johnson] believes originated as responses to the 'situational imperatives' of the post-1925 period really are rooted more deeply in Japan's past."<sup>43</sup> But the period 1925 to 1975 is still a distinct unity in my opinion because it was dominated by men born in the middle to late Meiji era who virtually all survived the war and continued to work for the government if they were not uniformed military officers, and because it was a period of global, not just Japanese, concern for economic policy. Japan's use of industrial policy to transform its economy coincided with Stalin's First Five-Year Plan, Hitler's New Order, Roosevelt's New Deal, Keynesianism, the German Wirtschaft Wunder, the Chinese Great Leap Forward, the "welfare state," and many other ideologies and formulations of the proper role of the state in economic affairs. Japan made a critically important contribution to this era and to the modes of thought and political lessons that grew out of it. The period of my history also virtually coincides, in Japanese terms, with the Showa era, and while I agree that there is nothing sacrosanct about 1925 to 1975, that is also true about the Showa period, the twentieth century, or the "postwar" era.

Oyama's second point is more important. He asks why I ended my study in 1975. What started to change then? More precisely, did the success of the Japanese developmental state in the postwar era depend on unusually favorable international conditions? If the postwar conditions were unusually favorable, is the developmental state possible under different international conditions? These questions are in line with Goldfrank's criticism that "Johnson's book consistently understates the contributions of world-systemic factors (e.g., Japanese and U.S. imperialism, the opportunities in the Asian regimes)."<sup>44</sup> Although I would not put it in Goldfrank's terms, I accept his point.

The cold war both promoted and camouflaged the enrichment of Japan and the rest of capitalist Asia. In *MITI and the Japanese Miracle*, I described the Korean War as the virtual equivalent of the Marshall Plan for Japan. There is no question about the importance of the environment in which Japan's high-speed economic growth occurred. But two points at least need to be made as guides to future research. First, the policies, attitudes, and delusions of the United States need to be studied, as do those who responded to them. Second, Japan was not the only country allied

43. Arthur Tiedemann, review, *American Historical Review* 88, no. 1 (February 1983).

44. Goldfrank, review, pp. 722-23.

with the United States or prepared to manipulate the Americans' preoccupation with the USSR to its own advantage. But it was Japan that gave a virtuoso performance of how to extract the most from the United States while paying the least to support its global strategies. That cannot be explained by "world-system factors." In a more general sense, the gains from a developmental state strategy may never again be as great as they were from 1945 to 1975, but other things being equal, a developmental state will always extract more of what gains are possible within a particular international environment than will a state with different priorities.

Japan's commitment to industrial policy did not end in 1975. If anything it became more intense. The new roles for industrial policy that began after 1975 were the nurturing of high-tech industries not already developed in reference economies, promoting Japan's national interests while pretending to support its competitors' rules for so-called "free trade" and "borderless economies," and achieving national security through technonationalism.<sup>45</sup> This agenda was very different from that of 1925 to 1975. The mid-1970s saw the end of the era of Japan's catching up and the beginning of its uneasy tenure as an economic superpower, which is why my book ends there.

#### GOVERNMENT-BUSINESS RELATIONSHIPS

Oyama's last point of controversy is his most important. It concerns the patterns of interaction within the developmental state between the official state bureaucracy and "privately" owned and managed business enterprises. This area was and remains controversial because scholars cannot agree on how to incorporate and weigh cultural differences as they manifest themselves in economic organizations and labor-management relations. It is the area where scholars have most often trapped themselves by projecting onto Japan the norms of the American private sector. David Friedman, Kent Calder, Daniel Okimoto, and Richard Samuels have all sought to improve on my picture of the developmental state by decreasing the weight of the state in economic affairs and increasing the influence of private managers allegedly responding to private incentives. I believe that they have all erroneously (perhaps also ideologically, because they are all Americans writing during the last decade of the cold war) conceived the relationship between the government and private actors as dichotomous and zero-sum and that Calder, in particular, has failed to

45. On technonationalism, see Richard J. Samuels, "*Rich Nation, Strong Army*": *National Security and the Technological Transformation of Japan* (Ithaca: Cornell University Press, 1994), and Jeff Shear, *The Keys to the Kingdom: The FS-X Deal and the Selling of America's Future to Japan* (New York: Doubleday, 1994).

grasp that "private" may mean something different in Japan's ethical system than it does in his own.<sup>46</sup>

Oyama accurately notes that I claim to have found three different patterns of public-private interaction during the fifty years of Japan's industrial policies that I cover. These are self-control, state control, and public-private cooperation. By self- or private control I meant that the state delegated control to private cartels for each industry and that each industrial sector was run by the members of the cartels in response to state incentives. This pattern prevailed from approximately 1931 to 1940, and it resulted in almost total control of Japanese manufacturing by zaibatsu organizations.

This pattern was followed by state control, meaning the direct imposition of state institutions onto the private economy, displacing private cartels, private ownership, private labor organizations, and private management with so-called control associations (*toseikai*) during the war and public corporations (*kodan*, *jigyodan*, and so on) during the occupation and after the restoration of sovereignty down to the present time.<sup>47</sup> Just as private control was never complete during the first period—steel, communications, and the most important portion of rail transport were state enterprises—state control was never complete during the second period. This was particularly true of the *toseikai*, which were covertly dominated by the zaibatsu. The most complete achievement of state control actually occurred during the Allied Occupation. This second period lasted from approximately 1940 to 1952.

Neither self-control nor state control worked very well. The first led to extremes of concentration and oligopoly that elicited violent protests against "monopoly capitalism" from workers and particularly from the military and other groups committed to national unity and a national singleness of purpose. The second led to the bureaucratism and misallocation of resources everywhere associated with state socialism. These conditions contributed directly to Japan's defeat in World War II, in which it was not so much outfought as it was outproduced. After 1952, the Japanese public and private sectors reconciled with each other and perfected cooperative management schemes. These schemes avoided an emphasis

46. See David Friedman, *The Misunderstood Miracle: Industrial Development and Political Change in Japan* (Ithaca: Cornell University Press, 1988); Kent E. Calder, *Strategic Capitalism: Private Business and Public Purpose in Japanese Industrial Finance* (Princeton: Princeton University Press, 1993); Daniel Okimoto, *Between MITI and the Market: Japanese Industrial Policy for High Technology* (Stanford: Stanford University Press, 1989); and Richard J. Samuels, *The Business of the Japanese State: Energy Markets in Comparative and Historical Perspective* (Ithaca: Cornell University Press, 1987).

47. Although long out of date, still the only study of postwar public corporations is Chalmers Johnson, *Japan's Public Policy Companies* (Washington, D.C.: American Enterprise Institute, 1978).

on either private profit or the state's socialization of wealth. They were made possible by the elimination of the military from public life, the reform of the zaibatsu replacing owners with managers, and the offering of career job security to male heads of households in strategic, exporting industries. This new approach worked phenomenally well and captured the attention of industrial sociologists around the world. They launched what amounts to virtually a new discipline under the rubric of the "principles of Japanese management."<sup>48</sup>

Oyama, however, perceptively argues that the differences between these three modes are more apparent than real. He believes that each of them boils down to Murakami Yasusuke's "compartmentalized competition" (*shikirareta kyoso*).<sup>49</sup> In all three periods there is a single pattern in which the state cartelizes or compartmentalizes each industry, restricting new entrants. It does so by promoting and protecting so-called *keiretsu* (industrial groups) from any form of legal or financial challenge by outsiders and protecting the domestic economy from international competition. Each individual industry thus enjoys a stable, cooperative environment in which it can divide up the domestic market and export to the American market, given the Americans' postwar willingness to trade access to their market for the right to have U.S. military bases on Japanese soil and other passive forms of support for their foreign policies.

The cartels of the 1930s, the wartime control associations, and the postwar *keiretsu* all had a similar structure. It consisted of a state "mother" agency or bureau (*genkyoku*) that maintained a "vertical relationship" with its clients, an officially recognized trade association for each industry, and individual enterprises managing their affairs through ad hoc, nonlegal, *Gemeinschaft*-type relationships. In Oyama's perspective, the government-business relationship in Japan has always been "informal and covert" (*hikoshiki-sei ammoku-sei*). State control was never fully achieved before or during the war, and it has never been fully surrendered to the present day.

I believe these are stimulating propositions that deserve further research. The chief evidence for my alleging a dialectical progression toward public-private cooperation is that in the third period Japan perfected new forms of management, enlisted extraordinary labor commit-

48. See, *inter alia*, Uchihashi Katsuto, Okumura Hiroshi, and Sataka Makoto, eds., *Nihon kaisha genron* (Principles of Japanese companies) (Tokyo: Iwanami Shoten, 1994), 6 vols., and Matsumoto Koji, *The Rise of the Japanese Corporate System*, trans. Thomas I. Elliott (London: Kegan Paul International, 1991). By foreign writers, the seminal works are Rodney Clark, *The Japanese Company* (New Haven: Yale University Press, 1979), and W. Mark Fruin, *The Japanese Enterprise System* (Oxford: Clarendon Press, 1992).

49. Murakami Yasusuke, *Shinchukan taishu no jidai* (The age of the new middle mass) (Tokyo: Chuo Koron Sha, 1984).

ment, and got rich, whereas in the earlier periods it faltered badly. The Japanese have not always been the masters of creative industrial management, to say the least. But the favorable postwar outcome may be due to factors other than improved state-civilian relationships. The exact nature and terms of the internal organization of "Japan, Inc." remain obscure, and the ideological attempts of the Americans during the cold war to redefine Japan as an appropriate ally did not help in clarifying them.

Rather than attempting this sort of research, Calder reformulates Japan's modern economic history. He asserts that the state's schemes for defensive modernization during the Meiji era were "mainly in support of private-sector objectives" and that "institutionally speaking, the role of the private sector in the Japanese economy was thus prior to that of the state."<sup>50</sup> His evidence for these propositions is drawn from a history of the Industrial Bank of Japan (IBJ), which he only obliquely acknowledges was from 1902 to 1952 a government organ and was "privatized" by order of the Allied Occupation. I also believe he has failed to do elementary area studies research on the different meanings of *ko* and *shi* in Japan and "public" and "private" in the United States.<sup>51</sup> He fails to understand that even his "private" managers in the post-Occupation IBJ are not American-style, short-term profit maximizers but engaged in a nationally sanctioned cooperative enterprise. The Japanese manager, as Rodney Clark classically put it, has "a view of management as a bureaucratic and cooperative venture: the government of a company rather than the imposition of an entrepreneurial will on a market place and a work force by superior skill, courage, or judgment."<sup>52</sup>

Calder's error, like that of the writers mentioned earlier who overstate or misinterpret the role of the private sector in Japan, comes from a combination of parochialism and ideology. Given the history of federalism and the separation of powers in the United States, it is a particularly inappropriate venue from which to study the East Asian state. This source of error was then compounded by the imperial pretensions of the United States during the Occupation and the cold war. These writers, in my opinion, are trying to force Japan to fit the paradigms of government that they were taught in American political science courses. The best of them learn from their failed attempts and go on to become mature, serious comparativists. They then begin to confront what X. L. Ding is getting at when he writes,

50. Calder, *Strategic Capitalism*, p. 25.

51. See Patricia Boling, "Private Interest and the Public Good in Japan," *Pacific Review* 3, no. 2 (1990): 138–50.

52. Clark, *Japanese Company*, pp. 36–37, quoted in Johnson, *MITI and the Japanese Miracle*, p. 62.

In East Asia, the pattern of state-society relations historically differs notably from the modern Western pattern, and the distinctive features of the East Asian pattern do not simply disappear after industrialization or democratization. In East Asia, the states are organizationally pervasive, without clear-cut boundaries. Their powers and functions are diffuse, and they pay little respect to due process. Consequently, the lines between public and private, political and personal, formal and informal, official and nonofficial, governmental and market, legal and customary, and between procedural and substantial, are all blurred. This is the case in precommunist China, in semi-authoritarian Taiwan, as well as in democratic Japan.<sup>53</sup>

I believe Hiwatari is right when he advises that "Calder should consider who created and protected the special kind of bank (long-term credit bank) that he asserts is the headquarters of 'corporate-led strategic capitalism.'"<sup>54</sup> However, it is equally important to stress, as I did in the earlier discussion of industrial policy versus the market, that regardless of the cultural or nationalistic norms that may prevail in either the state or civilian enterprises, both entities need each other. That is what I think the Japanese discovered as a result of their disastrous midcentury experiences and what American political scientists have yet to discover. The concept "developmental state" means that each side *uses* the other in a mutually beneficial relationship to achieve developmental goals and enterprise viability. When the developmental state is working well, neither the state officials nor the civilian enterprise managers prevail over the other. The state is a "catalytic" agency, in Michael Lind's sense of the term, and the managers are responding to incentives and disincentives that the state establishes.<sup>55</sup> This is not an easy combination to put together, but when it is done properly, it can produce miracles of economic development. Whether, in the current climate of economic "globalization" and Anglo-American triumphalism, it can manage to maintain its equilibrium is something that remains to be seen. But I am quite certain that if the developmental state goes under, the U.S. regulatory state will not be far behind.

53. Ding, "Institutional Amphibiousness," p. 317.

54. Hiwatari, "After the Earthquake Election," p. 12.

55. Michael Lind, "The Catalytic State," *National Interest* (Spring 1992): 3-12.

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# Democracy and Development

Political Institutions and  
Well-Being in the World,  
1950–1990

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PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE  
The Pitt Building, Trumpington Street, Cambridge, United Kingdom

CAMBRIDGE UNIVERSITY PRESS

The Edinburgh Building, Cambridge CB2 2RU, UK  
40 West 20th Street, New York, NY 10011-4211, USA  
477 Williamstown Road, Port Melbourne, VIC 3207, Australia  
Ruiz de Alarcón 13, 28014 Madrid, Spain  
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First published 2000

Reprinted 2002

Printed in the United States of America

Typeface Centennial 9.5/12.5 pt. System QuarkXPress [BTS]

*A catalog record for this book is available from the British Library.*

*Library of Congress Cataloging in Publication data available*

ISBN 0 521 79032 8 hardback  
ISBN 0 521 79379 3 paperback

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## **Chapter Three**

### **Political Regimes and Economic Growth**

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#### **Introduction**

With the birth of new nations in Asia and Africa, the fear that democracy would undermine economic growth began to be voiced in the United States. The first statements to that effect were perhaps those by Walter Galenson and by Karl de Schweinitz, who argued, both in 1959, that in poor countries democracy unleashes pressures for immediate consumption, which occurs at the cost of investment, hence of growth. Galenson mentioned both the role of unions and that of governments. He thought that unions "must ordinarily appeal to the worker on an all-out consumptionist platform. No matter how much 'responsibility' the union leader exhibits in his understanding of the limited consumption possibilities existing at the outset of industrialization, he cannot afford to moderate his demands." As for governments, he observed that "the more democratic a government is, . . . the greater the diversion of resources from investment to consumption." According to de Schweinitz (1959: 388), if trade unions and labor parties "are successful in securing a larger share of the national income and limiting the freedom for action of entrepreneurs, they may have the effect of restricting investment surplus so much that the rate of economic growth is inhibited." That argument enjoyed widespread acceptance under the influence of Huntington, who claimed that "the interest of the voters generally leads parties to give the expansion of personal consumption a higher priority via-à-vis investment than it would receive in a non-democratic system" (Huntington and Domiguez 1975: 60; Huntington 1968).

Democracy was thus seen as inimical to economic development. Moreover, via a rather dubious inference, proponents of that view concluded that dictatorships were therefore better able to force savings and launch economic growth. To cite a more recent statement: "Eco-

nomic development is a process for which huge investments in personnel and material are required. Such investment programs imply cuts in current consumption that would be painful at the low levels of living that exist in almost all developing societies. Governments must resort to strong measures and they enforce them with an iron hand in order to marshal the surpluses needed for investment. If such measures were put to a popular vote, they would surely be defeated. No political party can hope to win a democratic election on a platform of current sacrifices for a *bright future*" (Rao 1984: 75).<sup>1</sup>

The reasoning bears reconstruction. First, that argument assumes that poor people have a higher propensity to consume.<sup>2</sup> This is why democracy may be compatible with growth at high but not at low levels of income. Second, the underlying model of growth attributes it to the increase in the stock of physical capital. Finally, democracy is always responsive to pressures for immediate consumption. The chain of reasoning is thus the following: (1) Poor people want to consume immediately. (2) When workers are able to organize, they drive wages up, reduce profits, and reduce investment (by lowering either the rate of return or the volume of profit or both). (3) When people are allowed to vote, governments tend to distribute income away from investment (either they tax and transfer or they undertake less public investment). (4) Lowering investment slows down growth. Note, as well, that this reasoning implies that the impact of mean-preserving inequality on growth is ambivalent: In the Kaldor-Pasinetti models, inequality promotes growth, as it increases the incomes of those who save more, but in the median-voter models it slows down growth to the extent to which the political system responds to demands for redistribution.

Arguments in favor of democracy are not equally sharp, but they all focus in one form or another on allocative efficiency: Democracies can better allocate the available resources to productive uses. One view is that because authoritarian rulers are not accountable to electorates,

<sup>1</sup> At least Huntington and his collaborators wrote during a period when many dictatorships, "authoritarian" and "totalitarian," did grow rapidly. But Rao's assertion was made in 1984, after the failure of several Latin American authoritarian regimes and Eastern European communist regimes was already apparent.

<sup>2</sup> Pasinetti (1961) claimed that the propensity to consume is higher for workers than for capitalists, and Kaldor (1956) believed that it is higher for wages than for profits, whereas the scholars discussed here seem to assume that in general the marginal propensity to consume declines with income. Barro and Sala-i-Martin (1995: 77–9) show that in the optimal growth model the savings rate decreases as a result of the substitution effect and increases in income as a consequence of the income effect, the net effect being ambivalent.

they have no incentive to maximize total output, but only their own rents. As a result, democracies better protect property rights, thus allowing a longer-term perspective to investors. There is also a vague sense that by permitting a free flow of information, democracies somehow improve the quality of economic decisions.

According to the first view, the state is always ready to prey on the society (North 1990), and only democratic institutions can constrain it to act in a more general interest. Hence, dictatorships, of any stripe, are sources of inefficiency. Barro (1990), Findlay (1990), Olson (1991), and Przeworski (1990) have constructed models that differ in detail but generate the same conclusion. These models assume that some level of government intervention in the economy is optimal for growth. Then they all show that, depending on the details of each model, dictatorships of various stripes can be expected to undersupply or oversupply government activities. One interesting variant of this approach is by Robinson (1995), who thinks that dictators are afraid, at least under some conditions, that development would give rise to political forces that would overturn them, and thus they deliberately abstain from developmentalist policies.

Perhaps the best-known informational argument is based on the Drèze and Sen (1989) observation that no democracy ever experienced a famine, which they attribute to the alarm role of the press and the opposition. Thus, Sen (1994a: 34) observes that “a free press and an active political opposition constitute the best ‘early warning system’ that a country threatened by famine can possess.” He also cites an unlikely source, Mao, reflecting on the great Chinese famine of 1962, to the effect that “without democracy, you have no understanding of what is happening down below.” Yet it is not apparent whether this is an argument strictly about avoiding disasters or about average performance.<sup>3</sup>

This summary makes no pretense to being exhaustive. All we want to highlight is that the arguments in favor of dictatorship and those in favor of democracy are not necessarily incompatible. The arguments against democracy claim that it hinders growth by reducing investment; the arguments in its favor maintain that it fosters growth by promoting allocative efficiency. Both may be true: The rate at which

<sup>3</sup> Sah and Stiglitz (1988) compared the quality of the decisions whether or not to undertake a series of economic projects made under different decision rules. Their conclusions are ambivalent: Although majority rule is conducive to good decisions under many conditions, decisions by smaller groups are better when the costs of information are high, whereas decisions by larger groups are superior when the chances of adopting a bad project are high.

productive factors grow may be higher under dictatorship, but the use of resources may be more efficient under democracy. And because these mechanisms work in opposite directions, the net effect may be that there is no difference between the two regimes in the average rates of growth they generate. The patterns of growth may differ, but the average rates of growth may still be the same.

Rates of growth may thus differ between regimes either because the productive inputs increase at different rates or because they are used with different efficiencies. To assess the impact of regimes on growth, we proceed by the following steps:

First, we examine whether or not it is valid to assume that the productive inputs grow at the same rates under the two regimes. This is a test of the validity of the hypothesis that regimes do not affect the rates of growth of productive resources.

Second, we estimate separately for each regime a production-function model,  $Y = AF(K, L) = AK^\alpha L^\beta$ , in growth form (suppressing the  $i, t$  subscripts):<sup>4</sup>

$$\dot{Y}/Y = \dot{A}/A + \alpha \dot{K}/K + \beta \dot{L}/L + \Theta \lambda + e,$$

where  $\lambda$  is the instrument for the regime variable. The coefficients<sup>5</sup>  $\dot{A}/A$ ,  $\alpha$ , and  $\beta$  provide selection-unbiased estimates of, respectively, technical progress and the efficiency with which capital stock and labor force contribute to growth under each regime. This is then a test of the hypothesis that the efficiency with which resources are used is the same under the two regimes.

To calculate the effects of regimes independent of the exogenous conditions under which they were observed, we need to generate the growth rates that would be expected had each country been observed each year under each regime. If the hypothesis that the growth of productive inputs is exogenous with regard to regimes is not rejected, the expected values of the growth rates under the two regimes are obtained by multiplying the coefficients characterizing each regime by the rates of growth of the productive inputs observed for each country during each year. If the growth of productive inputs is endogenous with regard to regimes, the expected growth rates are obtained by multiplying the coefficients characterizing each regime by the average rate of growth

<sup>4</sup> A notational explanation for non-economists: The dots over the variables indicate time derivatives, so that for any  $X$ ,  $\dot{X} = dX/dt$ , and  $\dot{X}/X$  is the rate of growth.

<sup>5</sup> We refer to  $\dot{A}/A$  as a coefficient because we treat it as a constant, either for regimes or for countries or for years, depending on estimation methods.

of productive inputs observed under each regime. In either case this procedure generates predicted values of growth for each country during each year under each regime. These values are then averaged over all observations, and the regime averages are compared. The regime effect is the difference between these averages.

Finally, we study whether or not the production function and the rate of growth of productive inputs are stable for each of the regimes. Because the two regimes are observed at different income levels, and because both the production functions and the growth of inputs may depend on the level of development, we need to test whether the observed differences are indeed due to regimes or merely to wealth.

### **Political Regimes and Economic Growth**

The observed rate of growth of total income ( $YG = \dot{Y}/Y$ ) is higher under dictatorships, 4.42, than under democracies, 3.95, implying that income doubles in 15.8 years under dictatorship and in 17.7 years under democracy. Yet we already know that one should not draw inferences from the observed values.

To identify the effect of regimes, we need to distinguish the effects of the conditions under which these regimes were observed from the effect of regimes. We present first the results concerning the effect of regimes on the growth of productive inputs, then those concerning the efficiency with which these inputs are used under each regime, and, finally, the conclusions about the overall effect of regimes on the growth of total income.

Do productive inputs grow at the same rate under the two regimes? The claim that democracy undermines investment, whether in general or only in poor countries, finds no support in the evidence. The observed average share of investment in gross domestic product (GDP),  $INV = I/Y$ , was in fact much higher in democracies, 20.90 percent, than in dictatorships, 14.25 percent. But because investment shares increase with per capita income, and because, as we already know, dictatorships have generally existed in poorer countries, this could be just an effect of income. Indeed, controlling for income, as well as for a number of other variables in a selection model, shows that regimes have no overall effect on investment.<sup>6</sup> Table 3.1 presents the results of

<sup>6</sup> The variables in the investment equation include lagged investment share (given that investment decisions made one year take time to realize, INVLAG), lagged per capita income (an instrument for expected domestic demand, LEVLAG), the average rate of

**Table 3.1A.** Investment share in GDP (INV), by per capita income (LEVEL)

LEVEL	Proportion dictatorships	Investment share		
		All	Dictatorships	Democracies
0–1,000	0.9273	8.89	8.79	10.14
1,001–2,000	0.7472	13.53	13.66	13.17
2,001–3,000	0.6207	17.87	17.83	17.93
3,001–4,000	0.5874	20.04	20.47	19.42
4,001–5,000	0.5424	22.76	23.75	21.57
5,001–6,000	0.4308	24.35	25.48	23.50
6,001–	0.0812	25.40	29.92	25.00
Total ( <i>N</i> = 4,126)		16.90	14.25	20.90

*Note:* All cell entries are based on at least 68 observations.

statistical analyses that used different estimation methods.<sup>7</sup> Regardless of the method, the regime difference between the selection-corrected expected investment shares is never larger than 1 percent. Moreover, among poorer countries, those with per capita incomes lower than \$3,000, both the observed and the corrected investment shares are slightly higher in democracies. Hence, there is no reason to think that regimes affect investment even in poor countries: Had these regimes

growth in the world (a measure of world demand, WORLD), and the relative price of investment goods (PINV). Alternatively, we estimate a 2SLS model with the predicted growth rate as an instrument for the current demand. For a review of econometric models of investment, see Rama (1993).

<sup>7</sup> Because we present several tables with the same structure, here is a short guide to reading them, first by row, then by column. "Biased" stands for the observed values or ordinary least squares (OLS) regressions in which regime (REG) is a dummy variable. Then follow various selection-corrected average predicted values of the dependent variable under the two regimes. The correction for selection is always based on the dynamic probit described in Appendix 2.1. The performance models depend on the structure of the pooled time series, specifically autocorrelation, homogeneity, and simultaneity. Finally, the last two rows refer to an alternative manner of estimating selection models, due to Heckman (1988): "Unobservable" assumes that selection entails unobserved variables, and "Observable" that it entails only observed ones. The columns "Regime means" give the average values of the dependent variable under the two regimes. "Constant regime effect" assumes that the regime effect is an intercept dummy, and "Individual regime effect" assumes that it is a sum of differences in slopes multiplied by the values of the independent variables. For details, see Appendix I.

**Table 3.1B.** Selection-corrected estimators of investment share (INV)

Estimator (selection/INV)	Regime means		Regime effect	
	Dictatorships (N = 2,396)	Democracies (N = 1,595)	Constant	Individual (N = 3,991)
Biased	14.28 (9.40)	20.98 (8.02)	0.0860 (0.1041)	0.0362 (0.3340)
MLE	17.19 (9.26)	16.97 (9.09)		
1F-HATANAKA	21.61 (6.97)	21.25 (6.50)		
1F-AR1	16.69 (7.60)	17.73 (7.69)		
2SLS-1F-AR1	16.84 (7.85)	17.69 (7.81)		
Unobservable			0.0806 (0.1092)	0.0348 (0.3437)
Observable			0.0797 (0.1019)	0.0042 (0.3118)

**By per capita income (LEVEL)**

	LEVEL < \$3,000		LEVEL ≥ \$3,000	
	Dictatorships (N = 1,875)	Democracies (N = 469)	Dictatorships (N = 478)	Democracies (N = 1,104)
Biased	11.95 (7.80)	14.38 (6.08)	23.41 (9.11)	23.87 (6.99)
1F-AR1	12.17 (2.14)	13.23 (1.70)	23.68 (1.95)	23.61 (0.86)
1F-HATANAKA	14.90 (4.76)	12.91 (5.30)	24.07 (4.43)	24.15 (5.54)

*Notes:* Probit equations include lagged values of LEVEL, STRA, and RELDIF. The INV equations include INVLAG, LEVEL, PINV, and WORLD. The 2SLS estimation uses fitted values of YG as instrument. Standard errors in parentheses.

**Table 3.2A.** Rate of growth of capital stock (KSG), by per capita income (LEVEL)

LEVEL	Proportion dictatorships	KSG		
		All	Dictatorships	Democracies
0–1,000	0.9273	5.624	5.440	7.947
1,001–2,000	0.7472	7.627	8.112	6.189
2,001–3,000	0.6207	8.925	9.860	7.390
3,001–4,000	0.5874	7.494	7.621	7.314
4,001–5,000	0.5424	8.074	6.806	9.576
5,001–6,000	0.4308	8.038	9.297	7.085
6,001–	0.0812	6.080	10.650	5.676
Total ( <i>N</i> = 4,126)		7.007	7.310	6.547

*Note:* All cell entries are based on at least 68 observations.

existed under the same conditions, specifically in countries with the same per capita incomes, facing the same relative prices of investment goods and world demand, and had they been matched for unobservable factors that affect regime selection, their shares of investment in GDP would have been the same.

Hence, even if pressures for immediate consumption are higher in poor countries, democracies do not transform them into lower rates of investment than do dictatorships. Poor countries simply invest little regardless of their regime: Cape Verde between 1977 and 1983, Zambia during 1966–68 and 1970–75, and Romania between 1967 and 1981 are the only countries with per capita incomes under \$1,000 that maintained investment rates above 30 percent, whereas many wealthier countries invested at such rates. The share of investment is the same under the two regimes in wealthier countries, those with incomes over \$3,000.

Another way to think about investment is in terms of the growth of capital stock.<sup>8</sup> The observed rate of growth of capital stock ( $KSG = \dot{K}/K$ ) is somewhat higher under dictatorships, 7.31, than under democracies, 6.56 (Table 3.2). The observed difference for countries with

<sup>8</sup> Note that the investment share is  $INV = I/Y$ , and the rate of growth of capital stock is  $KSG = \dot{K}/K = (I - \delta K)/K$ . The depreciation rate implied by the Penn World Tables (PWT) data is quite high.

**Table 3.2B.** Selection-corrected estimators of the rate of growth of capital stock (KSG)

Estimator (selection/INV)	Regime means		Regime effect	
	Dictatorships (N = 2,396)	Democracies (N = 1,595)	Constant	Individual (N = 3,991)
Biased	7.24 (14.00)	6.49 (10.78)	0.5420 (0.5094)	-0.3571 (1.4630)
MLE	7.50 (2.57)	6.99 (2.26)		
2SLS-MLE	7.01 (9.99)	7.06 (9.57)		
Unobservable			0.5856 (0.5350)	-0.3601 (1.4642)
Observable			0.6202 (0.5127)	0.0056 (5.6502)

**By per capita income (LEVEL)**

	LEVEL < 3,000		LEVEL ≥ 3,000	
	Dictatorships (N = 1,917)	Democracies (N = 487)	Dictatorships (N = 479)	Democracies (N = 1,108)
Biased	7.03 (14.47)	6.71 (13.29)	8.05 (11.91)	6.39 (8.29)
2SLS-MLE	6.88 (11.46)	7.09 (12.25)	7.94 (6.85)	6.94 (6.61)

*Notes:* Probit equations include lagged values of LEVEL, STRA, and RELDIF. The KSG equations include LEVLAG, WORLD, PINV, PRIME, and COMEX. The 2SLS estimation adds YG, with YGLAG as instrument. In 1F PANEL: LEVLAG, WORLD, PINV, and PRIME. Standard errors in parentheses.

incomes below \$3,000 is negligible. Above \$3,000, capital stock grew faster under dictatorship, at the rate of 8.05, than under democracy, where it increased at the rate of 6.39. Correcting for selection, with the same exogenous variables we used for the investment share, shows again, however, that regimes do not affect the growth of capital stock in the sample as a whole and not among countries with incomes under

**Table 3.3A.** Rate of growth of labor force (LFG); by per capita income (LEVEL)

LEVEL	Proportion dictatorships	Rate of labor-force growth		
		All	Dictatorships	Democracies
0-1,000	0.9273	2.314	2.338	2.019
1,001-2,000	0.7472	2.320	2.312	2.342
2,001-3,000	0.6207	2.295	2.365	2.181
3,001-4,000	0.5874	2.013	2.254	1.670
4,001-5,000	0.5424	1.561	1.979	1.066
5,001-6,000	0.4308	1.205	1.711	0.822
6,001-	0.0812	1.395	1.711	1.367
Total ( <i>N</i> = 4,128)		2.006	2.270	1.608

*Note:* All cell entries are based on at least 68 observations.

\$3,000. Above \$3,000, the selection-corrected values are somewhat higher under dictatorship, 7.94, as opposed to 6.94 under democracy.

Hence, different regimes affect neither the share of investment in GDP nor the rate of growth of capital stock. Moreover, contrary to all the arguments, poor countries invest little regardless of the regime, and it is in wealthier countries that investment is slightly higher under dictatorships.

In turn, the rate of growth of the labor force ( $LFG = \dot{L}/L$ ) is higher under dictatorships (Table 3.3). The observed values are 2.27 percent per annum under dictatorships and 1.61 under democracies. Note again the observed patterns. The rates of growth of the labor force are about the same under the two regimes in countries with per capita incomes of less than \$3,000. But in countries with higher incomes, the difference between them becomes dramatic. Indeed, the labor force grows faster in dictatorships with incomes above \$6,000 than in democracies with incomes between \$3,000 and \$4,000.

Because the labor force grows at a slower rate in wealthier countries, one might suspect again that this difference is due to the distribution of regimes by income. Some of it is, but not enough to eradicate the effect of regimes. Even when the regimes are matched for their income, their colonial heritage, and the frequencies of Catholics,

**Table 3.3B.** Selection-corrected estimators of labor force growth (LFG)

Estimator (selection/LFG)	Regime means		Regime effect	
	Dictatorships (N = 2,396)	Democracies (N = 1,595)	Constant	Individual (N = 3,991)
Biased	2.28 (1.94)	1.59 (1.20)	0.2565 (0.0695)	0.0820 (0.3354)
2SLS	2.17 (0.37)	1.72 (0.28)		
AR1	2.17 (0.37)	1.72 (0.28)		
HATANAKA	2.16 (0.53)	1.75 (0.68)		
2F PANEL	2.00 (0.79)	1.81 (0.53)		
Unobservable			0.2795 (0.0728)	0.0870 (0.3353)
Observable			0.2863 (0.0702)	0.0893 (0.3462)
<b>LFPW sample</b>	<b>N = 2,076</b>	<b>N = 1,254</b>		
Biased	2.39 (1.93)	1.65 (1.19)		
OLS	2.27 (0.41)	1.81 (0.66)		
<b>By per capita income (LEVEL)</b>				
Estimator	<b>LEVEL &lt; 3,000</b>		<b>LEVEL ≥ 3,000</b>	
	Dictatorships (N = 1,917)	Democracies (N = 487)	Dictatorships (N = 479)	Democracies (N = 1,108)
Biased	2.35 (2.03)	2.22 (1.02)	2.03 (1.54)	1.32 (1.17)
OLS-AR1	2.33 (0.27)	2.35 (0.44)	1.92 (0.50)	1.26 (0.44)

*Notes:* Probit equations include lagged values of LEVEL, STRA, and RELDIF. The LFG equations include LEVEL, NEWC, BRITCOL, CATH, PROT, and MOSLEM, plus LFPW in the LFPW sample. The 2SLS estimation is based on the same variables plus YG, with YLAG as instrument. Standard errors in parentheses.

Protestants, and Moslems, even if they are matched for demand (2SLS), or for the lagged rate of population growth (HATANAKA estimator), or for country-specific effects (PANEL estimator), as well as for the factors affecting selection, and, in a smaller sample, for the labor-force participation of women (LFPW), the labor force grows faster under dictatorships. The selection-corrected difference is small in countries with incomes under \$3,000, but quite large in those over \$3,000.<sup>9</sup>

Hence these findings generate a surprise. Contrary to all the arguments, the kind of regime does not affect the rate of investment and the growth of capital stock. And for reasons to be investigated later, it appears that the regime type does affect the growth of the labor force.

To examine the effect of regimes on the efficiency with which resources are used in production, we need to compare the coefficients of the respective production functions. The constant measures total factor productivity, and the coefficients on capital and labor represent the elasticities of output with regard to these factors.<sup>10</sup>

As shown in the first two columns of Table 3.4, which provide the results for the entire sample, total factor productivity is somewhat higher in democracies. The elasticity with regard to capital is slightly higher in dictatorships, but elasticity with regard to labor is higher in democracies. Hence, one is led to conclude that democracies benefit more from technical progress and use labor more effectively, but dictatorships more efficiently employ the physical capital stock. Yet because there are reasons to suspect that production functions depend on the composition of each regime sample, we shall return to this topic later.

What, then, is the overall effect of regimes on growth? Assuming that the two regimes exist under the same conditions reduces the difference between the expected growth rates almost to zero. Whether one estimates the model by unconstrained OLS or constrains the coefficients of the production function<sup>11</sup> or uses the appropriate panel methods or

<sup>9</sup> The results for the split sample should be treated with some skepticism. A labor-force growth series is hard to estimate: It has some simultaneity, it is autocorrelated, and it probably has a cyclical component; given that we need to use country-invariant variables, we cannot use fixed effects, and the random-effects model does not fit well. To see if it makes a difference how the model is estimated, we provide in Table 3.3B several alternative estimators. Fortunately, they all lead to the same conclusion. When the sample is split, however, statistical problems become overwhelming. The best estimator seems to be OLS-AR1, which is what we report.

<sup>10</sup> For comments on estimation methods, see Appendix 3.1.

<sup>11</sup> When selection is estimated by the dynamic probit, the OLS results, constrained or not, are almost identical with the maximum-likelihood estimates.

**Table 3.4.** Barebones model, by low and high per capita incomes, decomposed by sources of growth, with LFG taken as exogenous

Estimator	Entire Sample			\$3,000 ≤ Income < \$8,000			Income > \$3,000		
	Dic	Dem	Dic	Dem	Dic	Dem	Dic	Dem	
N	2,396	1,595	1,917	487	594	462	479	1,108	
Y/P	1,909	6,210	1,227	1,761	4,469	5,490	4,642	8,165	
Biased	4.43	3.92	4.30	4.11	4.83	4.30	4.91	3.83	
	(6.94) <sup>a</sup>	(4.82)	(6.97)	(6.20)	(6.75)	(4.51)	(6.81)	(4.07)	
 Best estimate: Method									
	OLS	2F	OLS	OLS	OLS	2F	OLS	2F	
Constant	0.8966 (0.1433)	1.0430 (0.2078)	0.8680 (0.1551)	0.9226 (0.3957)	0.9353 (0.3902)	1.7785 (0.3058)	0.9230 (0.3733)	1.3439 (0.2058)	
α	0.4004 (0.0060)	0.3447 (0.0086)	0.3937 (0.0064)	0.3929 (0.0470)	0.4409 (0.0178)	0.2643 (0.0160)	0.4383 (0.0166)	0.2751 (0.0119)	
β	0.3138 (0.0435)	0.3974 (0.1132)	0.3173 (0.0460)	0.2524 (0.1532)	0.2926 (0.1332)	0.3838 (0.1891)	0.2960 (0.1295)	0.5530 (0.1286)	
Θ	-1.1099 (0.3355)	-0.0180 (0.2461)	-0.1804 (0.3941)	-0.0193 (0.2748)	-1.2962 (0.7035)	-0.0353 (0.4791)	-1.1945 (0.6903)	0.0719 (0.4288)	
YG-HAT	4.30 (5.03)	4.23 (4.34)	4.35 (5.57)	4.23 (5.56)	4.81 (4.61)	4.44 (2.80)	4.40 (4.21)	4.09 (2.73)	
Capital	2.7776	2.3914	2.7430	2.7376	3.3985	2.0373	3.0201	1.8958	
Labor	0.6303	0.7983	0.7370	0.5737	0.4784	0.6274	0.4738	0.8479	
TFP	0.8966	1.0430	0.8680	0.9226	0.9353	1.7785	0.9230	1.3439	

Constrained OLS ( $\alpha + \beta = 1$ )		<b>F for constraint</b>		<b>17.19</b>		<b>37.56</b>		<b>5.38</b>		<b>3.90</b>		<b>5.49</b>		<b>4.13</b>		<b>10.06</b>	
		<b>F</b>	<b>Probability</b>	(0.0000)	(0.0001)	(0.0000)	(0.0000)	(0.0207)	(0.0489)	(0.0185)	(0.0427)	(0.0017)					
Constant	0.1939 (0.0934)	0.5796 (0.0934)	0.1447 (0.1016)	0.1036 (0.1798)	0.3323 (0.2438)	1.0229 (0.1713)	0.3333 (0.2355)	0.9053 (0.1110)									
$\alpha$	0.4094 (0.0059)	0.3619 (0.0079)	0.4033 (0.0063)	0.3984 (0.0115)	0.4466 (0.0176)	0.3179 (0.0143)	0.4430 (0.0165)	0.3199 (0.0111)									
$\beta$	0.5906 (0.0059)	0.6381 (0.0079)	0.5967 (0.0063)	0.6016 (0.0115)	0.5534 (0.0176)	0.6821 (0.0143)	0.5570 (0.0165)	0.6801 (0.0111)									
$\Theta$	-1.0397 (0.3381)	0.2609 (0.2133)	-1.1933 (0.3978)	-0.0029 (0.2870)	-1.0751 (0.6967)	0.4813 (0.4106)	-0.9831 (0.6847)	0.3965 (0.3665)									
YGHAT	4.22 (5.17)	4.37 (4.60)	4.34 (5.73)	4.28 (5.66)	4.68 (4.71)	4.59 (3.43)	4.24 (4.30)	4.15 (3.19)									
Capital	2.8398	2.5104	2.8100	2.7762	3.4424	2.4507	3.0527	2.2045									
Labor	1.1864	1.2818	1.3859	1.3972	0.9047	1.1150	0.8540	1.0427									
TFP	0.1939	0.5796	0.1447	0.1036	0.3323	1.0229	0.3333	0.9053									

a Standard errors in parentheses.

applies the Heckman (1988) instrumental-variable approach, the differences between selection-unbiased expected rates of growth are minimal. Introducing human capital, specifically, the rate of growth in the years of education attained by the average member of the labor force ( $\text{EDTG} = \dot{H}/H$ ), reduces the size of the sample, but the results are again the same.

Because the labor force grows faster under dictatorship even when the two regimes are matched for exogenous conditions, lines with "LFG endogenous" in Table 3.5 take the rate of growth of the labor force at the mean values observed for each regime. These results are somewhat more favorable to dictatorships. But the difference between regimes is still minuscule. Hence, there is no reason to think that the regime type affects the rate of growth of total income.

Another way to test the effect of regimes is to focus on the countries that experienced regime changes. Here again, however, one should proceed prudently. Countries in which regimes are unstable may be different from those that have had single regimes persisting during the entire period. Yet the observed average rate of growth was the same in those countries that did not experience any regime transitions and in those that underwent one or more regime changes: The rate of growth for the former was 4.23 percent ( $N = 2,813$ ), and for the latter 4.25 ( $N = 1,313$ ). Stable dictatorships grew at the rate of 4.38 percent ( $N = 1,709$ ), whereas dictatorships in the countries that also experienced democracy grew at the rate of 4.51 ( $N = 772$ ). Stable democracies grew at the rate of 3.98 percent ( $N = 1,104$ ), and democracies that rose from or gave way to dictatorships grew at 3.88 percent ( $N = 541$ ). Hence, there is no reason to think that growth in the countries where regimes were stable was different from that in countries where regimes changed.<sup>12</sup>

With this reassurance, we can compare the rates of growth of democracies preceding dictatorships with those of democracies following dictatorships, and vice versa. The average rate of growth during all the years of democracies preceding dictatorships was 4.49 percent ( $N = 290$ ), and for dictatorships following democracies, 4.37 ( $N = 425$ ). Hence, transitions from democracy to dictatorship did not affect the rate of growth. Growth during all the years of dictatorships preceding democracies was higher, at the average of 4.74 percent ( $N = 607$ ), than the average of 3.64 percent ( $N = 371$ ) during all the democratic years that followed. But because recovery from the crises accompanying transitions to democracy is slow, and the observations are right-hand

<sup>12</sup> For a more extensive discussion of the effect of regime stability on growth, see Chapter 5.

**Table 3.5.** Selection-corrected estimators of the rate of growth of income (YG)

Estimator	Regime means		Regime effect	
	Dictatorships (N = 2,396)	Democracies (N = 1,595)	Constant (N = 3,991)	Individual
Biased	4.43 (6.94)	3.92 (4.82)	-0.0227 (0.1252)	0.0006 (0.4908)
Unconstrained OLS	4.30 (5.02)	4.24 (4.48)		
Constrained OLS (LFG exogenous)	4.22 (5.17)	4.37 (4.60)		
Constrained OLS (LFG endogenous)	4.38 (5.15)	4.11 (4.55)		
PANEL	4.22 (5.17)	4.23 (4.34)		
PANEL	4.38 (5.15)	4.07 (4.34)		
Unobservable			0.0741 (0.1312)	0.0461 (0.4871)
Observable			-0.0926 (0.1537)	0.0490 (0.5061)
<hr/>				
<b>EDTG sample</b>	<b>N = 1,745</b>	<b>N = 1,042</b>		
Biased	4.57 (6.91)	3.91 (4.71)		
Unconstrained OLS (LFG exogenous)	4.45 (4.71)	4.34 (3.88)		
Constrained OLS (LFG exogenous)	4.36 (4.87)	4.94 (4.01)		
2F PANEL (LFG exogenous)	4.45 (4.71)	4.33 (3.74)		

*Notes:* Probit equations include lagged values of LEVEL, STRA, and RELDIF. The "barebones" model includes KSG, LFG, and, in a smaller sample, EDTG. "Constrained" means that the coefficients on the arguments of the production function were constrained to 1.00. PANEL is OLS for dictatorships and 2F for democracies. "LFG exogenous" is based on the assumption that LFG is exogenous; "LFG endogenous" takes LFG at the observed mean of each regime.

censored, the conclusion that transitions to democracy slow down growth would be erroneous. Just note that many of the democratic observations followed transitions from either bureaucratic-authoritarian or communist dictatorships during the 1980s, including the very end of the decade. Because those democracies did not have time to recover by 1990, they weigh down the democratic average.

In sum, neither the selection-corrected values for the entire sample nor the paths of growth associated with regime transitions give any support to the claim that regime types affect the rate of growth of total income. Selection-corrected average rates of growth are the same for the two regimes. And there is no reason to think that steady-state rates of growth would be different under the two regimes when countries experience regime transitions.

The first conclusion, therefore, must be that political regimes have no impact on the rate of growth of total income. The arguments about the superiority of dictatorships in mobilizing savings for investment find no support in the evidence. Indeed, the input that grows faster under dictatorships is not capital but labor. The differences in the efficiency with which productive inputs are utilized are small. And, as a consequence, the selection-corrected average expected values of growth are almost identical. Yet conclusions are premature, for there are still methodological problems to confront.

### Poor and Wealthy Countries

We still face the following difficulty: Dictatorships existed predominantly in poor countries: 38.5 percent of annual observations (946 out of 2,481) of dictatorships were in countries with incomes under \$1,000, but only 4.5 percent of democracies (75 out of 1,645) were that poor. Democracies flourished in wealthy countries: 46.8 percent of them (769) were observed in countries with incomes above \$6,000, whereas only 2.8 percent (68) of dictatorships existed at such income levels. Hence, nearly all our observations of countries with incomes below \$1,000, 92.6 percent (946 out of 1,021), are of dictatorships, and nearly all our observations of countries with incomes above \$6,000, 91.9 percent (769 out of 837), are of democracies.

Now, examining the rates of growth in countries classified by intervals of \$500 of per capita income (Table 3.6) shows that very poor countries (under \$1,000) grow slowly, at about 3.5 percent. Growth accelerates in wealthier economies, reaching a peak of 5.1 percent between \$2,000 and \$3,000. Then it slows down again to about 3.8

**Table 3.6.** Rate of growth of GDP (YG), by per capita income (LEVEL)

LEVEL	Proportion dictatorships	Rate of growth of GDP <sup>a</sup>		
		All	Dictatorships	Democracies
0–1,000	0.9273	3.519	3.464	4.220
1,001–2,000	0.7472	4.636	4.809	4.123
2,001–3,000	0.6207	5.142	5.633	4.335
3,001–4,000	0.5874	4.740	4.915	4.492
4,001–5,000	0.5424	4.552	4.507	4.606
5,001–6,000	0.4308	4.312	4.772	3.963
6,001–	0.0812	3.770	6.054	3.568
Total (N = 4,128)		4.233	4.424	3.945

<sup>a</sup> All cell entries are based on at least 68 observations.

**Moving averages of rates of growth by bands of \$500**

LEVEL	All	Dictatorships	Democracies
250–750	3.071	3.107	2.380
500–1,000	3.689	3.647	4.164
750–1,250	4.140	4.050	4.724
1,000–1,500	4.505	4.682	3.848
1,250–1,750	4.969	5.381	3.932
1,500–2,000	4.827	5.021	4.396
1,750–2,250	4.972	5.092	4.744
2,000–2,500	5.444	5.664	5.055
2,250–2,750	5.793	6.989	3.993
2,500–3,000	4.827	5.599	3.653
2,750–3,250	4.808	4.955	4.613
3,000–3,500	5.130	5.238	4.977
3,250–3,750	4.594	4.183	5.445
3,500–4,000	4.317	4.565	3.965
3,750–4,250	4.382	5.065	3.491
4,000–4,500	4.984	4.908	5.086
4,250–4,750	4.742	4.771	4.714
4,500–5,000	3.965	3.881	4.050
4,750–5,250	4.558	4.580	4.535
5,000–5,500	4.217	4.360	4.088
5,250–5,750	4.116	4.003	4.194
5,500–6,000	4.418	5.350	3.845
5,750–6,250	3.363	4.479	2.878
6,000–	3.770	6.054	3.568

percent when countries reach incomes above \$6,000. Hence, in accordance with Quah (1996), incomes diverge among poor countries, until about \$2,500, and they converge among wealthy countries.

If very poor and very rich economies both grow slowly regardless of the regime they have, then this pattern does not present a problem. But if poor countries grow slowly because they are ruled by dictatorships, or rich ones because they are democratic, then we cannot make such an inference, for perhaps if the poor countries had been democratic they would have grown faster. In fact, the 75 democratic years at incomes under \$1,000 witnessed growth at the rate of 4.22 percent, but dictatorships grew at the rate of 3.46 percent in equally poor countries. Conversely, if the rich countries had been authoritarian, perhaps they would have grown faster. Again, the 68 authoritarian years at incomes above \$6,000 enjoyed growth at the rate of 6.05 percent, whereas democracies had a rate of growth of 3.57 percent at those incomes. Our counterfactual procedure matches the regimes for the conditions under which they existed, specifically for their productive inputs and a variety of other conditions. But to find out how a country observed, say, as a dictatorship would have grown had it been a democracy under the same conditions, we use the information about the way these productive inputs are transformed into outputs under each regime. And this information, about production functions, is derived from the actual observations, which means disproportionately from poor dictatorships and rich democracies. Hence these production functions may be different not because of the impact of regimes but because of the effect of wealth.

Thus, to test whether or not the results depend on the samples, we need to estimate production functions separately for different levels of development, as always measured by per capita income (Table 3.4). First we consider only countries with incomes under \$3,000, which we shall call "poor." Their production functions are almost identical, and regimes make no difference for the average growth rates. Then we take countries with incomes above \$3,000, "wealthy," where the difference between the observed growth rates is particularly high, 4.91 percent for dictatorships, and 3.83 for democracies. The difference between the average values almost vanishes when corrected for selection, but the production functions are quite different. Finally, given that there are very few dictatorships with incomes above \$8,000,<sup>13</sup> we need to

<sup>13</sup> The wealthiest dictatorship we observed was Singapore, with an income of \$11,698, and the wealthiest democracy in our sample, the United States, had an income of \$18,095. There were 200 democratic years with incomes above that of Singapore.

know if the difference between wealthy dictatorships and wealthy democracies is still due to the composition of the respective samples, so we analyze separately countries within the \$3,000–\$8,000 income band.

These tests suggest that per capita income of \$3,000 is the natural breaking point.<sup>14</sup> The production functions are almost identical in countries with incomes below \$3,000, but they differ between regimes in wealthier countries. In particular, the difference between the two regimes becomes visible if we consider only countries within the \$3,000–\$8,000 income band. Hence, this difference is not due to diminishing returns in wealthy democracies.

### *Poor Countries*

In poor countries, the two regimes are almost identical, with observed rates of growth of 4.34 percent under dictatorship and 4.28 under democracy. The two regimes generate productive inputs at the same rate and use them in identical ways. They invest about 12.5 percent of GDP and increase capital stock at the rate of about 6 percent, and labor force at the rate of about 2.2 percent. An increase of 1 percent in the capital stock raises output by about 0.40 percent under both regimes, and an increase in the labor force by 1 percent augments output by about 0.60 percent.<sup>15</sup> Neither regime benefits much from technical progress, about 0.1 percent per annum; both get 2.8 percent in growth from an increase in capital stock, and 1.4 percent from an increase in labor force. With identical supplies of factors and their identical utilization, they grow at the same rate under the two regimes: The selection-corrected average growth rates are the same.

The idea that democracies in poor countries process pressures for immediate consumption, resulting in lower investment and slower growth, seemed persuasive at the time it was advanced, and it was not implausible. There appear to be good reasons to think that people in poor countries want to consume more immediately: They cannot afford to make intertemporal trade-offs if they cannot expect to live to benefit from their short-term sacrifices. It is also plausible that unions, particularly if they are decentralized, and political parties, competing for

<sup>14</sup> We have investigated several more income bands, beginning with \$0–\$3,000 and moving the lower and upper cutoffs by \$1,000, until \$8,000–\$11,000.

<sup>15</sup> This is a constrained estimate. Constrained estimates are cited in the rest of this paragraph.

votes, would push forward demands for immediate consumption. Yet, as likely as that view may seem, it simply is not true. Perhaps this only means that democracy is not very effective at processing what people want; perhaps developmental goals are not any more attractive to people under dictatorship than under democracy; perhaps poverty is so constraining that even dictators cannot squeeze savings out of indigent people.

The last explanation is most plausible. One piece of evidence is that very few countries that were very poor when we first observed them ever developed. Of the forty-eight countries that entered our purview with incomes below \$1,000, only three made it to above \$3,000 by 1990. The two miracles were Taiwan, which had an income of \$968 in 1950 and \$8,067 in 1990, and South Korea, which went from \$814 in 1950 to \$6,665 in 1990. Thailand had an income of \$815 in 1950 and \$3,570 in 1990. Four more countries that began under \$1,000 made it to more than \$2,000, and eleven more to at least \$1,000. But at the end of the period, thirty – out of forty-eight – very poor countries remained within the income band in which they had begun. The experiences of countries that were first observed with incomes between \$1,000 and \$2,000 were more heterogeneous, but, again, of the forty-five first observed at that level, only five experienced sustained growth: Japan, which went from \$1,768 in 1950 to \$14,317 in 1990, Singapore from \$1,845 in 1965 to 11,698 in 1990, Portugal from \$1,314 in 1950 to 7,487 in 1990, Greece from \$1,480 in 1950 to \$6,768 in 1990, and Malta from \$1,377 in 1964 to \$6,627 in 1990. Four countries descended to below \$1,000, and twelve still had incomes between \$1,000 and \$2,000 in 1990. In turn, none of the forty-two countries that were first observed with per capita incomes above \$2,000 fell below their starting range, and all but seven of them at least doubled their incomes by the end of the period. Because the observation periods were not the same for all countries and typically were shorter for the poorer ones, many of which became independent around 1960, these data are somewhat biased against poor countries. Nevertheless, most countries that we first observed below \$2,000 had about thirty years to grow, and yet most remained poor: evidence of a “low-level trap” (Table 3.7).

Thus, poverty constrains. Whatever the regime, the society is too poor to finance an effective state. Collecting total revenues of \$127 per capita, as governments do on the average in countries with incomes under \$1,000, can pay for little else than collecting these revenues. Government expenditures add up to \$167 per person in these

**Table 3.7.** Per capita income at the beginning and end of the period, by bands of \$1,000

Entered	Exited											Total
	0-1	1-2	2-3	3-4	4-5	5-6	6-7	7-8	8-9	9-10	10-	
0-1	30	11	4	1	0	0	1	0	1	0	0	48
1-2	4	12	15	6	2	1	2	1	0	0	2	45
2-3	0	0	1	3	3	1	0	1	0	3	1	13
3-4	0	0	0	2	0	2	0	1	0	0	4	9
4-5	0	0	0	0	2	0	1	0	0	0	5	8
5-	0	0	0	0	0	0	1	1	0	0	10	12
Total	34	23	20	12	7	4	5	4	1	3	22	135

*Notes:* "Entered" stands for 1950 or the year of independence or the first year data were available, and "Exited" for 1990 or in some cases the last year data were available. Per capita incomes are given in thousands (1985 PPP USD). Cell entries are numbers of countries.

countries, so they run deficits higher than 7 percent of GDP. In countries with incomes between \$1,000 and \$2,000, governments collect \$372 per capita and spend \$450, still running deficits over 7 percent. And, like the investment share, government revenue (particularly tax revenue) as a share of GDP increases monotonically in per capita income.<sup>16</sup> Thus already in countries with incomes between \$2,000 and \$3,000, revenues of the central government add to \$668 per capita. Between \$3,000 and \$4,000 they are \$904, and above \$6,000 they are \$2,608. To put it differently, per capita public expenditures in countries with incomes between \$3,000 and \$4,000 are larger than total per capita incomes in countries with incomes under \$1,000; per capita public expenditures in countries with incomes above \$6,000 are about the same as total per capita incomes in countries between \$3,000 and \$4,000.

Poor countries cannot afford a strong state, and when the state is weak, the kind of regime matters little for everyday life. In a village located three days' travel away from the capital, often the only presence of the state is a teacher and occasionally roving uniformed bandits.<sup>17</sup> Just calculate: If a mile of road costs about a million dollars, in a country with

<sup>16</sup> Cheibub (1998) shows that selection-corrected tax revenues are the same for the two regimes.

<sup>17</sup> The best portrayal of life under a weak state is by Alvaro Mutis (1996).

per capita income under \$1,000 it would take the total government expenditures per 600,000 persons to build 100 miles of road. There is little room for regimes to make a difference when the state is that poor.

Note that we are not arguing that a fiscally large or otherwise large state is necessarily good for development, but only that if the state is to be able to make a difference for better conditions, it must have resources. The role of the state in economic development is a notoriously controversial issue. Most of the statistical research on this topic has been mindless: Studies that discover that the state is bad for growth simply stick government-consumption expenditures into the equation for growth and discover that its sign is negative. Needless to say, the same would happen if one did that with private-consumption expenditures: We did it and know it to be so. If one thinks that government-consumption expenditures affect growth, the term introduced into the production-function equation should be the change in government consumption, not the share of government consumption in GDP.<sup>18</sup> But the real test of the impact of government is to consider separately the effects of private and public capital stocks. The idea, due to Barro (1990), is that private capital and public capital play different roles in development and that they are complementary, so that even if the production function exhibits diminishing returns in each stock, the joint returns will be constant or even increasing. Moreover, because the ideal combination of private and public capital stocks is one in which their marginal products are equal (with an appropriate correction if public investment is financed by distortionary taxes), for each level of private capital stock (and investment) there is an optimal level of government capital stock (and investment).<sup>19</sup> The state, as measured by the size of the government capital stock, can thus be too small, just right, or too big.

This is a plausible view, but it hurls itself against a practical problem, namely, that standard national accounts do not measure the public capital stock, only current capital expenditures by the central govern-

<sup>18</sup> Ram (1986) has shown that the model that introduces the level of government-consumption expenditures into the production-function equation is misspecified. He has developed a specification that allows an assessment of the impact of government on growth without having explicit information about the public capital stock. We (Cheibub and Przeworski 1997) applied Ram's specification to our data set and discovered that the contribution of the state is positive, but for various reasons we have second thoughts about this approach.

<sup>19</sup> It is a different matter whether or not a government, even a benevolent one, would implement it. On the time inconsistency of optimal taxation, see Benhabib and Velasco (1996).

ment. And without such data, estimating the effect of government capital is difficult, if not impossible. What one would want to estimate would be a production function of the form

$$\dot{Y}/Y = \dot{A}/A + \alpha(\dot{P}/P) + \tau(\dot{S}/S) + \beta(\dot{L}/L) + e,$$

but we have no separate information about private and public capital stocks,  $P + S = K$ . In Appendix 3.2 we perform some heroics that permit us to estimate instead an equation of the form

$$\dot{Y}/Y = \dot{A}/A + \alpha(\dot{K}/K) + \Omega(\dot{S}/Y) + \beta(\dot{L}/L) + e,$$

where  $\Omega$  can be interpreted as the marginal product of government capital stock when private capital and public capital grow at the same rate.

Note first that whereas government capital expenditures (GXPKTOTL),  $\dot{S}$ , account for a relatively large share of public expenditures in poor countries, they add up to almost nothing in absolute terms: \$46 per capita in countries with incomes under \$1,000, and \$109 in those with incomes between \$1,000 and \$2,000. In countries between \$3,000 and \$4,000, per capita public capital expenditures already amount to \$190; in those with incomes above \$6,000, they are \$369.

Table A3.1.1, which we put in Appendix 3.1 because interpreting the results requires understanding how they were derived, shows that government capital expenditures have no effect on growth in poor countries, but they do have a sizable positive effect in wealthy countries. Unfortunately, the interpretation of the coefficient  $\Omega$  is ambivalent: Either the marginal product of public capital increases as total capital per worker ( $CAPW = K/L$ ) rises or private capital stock grows in the more-developed countries faster than public capital stock. And even if  $\Omega$  is a valid measure of the marginal product of public capital, it is not clear why it should increase as countries become more developed. One interpretation would be that governments in poor countries simply allocate capital expenditures unwisely, but the almost monotonic relation between  $\Omega$  and  $K/L$  makes that farfetched. The interpretation we find more plausible is that the complementarity between private investment and public investment, the latter largely in infrastructure, increases as the private capital stock increases. A road contributes to development only to the extent that there is something to be transported.

Ideally, we would want to see if public capital stock plays different roles under the two regimes. Unfortunately, the sample that contains

information about public capital expenditures ( $N = 1,366$ ) is extremely unbalanced: There are very few observations of wealthy dictatorships and equally few of poor democracies. Hence, whereas going through our standard steps, that is, correcting for selection and estimating the production functions separately for the two regimes, shows that public capital plays no role under dictatorships and a positive role under democracies, this is just an effect of sample composition. In turn, splitting the sample between poor and wealthy countries is not feasible given its imbalance. Yet for the purpose of our argument it is sufficient to know that in poor countries the state plays little, if any, productive role, but in wealthy countries it does.

In sum, poor countries are too poor to afford a strong state, and without an effective state there is little difference any regime can make for economic development. Investment is low in poor democracies, but it is not any higher in poor dictatorships. The labor force grows rapidly in both. Development is factor-extensive: Poor countries benefit almost nothing from technical change. Clearly, this does not imply that all poor countries are the same or even that regimes may not make a difference for other aspects of people's lives; indeed, we show later that they do. But not for economic development in poor countries.

### *Wealthy Countries*

Once countries reach some level of development – somewhere between \$2,500 and \$3,000, that of Algeria in 1977, Mauritius in 1969, Costa Rica in 1966, South Korea in 1976, Czechoslovakia in 1970, or Portugal in 1966 – patterns of economic development under democracy and dictatorship diverge. In countries with incomes above that threshold, regimes do make a difference for how resources are used, for how much people produce and how much they earn. To show that this is true, we have to go through a number of steps, piecing together bits of evidence derived from disparate sources and based on distinct samples. Yet we think that the overall conclusion is overwhelming.

Dictatorships appear not to change their ways whether they are in poor or wealthy countries. Although in more-developed economies they rely somewhat less on growth of the labor force and somewhat more on the growth of capital stock, they use the inputs in almost the same way and get little benefit from productivity growth. Democracies, in turn, exhibit different patterns in poor and wealthy countries. Their capital stock grows somewhat slower, and the labor force much slower, when they are affluent; they use labor more productively and benefit

more from productivity growth. As a result, the patterns of growth are different in wealthier dictatorships and democracies.

Note, back in Table 3.4, that the factors that differentiate wealthy dictatorships from wealthy democracies are the patterns, not averages. Corrected for selection, the average rates of growth of income are again almost identical under the two regimes. Although the observed rates of growth are higher under dictatorships, if the two regimes had used the same inputs in production, they would have grown at the same rate. But they would have grown in different ways.

Growth under wealthy dictatorships is labor-extensive. The labor force grows at a much faster pace under dictatorships, at 2.03 percent, than under democracies, where it grows at 1.32 percent. And whereas the elasticity of output with regard to labor is about 0.56 under dictatorship, it is 0.68 under democracy. Wealthier dictatorships benefit little from technical progress, 0.33; they get most of their growth from capital, 3.05, and in spite of employing many more workers, they get less of it from labor, 0.85. Wealthier democracies benefit from technical progress, 0.91, get less growth out of capital, 2.20, and more from the labor input, 1.04, even though they employ fewer additional workers.

Because the labor force grows faster under dictatorships, and the elasticity of output with regard to labor is lower, output per worker ( $GDWP = Y/L$ ) is also lower. In the entire sample, the observed values are obviously lower: \$5,113 under dictatorships and \$14,554 under democracies. But selection-corrected values, controlled for capital stock and the size of the labor force, are still much lower for dictatorships: An average worker produces \$6,843 under dictatorship versus \$9,054 under democracy. As we would by now have expected, the difference in poor countries is negligible: Output per worker is \$3,519 in dictatorships, and \$3,639 in democracies. But above \$3,000, the difference is large: \$13,410 versus \$17,857. To harp on what may by now be obvious, these are the outputs that would be generated under the two regimes if they had exactly the same capital stock, labor force, and whatever it is that we do not observe that affects both regime selection and output per worker.

Thus, dictatorships in countries with incomes above \$3,000 use labor extensively. Their labor force grows faster, the marginal worker contributes less to output, and the average worker produces less than in democracies. It merits noting that this difference is not due to labor-force participation by women (LFPW), whose values are almost identical under the two regimes at every income level. More women participate in gainful activities in very poor countries, where they work in agriculture,

**Table 3.8A.** Labor exploitation (labor-share sample,  $N = 2,061$ )

LEVEL	Average labor shares		
	All	Dictatorships	Democracies
0–1,000	33.04 (308)	32.21 (277)	40.48 (31)
1,001–2,000	32.61 (429)	32.90 (332)	31.61 (97)
2,001–3,000	30.43 (282)	30.70 (158)	30.10 (124)
3,001–4,000	33.44 (218)	34.17 (138)	32.18 (80)
4,001–5,000	35.10 (131)	33.55 (81)	37.63 (50)
5,001–6,000	36.59 (102)	31.08 (48)	41.48 (54)
6,001–	48.94 (693)	36.43 (29)	49.59 (562)
Total	35.53 (2,061)	32.63 (1,063)	42.71 (998)

and in wealthy countries, where they are disproportionately employed in services. Regimes have no effect on their labor-force participation: The observed participation rates are 31.9 under dictatorships and 31.0 under democracies. Once the proportion of the labor force working in agriculture is controlled for, selection-corrected rates are also the same. Dictatorships simply rely on using many additional workers, of whatever sex, even if they produce less on the average and at the margin.

Perhaps the reason is that dictatorships exploit labor.<sup>20</sup> To examine that possibility, we must rely on a different data source and a much smaller sample<sup>21</sup> (Table 3.8). The average labor share of value added

<sup>20</sup> This is not to say that workers are not, in some sense, exploited under democracies. We use the term in Roemer's sense (1982): Workers under dictatorship would be better off if they could withdraw, with the same endowments, to democracy.

<sup>21</sup> The labor-share data come from the World Bank (1995), whose 1995 development report (p. 234) describes this series as "derived by dividing total earnings of employees by value added in current prices to show labor's share in income generated in the manufacturing sector." There are 2,061 observations, all for the period 1961–1990. They cover countries that are, on the average, wealthier than the full sample, but in the entire range, from \$370 to \$18,095. The mean is 35.5 (s.d. = 13.0), with a minimum of 6.1 in Rwanda in 1977 and a maximum of 100.1 in the Bahamas in 1981. Note that the unconstrained labor elasticities in Table 3.4 are 0.27 for dictatorships and 0.39 for democracies; hence, they are close to the competitive labor share. For some developed countries, the numbers are surprisingly small: The 1990 labor share in the United States was 35.6 (48.5 in 1963), and in Sweden 34.8 (56.5 in 1963). For other countries they are closer to what one would expect: The 1989 labor share in France was 58.4 (68.4 in 1980), and the 1990 share in Norway was 59.0 (54.7 in 1963). Altogether, these numbers appear reasonable.

**Table 3.8B. Accounting for the difference in wages**

	Dictatorships (N = 1,052)	Democracies (N = 994)
Observed values:		
(1) GDPW = $Y/L$	6,332 (4,858)	16,665 (8,871)
(2) LS = $wL/Y$	32.5 (11,42)	42.7 (13,78)
(3) WAGE = LS * (Y/L)	2,058 (1,873)	7,116 (5,376)
Selection-corrected values:		
LS   Y/P		
LS   Y/L, OTHER (2SLS)		
(4) (Y/L)   A.K.L	33.5 (1.74)	40.0 (4.19)
(5) WAGE   (Y/L)	33.7 (3.20)	41.2 (9.29)
Accounting for difference in wage:		
(6) Actual output/worker (from line 1)	6,332 -	16,665 =
(7) Wages assuming same labor share (line 6 * 0.3553)	2,250 -	5,921 =
(8) Actual wages (from line 3)	2,058 -	7,116 =
(9) Difference due to labor shares (line 8 minus line 9)	-192 -	1,195 =
(10) Output/worker assuming same inputs (from line 4)	8,375 -	11,529 =
(11) Wages assuming same inputs, same labor share (line 10 * 0.3553)	2,976 -	4,096 =
(12) Wages assuming same output per worker (from line 5)	3,733 -	5,057 =
Summary:		
(13) Due to difference in inputs (line 7 minus line 11)	-2,551	-2,551
(14) Due to difference in productivity (line 11)	-1,120	-1,120
(15a) Due to difference in labor shares (line 9)	-1,387	
(15b) Due to difference in labor shares (line 12)		
(16) Total difference in wages (lines 13 + 14 + 15)	-5,058	-1,324
(17) Error (line 8 minus line 16)		-4,995
		-63

in manufacturing (LS) during the 1,052 dictatorial years was 32.5 percent, and the average during the 994 democratic years was 42.7 percent. Only a part of this difference vanishes when controlled for output per worker: Selection-corrected labor shares are still larger for democracies, and the estimates are tight. Hence, even if they had generated the same output per worker, dictatorships would have paid workers a smaller share of value added than would democracies. See also Rodrik (1998).

Although the labor-share data concern only the manufacturing sector, another way to see the same result is to calculate annual wage rates (WAGE), multiplying output per worker by the labor share. The observed wage under dictatorship is \$2,058, whereas under democracy it is \$7,116, a difference of \$5,058 in favor of democracies. If the labor share had been the same under the two regimes, 35.5 percent, their difference in wages would have been \$3,671. Hence, \$1,387 of the observed difference is due to labor shares.

Because a large part of the observed difference is obviously due to income levels, in Table 3.8 we engage in some accounting. The assumption that dictatorships and democracies have exactly the same productive inputs yields the conclusion that the average output per worker would be \$8,375 under dictatorship and \$11,529 under democracy, for a difference of \$3,154: As in the full sample, workers produce less under dictatorships. If the two regimes had had the same inputs and the same labor share, the difference in wages due only to productivity would have been \$1,120. Hence, if labor shares were the same, the difference in inputs would account for \$2,551 (\$3,671 – \$1,120), and the difference in productivity would account for \$1,120, of the differences in wages. In turn, assuming that output per worker is the same under the two regimes yields a selection-corrected difference of \$1,324.

Hence, of the observed difference in wages (to remind, \$5,058), \$2,551 is due to the fact that the regimes existed under different conditions and used different productive inputs, \$1,120 is due to dictatorships being less productive, and \$1,387 is due to differences in labor shares.

Although the number of observations is too small to permit correcting for selection within subsamples, it appears again that the gap between regimes opens up at about \$3,000 of per capita income. Whereas the labor share and average wage were much higher in India than in China when both countries had similar per capita incomes, that

pattern is not characteristic of other poor countries.<sup>22</sup> Under \$3,000, the labor share during 767 dictatorial years was almost identical, at 32.2 percent, with the 32.0 percent during the 252 democratic years. Between \$3,000 and \$8,000, the labor share under 288 years of dictatorship was 33.7 percent, but under 323 years of democracy it climbed to 39.6 percent. Wages offer a similar picture. Under \$3,000, an average worker earned \$1,238 under dictatorship and \$1,698 under democracy, but this difference is due entirely to the fact that democracies are still somewhat wealthier in this income range. Between \$3,000 and \$8,000, the average wage was \$4,193 under dictatorship, \$1,556 less than the \$5,649 under democracy. Some of this difference is again due to the fact that democracies have higher output per worker in this range than do dictatorships. But even if workers under wealthy dictatorships had produced the same output as under democracy, they would have earned \$4,777, still \$872 less.

There are few observations in this sample for which labor-share data are available for both the entry and exit of a regime. But the impact of transitions to dictatorship can be seen: In the eighteen cases we observed, dictatorships immediately reduced labor share by 2.6 per-cent of value added, from 27.4 to 24.8. The “bureaucratic-authoritarian” regimes in Latin America were particularly brutal in redistributing incomes from labor to capital. The Argentine military reduced the labor share from 29.4 in 1975 to 18.1 in 1976 and to 14.2 in 1982, its last year of existence. In Chile, labor share was squeezed from 29.6 in 1972 to 16.3 in 1973 and to 14.8 by the end of dictatorship, in 1989. Transitions to democracy, however, had no immediate effect on income shares.

To get an intuitive sense of these patterns, compare first the neo-liberal miracle, Singapore, with the persistently social-democratic Austria, when the two countries had the same levels of per capita income (Figure 3.1). In 1976 Singapore had per capita income of \$5,606, and the average worker produced \$13,394. The labor share was 33.1, which meant that the average worker earned \$4,433. Austria had almost the same per capita income, \$5,672, by 1963, and output per worker was somewhat lower, \$12,328. But the Austrian worker took home 48.6 percent of what he or she produced, so that the average wage was \$5,991: \$1,558 more. By 1990, Singapore had per capita

<sup>22</sup> As India reached per capita income of \$1,000 in 1984, the labor share was 50.3, and the average wage was \$1,313. China reached that level of income a year earlier, with a labor share of 15.9 and a wage of \$287.

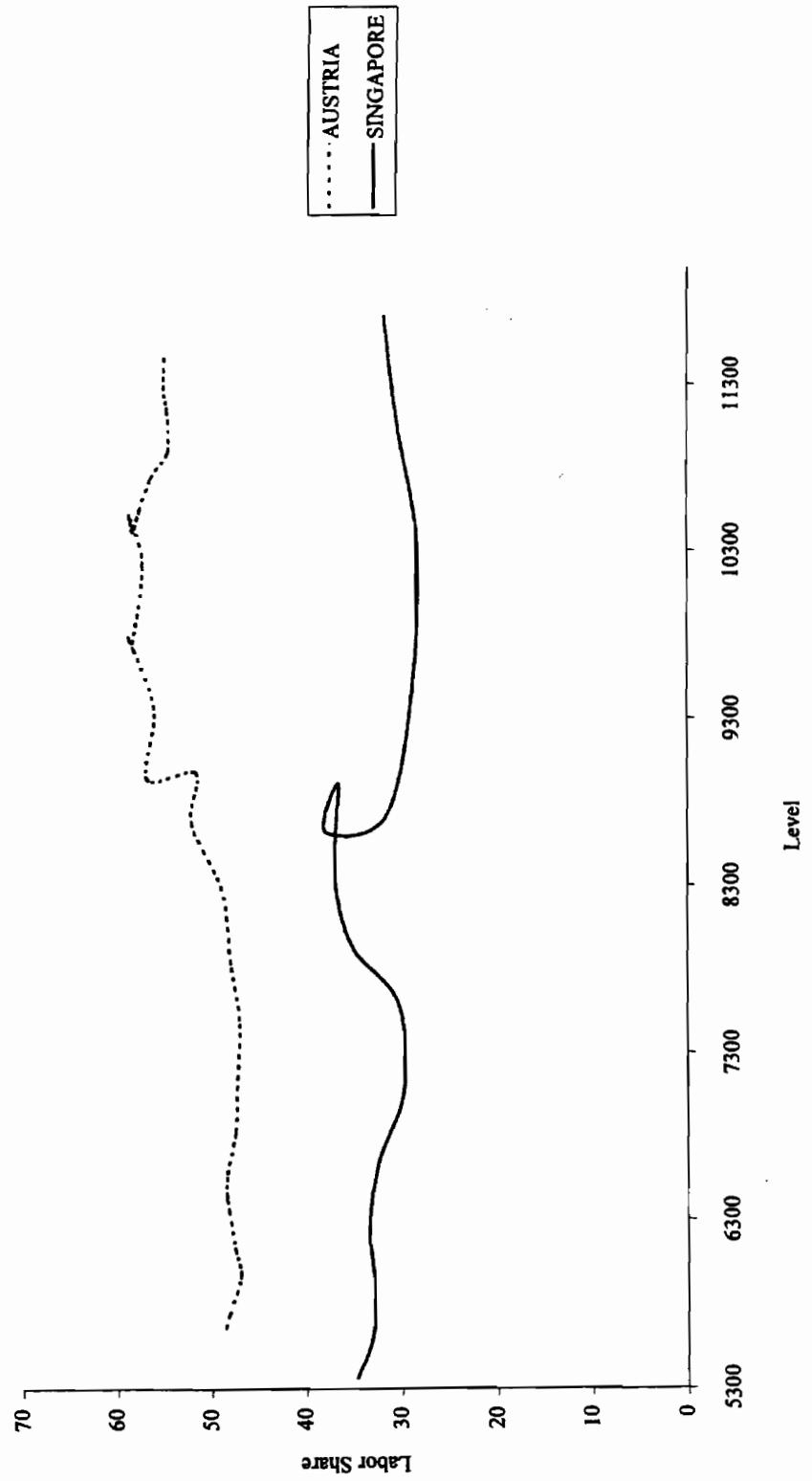


Figure 3.1. Labor shares in Singapore and Austria at similar levels of per capita income from year to year

income of \$11,698, and output per worker reached \$24,396. The labor share was 31.7, and average wage was \$7,725. Austria reached the income of \$11,462 by 1987, and the average worker produced \$24,366 by that time. The labor share was 54.7, so that the average wage was \$13,328: \$5,603 more than in Singapore. And this illustration is not tendentious: Among all countries in the same income range, between \$5,606 and \$11,698, average output per worker was \$17,143 under dictatorship ( $N = 45$ ) and \$21,004 under democracy ( $N = 426$ ), the average labor shares were, respectively, 34.3 and 48.9, and the average wages were \$6,882 and \$10,402: a difference of \$3,620.

The experience of Mexico and Portugal during the 1980s, when the two countries had incomes in the \$4,974–\$6,575 range, is similar (Figure 3.2). Mexico's labor share hovered around 20 percent; Portugal's declined from 46.9 to 36.2 during that period. Still, by 1989, an average Mexican worker earned \$3,192, and a Portuguese earned \$4,917.

Finally, examine the experience of Argentina, where we can observe several regimes: dictatorship until 1972, democracy between 1973 and 1975, another dictatorship between 1976 and 1982, and a new democracy after 1983. The advent of democracy in 1973 increased the labor share by about 4 percent, and the wage went up from \$3,942 in 1972 to \$4,697 one year later (Figure 3.3). Wage reduction by the military regime of 1976 was drastic: Labor share fell from 29.4 percent in 1975 to 18.1 percent, and average wage tumbled from \$4,716 to \$2,825. When democracy was reestablished in 1983, labor share increased only slightly, as the Argentine economy was buffeted by crises. By 1990, it stood at 20.5, and average wage was \$2,748: higher than the \$2,155 during the last year of the military dictatorship, but well below the Argentine historical levels.

Thus, growth under wealthier dictatorships is both labor-extensive and labor-exploitative. The labor force grows faster under dictatorship, the marginal worker produces less, and the average worker much less, than under democracy. Even if they were matched for capital stock and labor force, workers would produce less under dictatorship. And labor earns less under dictatorship. Some of this difference is attributable to lower output, but a large difference remains even when we account for differences in factor endowments and even if we assume away differences in productivity. Democracy entails the freedom for workers to associate independently of their employers and the state. And strikes are three times more frequent under democracy than under dictatorship: 0.2434 per year under the former and 0.0895 under the latter. Because, in addition, under democracy workers also vote, these results

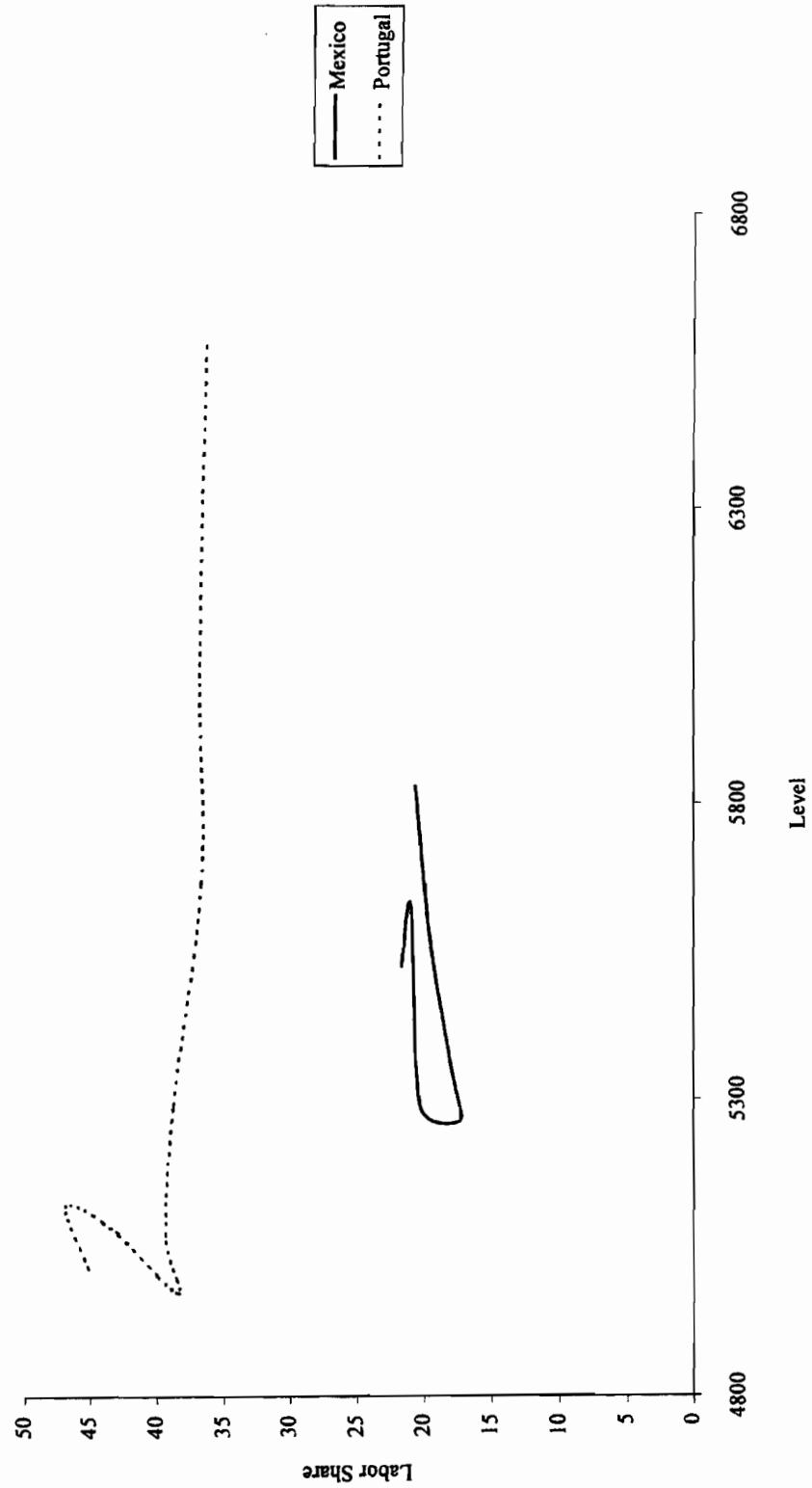


Figure 3.2. Labor shares in Mexico and Portugal at similar levels of per capita income from year to year

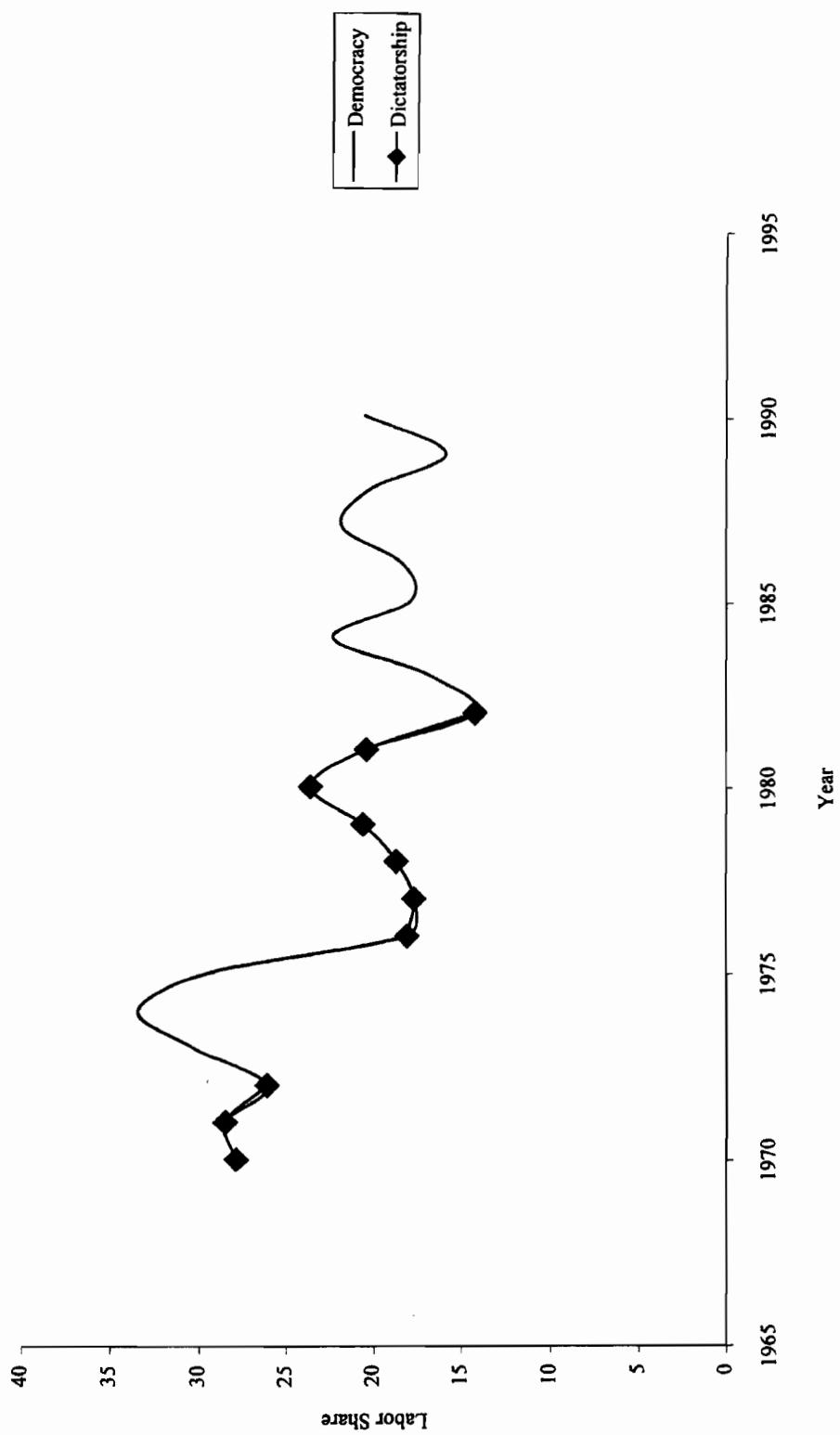


Figure 3.3. Argentina's labor share by regime

are not surprising. Dictatorships repress workers, exploit them, and use them carelessly. Democracies allow workers to fight for their interests, pay them better, and employ them better.

### Miracles and Disasters

A list of regimes under which economies grew at the average rate of at least 7 percent per year, thus doubling incomes in ten years, consists almost exclusively of dictatorships. Indeed, the only exception is the somewhat peculiar case of the Bahamas. But the list of countries in which total income declined or grew at less than 1 percent per year during at least seven years looks almost the same: Almost all regimes on that list are also dictatorships.<sup>23</sup> The observed variation of performance is simply much higher for dictatorships (s.d. = 7.04) than for democracies (s.d. = 4.85), and so is the selection-corrected variance. Hence, looking only at best practice leads to dangerously misleading conclusions.

Although some countries, notably Singapore, South Korea, and Taiwan, sustained rapid rates of growth over the entire period, glory is transitory (Table 3.9). Of the countries that grew fastest during the 1950s – Turkey, Costa Rica, West Germany, and the Philippines – none appears on the list of tigers in the successive periods. The next two decades were periods of sustained growth: Gabon, Ivory Coast, Iraq, Jordan, South Korea, Singapore, Malta, and Romania grew at the average rates above 7 percent during the 1960s and 1970s. But growth collapsed during the 1980s, and only four countries maintained their rhythm of the previous decade: South Korea, Singapore, Taiwan, and the Yemen Arab Republic. In turn, some earlier miracles turned into disasters. In Iraq, after two decades of rapid growth, income fell at the rate of 7.04 percent during the eight years in the 1980s for which data are available. The same was true for Ivory Coast, which, having sustained rapid growth between 1960 and 1980, suffered a declining income afterward. Nigeria, having experienced spectacular growth during the 1970s, had income growing at only 0.32 during the next decade. Suriname grew at 8.50 during the 1970s, only to decline to a rate of 2.27 in the 1980s. Yugoslavia grew at 7.40 during the 1970s, and -1.25 during the next decade.

<sup>23</sup> Among Temple's ten miracles (1999: 116) between 1960 and 1990 there were two democracies, Japan and Malta, and among his ten disasters there was one democracy, Venezuela, and one country that experienced regime transitions, namely, Ghana.

**Table 3.9.** Miracles and disasters (fastest- and slowest-growing regimes, over periods of at least ten years)

Country	Number of years	First year	Growth rate	Regime	Comment
Fastest (more than 7%):					
Botswana	24	1966	9.55	Dic	Primary-commodity exporter
Nigeria	13	1966	9.24	Dic	Oil exporter
Yemen A. R.	20	1970	9.19	Dic	
Singapore	26	1965	9.14	Dic	
South Korea	27	1961	8.66	Dic	
Taiwan	39	1952	8.41	Dic	
Ecuador	16	1963	7.82	Dic	Oil exporter
Brazil	15	1964	7.54	Dic	
Turkey	10	1951	7.49	Dic	
Bahamas	10	1978	7.47	Dem	
Cape Verde Islands	16	1975	7.40	Dic	
Syria	30	1961	7.02	Dic	One year of war
Jordan	36	1955	7.01	Dic	Two years of war
Slowest (less than 1%):					
Madagascar	30	1961	0.85	Dic	Primary-commodity exporter
Comoros	16	1975	0.81	Dic	Primary-commodity exporter
Western Samoa	11	1980	0.64	Dic	
Papua New Guinea	16	1975	0.62	Dem	
Chad	30	1961	0.61	Dic	War, primary-commodity exporter
Peru	10	1980	0.48	Dem	War, primary-commodity exporter
Uruguay	12	1973	0.48	Dic	Primary-commodity exporter
Guyana	25	1966	0.33	Dic	Primary-commodity exporter
Angola	15	1975	0.08	Dic	War, oil exporter
Mozambique	16	1975	-0.95	Dic	War

Some of the sharp oscillations in growth were due to wars, about which we say more in the next chapter. Another source of variance in growth rates was reliance on the export of primary commodities (COMEX). Countries that derived at least half of their export revenue from primary commodities grew, in general, at a slower rate, 3.47 (s.d. = 7.42; N = 1,346), than countries that did not, which grew at the rate of 4.60 (s.d. = 5.58; N = 2,780). Note that commodity-exporting countries experienced greater variance in their growth performance. Finally, oil exporters (OIL) grew at a faster rate, 4.78 (s.d. = 7.71; N = 413), than countries that did not export oil, 4.17 (s.d. = 6.09; N = 3,713), but the variance in growth rates was again higher among oil exporters.

Once we eliminate the years of wars and of post-war recoveries and the countries that export oil or other primary commodities, the variance in growth rates is reduced under both regimes. But it is still much larger, s.d. = 6.08, under dictatorships than under democracies, s.d. = 3.87. And the lists of miracles and disasters are still populated almost exclusively by dictatorships. Thus, looking at best practice is misleading: The tigers may be dictatorships, but dictatorships are no tigers.

### Conclusion

The main conclusion of this analysis is that there is no trade-off between democracy and development, not even in poor countries. Although not a single study published before 1988 found that democracy promoted growth, and not one published after 1987 concluded in favor of dictatorships (Przeworski and Limongi 1993), there was never solid evidence that democracies were somehow inferior in generating growth – certainly not enough to justify supporting or even condoning dictatorships. We hope to have put the issue to rest. There is little difference in favor of dictatorships in the observed rates of growth. And even that difference vanishes once the conditions under which dictatorships and democracies existed are taken into account. Albeit in omniscient retrospect, the entire controversy seems to have been much ado about nothing.

Poverty appears to leave no room for politics. In countries with incomes below \$3,000, the two regimes have almost identical investment shares, almost identical rates of growth of capital stock and of labor force, the same production function, the same contributions of capital, labor, and factor productivity to growth, the same output per worker, the same labor shares, and the same product wages. Poor

countries invest little, get little benefit from total factor productivity, and pay low wages. And though a few countries have escaped this bond of poverty, most poor countries, have remained poor. Democracy is highly fragile in such countries, and thus most of them have dictatorial regimes. But regimes make no difference for growth, quantitatively or qualitatively.

Perhaps surprisingly, affluence differentiates regimes. Wealthier dictatorships invest a somewhat larger share of income, experience higher growth of the labor force, have higher capital and lower labor elasticities, derive more growth from capital input and less from labor input and from total factor productivity, have lower output per worker, have a lower labor share, and pay lower wages. Wealthier dictatorships grow by using a lot of labor and paying it little. Because they repress labor, they can pay it little; perhaps because they can pay it little, they care less how it is used. They pay more for capital – the average relative price of investment goods is higher under dictatorships – and they use it well. But because they rely on force to repress workers, they can pay lower wages and use labor inefficiently.

In the end, total output grows at the same rate under the two regimes, both in poor countries and in wealthier countries. But the reasons are different: In poor countries, regimes simply do not matter. In wealthier countries, their average growth rates are the same, but the patterns of growth are different.

### **Appendix 3.1: Identification, Specification, and Robustness**

Regimes can affect growth by influencing either the growth of factors that enter into production or their utilization. But the effect of regimes can be identified only if there are some conditions that are exogenous with regard to regimes. Our general strategy, then, is to test repeatedly whether or not the variables that enter on the right-hand side of a growth equation are exogenous with regard to regimes, and, if they are not, to repeat the procedure with regard to these factors until the right-hand-side variables are all exogenous.

Because our purpose is to examine how political regimes affect economic growth, we need to develop first an understanding of its proximate causes. These causes are economic: Whereas political factors affect the decisions of governments and of private agents (households and firms) concerning the allocation of resources and the distribution of incomes, the performance of an economy results from these decisions. Hence, we look first for proximate causes of growth and then for

the factors that in turn affect these proximate causes, both the supply of productive factors and their productivity.

To choose a growth model, we looked first for a specification that would best account for the variations in the observed growth rates in the entire sample, would make economic sense, and would not a priori favor one political regime over another.

There are many such models. The statistical literature explaining the growth of countries, via “growth regressions,” is now voluminous, and new variables that matter are discovered almost every week. But it turns out that few are robust. Levine and Renelt (1992) employed virtually every variable that had previously been used in growth models. They also listed 40 cross-sectional growth studies published between 1980 and 1990. Only investment (in physical capital) and the initial level of income were always robust, in the Leamer (1983, 1985) sense. They discovered that the coefficients on other terms were fragile and were particularly sensitive to the factor of education. Because we do not want to prejudice the findings concerning regimes by our specification of the growth model, we are thus led to a minimalist approach, working with only those variables that are robust and testing for robustness by introducing additional variables.<sup>24</sup>

In the end, we use throughout what we call a “barebones” model: a simple production function of the form  $Y = AF(K, L)$ . To test robustness, we augment this production by some other variables, listed in Table A3.1.1. We do not use the initial level of income among the right-hand-side variables, because that practice strikes us as mindless if the model is estimated in growth form. If the income level affects the rate of growth, it must influence it via the return to factors. Hence, to test the effect of income, we estimate the production function separately for countries within different income bands (see Table 3.4), rather than attempting to “control” for it statistically.

We estimate the model in growth form to avoid problems due to autocorrelation of output levels over time.<sup>25</sup> With an apology to economists, we show how this growth form is derived.

<sup>24</sup> This approach is not without problems. See Temple (1999).

<sup>25</sup> An alternative would be to estimate the growth model in the form used by Mankiw, Romer, and Weil (1992), in which the rate of convergence can be inferred from the values of the coefficients. Both practical and theoretical considerations, however, speak against that approach. From the practical point of view, that approach requires averaging growth rates over some periods of time, whether decennia or quintennia, to avoid problems of autocorrelation. From the theoretical point of view, it is not apparent how to interpret the convergence coefficients (Quah 1993).

### Appendix 3.1: Specification and Robustness

The theoretical point of departure in analyses of growth is the production function:

$$Y(t) = F(\cdot, \cdot, \cdot). \quad (1)$$

Particular models differ in specifying what productive factors enter into the parentheses and how.

The “barebones” model is (dropping time subscripts)

$$Y = AF(K, L), \quad (2)$$

where  $K$  is capital stock, and  $L$  is the labor force. Let  $F$  be the Cobb-Douglas function of the form

$$Y = AK^\alpha L^\beta. \quad (3)$$

Then all we need to do is take logarithms of both sides of (3), and then the derivatives of the logs with regard to time, to get

$$\dot{Y}/Y = \dot{A}/A + \alpha(\dot{K}/K) + \beta(\dot{L}/L),$$

where  $AF_K(K/Y) = \alpha$  is the marginal elasticity of output with regard to capital, and  $AF_L(L/Y) = \beta$  is the elasticity with regard to labor.

Both  $\alpha$  and  $\beta$  have, therefore, theoretical interpretations, and we have expectations about the values of these numbers. If  $F$  is Cobb-Douglas, then in a competitive economy the elasticities equal the income shares, respectively, of capital and labor. The exact numbers are matters of some controversy. The World Bank (1991: 43) estimated the marginal elasticity of output with regard to capital to be 0.4 between 1960 and 1987. In perhaps the most careful study to date, Islam (1995) arrived at estimates slightly over 0.4 for a sample of 96 non-oil-producing countries. In turn, the World Bank (1991: 43) estimated  $\beta$  to be about 0.45. Our estimates of  $\alpha$  and  $\beta$  are extremely robust, not affected by the presence of other variables. In the entire sample, the unconstrained estimate of  $\alpha$  is 0.40, and of  $\beta$  a somewhat low 0.33. Constraining the elasticities to sum up to 1 does not change  $\alpha$  and brings  $\beta$  to its complement to 1, that is, 0.60. Yet the constraint  $\alpha + \beta = 1$  is almost always rejected by the  $F$  test. Adding human capital, which we do not introduce into our basic specification because the data are available for only a much smaller sample ( $N = 2,787$ ), brings the values of  $\alpha$  and  $\beta$  down somewhat, but the unconstrained elasticity with regard to human capital is very low and not statistically significant. When the sum of the three elasticities is constrained to 1 in OLS, the growth of human capital becomes significant, but it is still very small.

Our data set consists of annual observations. Contrary to frequent practice, we do not average these observations over some longer periods (decades, quintennia), a procedure typically used to smooth business-cycle effects. It may be a matter of dispute whether or not our coefficients on the labor input are always of a reasonable magnitude. But because we have to match economic performance with regime changes, and these occur on an annual basis, we must consider growth on the same basis. Averaging over time may smooth business-cycle effects, but we have seen too many regressions in which political characteristics have been said to have caused economic performance that occurred earlier.

To control for the omitted variables that are constant over time or over countries, whenever possible we have used panel methods. To consider the endogeneity of the right-hand-side variables, we also followed the suggestion of Temple (1999) to use their lagged values as instruments in panel analyses. Those results, however, turned out to yield nonsensical values for coefficients.

One specification issue is to what extent country-specific characteristics, rather than external shocks, determine growth rates. Easterly et al. (1993) observed that country growth rates were highly unstable over time, whereas country characteristics used to explain growth were much more stable. Hence, shocks, especially those to terms of trade, play a large role in explaining growth. Nevertheless, our finding that the entire 1950–1990 sample and various subsamples almost never pass tests for homogeneity goes against the Easterly et al. (1993) argument: We do find country-specific effects, and most of the time the Hausman test indicates that these are fixed effects. Nevertheless, as suggested by Easterly and associates, we modeled external shocks, taking as the independent variables the average rate of growth for the entire world during a particular year (WORLD) and the U.S. prime rate (PRIME). The latter variable never matters once WORLD is present in a specification, and we dropped it. As Table A3.1.1 shows, none of the results is affected by the presence of these additional variables.

Finally, the quality of the PWT data set is very uneven. Hence, one factor that may affect the results is biased reporting of data. We thus test robustness with regard to the rating of data quality, PPPQUAL.

Table A3.1.1 shows the effect of model specification on the selection-corrected values of growth under the two regimes. The results are perfectly robust: Whatever variable one introduces into the speci-

**Table A3.1.1.** Robustness

<b>Variables:</b> KSG, LFG, and:	<b>Method</b>	<b>Dictatorships</b>		<b>Democracies</b>	
		<b>Mean</b>	<b>YGHAT</b>	<b>Mean</b>	<b>YGHAT</b>
WORLD	2F	2.83	4.30 (4.87) <sup>a</sup>	2.81	4.26 (4.40)
OPENC	2F	47.73	4.28 (4.87)	55.17	4.25 (4.31)
COMEX	OLS	0.40	4.30 (5.02)	0.21	4.24 (4.48)
CPI	2F	20.80	4.31 (4.46)	46.92	4.22 (4.08)
XR	2F	83.21	4.28 (4.87)	54.73	4.25 (4.35)
PPPQUAL	OLS	2.27	4.32 (5.04)	6.60	4.25 (4.45)

*Notes:* WORLD is the average rate of growth in the world during the particular year. OPENC is the sum of exports and imports as a proportion of GDP. COMEX is a dummy variable indicating that a country is a primary-commodity exporter. CPI is the rate of change in the consumer price index. XR is the nominal exchange rate (local currency to dollars). PPPQUAL is a rating of data quality (1 = worst, 10 = best).

<sup>a</sup> Standard errors in parentheses.

fication of the growth equations, regimes do not affect the average growth rates. Note in particular that whereas the data quality (measured on a 1-to-10 scale) is much lower for dictatorships, which also tend to be much poorer, the quality of the data is not correlated with the reported growth rates and does not affect regime results.

The most difficult decision, and perhaps a dubious decision, we made in classifying regimes was to consider as dictatorships those countries that had regular and apparently free elections but in which the incumbents always won the elections (see Chapter 1, the “alternation” rule). Such countries grew at an exceptionally fast pace, 5.11 per annum ( $N = 377$ ), as contrasted with the rate of 4.30 ( $N = 2,104$ ) for other dictatorships, and 3.95 ( $N = 1,645$ ) for democracies. To test the robustness of our conclusions with regard to this classification rule, we reclassified these cases as democracies and replicated our standard analysis. The results, presented in Table A3.1.2, show that this reclas-

**Table A3.1.2.** Selection-corrected estimators of the rate of growth of income (YG), under modified classification of regimes

Estimator (selection/YG)	Regime means	
	Dictatorships (N = 2,030)	Democracies (N = 1,961)
Biased	4.32 (7.02)	4.12 (5.19)
Unconstrained OLS	4.13 (4.97)	4.30 (4.73)
Constrained OLS	4.10 (5.14)	4.40 (4.81)
PANEL	4.17 (4.84)	4.29 (4.62)

sification does alter the results slightly in favor of democracy, but far from enough to undermine the conclusions.

### **Appendix 3.2: Estimating the Contribution of Public Investment**

Assume now that output is produced in different ways by private capital stock,  $P$ , and government capital stock,  $S$ , with

$$P + S = K. \quad (1)$$

Let the production function be Cobb-Douglas:

$$Y = AP^\alpha S^\beta L^\gamma. \quad (2)$$

Then (2) can be written in growth form as

$$\dot{Y}/Y = \dot{A}/A + \alpha(\dot{P}/P) + \beta(\dot{S}/S) + \gamma(\dot{L}/L). \quad (3)$$

Our problem is that we do not know  $\dot{P}$ ,  $P$ , and  $S$ .

Now let

$$\tau = \alpha X + \delta, \quad (4)$$

where  $X$  is such that

### Appendix 3.2: Contribution of Public Investment

$$\dot{P}/P + (\dot{S}/S)X = \dot{K}/K = (\dot{P} + \dot{S})/(P + S),$$

or

$$X = (\dot{S}/S)(\dot{K}/K - \dot{P}/P). \quad (5)$$

Substituting (5) into (4) and then into (3) yields

$$\dot{Y}/Y = \dot{A}/A + \alpha(\dot{K}/K) + \tau(\dot{S}/S) + \beta(\dot{L}/L). \quad (6)$$

Because this expression still contains  $S$ , we multiply  $\dot{S}/S$  by  $Y/Y$  to obtain

$$\dot{Y}/Y = \dot{A}/A + \alpha(\dot{K}/K) + \Omega(\dot{S}/Y) + \beta(\dot{L}/L), \quad (7)$$

where  $\Omega = \delta(Y/S)$ , and  $\alpha$  is now the elasticity of output with regard to private capital stock.

We have all the data necessary to estimate (7), but the difficulties with this way of proceeding are that the coefficient  $\Omega$  need not be a constant, and it does not have an obvious interpretation even if it is. Note from (4) that  $\delta = \tau - \alpha X$ , so that

$$\Omega = \delta(Y/S) = (\tau - \alpha X)(Y/S). \quad (8)$$

Given (3),  $\tau$  is the elasticity  $(dY/dS)(S/Y)$ . Substituting (5) yields, therefore,

$$\Omega = dY/dS - \alpha(\dot{K}/K - \dot{P}/P)(Y/\dot{S}). \quad (9)$$

In a steady state in which  $\dot{K}/K = \dot{P}/P = \dot{S}/S$ ,  $\Omega$  is then the marginal product of government capital. If public capital stock rises faster than private, then the estimate of the marginal product is downward-biased; if private capital stock increases faster, the bias is upward.

Now, if  $\Omega$  is a marginal product, then we would expect its value to fall in the stock of public capital. In fact, when we split the 1,366 available observations according to the values of total capital per worker, we observe it to increase (Table A3.2.1). The OLS estimates increase slowly, but the two-way fixed-effects estimates rise sharply. Therefore, either the marginal product of public capital in fact increases with total capital per worker or private capital grows faster than public capital in the more-developed countries.

**Table A3.2.1.** Coefficients ( $\Omega$ ) on public capital, by capital per worker

$K/L$	$N$	$\Omega$		$K/L$	$N$	$\Omega$	
		OLS	2F			OLS	2F
-1,000	259	4.13 (1.452)	1.12 (0.191)	1,001–	1,107	3.27 (1.113)	16.36 (3.291)
-2,000	347	2.41 (0.856)	1.54 (0.300)	2,001–	1,019	4.85 (1.559)	18.79 (3.569)
-3,000	415	2.83 (0.951)	3.48 (0.584)	3,001–	951	4.46 (1.391)	17.10 (3.227)
-4,000	499	2.76 (1.030)	8.03 (1.627)	4,001–	867	4.40 (1.181)	21.58 (3.311)
-5,000	565	3.19 (1.131)	8.16 (1.608)	5,001–	851	4.03 (1.045)	21.63 (3.267)
-6,000	600	3.09 (1.137)	7.84 (1.629)	6,001–	766	4.10 (0.988)	22.40 (3.260)
-7,000	640	2.42 (0.879)	6.92 (1.440)	7,001–	726	6.27 (1.509)	27.35 (3.721)
-8,000	669	3.17 (1.155)	7.83 (1.647)	8,001–	697	2.75 (0.638)	20.92 (2.783)

*Note:* All samples under the given values are homogeneous; hence the appropriate estimator is OLS. All samples above the given values are heterogeneous, and random effects are biased; hence the appropriate estimator is two-way (country and year) fixed effects.

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# PROBLEMS OF DEMOCRATIC TRANSITION AND CONSOLIDATION

*Southern Europe,  
South America, and  
Post-Communist Europe*

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The Johns Hopkins University Press  
Baltimore and London

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© 1996 The Johns Hopkins University Press  
All rights reserved. Published 1996  
Printed in the United States of America on acid-free paper  
6 8 9 7 5

The Johns Hopkins University Press  
2715 North Charles Street  
Baltimore, Maryland 21218-4363  
[www.press.jhu.edu](http://www.press.jhu.edu)

Library of Congress Cataloging-in-Publication Data  
will be found at the end of this book.  
A catalog record for this book is available from the British Library.

ISBN 0-8018-5157-2 ISBN 0-8018-5158-0 (pbk.)

## The Implications of Prior Regime Type for Transition Paths and Consolidation Tasks

HAVING ANALYZED the necessary conditions for a consolidated democracy and then spelled out the key differences among the four ideal-typical non-democratic regimes, it should be clear that the characteristics of the previous nondemocratic regime have profound implications for the transition *paths* available and the *tasks* different countries face when they begin their struggles to develop consolidated democracies. Within the logic of our ideal types, it is conceivable that a particular authoritarian regime in its late stages might have a robust civil society, a legal culture supportive of constitutionalism and rule of law, a usable state bureaucracy that operates within professional norms, and a reasonably well-institutionalized economic society. For such a polity, the first and only necessary item on the initial democratization agenda would relate to political society—that is, the creation of the autonomy, authority, power, and legitimacy of democratic institutions. We argue in chapter 6 that Spain, in the early 1970s, approximated this position. However, if the starting point were from a totalitarian regime of the communist subtype, democratic consolidation would entail the task of simultaneously crafting not only political society and economic society, but also every single arena of a democracy as well. The full implications of these arguments are spelled out in a more systematic and detailed manner in tables 4.2 and 4.3, but here let us first depict the argument in its most stark form, table 4.1.

The analytic utility of distinguishing between post-totalitarian and totalitarian regimes should now be clear. As table 4.1 demonstrates, it is conceivable that a post-totalitarian regime could begin a transition to democracy with a combination of low-medium or medium scores on each condition necessary for a consolidated democracy except for the autonomy of political society. Hungary in early and mid-1989 came closest to approximating this position. While the tasks facing democrats starting from a mature post-totalitarian regime are challenging, they are substantially less than those facing democrats starting from a totalitarian regime. However, it should also be clear that, precisely because post-totalitarian regimes have a prior totalitarian period, there will be *legacies* to over-

Table 4.1. The Implications of Prior Nondemocratic Regime Type for the Tasks of Democratic Consolidation

Arena Characteristics	Authoritarian	Totalitarian	Post-totalitarian	Sultanistic
Civil society autonomy	Medium to high	Low	Low to medium	Low to medium
Political society autonomy	Low to medium	Low	Low	Low
Constitutionalism and rule of law	Low to high	Low	Medium	Low
Professional norms and autonomy of state bureaucracy	Low to high	Low	Low to medium	Low
Economic society with a degree of market autonomy and plurality of ownership forms	Medium to high	Low (Communist) or medium (Fascist)	Low to low-medium	Low to medium

Note: The character of the arenas in the prior nondemocratic regime in the period relatively close to the start of the transition is of the greatest importance for the tasks democratic leaders will face. The less developed the arena, the greater the tasks democratic leaders will have to accomplish before the new regime can be a consolidated democracy.

come that are simply not found in an authoritarian regime that has never been totalitarian.

Sharp differences between authoritarian and sultanistic regimes in our typology also help direct attention to the fact that the immediate implications of a sultanistic regime for democracy-crafters (as in Haiti) are that they will have to begin the construction of civil society, constitutionalism and a rule of law, professional norms of the bureaucracy, economic society, and political institutions from a very low base.

The delineation of the different regime types also allows us to be more specific about the possibilities and limits of "pacts" as a transition option available or not available in any particular nondemocratic regime type. Before discussing under what conditions pacts are possible, three general analytic points about pacts must be stressed. First, neither theoretically nor historically do democratic transitions necessarily involve pacts. Indeed, of the eight distinctive paths to redemocratization Stepan analyzed elsewhere, only three involved pacts.<sup>1</sup> Second, pacts can range from very democratic to very nondemocratic in their intention and consequences. A pact might be specifically crafted to provide for the rapid dismantling of a nondemocratic regime and the setting of an early and specific date for free elections. Such a pact would be clearly democratic in its intention and, if implemented, its consequences. Or a pact may explicitly entail some nondemocratic constraints for a short period before and after the first foundational election. In contrast, a consociational pact that is not initially undemocratic, if maintained too long, might preclude the entry into politics of new groups and eventually

1. See Alfred Stepan, "Paths toward Redemocratization: Theoretical and Comparative Considerations," in Guillermo O'Donnell, Philippe C. Schmitter, and Laurence Whitehead, eds., *Transitions from Authoritarian Rule: Comparative Perspectives* (Baltimore: Johns Hopkins University Press, 1986), 64–84, 170–74.

**Table 4.2. The Implications of Prior Nondemocratic Regime Type for Paths to Democratic Transition**

Path	Authoritarianism	Totalitarianism	Post-totalitarianism	Sultanism
<b>1. Reforma-pactada, ruptura-pactada</b>	Given that civil society can be reasonably well developed and that some moderate political opposition with a national constituency can exist, <i>reforma-pactada ruptura-pactada</i> between regime moderates and democratic opposition moderates is possible. Either regime leaders or the opposition could win fair elections and complete a transition.	No space for organized democratic opposition or for regime moderates. Thus <i>reforma-pactada</i> path is unavailable.	In mature post-totalitarianism, there can be collective leadership and a moderate wing. Likewise, the democratic opposition could have a well-developed "second culture" and incipient political groupings. If leaders of a mature post-totalitarian regime believe that elections are necessary and they have a chance to win, <i>reforma-pactada</i> with the leaders of the second culture or incipient opposition leading to free elections is possible.	Given a lack of rule of law and civil liberties on the one hand and personalistic penetration of the entire polity by the sultan on the other, the two prerequisites for a four-player pacted reform, an organized nonviolent democratic opposition and regime moderates with sufficient authority to negotiate a pact, do not exist, leaving the <i>reforma-pactada</i> virtually impossible.
<b>2. Defeat in War</b>	Defeat in war or war-related collapse could lead to a democratic transition with weak negotiating power by prior nondemocratic regime if representatives of democratic forces in civil and political society are available and demand an electoral path.	Virtually the only path in which totalitarianism defeated in war could lead rapidly to a democratic regime is by occupation by a democratic regime and externally monitored democratic installation.	In early post-totalitarianism democratic prospects could resemble totalitarianism. In mature post-totalitarianism, assumption of government by a democratic opposition and the early holding of elections are possible.	Given absence of the rule of law and widespread para-state violence, the democratic path is virtually not available without external monitoring and guarantees.

**Table 4.2. (continued)**

Path	Authoritarianism	Totalitarianism	Post-Totalitarianism	Sultanism
<b>3. Interim government after regime termination not initiated by regime (coup by nonhierarchical military, armed insurgents, or mass uprising and regime collapse)</b>	<p>In an authoritarian regime, it is possible that an organized democratic opposition in civil society and even political society exists. If they demand early elections, this transition path is quite possible. However, in the absence of effective demand for elections, the interim government will be tempted to exercise revolutionary power in policy areas and to postpone or cancel elections, thus delaying the transition or leading to a new nondemocratic regime.</p>	<p>An interim government is unlikely. However, should a deep crisis lead to a successor government, given flattened civil society and the absence of organized democratic political society, successful pressure for the holding of free elections is unlikely. The successors might search for electoral legitimization, but this does not ensure democratization.</p>	<p>Early elections are only the most likely path in mature post-totalitarianism where opposition activists might form government and proceed to democratization. In early or frozen post-totalitarianism, the most likely regime transition is mass uprising which, if not repressed, could lead to regime collapse and an interim government. The interim government may well be formed by elites connected with the old regime who are able to consolidate their power electorally in the still "flattened society."</p>	<p>High chance that "interim government" will claim to act in the name of the people and will postpone elections in order to carry out reforms. Given previous lack of autonomy of civil or political society, there is a high chance that groups associated with the sultan will claiming legitimacy for having supported the uprising will achieve nondemocratic power. The best chance for democratic transition is if revolutionary upheaval is led by internally supported, democratically inclined leaders who set a date for elections and allow free contestation of power.</p>

**Table 4.2. (continued)**

Path	Authoritarianism	Totalitarianism	Post-Totalitarianism	Sultanism
<b>4. Extrication from rule by hierarchically led military</b>	If a regime is led by a hierarchical military, the “military as institution,” if it feels under internal or external threat, may play a role in pressuring the “military as government” to withdraw from direct rule and to hold “extrication elections.” The length of transition and the extent of the “reserve domains of power” the military can impose as the price of extrication decrease with the severity of the internal or external threat to the military as institution and the strength of democratic forces in civil and political society.	Path not available to this regime type. Primacy of revolutionary party and unconstrained role of leaders make rule by hierarchical military impossible.	Path not available to this type given leading role of the party.	Path not available to this regime type. Sultanism implies a degree of fusion of private and public, and the sultan’s interference with bureaucratic norms is incompatible with rule by a hierarchical military.
<b>5. Some regime-specific possible transition paths and likely outcomes</b>			Leadership of totalitarian regime could split, opening the way for popular mobilization, liberalization, and possibly even an interim government that holds elections. Given the level of control prior to the mobilization of protest, a more probable outcome is that the dynamic of mobilization leads to re-imposition by force of totalitarian controls or to shift to post-totalitarianism. See transition paths open to post-totalitarianism.	Given dynastic tendencies of sultanism, if sultan dies of natural causes family members will attempt to continue sultanistic regime; thus, normally no regime-led liberalization will take place.

**Table 4.2. (continued)**

Path	Authoritarianism	Totalitarianism	Post-Totalitarianism	Sultanism
<b>6. Other regime-specific paths</b>	If a civilian-led authoritarian regime initiates a democratic transition, whatever agreements have been made will only tend to have the power the electorate and elected officials give to them. The emerging democracy will therefore normally be less constrained than if the prior nondemocratic regime had been led by a hierarchical military.	If totalitarian regime is supported by an external hegemon, withdrawal of hegemon's support could alter all power relationships. Cost of repression increases. Opposition and mobilization increase, and collapse becomes a possible outcome. If regime falls, chaos or provisional government is most likely. Given the absence of organized democratic opposition, even if provisional government begins a transition, control by people emerging out of the old regime is most likely.	If post-totalitarian regime is supported by external hegemon, it could collapse if hegemon removes coercive guarantee. If it is an early post-totalitarian regime, the successor regime is likely to be authoritarian or controlled by leaders emerging out of the previous regime. If it is a late post-totalitarian regime, civil society leaders of the provisional government could call early and completely free elections.	If the sultan is dependent on a foreign patron, a continuation of a crisis and pressure by the patron might lead to the ruler holding snap elections which he thinks he can control. Defeat in elections is a possibility, especially if an external patron supports the opposition. But democratic governance will be greatly aided by continued engagement of the patron in the democratization process. Foreign patron can sometimes force the sultan to step down.
<b>7. Other regime-specific paths</b>	Totalitarian regime could shift to post-totalitarianism. See transition options for post-totalitarianism.			

become a form of “exclusionary consociational authoritarianism.”<sup>2</sup> Finally, a pact that is designed to exclude some groups permanently and vastly to over-represent other groups is clearly undemocratic in its intention and, as long as it is sustained, in its consequences. Third, as Stepan has argued elsewhere, “pact creation does not necessarily mean pact maintenance—pacts can fall apart.... Pacts—with or without consociational elements—cannot be created in all political systems. Party pacts have two requirements: first, leaders with the organizational and ideological capacity to negotiate a grand coalition among themselves; second, the allegiance of their political followers to the terms of the pact.”<sup>3</sup>

Much of the transition literature on pacts contains references to “hard-liners” and “moderates.” Transitions are frequently seen as involving a pact between the regime moderates and the opposition moderates who are both able to “use” and “contain” their respective hard-liners. This is, in essence, a four-player game theory model.<sup>4</sup> However, two conditions must be satisfied for it to be a true four-player game. The moderate players in the regime must have sufficient autonomy so that they can, over time, conduct strategic as well as tactical negotiations with the players from the moderate opposition. Conversely, the moderates in the opposition need a degree of continued organizational presence, power, and followers in the polity to play their part in the negotiation pacts. For many writers on transitions, the *locus classicus* of such a pact occurred in Spain.<sup>5</sup> In Spain, as we shall see in chapter 6, regime and opposition moderates initially crafted a pacted reform. Eventually, negotiations led to a pacted rupture that allowed the dismantling of the nondemocratic elements of the Franco state and the creation of new democratic structures. This overall process is called *reforma pactada-ruptura pactada*.

While there are often references to the possibility of pacts being a key part of most transitions, full four-player pacts are possible only in two of our four ideal-typical nondemocratic regimes. A regime that approximates the sultanistic ideal type does not have the *reforma pactada-ruptura pactada* available as a transition path because the two moderate players are absent. The essence of the sultanistic ideal type is that the sultan fuses personal and public power. Important figures in the regime are significant not because of any bureaucratic or professional position they hold, but because of their presence on the personal staff of the sultan.

2. Jonathan Hartlyn discusses consociational exclusion in *The Politics of Coalition Rule in Colombia* (Cambridge: Cambridge University Press, 1988).

3. Stepan, “Paths toward Redemocratization,” 80. Stress in original. For an excellent analysis of the difficulties of pact maintenance, see Eric Nordlinger, *Conflict Regulation and Divided Societies* (Cambridge: Center for International Affairs, Harvard University Press, 1972).

4. See, for example, Adam Przeworski, “The Games of Transition,” in Scott Mainwaring, Guillermo O’Donnell, and Samuel Valenzuela, eds., *Issues in Democratic Consolidation* (Notre Dame, Indiana: University of Notre Dame Press, 1992), 105–53.

5. For a rigorous and appropriate application of the game theory approach to the Spanish case, see Josep M. Colomer, *Game Theory and the Transition to Democracy: The Spanish Model* (Aldershot, England: Edward Elgar Publishing, 1995), and “Transitions by Agreement: Modeling the Spanish Way,” *American Political Science Review* (December 1991); 1283–1302.

**Table 4.3. The Implications of Nondemocratic Regime Type for the Minimal Tasks of Completing Transition to and Consolidation of a Democratic Regime from that Regime Type**

Necessary Conditions	Authoritarianism	Totalitarianism	Post-totalitarianism	Sultanism
<b>1. Rule of law and civil society freedom</b>	In some authoritarian regimes there is a tradition of rule of law and civil society that might be quite lively, but civil liberties will need to be extended and protected. Laws giving autonomy to trade unions, media, etc., may need to be enacted and implemented.	Rule of law did not exist. Much of the legal code, to the extent that it existed, was highly politicized and instrumental for the party-state but not for its citizens and therefore was incompatible with democracy. Civil liberties are minimal and need to be legalized, developed, and protected. The "flattened" nature of civil society requires fundamental changes that are difficult to generate in a short time.	An extensive reform of the legal system to assure civil rights and rule of law will be needed.	Given the legacy of the fusion of public and private and the extreme personalization of power, the establishment of a rule of law and guarantees for citizens have a high priority and will be a difficult task.
<b>2. Political society autonomy and trust and legal condition for it</b>	All the normal conditions ensuring the free electoral competition between parties need to be created. In some cases, party competition has only been suspended and can easily be revitalized. In other cases, the formation of parties needs to be legalized and restrictions on specific parties lifted. In some cases the political rights of key political actors need to be re-established. In exceptional cases an authoritarian state party may have to be dismantled.	The party's dominant position in all areas of society and its privileged status and resources must be dismantled, its presence in all institutions removed, and almost all of its property transferred to the state. However, if citizens want to recreate the party they should be allowed to do so, and its support and power should depend on the votes people might want to give to it. Given the flattened social landscape the representation of interests will be particularly difficult.	The dismantling of the privileged status, legal and otherwise, of the dominant party will be needed. Legal reform will also be needed to assure the free formation and competition of political parties. While society may not be as "flattened" as under totalitarianism, the relative lack of economic and political differentiation makes political "representation" of interests difficult and complicates the development of a normal spectrum of democratic parties.	The suppression of semiprivate violence and the creation of a modicum of trust are requirements for the development of political parties, free contestation for power, and sufficient autonomy for the working of democratic procedures and institutions.

**Table 4.3. (continued)**

Necessary Conditions	Authoritarianism	Totalitarianism	Post-totalitarianism	Sultanism
<b>3. Constitutional rules to allocate power democratically</b>	In some cases, there can be an immediate declaration that a previous democratic constitution has been reinstated; in other cases amendments to a nondemocratic constitution may be viable; in still others a full democratic constituent assembly and constitution-making process are needed.	A paper constitution may exist that, when filled with democratic content, might lead to perverse consequences, since it was not designed for a democratic society. The making of a new democratic constitution will be necessary but difficult due to an inchoate political society, the lack of a constitutional culture, and the legacy created by the verbal commitments of the previous constitution.	Given the fictive character of the constitution, there are serious costs to using these institutions, and the making of a democratic constitution should be a high priority.	A universalistic legal culture will have to be developed. Even while there may be a usable constitution, given the recent abuse of constitutional rules, a spirit of trust and respect for constitutionalism does not exist at the end of a sultanistic period.
<b>4. State bureaucracy acceptable and serviceable to democratic government</b>	To the extent that the bureaucracy has not been politicized and has maintained professional standards, there may be no immediate need for bureaucratic reform. In some cases, a more or less limited purge of bureaucrats, including the judiciary and the military, might be desirable. But if a hierarchical military played a major role in the previous nondemocratic regime, such purges may be quite difficult.	The delegation of major tasks of the state to the party and the penetration of the party into all bureaucratic and social institutions make the creation of a nonpoliticized bureaucracy an imperative and difficult task. The dismantling of the party within the state might seriously reduce the efficiency and coordination of the state apparatus and open the door for a clientelistic take-over by the new democrats or by opportunists.	The fact that many functions of the state, including judiciary functions, were performed by party bureaucrats makes purges and reform of the state bureaucracy widespread demand but a complex and contentious issue to resolve. The skills of the former bureaucratic elite and the lack of experience of the opposition may well give the former elite a privileged position.	The clientelistic penetration and corruption of bureaucratic institutions limit their efficiency and legitimacy and put extensive reform on the agenda. Even democratically elected leaders may perpetuate clientelistic practices rather than rational administration.

**Table 4.3. (continued)**

Necessary Conditions	Authoritarianism	Totalitarianism	Post-totalitarianism	Sultanism
<b>5. Sufficient autonomy for economy and economic actors to assure pluralism of civil society, political society, and economic society</b>	If the economy has been a functioning mixed economy, there may be no immediate changes necessary to facilitate the transition and consolidation of democracy. Whatever further reforms are desired or needed will be part of normal political processes that could include more socialization or more privatization of property and more or less social and/or economic regulation of the market.	In communist totalitarianism the almost total public ownership of property and the linkages between the party and the economy make the growth of autonomy of civil and political society particularly difficult. Fundamental reform of the economy is imperative, but the absence of a legal institutional framework for a market economy and the weakness of legal culture make the creation of an "economic society" difficult and facilitate the emergence of illegal or alegal practices.	Ultimate control by the state of all economic activity does not seem conducive to the minimal degree of civil and political society robustness necessary for a democratic polity. Some reforms are necessary to create an institutionalized economic society. A full-blown market economy is not a requirement for democracy.	Dismantling of the patrimonial and clientelistic structures of the ruler and his allies will be necessary to allow the normal development of civil, political, and economic society.

But there is absolutely no room on the “household” staff of the sultan for a moderate player who publicly negotiates the demise of his employer. The other players who never exist in an ideal typical sultanistic regime are moderates from the organized democratic opposition. Neither civil society nor political society has enough autonomy to enable a publicly organized democratic opposition to develop sufficient negotiating capacity for it to be a full player in any pacted transition.<sup>6</sup>

A similar logic would preclude the ideal-typical totalitarian regime from even a full two-player game. There is a big player (the totalitarian hard-line maximum leader and his party-state staff) and a small underground opposition (half a player?) that can struggle to exist and possibly resist but that has absolutely no capacity to negotiate a pacted transition.

Even early post-totalitarian regimes do not have sufficient diversity and autonomy in the ruling party-state leadership or sufficient strength and autonomy within the democratic opposition really to produce all the players needed to conclude successfully a four-player democratic transition game. Indeed, as we argued in chapter 3, if an early or a “frozen” post-totalitarian regime faces a crisis of opposition, it is particularly vulnerable to collapse if it is not able to repress that opposition, given its limited negotiating capability. But a mature post-totalitarian regime (such as Hungary in the mid-1980s) and a wide range of authoritarian regimes (such as Spain and Brazil in the mid-1970s) can produce four-player games. Thus although “pacted transitions” figure prominently in the literature, the classic four-player pacted transitions are in fact available as a transition path only in some authoritarian and mature post-totalitarian regimes.

A transition path that would seem available to most nondemocratic regimes but that, upon closer scrutiny, is in fact available only to the authoritarian regime type concerns the military. If the costs of rule by the “military as government” are considered too great for the “military as institution,” a free election may become part of the extrication formula for the hierarchical military in charge of an authoritarian regime.<sup>7</sup> However, the control of the government by a hierarchical military bureaucracy is completely inconsistent with the logics of sultanism or totalitarianism or of the leading role of the party in post-totalitarianism.

We are now ready to present for analysis a resumé of the implications of nondemocratic regime types for *paths* to democratic transition (table 4.2), and of the implications of nondemocratic regime type for the minimal *tasks* of completing the transition to and consolidation of a democratic regime (table 4.3).

6. For example, the only Warsaw Pact country in 1988 not to have one opposition samizdat journal published in the country was Romania, a country that combined under Ceausescu strong sultanistic and totalitarian tendencies. For the special difficulties of a successful democratic transition from a sultanistic regime, see the introductory chapter by H. E. Chehabi and Juan J. Linz in their edited volume in progress, *Sultanistic Regimes*, and Richard Snyder, “Explaining Transitions from Neopatrimonial Dictatorships,” *Comparative Politics* 24 (July 1992): 379–99. Also see Michael Bratton and Nicholas van de Walle, “Neopatrimonial Regimes and Political Transition in Africa,” *World Politics* (July 1994): 453–89.

7. An extensive conceptual and political analysis of the distinction between the “military as government” and the “military as institution” is developed in chapter 5.

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# **THE POLITICAL ECONOMY OF DEMOCRATIC TRANSITIONS**

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PRINCETON UNIVERSITY PRESS      PRINCETON, NEW JERSEY

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Published by Princeton University Press, 41 William Street,  
Princeton, New Jersey 08540  
In the United Kingdom: Princeton University Press, Chichester,  
West Sussex

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**Library of Congress Cataloging-in-Publication Data**

Haggard, Stephan.  
The Political economy of democratic transitions / Stephan Haggard  
and Robert R. Kaufman.  
p. cm.  
Includes bibliographical references and index.  
ISBN 0-691-02974-1 (cloth : alk. paper). — ISBN 0-691-02775-7  
(pbk. : alk. paper)  
1. Democracy—Economic aspects.  
2. Authoritarianism—Economic aspects. 3. Economic  
policy—Political aspects. 4. Democracy—Cross-cultural studies.  
5. Authoritarianism—Cross-cultural studies. 6. Economic  
policy—Cross-cultural studies. I. Kaufman, Robert R. II. Title.  
JC423.H29 1995  
338.9—dc20  
94-49595  
CIP

This book has been composed in Times Roman

Princeton University Press books are printed on acid-free paper  
and meet the guidelines for permanence and durability of the  
Committee on Production Guidelines for Book Longevity of the  
Council on Library Resources

Printed in the United States of America by Princeton Academic Press

1 3 5 7 9 10 8 6 4 2  
(Pbk.)  
1 3 5 7 9 10 8 6 4 2

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## CHAPTER ONE

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### The Political Economy of Authoritarian Withdrawals

SEVERAL different factors might account for the dramatic increase in the number of authoritarian withdrawals during the 1970s and 1980s. The wide geographic spread of the movement toward democracy suggests that international pressures played an important role. Diplomatic pressures from the Western European democracies and the lure of membership in the European Community were significant in the southern European transitions, and contributed to limiting the Turkish military's stay in power in the early 1980s. In the Caribbean, Central and South America, and the Philippines, American influence mattered.<sup>1</sup> The United States' encouragement of constitutional government reflected the attempt to counter leftist threats through political reform, a strategy that dates to the Alliance for Progress. Most of the transitions at the end of the decade occurred among Eastern European states that could no longer count on the military and political backing of their Soviet patrons.

The "contagion effect," discussed in work by Laurence Whitehead, has been another international source of pressure on authoritarian regimes. Successful democratic opposition in one country has an impact on the perceptions and behavior of actors in neighboring countries or in those with strong cultural links.<sup>2</sup> Developments in Spain resonated throughout Latin America and the "people power" revolution in the Philippines challenged other Asian dictatorships. Events in Poland and East Germany had implications for other Eastern European regimes and the Soviet Union; their collapse, in turn, was debated virtually everywhere.

The structural changes associated with long-term economic growth constitute still a third influence at work. In southern Europe, the East Asian newly industrializing countries, and Eastern Europe, economic development resulted in the emergence of more complex, literate, middle-class societies that demanded increased political participation. Economic success thus arguably contributed to the demise of authoritarianism.

Given the myriad of forces that have worked to destabilize incumbent

<sup>1</sup> See Abraham Lowenthal, ed., *Exporting Democracy: Themes and Issues* (Baltimore: Johns Hopkins University Press, 1991).

<sup>2</sup> Laurence Whitehead, "The International Dimension of Democratization: A Survey of the Alternatives," paper presented at the International Political Science Association Congress, Buenos Aires, 21–25 July, 1991.

authoritarian rulers over the past several decades, our emphasis on the role of economic crisis requires justification. As Samuel Huntington has argued, specific transitions from authoritarianism to democracy are overdetermined: each is attributable to different combinations of causes, none of which is either necessary or sufficient to explain democratic transitions in general.<sup>3</sup> Why, then, should we focus intensively on economic crisis and adjustment as catalysts of political change?

One reason is that economic crisis *did* appear to accelerate, if not cause, the collapse of authoritarian regimes in a number of countries. This was particularly true in Latin America and Africa, where the shocks of the 1980s were profound. Where poor economic performance played a role in authoritarian withdrawals, it is important to specify clearly how economic deterioration affected political transformation. How did crisis affect the power relations among supporters of the regime and anti-regime opponents? Why were some regimes more vulnerable than others to the pressures created by these shifts?

A second reason to examine the impact of economic crisis is that even where it was not solely responsible for the transition itself, it had powerful effects on the *terms* on which authoritarian governments withdrew. Authoritarian governments able to avoid crises or adjust effectively were better positioned to resist pressures to leave office and maintained greater control over the timing and conditions of their exit. As we will suggest in Part Two, the differences between crisis and non-crisis transitions thus had an important impact on the institutional characteristics of incoming democratic governments.

This chapter provides an overview of the challenges economic crises pose to authoritarian regimes and the cross-national variation in responses to those challenges. We focus particularly on the withdrawal of military regimes, the typical form authoritarian rule took in middle-income capitalist societies, reserving the discussion of the more unusual dominant-party regimes to chapter 8. In the first section, we discuss the way economic factors, including both the level of development and short-run performance, affect the stability of authoritarian regimes. We begin with the general proposition that in relatively differentiated middle-income countries, the probability of a democratic transition increases during periods of economic distress.

Though the empirical evidence reviewed in the second section suggests that this hypothesis is plausible, the relationship is not a deterministic one; there are a number of anomalous cases in which democratic transitions occurred in the absence of economic crises. In the third section, we outline

<sup>3</sup> Samuel Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman: Oklahoma University Press, 1991), p. 38.

the institutional factors that made military regimes more or less vulnerable to economic crisis, emphasizing organizational and other sources of cohesion and factionalism, and provide an overview of how the general argument applies to the case studies that follow in chapters 2 and 3.

### ECONOMIC DEVELOPMENT AND THE STABILITY OF AUTHORITARIAN REGIMES

#### *The Lipset Hypothesis*

Virtually all of the theoretical discussion of the effect of economic factors on regime type has focused on the question raised over thirty years ago by Seymour Martin Lipset: whether a high *level* of development is a precondition for the emergence and maintenance of democratic rule.<sup>4</sup> Notwithstanding the controversy it has generated, there are both theoretical and empirical reasons why the Lipset hypothesis is plausible.<sup>5</sup> As Robert Dahl has suggested, the diffusion of skills and organizational resources associated with high levels of economic development expands the range of groups with capacities to influence politics. "A modern dynamic pluralist society disperses power, influence, authority and control away from any single center toward a variety of individuals, groups, associations and organizations."<sup>6</sup> Such developments, in turn, increase the costs of repression relative to those of toleration, and thus the chances that authoritarian rulers will acquiesce to pressures for political liberalization and democratic reform when they arise.

Empirically, the correlation initially observed by Lipset between measures of economic development and democracy has remained one of the strongest findings in political science.<sup>7</sup> With some important exceptions, such as India, very poor countries tend to be authoritarian; very rich countries are overwhelmingly democratic.

Predictably, however, there is wide variation in regime type among middle-income countries that are neither very rich nor very poor. Hunt-

<sup>4</sup> Seymour Martin Lipset, "Some Social Requisites of Democracy: Economic Development and Political Legitimacy," *American Political Science Review* 53 (1959): 69–105.

<sup>5</sup> For a review of these hypotheses, see Alex Hadenius, *Democracy and Development* (New York: Cambridge University Press, 1992), pp. 77–82.

<sup>6</sup> Robert Dahl, *Democracy and Its Critics* (New Haven: Yale University Press, 1989), p. 252.

<sup>7</sup> For comprehensive reviews of the literature and presentation of new empirical findings, see Hadenius, *Democracy and Development*; Larry Diamond, "Economic Development and Democracy Reconsidered," *American Behavioral Scientist* 35 (1992): 450–99; John F. Helliwell, "Empirical Linkages Between Democracy and Economic Growth," *British Journal of Political Science*, 24 (1994): 225–48.

ington has suggested that such middle-income countries occupy a "zone of transition or choice, in which traditional forms of rule become increasingly difficult to maintain and new types of political institutions are required to aggregate the demands of an increasingly complex society. . . ."<sup>8</sup> As he points out, the recent wave of democratic transitions has occurred primarily among these middle-income countries.

But prior to the recent wave of democratic transitions, these same "transitional" countries had spawned new forms of *authoritarian* rule. The well-known work of Guillermo O'Donnell found that bureaucratic-authoritarian installations occurred in the most developed Latin American countries, not the least developed.<sup>9</sup> In a recent cross-national study, Lipset, Seong, and Torres found an "N-curve" relationship between authoritarianism and economic development. The probability of nondemocratic regimes *increased* with development in a middle range of countries (per capita income between \$2,346 and \$5,000 in 1980), but *decreased* with development among lower- and upper-income countries.<sup>10</sup>

In short, the relationship between level of development and regime type seems indeterminate among middle-income countries, which have been characterized by both authoritarian and democratic rule. A certain threshold of national income may constitute an important condition for democratic rule. But the level of economic development cannot tell us anything about the dynamics of democratic transitions or why they occur when they do.

### *Economics and Politics: The Equation in the Short Run*

An alternative hypothesis is that the stability of authoritarian regimes depends both on the overall level of development *and* on economic conditions in the short run.<sup>11</sup> Authoritarian regimes vary according to which segments of the population are given preference, but all are responsive to the economic interests and demands of at least some sectors of their societies. Inclusionary authoritarian regimes such as Peru's initially mobilized mass support from above. Some authoritarian regimes, such as those in Central America and Africa, are based on highly personalistic ties between rulers and traditional social elites or clients. More typical of our

<sup>8</sup> Huntington, *The Third Wave*, p. 201.

<sup>9</sup> Guillermo O'Donnell, *Modernization and Bureaucratic-Authoritarianism: Studies in South American Politics* (Berkeley, Calif.: Institute of International Studies, 1973).

<sup>10</sup> S. M. Lipset, K. R. Seong, and J. C. Torres, "A Comparative Analysis of Social Requisites of Democracy," unpublished paper, Hoover Institution, Stanford University, 1991; Diamond, "Economic Development and Democracy Reconsidered."

<sup>11</sup> See also John Londregan and Kenneth Poole, "Poverty, the Coup Trap and the Seizure of Executive Power," *World Politics* 42 (1990): 151-83.

sample of middle-income countries are “bureaucratic-authoritarian” regimes based around a military-technocrat alliance, an economic reform program, and support from some portions of the modern private sector, both domestic and foreign.

Whatever the nature of the underlying “authoritarian bargains,” poor economic performance—whether the result of external shocks, bad policy, or both—means a reduction in the resources available to political elites for sustaining bases of support. The effort to control inflation or to undertake structural reforms can further weaken the government’s hand. Stabilization of inflation and balance-of-payments adjustment typically involve policies that reduce aggregate income in the short run. Though these stabilization measures are likely to be the most difficult politically, structural adjustment measures also have costs, since governments are typically unable to compensate for the withdrawal of rents from previously privileged groups.

In some cases, authoritarian rulers may be able to weather economic distress by forcing the costs of adjustment onto excluded groups, yet there are significant constraints in attempting to do so. Authoritarian governments cannot appeal to broad principles of democratic legitimization. Coercion is also costly, and generally either ineffective or counterproductive in securing the confidence of the private sector. To survive, such governments must sustain bases of support; they are therefore accountable even if that accountability is not always institutionalized and is focused on a relatively narrow range of interests.

We can examine the effects of economic crises on the stability of military regimes by tracing the interests and likely political responses of three sets of political and economic actors: private-sector business groups; middle-class and popular-sector organizations; and military and political elites who control the state and the main instruments of coercion.

First, deteriorating economic performance disrupts the “authoritarian bargains” that rulers typically forge with some portion of the private sector. The specific bases of business support depend, of course, on the structure of the economy, the resources available to specific groups, and the political project of the government. In our sample of countries, authoritarian regimes have rested on a wide variety of coalitional foundations, including import-substituting industrialists in most Latin American countries, financial and agro-export elites in Chile, and export-oriented manufacturing firms in Korea and Taiwan. Yet in all mixed-economy middle-income countries, business elites are pivotal actors because they control both existing assets and the flow of investment that is crucial to continued growth. Even where authoritarian governments restrict the formal political access of such groups, political leaders nonetheless seek their cooperation and support.

In military regimes, this cooperation is secured in three ways: by promising protection against perceived threats to private property; by pursuing

broad development strategies that favor certain sectors; and by providing more particularistic favors or rents. Economic crisis and corresponding pressures for policy adjustment weaken the ability of the government to deliver in all three of these areas, and thus encourage a reassessment of the overall political bargain.

The initial reactions of the private sector to poor economic performance typically focus on changes in specific policies or government personnel. But if private sector actors believe that authoritarian governments are unwilling or unable to change policies detrimental to their individual and collective interests, if they lose “confidence,” they can quickly recalculate the costs associated with democratization; this is particularly likely where there are opportunities to ally with “moderate” oppositions. On purely self-interested grounds, crises can push business groups to view democracy as the system most likely to provide them with opportunities to defend their interests.

The defection of private-sector groups poses particularly serious challenges to military regimes; the private sector is well placed to play an organizational and financial role within the opposition. But more important is the fact that loss of private-sector confidence confronts the government with bleak prospects for future investment and growth. It is possible to coerce individuals, and even to seize their assets, but it is difficult to force them to invest.

Middle- and lower-income groups, by contrast, are more vulnerable to political repression, and in all the countries in our sample, repressive tactics were used to “manage” public protests against deteriorating economic conditions. But military governments have relied on material rewards to win support or deflect opposition from these groups as well, and economic crisis clearly weakens the government’s ability to do so. In several cases, rulers actively bid for the allegiance of portions of the popular sector through public employment, large-scale public works projects, and consumer subsidies. Even in harshly antilabor regimes, material payoffs have played an important role. In both Korea and Taiwan, for example, the political control of labor was a component of export-led growth strategies. But this growth strategy resulted in a steady improvement of living standards that bought the government the acquiescence, if not support, of some segments of labor. Even in the Southern Cone countries of Latin America, arguably the most labor-repressive of all authoritarian regimes, governments used exchange-rate policy, partial indexation, and other forms of compensation to limit the deterioration of workers’ incomes.

The primary political weapon of mass-based groups and social movements in authoritarian settings is the mobilization of protest: strikes, street demonstrations, or where opportunities exist, referenda and electoral campaigns. These protests are frequently directed at political targets, but it

would be misleading to interpret their origins and popularity as purely political. Such movements often have their origins in reaction to particular economic grievances: unemployment; inflation in the prices of staples, fuel, and transportation; declining real wages.<sup>12</sup> More importantly, these conditions provide opportunities for the political leaders of the opposition to draw in new adherents by linking economic circumstances to the exclusionary nature of the political order.<sup>13</sup>

Most crucial to the survival of military regimes, finally, is the continuing loyalty of the politico-military elite itself: the heads of the armed forces, strategic segments of the state apparatus, and in some cases, the individuals who control the machinery of the ruling party. We follow O'Donnell and Schmitter, Przeworski, and others in arguing that, except in cases of military defeat and foreign occupation, the proximate cause for the exit of authoritarian regimes can almost always be found in splits within this elite.<sup>14</sup> The crucial question for our purposes is the extent and manner in which economic conditions play a role in creating these divisions.

O'Donnell and Schmitter argue that the emergence of divisions between "hardliners" and "softliners" reflects preferences and assessments of risk that are not systematically related to economic conditions.<sup>15</sup> Agencies or individuals involved in earlier acts of repression, for example, are more inclined to adopt a "hardline" position against political liberalization than are officers who are less exposed to future reprisals. Similarly, willingness to support the use of coercion in response to protest may also reflect purely political assessments about the efficacy of coercion in deterring the escalation of protest or the possibilities of reaching agreement with a moderate opposition.

<sup>12</sup> This is not to suggest that all grievances are economic, particularly among middle-class groups. Because of their access to communications and organizational resources, white-collar groups, particularly within the liberal professions, play an especially important role in anti-government protests. These groups do not always favor democracy, but arbitrary governmental authority can pose threats not only to their careers but to professional norms, such as the integrity of the law or of universities. Except during periods of intense polarization, they are thus inclined to press for constitutionalism. Their incorporation into popular democratic movements is often pivotal to the process of political transition, in part because it affects the government's calculus concerning the use of coercion.

<sup>13</sup> For a useful discussion of the way these mobilizations can be affected by the strength of the union movement and past relationships to the party and the incumbent regime, see J. Samuel Valenzuela, "Labor Movements in Transitions to Democracy: A Framework for Analysis," *Comparative Politics*, 21 (1989): 445-73.

<sup>14</sup> See Guillermo O'Donnell and Philippe Schmitter, *Tentative Conclusions about Uncertain Democracies*, pt. 4 of O'Donnell, Schmitter, and Laurence Whitehead, eds., *Transitions from Authoritarian Rule* (Baltimore: Johns Hopkins University Press, 1986), pp. 15-17. Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America* (New York: Cambridge University Press, 1991), chap. 2, pp. 51-94.

<sup>15</sup> Ibid.

Even where economic crises are not the *source* of factional conflicts between hard and softliners, however, they are likely to widen them. In the first instance, economic downturns affect the loyalty of the military-political elite directly by reducing the ability of the government to deliver material benefits. Like any other component of the public sector, military establishments are threatened by adjustment measures: devaluations which increase the cost of foreign procurement, reductions of pay, and budget cuts. Opponents to adjustment measures may thus find important allies from within the armed forces themselves.

The changes in the interests of the major actors that we have outlined ultimately affect the course of political change through their influence on the strategic interactions between the politicians who constitute the leadership of the opposition and authoritarian elites. As these dynamics have been well charted by O'Donnell and Schmitter and by Przeworski, we need not reiterate them in detail.<sup>16</sup> We have already noted how the widening disaffection with the regime presents new opportunities for opposition politicians to mobilize support. There may be divisions within the opposition; we discuss their effects in more detail in the case studies. But from the perspective of the authoritarian leadership, the defection of private-sector groups and the widening of popular-sector protest increase both the cost of coercion and the risk that it will prove ineffective. It is precisely under such conditions that the splits we have noted within the regime begin to have strategic importance for the transition process. "Softliners" begin to calculate that the corporate interests of the ruling elite are best guarded by conciliation, rather than further repression. Even when the objective is a "broadened dictatorship" rather than a transition to democratic rule, the division within the government between softliners and hardline defenders of the status quo provides the opportunity for the opposition to press for broader political reforms.

#### ECONOMIC CRISIS AND AUTHORITARIAN WITHDRAWALS: EMPIRICAL PATTERNS

The relevance of short-term economic performance to authoritarian withdrawals can be gauged in a preliminary way by a survey of twenty-seven democratic transitions occurring between 1970 and 1990. Transitions are defined here as the first year of a competitively elected government; the two exceptions are Brazil, in which the opposition came to power through the electoral college, and Thailand, where the prime minister was selected by legislators not all of whom had been elected.

<sup>16</sup> See O'Donnell and Schmitter, *Tentative Conclusions*, pp. 15–36; and Przeworski's discussion of the hardliner-softliner dynamic in *Democracy and the Market*, pp. 51–88.

As Table 1.1 shows, these transitions occurred under a wide range of conditions, including relatively strong economic growth. Nevertheless, in a substantial majority of the cases, the years preceding the transition were marked by declining growth, increasing inflation, or both. Twenty-one of the twenty-seven countries experienced declining growth prior to the transition; among the remaining cases, long-term growth rates were very low in El Salvador and Ghana, and had declined by historic standards in Brazil. Two-thirds of the transitions were also preceded by increasing inflation. In Argentina and Uruguay, inflation was very high, although it had declined somewhat relative to the earlier period.

Only in Korea, Chile, and Turkey did transitions occur during periods of high and rising rates of growth and declining rates of inflation. Thailand presents a somewhat ambiguous case, since growth slowed somewhat in the early 1980s. However, overall economic conditions remained highly favorable in Thailand throughout the 1980s; growth rates were among the highest in the world and inflation decreased. For these reasons, we do not consider Thailand a crisis case.

On the other hand, although yearly growth rates improved slightly in some other countries prior to transitions, in most instances they remained very low. Brazil, which we classify as a case of crisis-induced transition, experienced a brief economic upswing in the year prior to the transition, but this had been preceded by several years of severe recession. Moreover, the outgoing regime had failed to confront a number of pressing adjustment issues and inflation accelerated substantially prior to the change in regime.

The inferences that can be drawn from these data about the causal relationship between economic conditions and regime change are limited by the fact that the table does not include countries in which regimes survived severe economic shocks. There is surprisingly little cross-national statistical work on the economic determinants of regime change, however. One recent exception is a study by Mark Gasiorowski,<sup>17</sup> which uses a pooled time-series technique to explore the relationship between economic conditions, measured in terms of growth and inflation, and transitions to and from democracy. Gasiorowski finds little effect of growth on democratization, but argues that in the 1980s high inflation had a statistically significant effect on the probability that authoritarian regimes would transit to democracy.

To clarify theoretical expectations, it is useful to consider those regimes that did not democratize in response to economic crises. During the 1970s and 1980s, these survivors consisted mainly of authoritarian regimes in Africa and the Middle East, and until 1989, the Communist regimes of

<sup>17</sup> Mark Gasiorowski, "Economic Crisis and Political Regime Change: An Event History Analysis," unpublished ms., Department of Political Science, Louisiana State University, October 1993.

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**TABLE 1.1**  
Economic Performance prior to Democratic Transitions

	<i>GDP Growth</i>		
	Avg. Performance, Transition Year and Two Previous Years	Avg. Performance, Five Previous Years	<i>A - B</i>
	(A)	(B)	
Honduras, 1982	-0.5	7.6	-8.1
Romania, 1990	-4.3	2.9	-7.2
Philippines, 1986	-3.2	3.9	-7.1
Ecuador	6.3	13.2	-7.0
Bolivia, 1982	-1.5	4.4	-6.6
Portugal, 1976	1.3	7.4	-6.1
Argentina, 1983	-3.2	2.4	-5.6
Uruguay, 1985	-2.4	2.0	-4.4
Hungary, 1990	-2.3	1.8	-4.1
Spain, 1977	2.5	6.2	-3.7
Nicaragua, 1990	-4.6	-0.9	-3.5
Greece, 1974	4.3	7.7	-3.4
Thailand, 1973	6.3	9.2	-2.9
Nigeria, 1979	2.6	5.3	-2.7
Senegal, 1978	0.1	2.5	-2.4
Thailand, 1983	5.8	7.8	-2.0
Argentina, 1973	3.2	4.4	-1.2
Poland, 1989	2.2	3.1	-0.9
Guatemala, 1986	0.0	0.6	-0.6
Peru, 1980	3.5	4.1	-0.6
Czechoslovakia, 1989	1.7	2.2	-0.5
Turkey, 1974	6.5	6.9	-0.4
Brazil, 1985	3.3	3.1	0.2
El Salvador	-0.9	-1.2	0.3
Turkey, 1983	4.3	3.0	1.3
Korea, 1988	11.7	8.5	3.2
Chile, 1990	6.3	3.9	2.4
Ghana, 1979	3.3	-1.9	5.2
Paraguay, 1989	5.7	0.1	5.6

TABLE 1.1 (*continued*)

	<i>Inflation</i>		
	Avg. Performance, Transition Year and Two Previous Years (A)	Avg. Performance, Five Previous Years (B)	A - B
<i>Brazil, 1985</i>	188.7	75.5	113.2
<i>Poland, 1989</i>	112.2	34.1	78.1
<i>Bolivia, 1982</i>	69.7	10.1	59.6
<i>Ghana, 1979</i>	81.3	26.4	54.9
<i>Peru, 1980</i>	61.2	24.3	36.9
<i>Argentina, 1973</i>	51.4	19.7	31.7
<i>Portugal, 1976</i>	22.2	7.7	14.5
<i>Greece, 1974</i>	15.6	2.1	13.5
<i>Hungary, 1990</i>	20.5	7.1	13.4
<i>Uruguay, 1985</i>	58.9	45.6	13.3
<i>Guatemala, 1986</i>	19.7	7.7	12.0
<i>Philippines, 1986</i>	24.7	13.8	10.9
<i>Spain, 1977</i>	18.8	9.9	8.9
<i>Turkey, 1974</i>	14.3	7.5	6.8
<i>Thailand, 1973</i>	6.9	2.5	4.4
<i>Honduras, 1982</i>	12.2	7.9	4.3
<i>Paraguay, 1989</i>	23.6	19.5	4.1
<i>Romania, 1990</i>	2.7	1.7	1.0
<i>Nigeria, 1979</i>	15.7	16.0	-0.3
<i>Czechoslovakia, 1989</i>	0.5	1.9	-1.4
<i>El Salvador, 1984</i>	12.2	14.4	-2.2
<i>Ecuador, 1979</i>	11.7	14.1	-2.4
<i>Thailand, 1983</i>	7.2	9.8	-2.6
<i>Korea, 1988</i>	4.3	7.3	-3.0
<i>Chile, 1990</i>	19.2	23.5	-4.3
<i>Argentina, 1983</i>	204.4	211.2	-6.8
<i>Senegal, 1978</i>	5.3	13.9	-8.6
<i>Turkey, 1983</i>	32.9	51.7	-18.8

Source: International Monetary Fund, *International Financial Statistics*, various issues. Comparable data for inflation in Nicaragua is not available.

Note: Country names in italics are those of cases discussed in this volume.

Eastern Europe. The survival of authoritarianism in these regions was attributable in part to the continued backing of external patrons. Regimes in the more advanced Eastern European states collapsed quickly once Soviet support was withdrawn. Authoritarian regimes in poor countries have arguably been kept alive by the unwillingness of external donors to sever the aid tie, usually for strategic as well as humanitarian reasons. One important source of political pressure on the poorer African countries in the early 1990s was the evaporation of a strategic justification for continued support, and a greater willingness to link assistance to political reform.<sup>18</sup>

The failure of democracy to take root in poorer countries, however, also reflects structural conditions that were highlighted by Lipset in his original analysis. In particular, the capacity of rulers in very poor countries to prolong their domination was facilitated by the relative weakness of organized interests. Highly dependent private sectors and geographically dispersed rural cultivators lacked the independence or organization to launch sustained protest against declining economic conditions. In these societies, economic hardship was often associated with social violence, palace coups, and the deterioration of central control over population and territory.<sup>19</sup> But into the early 1990s, predatory personalist rulers were surprisingly adept at resisting reform and clinging to office through continued access to external aid, repression, and careful maintenance of select patronage relations.<sup>20</sup>

A plausible hypothesis that combines economic conditions in both the long and short run is that authoritarian regimes are more vulnerable to economic downturns in middle-income capitalist countries. In such societies, wealth holders are more sharply differentiated from the political elite. Social groups hold substantial and independent organizational and material resources that are crucial to regime stability. The middle and working classes are politically relevant and there are lower barriers to collective action on the part of urbanized low-income groups. Countries fitting this description are also more likely to have prior histories of party politics, labor mobilization, and civic association. In both southern Europe and Latin America, these political traditions provided the basis for political mobilization during periods of crisis.

<sup>18</sup> See Joan M. Nelson with Stephanie Eglington, *Encouraging Democracy: What Role for Conditional Aid?* (Washington D.C.: Overseas Development Council, 1992), pp. 15–18.

<sup>19</sup> See Londregan and Poole, "Poverty, the Coup Trap and the Seizure of Executive Power."

<sup>20</sup> For reviews of the constraints on democratization in Africa, see Robert H. Jackson and Carl G. Rosberg, "Democracy in Tropical Africa: Democracy versus Autocracy in African Politics," *Journal of International Affairs* 38 (1985): 293–305; Larry Diamond, "Introduction: Roots of Failure, Seeds of Hope," in Diamond, Juan Linz, and Seymour Martin Lipset, eds., *Democracy in Developing Countries: Africa* (Boulder, Colo.: Lynne Rienner, 1988), pp. 1–32; Thomas M. Callaghy and John Ravenhill, eds., *Hemmed In: Responses to Africa's Economic Decline* (New York: Columbia University Press, 1993).

### VARIATIONS IN RESPONSES: THE INSTITUTIONAL BASES OF MILITARY RULE

Neither these socioeconomic factors associated with level of development, nor short-term economic conditions, are fully able to explain the pattern of regime change; institutions also mattered (Figure 1.1). First, the distinction between military regimes and dominant-party systems appears to play some role in accounting for variations in the stability of authoritarian rule. One-party states outside of Eastern Europe showed considerable durability and substantial ability to control the pace of political liberalization. In Latin America, the Stroessner regime in Paraguay, based on an alliance between the military and the dominant Colorado party, was not forced from power until 1990. Mexico's ruling party continued to dominate the political landscape even in the face of crisis; we discuss that case in more detail in Chapter 8. One-party systems in Africa began to face more severe challenges in the early 1990s, in part as a result of declining external support. Nonetheless, single-party structures in countries such as Zambia arguably contributed to the surprising longevity of authoritarian rule in the face of secular economic decline and severe external shocks.<sup>21</sup> In Eastern Europe, Communist regimes survived the declining economic performance of the 1980s, and some, including Poland and Romania, weathered acute crises.

Military regimes in middle-income countries generally appeared more vulnerable to economic shocks. These governments faced strong challenges from civil society, yet lacked the mediation of a dominant party. Severe economic difficulties played an important role in virtually all of the Latin American transitions except Chile and were important in the collapse of the Marcos regime in the Philippines. However, some military regimes were able either to avoid crisis or to engage in successful economic adjustments that served to prolong authoritarian rule. Among the cases in this category are four that will be discussed in more detail in subsequent chapters: Korea, Chile, Turkey, and Thailand.

The differences between "successful" and "unsuccessful" regimes was partly fortuitous: some rulers were simply more skilled than others in manipulating the rivalries within the opposition and the ruling coalition itself. The more successful military governments also appeared to share some common institutional features, however, particularly mechanisms that reduced factionalism within the government and increased cohesion. We

<sup>21</sup> For a discussion of this factor in Africa during earlier decades, see Ruth Berins Collier, *Regimes in Tropical Africa: Changing Forms of Supremacy, 1945–1975* (Berkely, Los Angeles, and London: University of California Press, 1982). For an excellent discussion of the current period, see Michael Bratton and Nicolas van de Walle, "Neopatrimonial Regimes and Political Transitions in Africa," *World Politics* 46 (July 1994): 453–89.

**FIGURE 1.1**  
**The Political Economy of Authoritarian Withdrawals**

	<i>Economic Crisis</i>	<i>No Economic Crisis</i>
<b>I. POLITICAL CHALLENGES TO THE REGIME</b>	<p>Political demands overlap with:</p> <ol style="list-style-type: none"> <li>1. Economically motivated mass protest</li> <li>2. Defection of business elites</li> <li>3. Internal division of military-political elites over material benefits</li> </ol>	<p>Primarily political demands for liberalization</p>
<b>II. POLITICAL OUTCOMES</b>	<p>Military-dominant, low cohesion</p> <p>Internal divisions raise cost of coercion; government fails to control either elite defection or mass protest</p> <p>Regime unable to adjust to crisis</p> <p>Regime collapses; outgoing elites unable to influence structure of new regime (Argentina, Bolivia, Brazil, Peru, Uruguay, the Philippines)</p>	<p>Military-business-political coalition remains stable; regime controls terms of the transition (Thailand)</p>
Dominant party	<p>Government adjusts to crisis, reasserts authority internally, represses opposition, regains business loyalty</p> <p>Survives crisis, exerts control over terms of the transition (Chile 1981–82, Korea 1980)</p>	<p>Regime exerts strong control over terms of the transition (Chile 1990, Korea 1987, Turkey 1983)</p>

can see this most clearly by beginning with a discussion of those divided military governments that proved vulnerable to crisis.

### *Vulnerable Regimes*

Military governments that had difficulty adjusting were characterized by uncertain or divided control over the bureaucracy and the main instruments of economic policy, as well as economic teams that were politically weak or internally divided. To a certain extent, these divisions reflected disagreements over the technical diagnosis of daunting economic problems. More typically, they reflected political, economic, and ideological conflicts within the military establishment itself.

One important source of conflict lay in the division of labor between the military officers holding political office and those who remained in charge of military personnel and procurement. The interests of these two groups were especially likely to diverge during periods of economic crisis, when the military as *government* faced unpopular policy choices that had consequences for the armed forces as an *institution*.<sup>22</sup> The most durable arrangement for managing such conflicts was a fusion of military and political authority in the head of state.<sup>23</sup> But this pattern was approximated only in Chile and Korea among the countries considered in this volume; we return to these cases below.

In other cases, the military high command retained independence with regard to appointments and promotion, yet was excluded from day-to-day political decision-making. This arrangement created a potential center for opposition to government authority. In Bolivia, reformist officers complained of "political interference" and corruption, and played a key role in the return to civilian rule. Conflicts between military presidents and the military command also contributed to the overthrow of Velasco in Peru and Viola in Argentina. The Philippines constitutes a somewhat different case, since Marcos did not come from the military. However, the military split over the merits of Marcos's rule, and it was that split which proved fatal for the government.

Collegial participation in political decisions through juntas and ruling councils that represented the different service branches constituted one institutional way of resolving tensions between the military government and the high command. In Brazil and Uruguay, this arrangement contributed to more orderly transfers of political authority and the maintenance

<sup>22</sup> See Alfred Stepan, *The Military in Politics: Changing Patterns in Brazil* (Princeton, N.J.: Princeton University Press, 1971).

<sup>23</sup> Karen L. Remmer, *Military Rule in Latin America* (Boulder, Colo., San Francisco, and Oxford: Westview Press, 1991), pp. 37–41.

of military cohesion. But collegial rule could not fully overcome a variety of other divisions that tended to emerge within military governments over time, divisions that were typically exacerbated by crises.<sup>24</sup>

In general, these conflicts were rooted in the expansion of military roles and diversification into other specialized political, economic, or policy functions. These new roles provided officers opportunities to build independent organizational and political bases and weakened hierarchical lines of authority within the military chain of command. The resulting cleavages took a number of forms. In some cases, the autonomy of local commanders increased as a result of sustained internal war or drug-control operations, as in Bolivia. Elsewhere, the involvement of officers in the management of state enterprises and other governmental agencies also generated the potential for conflict, as well as the organizational base for alliances between officers and civilian groups opposing reform efforts; this pattern was visible in a number of Latin American and African countries.

Programmatic disagreements were most pronounced in the bureaucratic-authoritarian regimes, particularly in Latin America, that had come to office with quite explicit political-economic projects. Military factions opposing such projects typically had their own institutional bases of power in the armed forces or the state sector, and could count on powerful allies in the private sector or civilian political class as well. Within the Brazilian military, this generated fierce factional struggles throughout the 1960s and 1970s over how long to hold power and on what terms, and over competing models of economic development. In Argentina and Uruguay, opponents of the neoliberal policies of the mid-1970s had important bases of support in the planning and intelligence agencies and in the state enterprise sector.<sup>25</sup>

These various divisions within the military elite made it more difficult for governments to provide consistent and coherent backing for the risky policy adjustments required to establish credibility among important eco-

<sup>24</sup> In Argentina, the heads of the three branches of the armed forces were incorporated directly into a junta and a Legislative Advisory Council. But reciprocal veto powers made the government unwieldy and contributed to the fragmentation of the state apparatus. "As the guerilla threat was exterminated, internal splits reemerged over economic policy, political strategy, and the power and autonomy of the repressive apparatus." Maria Susana Ricci and J. Samuel Fitch, "Ending Military Regimes in Argentina: 1966–1973 and 1976–1983," in Louis W. Goodman, Johanna S. R. Mendelson, and Juan Rial, eds., *The Military and Democracy: the Future of Civil-Military Relations in Latin America* (Lexington, Mass.: Lexington Books, D. C. Heath, 1990), p. 59.

<sup>25</sup> Ibid., pp. 55–75. In Uruguay, military officials in control of the Banco de la Republica and ESCMACO provided important sources of support for opposition to technocrats in the Finance Ministry. See Howard Handelman, "Military Authoritarianism and Political Change," in Howard Handelman and Thomas G. Sanders, eds., *Military Government and the Movement toward Democracy in South America* (Bloomington: Indiana University Press, 1981), pp. 215–37.

nomic actors, including foreign creditors. As a result the economic policy-making apparatus either fragmented into warring factions or cycled between teams with contradictory programs. These weaknesses, in turn, contributed to a further decline in the credibility of government programs and a further deepening of the economic crisis.

As in Latin America and the Philippines, extensive factionalism also pervaded the armed forces in Thailand; rapid and relatively successful economic adjustment in that country thus constitutes somewhat of an anomaly in comparison with these other cases. We attribute this exceptionalism to the fact that military factionalism was counterbalanced by other institutional features of the regime, including both a unifying monarchy and a cohesive technocratic elite that enjoyed substantial prestige and independence. The technocrats did not prevent the military from making several important policy mistakes in the late 1970s, but the regime did avoid the severe macroeconomic disequilibria that generated serious political difficulties in the crisis cases. As in the other non-crisis cases discussed below, this in turn permitted military-backed governments to exert considerable control over the pace of political reform. Despite an extensive political liberalization and gradual transition, the military never fully relinquished its role in the polity in the 1980s, and launched another coup against the parliamentary system in 1991.

In all of the other factionalized military regimes, escalating economic crisis made the management of other political pressures more difficult. Some military regimes sought to build support through controlled electoral openings. However, where government parties were weak, even controlled elections posed hazards for authoritarian rulers.<sup>26</sup> In the absence of dominant parties, such rulers were impelled to forge links to notables or politicians with uncertain loyalty in order to orchestrate electoral victories. In situations of economic crisis, as opportunities for patronage declined, such links became more problematic, while the opportunities expanded for anti-regime electoral oppositions to exploit economic grievances for broader political ends. This was particularly apparent in Bolivia, Brazil, and the Philippines, where electoral contests crystallized opposition and served to undermine authoritarian rule.

Divisions within the government also affected the way economic elites weighed the risks of opening the political system to democratic oppositions. Where internal dissent was high, and again particularly where that dissent centered to some extent on the conduct of economic policy, private-sector groups were more likely to lose faith in the capacity of the regime

<sup>26</sup> Perhaps the most consistent voice for this perspective is Bolívar Lamounier. See for example "Authoritarian Brazil Revisited: The Impact of Elections on the *Abertura*," in Alfred Stepan, ed., *Democratizing Brazil: Problems of Transition and Consolidation* (New York: Oxford University Press, 1989), pp. 43–83.

to manage the economic crisis. As a result, they were more inclined to support political reforms aimed at altering the system of representation.

As suggested above, finally, cleavages within the elite also expanded the political space for mass democratic oppositions by lowering the risks of anti-regime protest. If it is known that some forces within the government dissent from the authoritarian status quo, repressive responses become less likely, and a crucial space is opened for oppositions to initiate anti-government protests. Under extreme conditions, repressing opposition initiatives may prove impossible because key portions of the military are unwilling to respond to orders to use force; this was most dramatically the case in the Philippines and East Germany.

### *Cohesive Military Regimes*

Three military regimes present full or partial exceptions to the foregoing pattern of internal division; each was able to exert substantial influence over the timing and terms of the democratic transition. Two of these, Chile and Korea, faced economic and political challenges in the early 1980s, and a third—Turkey—seized power in the midst of a deep economic, political, and social crisis. In all of these cases, governments did not leave power until they had made extensive adjustments in the economy and deep changes in the structure of the political system, in effect *creating* bases of support for the institutional and political changes initiated during the authoritarian period.

The precise reasons for these exceptional patterns hinge on a variety of case-specific factors, but in all three the capacity of the military establishment to contain internal divisions played an important role in the outcome. Three factors worked to mitigate these divisions: the fusion of political and military authority; a greater specialization of military roles; and the length of time in power.

Chile and Korea had by far the most cohesive military establishments of the countries considered here. One characteristic of each case, as already noted, was a fusion of military and political authority in the head of state. This reduced the ambiguity about lines of authority, allowing the top political-military leader not only to control appointments and personnel decisions within the military, but to exercise dual control—through both military and civilian chains of command—over military personnel seconded to the government itself. This factor, as we shall see in more detail in chapter 3, was crucial for the survival of the Pinochet regime in Chile. An equivalent structure existed in Korea, buttressed by executive control over a pervasive intelligence apparatus, even though Park Chung Hee and Chun Doo Hwan ruled nominally as civilians.

A variety of factors also encouraged the insulation of the corporate

hierarchies and the maintenance of loyalty to the central command. In Chile, the governing responsibilities of the Chilean military expanded substantially under Pinochet. But ironically, the socialization of the military to a narrow definition of mission during several decades of democratic government resulted in strong obedience to the chain of command, which in turn facilitated Pinochet's control over the military establishment.

In Korea, the threat from the north provided strong incentives for the maintenance of corporate unity within the armed forces. In the immediate wake of the Park assassination, a portion of the military elite was quickly able to reestablish internal discipline and to reassert its authority over the political system as a whole, surviving the worst economic difficulties the country had faced in twenty years.

In both cases, concentrated executive authority and dependable support from the military establishment allowed the government to provide unambiguous backing to coherent and powerful teams of economic technocrats. In Korea, Chun Doo Hwan gave unwavering support to his reform team. In Chile, Pinochet's support for the "Chicago boys" is well known. Notwithstanding some important reshuffling of the policymakers during the shocks of the early 1980s, the two regimes' support for technocratic elites continued through the end of their rule.

Turkey presents a more ambiguous institutional picture. Unlike either Chile or Korea, the military establishment had been characterized by political factionalism and struggles over patronage; in this respect, it was closer to the typical Latin American military establishments than to Chile or Korea. One implication was that even following the military coup the economic technocrats assembled under Özal had less extensive control over the bureaucracy, important segments of which were opposed to the reform effort; on some issues, the military itself proved recalcitrant.

Unlike other military governments, however, internal division within the Turkish armed forces was held in check by the relatively limited tenure and purpose of the military intervention. During the escalating political crisis of 1979–80, competing factions of "moderates" and "radicals" drew together in the face of paralysis of civilian government and near-civil war conditions; in exchange for the moderates' backing for intervention, radicals agreed to hold to a preannounced timetable for withdrawal. This unity of purpose almost certainly would have eroded had the military remained in power over a long period; this in fact had been the experience in comparable cases of "collegial" military government in Uruguay, Argentina, and Brazil. However, during the short period of military rule that ensued, the incoming government was able to sustain the institutional support necessary to undertake harshly repressive measures against opposition and to back important adjustment measures that had been initiated, but had failed, under the ousted democratic government.

Successful economic management did not ensure the indefinite survival

of these regimes. Even in good times, most rulers were eventually forced to respond in some measure to democratic forces based in the domestic working and middle classes and to foreign pressures, and all had in any case made some commitment to exit politics. However, in each of these regimes, as well as in Thailand, the capacity to engineer economic recoveries or sustain strong economic performance permitted incumbent elites to exert greater control over changes in the political rules of the game and the economic policy choices of successor governments. In short, the different transition paths we have outlined here had important ramifications for the nature of their successor governments.

Political changes occurring under favorable economic conditions differed in at least three important ways from those that occurred during crisis; these differences are addressed in detail in chapter 4. First, transitions in good times were more likely to be characterized by the persistence and/or the reconstruction of cooperative relations between the incoming democratic government and the private sector. In regimes unable to adjust to crisis, the defection of business groups from the ruling coalition left outgoing political and military authorities isolated vis-à-vis broad, but heterogeneous democratic oppositions. New democratic governments faced the difficult—and sometimes impossible—task of reestablishing private-sector confidence. Where economic crisis was avoided or successfully managed, relatively strong center-right blocs continued to play an important role on the political scene, providing support for continuity with some capacity to veto departures from previous economic policies.

Successful adjustment and/or avoidance of crisis also limited the role played by middle-class and professional groups in populist antiauthoritarian coalitions. Where regimes had been unable to adjust, middle-class groups were more likely to join with the popular sector around distributive demands as well as political reform. In the non-crisis cases, middle-class groups sometimes joined mass movements for political democracy, but adopted more conservative positions on economic issues. This reinforced continuity in economic policy and tended to leave groups on the left more isolated.

Finally, even where rightist blocs accepted the necessity of democratization, successful economic performance increased their capacity to influence the rules of political competition, particularly those providing guarantees for the interests of business and military elites and those regulating the entry of mass-based groups into the political process.

PROBLEMS OF  
DEMOCRATIC  
TRANSITION AND  
CONSOLIDATION

*Southern Europe,  
South America, and  
Post-Communist Europe*

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The Johns Hopkins University Press  
Baltimore and London

© 1996 The Johns Hopkins University Press  
All rights reserved. Published 1996  
Printed in the United States of America on acid-free paper  
6 8 9 7 5

The Johns Hopkins University Press  
2715 North Charles Street  
Baltimore, Maryland 21218-4363  
[www.press.jhu.edu](http://www.press.jhu.edu)

Library of Congress Cataloging-in-Publication Data  
will be found at the end of this book.  
A catalog record for this book is available from the British Library.

ISBN 0-8018-5157-2 ISBN 0-8018-5158-0 (pbk.)

## Modern Nondemocratic Regimes

DEMOCRATIC transition and consolidation involve the movement from a nondemocratic to a democratic regime. However, specific polities may vary immensely in the *paths* available for transition and the unfinished *tasks* the new democracy must face before it is consolidated. Our central endeavor in the next two chapters is to show how and why much—though of course not all—of such variation can be explained by prior regime type.

For over a quarter of a century the dominant conceptual framework among analysts interested in classifying the different political systems in the world has been the tripartite distinction between democratic, authoritarian, and totalitarian regimes. New paradigms emerge because they help analysts see commonalities and implications they had previously overlooked. When Juan Linz wrote his 1964 article “An Authoritarian Regime: Spain,” he wanted to call attention to the fact that between what then were seen as the two major stable political poles—the democratic pole and the totalitarian pole—there existed a form of polity that had its own internal logic and was a steady regime type. Though this type was non-democratic, Linz argued that it was fundamentally different from a totalitarian regime on four key dimensions—pluralism, ideology, leadership, and mobilization. This was of course what he termed an *authoritarian regime*. He defined them as: “political systems with limited, not responsible, political pluralism, without elaborate and guiding ideology, but with distinctive mentalities, without extensive nor intensive political mobilization, except at some points in their development, and in which a leader or occasionally a small group exercises power within formally ill-defined limits but actually quite predictable ones.”<sup>1</sup>

In the 1960s, as analysts attempted to construct categories with which to compare and contrast all the systems in the world, the authoritarian category proved useful. As the new paradigm took hold among comparativists, two somewhat surprising conclusions emerged. First, it became increasingly apparent that more regimes were “authoritarian” than were “totalitarian” or “democratic” combined.<sup>2</sup>

1. Juan J. Linz, “An Authoritarian Regime: The Case of Spain,” in Erik Allardt and Yrjö Littunen, eds., *Cleavages, Ideologies and Party Systems* (Helsinki: Transactions of the Westermarck Society, 1964), 291–342. Reprinted in Erik Allardt and Stein Rokkan, eds., *Mass Politics: Studies in Political Sociology* (New York: Free Press, 1970), 251–83, 374–81. Page citations will refer to the 1970 volume. The definition is found on 255.

2. See, for example, the data contained in footnotes 4 and 5 in this chapter.

Authoritarian regimes were thus the modal category of regime type in the modern world. Second, authoritarian regimes were not necessarily in transition to a different type of regime. As Linz's studies of Spain in the 1950s and early 1960s showed, the four distinctive dimensions of an authoritarian regime—limited pluralism, mentality, somewhat constrained leadership, and weak mobilization—could cohere for a long period as a reinforcing and integrated system that was relatively stable.<sup>3</sup>

Typologies rise or fall according to their analytic usefulness to researchers. In our judgment, the existing tripartite regime classification has not only become less useful to democratic theorists and practitioners than it once was, it has also become an obstacle. Part of the case for typology change proceeds from the implications of the empirical universe we need to analyze. Very roughly, if we were looking at the world of the mid-1980s, how many countries could conceivably be called "democracies" of ten years' duration? And how many countries were very close to the totalitarian pole for that entire period? Answers have, of course, an inherently subjective dimension, particularly as regards the evaluation of the evidence used to classify countries along the different criteria used in the typology. Fortunately, however, two independently organized studies attempt to measure most of the countries in the world as to their political rights and civil liberties.<sup>4</sup> The criteria used in the studies are explicit, and there is a very high degree of agreement in the results. If we use these studies and the traditional tripartite regime type distinction, it turns out that more than 90 percent of modern non-democratic regimes would have to share the same typological space—"authoritarian."<sup>5</sup> Obviously, with so many heterogeneous countries sharing the same

3. See Juan J. Linz, "From Falange to Movimiento-Organización: The Spanish Single Party and the Franco Regime, 1936–1968," in Samuel P. Huntington and Clement H. Moore, eds., *Authoritarian Politics in Modern Society: The Dynamics of Established One-Party Systems* (New York: Basic Books, 1970), 128–203. Also see Linz, "Opposition in and under an Authoritarian Regime: The Case of Spain," in Robert A. Dahl, ed., *Regimes and Oppositions* (New Haven: Yale University Press, 1973), 171–259.

4. One effort was by Michael Coppedge and Wolfgang Reinicke, who attempted to operationalize the eight "institutional guarantees" that Robert Dahl argued were required for a polyarchy. They assigned values to 137 countries on a polyarchy scale, based on their assessment of political conditions as of mid-1985. The results are available in "A Measure of Polyarchy," paper prepared for the Conference on Measuring Democracy, Hoover Institution, Stanford University, May 27–28, 1988; and their "A Scale of Polyarchy," in Raymond D. Gastil, ed., *Freedom in the World: Political Rights and Civil Liberties, 1987–1988* (New York: Freedom House, 1990), 101–28. Robert A. Dahl's seminal discussion of the "institutional guarantees" needed for polyarchy is found in Dahl, *Polyarchy: Participation and Opposition* (New Haven: Yale University Press, 1971), 1–16.

The other major effort to operationalize a scale of democracy is the annual Freedom House evaluation of virtually all the countries of the world. The advisory panel has included in recent years such scholars as Seymour Martin Lipset, Giovanni Sartori, and Lucian W. Pye. The value they assigned on their scale for each year from 1978–1987 can be found in Gastil, *Freedom in the World*, 54–65.

5. We arrive at this conclusion in the following fashion. The annual survey coordinated by Raymond D. Gastil employs a 7-point scale of the political rights and civil liberties dimensions of democracy. With the help of a panel of scholars, Gastil, from 1978 to 1987, classified annually 167 countries on this scale. For our purposes if we call the universe of democracies those countries that from 1978 to 1987 never received a score of lower than 2 on the Gastil scale for political rights and 3 for civil liberty, we come up with 42 countries. This is very close to the number of countries that Coppedge and Reinicke classify as "full polyarchies" in their independent study of the year 1985. Since our interest is in how countries become democracies we will

typological "starting place," this typology of regime type cannot tell us much about the extremely significant range of variation in possible transition paths and consolidation tasks that we believe in fact exists. Our purpose in the rest of this chapter is to reformulate the tripartite paradigm of regime type so as to make it more helpful in the analysis of *transition paths* and *consolidation tasks*. We propose therefore a revised typology, consisting of "democratic," "authoritarian," "totalitarian," "post-totalitarian," and "sultanistic" regimes.

### DEMOCRACY

To start with the democratic type of regime, there are of course significant variations within democracy. However, we believe that such important categories as "consociational democracy" and "majoritarian democracy" are subtypes of democracy and not different regime types.<sup>6</sup> Democracy as a regime type seems to us to be of sufficient value to be retained and not to need further elaboration at this point in the book.

### TOTALITARIANISM

We also believe that the concept of a totalitarian regime as an ideal type, with some close historical approximations, has enduring value. If a regime has eliminated almost all pre-existing political, economic, and social pluralism, has a unified, articulated, guiding, utopian ideology, has intensive and extensive mobilization, and has a leadership that rules, often charismatically, with undefined limits and great unpredictability and vulnerability for elites and nonelites alike, then it seems to us that it still makes historical and conceptual sense to call this a regime with strong totalitarian tendencies.

If we accept the continued conceptual utility of the democratic and totalitarian regime types, the area in which further typological revision is needed concerns the regimes that are clearly neither democratic nor totalitarian. By the early

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exclude those 42 countries from our universe of analysis. This would leave us with 125 countries in the universe we want to explore.

If we then decide to call long-standing "totalitarian" regimes those regimes that received the lowest possible score on political rights and civil liberties on the Gastil scale for each year in the 1978–1987 period, we would have a total of nine countries that fall into the totalitarian classification. Thus, if one used the traditional typology, the Gastil scale would imply that 116 of 125 countries, or 92.8 percent of the universe under analysis, would have to be placed in the same typological space. See Gastil, *Freedom in the World*, 54–65.

6. For discussions of variations within democracy, see Arendt Lijphart, *Democracies: Patterns of Majoritarian and Consensus Government in Twenty-one Countries* (New Haven: Yale University Press, 1984), esp. 1–36; Philippe C. Schmitter and Terry Lynn Karl, "What Democracy Is . . . and Is Not," *Journal of Democracy* 2, no. 2 (Summer 1991): 75–88; and Juan J. Linz, "Change and Continuity in the Nature of Contemporary Democracies," in Gary Marks and Larry Diamond, eds., *Reexamining Democracy* (Newbury Park, N.J.: Sage Publications, 1992), 182–207.

1980s, the number of countries that were clearly totalitarian or were attempting to create such regimes had in fact been declining for some time. As many Soviet-type regimes began to change after Stalin's death in 1953, they no longer conformed to the totalitarian model, as research showed. This change created conceptual confusion. Some scholars argued that the totalitarian category itself was wrong. Others wanted to call post-Stalinist regimes authoritarian. Neither of these approaches seems to us fully satisfactory. Empirically, of course, most of the Soviet-type systems in the 1980s were not totalitarian. However, the "Soviet type" regimes, with the exception of Poland (see chap. 12), could not be understood in their distinctiveness by including them in the category of an authoritarian regime.

The literature on Soviet-type regimes correctly drew attention to regime characteristics that were no longer totalitarian and opened up promising new studies of policy-making. One of these perspectives was "institutional pluralism."<sup>7</sup> However, in our judgment, to call these post-Stalinist polities *pluralistic* missed some extremely important features that could hardly be called pluralistic. Pluralist democratic theory, especially the "group theory" variant explored by such writers as Arthur Bentley and David Truman, starts with *individuals in civil society* who enter into numerous freely formed interest groups that are relatively autonomous and often criss-crossing. The many groups in civil society attempt to aggregate their interests and compete against each other in political society to influence state policies. However, the "institutional pluralism" that some writers discerned in the Soviet Union was radically different, in that almost all the pluralistic conflict occurred in *regime-created organizations within the party-state* itself. Conceptually, therefore, this form of competition and conflict is actually closer to what political theorists call *bureaucratic politics* than it is to *pluralistic politics*.<sup>8</sup>

Rather than forcing these Soviet-type regimes into the existing typology of totalitarian, authoritarian, and democratic regimes, we believe we should expand that typology by explicating a distinctive regime type that we will call *post-totalitarian*.<sup>9</sup> Methodologically, we believe this category is justified because on each of the four dimensions of regime type—pluralism, ideology, leadership, and mobi-

7. The strongest advocate of an institutional pluralist perspective for the analysis of Soviet politics was Jerry F. Hough, especially in his *The Soviet Union and Social Science Theory* (Cambridge, Mass.: Harvard University Press, 1977).

8. The pioneering critique of the institutional pluralist approach to Soviet politics is Archie Brown, "Pluralism, Power and the Soviet Political System: A Comparative Perspective," in Susan Gross Solomon, ed., *Pluralism in the Soviet Union* (London: Macmillan, 1983), 61–107. A useful review of the literature, with attention to authors such as Gordon Skilling, Archie Brown, and Jerry Hough, is found in Gabriel Almond (with Laura Roselle), "Model-Fitting in Communism Studies," in his *A Discipline Divided: Schools and Sects in Political Science* (Newbury Park, Calif.: Sage Publications, 1990), 157–72.

9. Juan Linz, in his "Totalitarian and Authoritarian Regimes," in Fred I. Greenstein and Nelson W. Polsby, eds., *Handbook of Political Science* (Reading, Mass.: Addison-Wesley Publishing Co., 1975), 3:175–411, analyzed what he called "post-totalitarian authoritarian regimes," see 336–50. Here, with our focus on the available paths to democratic transition and the tasks of democratic consolidation, it seems to both of us that it is more useful to treat post-totalitarian regimes not as a subtype of authoritarianism, but as an ideal type in its own right.

lization—there can be a post-totalitarian ideal type that is different from a totalitarian, authoritarian, or democratic ideal type. Later in this chapter we will also rearticulate the argument for considering sultanism as a separate ideal-type regime.<sup>10</sup>

To state our argument in bold terms, we first present a schematic presentation of how the five ideal-type regimes we propose—democratic, totalitarian, post-totalitarian, authoritarian, and sultanistic—differ from each other on each one of the four constituent characteristics of regime type (table 3.1). In the following chapter we make explicit what we believe are the implications of each regime type for democratic transition paths and the tasks of democratic consolidation.

### POST-TOTALITARIANISM

Our task here is to explore how, on each of the four dimensions of regime type, post-totalitarianism is different from totalitarianism, as well as different from authoritarianism.<sup>11</sup> Where appropriate we will also call attention to some undertheorized characteristics of both totalitarian and post-totalitarian regimes that produce dynamic pressures for out-of-type change. We do not subscribe to the view that either type is static.

Post-totalitarianism, as table 3.1 implies, can encompass a continuum varying from “early post-totalitarianism,” to “frozen post-totalitarianism,” to “mature post-totalitarianism.” Early post-totalitarianism is very close to the totalitarian ideal type but differs from it on at least one key dimension, normally some constraints on the leader. There can be frozen post-totalitarianism in which, despite the persistent tolerance of some civil society critics of the regime, almost all the other control mechanisms of the party-state stay in place for a long period and do not evolve (e.g., Czechoslovakia, from 1977 to 1989). Or there can be mature post-totalitarianism in which there has been significant change in all the dimensions of the post-totalitarian regime except that politically the leading role of the official party is still sacrosanct (e.g., Hungary from 1982 to 1988, which eventually evolved by late 1988 very close to an out-of-type change).

Concerning *pluralism*, the defining characteristic of totalitarianism is that there is no political, economic, or social pluralism in the polity and that pre-

10. For Juan Linz's first discussion of sultanism, see *ibid.*, 259–63. For a more complete discussion of sultanism, see H. E. Chehabi and Juan J. Linz, “Sultanistic Regimes,” paper prepared for a conference on sultanistic regimes at Harvard University in November 1990. The results of the conference, which included papers on such countries as Iran, the Philippines, the Dominican Republic, and Romania, will be published in a volume edited by H. E. Chehabi and Juan J. Linz.

11. We believe that readers can readily see for themselves how post-totalitarian regimes are not democratic regimes, so we will not discuss this point separately. We want to make clear that for our analytic purposes in this book that the term *post-totalitarian* refers to a type of nondemocratic regime before the transition to democracy. In this chapter our main concern is with ideal types. However, in chapter 15, “Post-Communism's Prehistories,” we provide ample empirical evidence of what a totalitarian or post-totalitarian (in contrast to an authoritarian) legacy means for each of the five arenas necessary for a consolidated democracy that we analyzed in table 1.1 in this book.

existing sources of pluralism have been uprooted or systematically repressed. In an authoritarian regime there is some limited political pluralism and often quite extensive economic and social pluralism. In an authoritarian regime, many of the manifestations of the limited political pluralism and the more extensive social and economic pluralism predate the authoritarian regime. How does pluralism in post-totalitarian regimes contrast with the near absence of pluralism in totalitarian regimes and the limited pluralism of authoritarian regimes?

In mature post-totalitarianism, there is a much more important and complex play of institutional pluralism within the state than in totalitarianism. Also, in contrast to totalitarianism, post-totalitarianism normally has a much more significant degree of social pluralism, and in mature post-totalitarian there is often discussion of a "second culture" or a "parallel culture." Evidence of this is found in such things as a robust underground *samizdat* literature with multi-issue journals of the sort not possible under totalitarianism.<sup>12</sup> This growing pluralism is simultaneously a dynamic source of vulnerability for the post-totalitarian regime and a dynamic source of strength for an emerging democratic opposition. For example, this "second culture" can be sufficiently powerful that, even though leaders of the second culture will frequently be imprisoned, in a mature post-totalitarian regime opposition leaders can generate substantial followings and create enduring oppositional organizations in civil society. At moments of crisis, therefore, a mature post-totalitarian regime can have a cadre of a democratic opposition based in civil society with much greater potential to form a democratic political opposition than would be available in a totalitarian regime. A mature post-totalitarian regime can also feature the coexistence of a state-planned economy with extensive partial market experiments in the state sector that can generate a "red bourgeoisie" of state sector managers and a growing but subordinate private sector, especially in agriculture, commerce and services.

However, in a post-totalitarian regime this social and economic pluralism is different in degree and kind from that found in an authoritarian regime. It is different in degree because there is normally more social and economic pluralism in an authoritarian regime (in particular there is normally a more autonomous private sector, somewhat greater religious freedom, and a greater amount of above-ground cultural production). The difference in kind is typologically even more important. In a post-totalitarian society, the historical reference both for the power holders of the regime and the opposition is the previous totalitarian regime. By definition, the existence of a previous totalitarian regime means that most of the pre-existing sources of responsible and organized pluralism have been eliminated or repressed and a totalitarian order has been established. There is therefore an active effort at "detotalitarianization" on the part of oppositional

12. For example, in mature post-totalitarian Hungary the most influential *samizdat* publication, *Beszélő*, from 1982 to 1989, was issued as a quarterly with publication runs of 20,000. Information supplied to Alfred Stepan by the publisher and editorial board member, Miklós Haraszti, Budapest, August 1994.

**Table 3.1. Major Modern Regime Ideal Types and Their Defining Characteristics**

Characteristic	Democracy	Authoritarianism	Totalitarianism	Post-totalitarianism	Sultanism
Pluralism	Responsible political pluralism reinforced by extensive areas of pluralist autonomy in economy, society, and internal life of organizations. Legally protected pluralism consistent with "societal corporatism" but not "state corporatism."	Political system with limited, not responsible political pluralism. Often quite extensive social and economic pluralism. In authoritarian regimes most of pluralism had roots in society before the establishment of the regime. Often some space for semiopposition.	No significant economic, social, or political pluralism. Official party has <i>de jure</i> and <i>de facto</i> monopoly of power. Party has eliminated almost all pretotalitarian pluralism. No space for second economy or parallel society.	Limited, but not responsible social, economic, and institutional pluralism. Almost no political pluralism because party still formally has monopoly of power. May have "second economy," but state still the overwhelming presence. Most manifestations of pluralism in "flattened polity" grew out of tolerated state structures or dissident groups consciously formed in opposition to totalitarian regime. In mature post-totalitarianism opposition often creates "second culture" or "parallel society."	Economic and social pluralism does not disappear but is subject to unpredictable and despotic intervention. No group or individual in civil society, political society, or the state is free from sultan's exercise of despotic power. No rule of law. Low institutionalization. High fusion of private and public.
Ideology	Extensive intellectual commitment to citizenship and procedural rules of contestation. Not teleological. Respect for rights of minorities, state of law, and value of individualism.	Political system without elaborate and guiding ideology but with distinctive mentalities.	Elaborate and guiding ideology that articulates a reachable utopia. Leaders, individuals, and groups derive most of their sense of mission, legitimization, and often specific policies from their commitment to some holistic conception of humanity and society.	Guiding ideology still officially exists and is part of the social reality. But weakened commitment to or faith in utopia. Shift of emphasis from ideology to programmatic consensus that presumably is based on rational decision-making and limited debate without too much reference to ideology.	Highly arbitrary manipulation of symbols. Extreme glorification of ruler. No elaborate or guiding ideology or even distinctive mentalities outside of despotic personalism. No attempt to justify major initiatives on the basis of ideology. Pseudo-ideology not believed by staff, subjects, or outside world.

*Table 3.1. (Continued)*

Characteristic	Democracy	Authoritarianism	Totalitarianism	Post-totalitarianism	Sultanism
<b>Mobilization</b>	Participation via autonomously generated organization of civil society and competing parties of political society guaranteed by a system of law. Value is on low regime mobilization but high citizen participation. Diffuse effort by regime to induce good citizenship and patriotism. Toleration of peaceful and orderly opposition.	Political system without extensive or intensive political mobilization except at some points in their development.	Extensive mobilization into a vast array of regime-created obligatory organizations. Emphasis on activism of cadres and militants. Effort at mobilization of enthusiasm. Private life is decried.	Progressive loss of interest by leaders and nonleaders involved in organizing mobilization. Routine mobilization of population within state-sponsored organizations to achieve a minimum degree of conformity and compliance. Many "cadres" and "militants" are mere careerists and opportunists. Boredom, withdrawal, and ultimately privatization of population's values become an accepted fact.	Low but occasional manipulative mobilization of a ceremonial type by coercive or clientelistic methods without permanent organization. Periodic mobilization of parastate groups who use violence against groups targeted by sultan.
<b>Leadership</b>	Top leadership produced by free elections and must be exercised within constitutional limits and state of law. Leadership must be periodically subjected to and produced by free elections.	Political system in which a leader or occasionally a small group exercises power within formally ill-defined but actually quite predictable norms. Effort at cooptation of old elite groups. Some autonomy in state careers and in military.	Totalitarian leadership rules with undefined limits and great unpredictability for members and nonmembers. Often charismatic. Recruitment to top leadership highly dependent on success and commitment in party organization.	Growing emphasis by post-totalitarian political elite on personal security. Checks on top leadership via party structures, procedures, and "internal democracy." Top leaders are seldom charismatic. Recruitment to top leadership restricted to official party but less dependent upon building a career within party's organization. Top leaders can come from party technocrats in state apparatus.	Highly personalistic and arbitrary. No rational-legal constraints. Strong dynastic tendency. No autonomy in state careers. Leader unencumbered by ideology. Compliance to leaders based on intense fear and personal rewards. Staff of leader drawn from members of his family, friends, business associates, or men directly involved in use of violence to sustain the regime. Staff's position derives from their purely personal submission to the ruler.

currents in civil society. Much of the emotional and organizational drive of the opposition in civil society is thus consciously crafted to forge alternatives to the political, economic, and social structures created by the totalitarian regime, structures that still play a major role in the post-totalitarian society. Much of the second culture therefore is not traditional in form but is found in new movements that arise out of the totalitarian experience. There can also be a state-led detotalitarianization in which the regime itself begins to eliminate some of the most extreme features of the monist experience. Thus, if there is growing “institutional pluralism,” or a growing respect for procedure and law, or a newly tolerated private sector, it should be understood as a kind of pluralism that emerges *out of* the previous totalitarian regime.

However, it is typologically and politically important to stress that there are significant limits to pluralism in post-totalitarian societies. In contrast to an authoritarian regime, there is *no* limited and relatively autonomous pluralism in the explicitly political realm. The official party in all post-totalitarian regimes is still legally accorded the leading role in the polity. The institutional pluralism of a post-totalitarian regime should not be confused with political pluralism; rather, institutional pluralism is exercised within the party-state or within the newly tolerated second economy or parallel culture. The pluralism of the parallel culture or the second culture should be seen as a *social* pluralism that may have political implications. But we must insist that the party and the regime leaders in post-totalitarian regimes, unless they experience out-of-type change, accord *no* legitimacy or responsibility to nonofficial political pluralism.<sup>13</sup> Even the formal pluralism of satellite parties becomes politically relevant only in the final stages of the regime after the transition is in progress.

When we turn to the dimension of *leadership*, we also see central tendencies that distinguish totalitarian from authoritarian leadership. Totalitarian leadership is unconstrained by laws and procedures and is often charismatic. The leadership can come from the revolutionary party or movement, but members of this core are as vulnerable to the sharp policy and ideological changes enunciated by the leader (even more so in terms of the possibility of losing their lives) as the rest of the population.<sup>14</sup> By contrast, in the Linzian scheme, authoritarian leadership is characterized by a political system in which a leader or occasionally a small group exercises power within formally ill-defined but actually quite predictable norms. There are often extensive efforts to co-opt old elite groups into leadership roles, and there is some autonomy in state careers and in the military.

13. Hungary in 1988–89 represents a mature post-totalitarian regime which, by engaging in extensive detotalitarianization and by increasingly recognizing the legitimacy of other parties, had experienced significant out-of-type changes even before the Communist Party lost power. See chapter 17.

14. For example, under Stalin, of the nine members of the Politburo in 1930, five had disappeared or been shot by 1937. See George K. Schueller, *The Politburo* (Stanford: Stanford University Press, 1951), 5–6.

As in a totalitarian regime, post-totalitarian leadership is still exclusively restricted to the revolutionary party or movement. However, in contrast to a totalitarian regime, post-totalitarian leaders tend to be more bureaucratic and state technocratic than charismatic. The central core of a post-totalitarian regime normally strives successfully to enhance its security and lessen its fear by reducing the range of arbitrary discretion allowed to the top leadership.

In contrast to those who say that the totalitarian regime concept is static, we believe that, when an opportunity presents itself (such as the death of the maximum leader), the top elite's desire to reduce the future leader's absolute discretion is predictably a dynamic source of pressure for out-of-type regime change from totalitarianism to post-totalitarianism. The post-totalitarian leadership is thus typologically closer in this respect to authoritarian leadership, in that the leader rules within unspecified but in reality reasonably predictable limits. However, the leadership in these two regime types still differs fundamentally. Post-totalitarian leadership is exclusively recruited from party members who develop their careers in the party organization itself, the bureaucracy, or the technocratic apparatus of the state. They all are thus recruited from the structures created by the regime. In sharp contrast, in most authoritarian regimes, the norm is for the regime to co-opt much of the leadership from groups that have some power, presence, and legitimacy that does not derive directly from the regime itself. Indeed, the authoritarian regime has often been captured by powerful fragments of the pre-existing society. In some authoritarian regimes, even access to top positions can be established not by political loyalties as much as by some degree of professional and technical expertise and some degree of competition through examinations that are open to the society as a whole. In mature post-totalitarian regimes, technical competence becomes increasingly important, but we should remember that the original access to professional training was controlled by political criteria. Also, the competences that are accepted or recognized in post-totalitarian systems are technical or managerial but do not include skills developed in a broader range of fields such as the law, religious organizations, or independent business or labor.

The limited party-bureaucratic-technocratic pluralism under post-totalitarianism does not give the regime the flexibility for change within the regime that co-optation of nonregime elites can give to many authoritarian regimes. The desire to resist the personalized leadership of the First Secretary-ideologue can be a source of change from totalitarian to post-totalitarian, but it can also lead eventually to the oligarchic leadership of aging men supported by the nomenklatura. Attempts at rejuvenation at the top by including or co-opting new men and women from the outside are normally very limited. In extreme cases (i.e., the GDR and post-1968 Czechoslovakia), frozen post-totalitarianism shows geriatric tendencies. Under crisis circumstances, the inability to renovate leadership, not so paradoxically, is a potential source of dynamic change in that a frozen post-totalitarian regime, with its old and narrow leadership base, has a very limited capac-

ity to negotiate. Such a leadership structure, if it is not able to repress opponents in a crisis, is particularly vulnerable to *collapse*. One of the reasons why midlevel cadres in the once all-powerful coercive apparatus might, in time of crisis, let the regime collapse rather than fire upon the democratic opposition has to do with the role of ideology in post-totalitarianism.

The contrast between the role of *ideology* in a totalitarian system and in a post-totalitarian system is sharp, but it is more one of behavior and belief than one of official canon. In the area of ideology, the dynamic potential for change from a totalitarian to a post-totalitarian regime, both on the part of the cadres and on the part of the society, is the growing empirical disjunction between official ideological claims and reality. This disjunction produces lessened ideological commitment on the part of the cadres and growing criticism of the regime by groups in civil society. In fact, many of the new critics in civil society emerge out of the ranks of former true believers, who argue that the regime does not—or, worse, cannot—advance its own goals. The pressures created by this tension between doctrine and reality often contributes to an out-of-type shift from a totalitarian regime effort to mobilize enthusiasm to a post-totalitarian effort to maintain acquiescence. In the post-totalitarian phase, the elaborate and guiding ideology created under the totalitarian regime still exists as the official state canon, but among many leaders there is a weakened commitment to and faith in utopia. Among much of the population, the official canon is seen as an obligatory ritual, and among groups in the “parallel society” or “second culture,” there is constant reference to the first culture as a “living lie.”<sup>15</sup> This is another source of weakness, of the “hollowing out” of the post-totalitarian regime’s apparent strength.

The role of ideology in a post-totalitarian regime is thus diminished from its role under totalitarianism, but it is still quite different from the role of ideology in an authoritarian regime. Most authoritarian regimes have diffuse nondemocratic mentalities, but they do not have highly articulated ideologies concerning the leading role of the party, interest groups, religion, and many other aspects of civil society, political society, the economy, and the state that still exist in a regime we would call post-totalitarian. Therefore, a fundamental contrast between a post-totalitarian and authoritarian regime is that in a post-totalitarian regime there is an important ideological legacy that cannot be ignored and that cannot be questioned officially. The state-sanctioned ideology has a *social presence* in the organizational life of the post-totalitarian polity. Whether it expresses itself in the extensive array of state-sponsored organizations or in the domain of incipient but still officially controlled organizations, ideology is part of the social reality of a post-totalitarian regime to a greater degree than in most authoritarian regimes.

15. Extensive discussions and references about “parallel society,” “second culture,” and the “living lie” are found in our chapter on post-totalitarianism in Hungary and Czechoslovakia (chap. 17).

The relative de-ideologization of post-totalitarian regimes and the weakening of the belief in utopia as a foundation of legitimacy mean that, as in many authoritarian regimes, there is a growing effort in a post-totalitarian polity to legitimate the regime on the basis of performance criteria. The gap between the original utopian elements of the ideology and the increasing legitimization efforts on the basis of efficacy, particularly when the latter fails, is one of the sources of weakness in post-totalitarian regimes. Since democracies base their claim to obedience on the procedural foundations of democratic citizenship, as well as performance, they have a layer of insulation against weak performance not available to most post-totalitarian or authoritarian regimes. The weakening of utopian ideology that is a characteristic of post-totalitarianism thus opens up a new dynamic of regime vulnerabilities—or, from the perspective of democratic transition, new opportunities—that can be exploited by the democratic opposition. For example, the discrepancy between the constant reiteration of the importance of ideology and the ideology's growing irrelevance to policymaking or, worse, its transparent contradiction with social reality contribute to undermining the commitment and faith of the middle and lower cadres in the regime. Such a situation can help contribute to the rapid collapse of the regime if midlevel functionaries of the coercive apparatus have grave doubts about their right to shoot citizens who are protesting against the regime and its ideology, as we shall see when we discuss events in 1989 in East Germany and Czechoslovakia.<sup>16</sup>

The final typological difference we need to explore concerns *mobilization*. Most authoritarian regimes never develop complex, all-inclusive networks of association whose purpose is the mobilization of the population. They may have brief periods of intensive mobilization, but these are normally less intensive than in a totalitarian regime and less extensive than in a post-totalitarian regime. In totalitarian regimes, however, there is extensive and intensive mobilization of society into a vast array of regime-created organizations and activities. Because utopian goals are intrinsic to the regime, there is a great effort to mobilize enthusiasm to activate cadres, and most leaders emerge out of these cadres. In the totalitarian system, "privatized" bourgeois individuals at home with their family and friends and enjoying life in the small circle of their own choosing are decried.

In post-totalitarian regimes, the extensive array of institutions of regime-created mobilization vehicles still dominate associational life. However, they have lost their intensity. Membership is still generalized and obligatory but tends to generate more boredom than enthusiasm. State-technocratic employment is an alternative to cadre activism as a successful career path, as long as there is "correct" participation in official organizations. Instead of the mobilization of enthu-

16. Daniel V. Friedheim is conducting major research on the question of collapse in such frozen post-totalitarian regimes. See Friedheim, "Regime Collapse in the Peaceful East German Revolution: The Role of Middle-Level Officials," *German Politics* (April 1993): 97–112, and his forthcoming Yale University doctoral dissertation in which he discusses East Germany.

siasm that can be so functional in a totalitarian regime, the networks of ritualized mobilization in a post-totalitarian regime can produce a "cost" of time away from technocratic tasks for professionals and a cost of boredom and flight into private life by many other people. When there is no structural crisis and especially when there is no perception of an available alternative, such privatization is not necessarily a problem for a post-totalitarian regime. Thus, Kadar's famous saying, "Those who are not against us are for us," is a saying that is conceivable only in a post-totalitarian regime, not in a totalitarian one. However, if the performance of a post-totalitarian as opposed to a totalitarian regime is so poor that the personal rewards of private life are eroded, then privatization and apathy may contribute to a new dynamic—especially if alternatives are seen as possible—of crises of "exit," "voice," and "loyalty."<sup>17</sup>

Let us conclude our discussion of post-totalitarianism with a summary of its political and ideological weaknesses. We do this to help enrich the discussion of why these regimes collapsed so rapidly once they entered into prolonged stagnation and the USSR withdrew its extensive coercive support. Indeed in chapter 17, "Varieties of Post-totalitarian Regimes," we develop a theoretical and empirical argument about why frozen post-totalitarian regimes are more vulnerable to collapse than are authoritarian or totalitarian regimes.

Totalitarianism, democracy, and even many authoritarian regimes begin with "genetic" legitimacy among their core supporters, given the historical circumstances that led to the establishment of these regimes. By contrast, post-totalitarianism regimes do not have such a founding genetic legitimacy because they emerge out of the routinization, decay, or elite fears of the totalitarian regime. Post-totalitarian regimes, because of coercive resources they inherit and the related weaknesses of organized opposition, can give the appearance of as much or more stability than authoritarian regimes; if external support is withdrawn, however, their inner loss of purpose and commitment make them vulnerable to collapse.

Post-totalitarian politics was a result in part of the moving away from Stalinism, but also of social changes in Communist societies. Post-totalitarian regimes did away with the worst aspects of repression but at the same time maintained most mechanisms of control. Although less bloody than under Stalinism, the presence of security services—like the Stasi in the GDR—sometimes became more pervasive. Post-totalitarianism could have led to moderate reforms in the economy, like those discussed at the time of the Prague Spring, but the Brezhnev restoration stopped dynamic adaptation in the USSR and in most other Soviet-type systems, except for Hungary and Poland.

17. The reference, of course, is to Albert Hirschman, *Exit, Voice and Loyalty* (Cambridge: Harvard University Press, 1970), 59. For a fascinating discussion of this dynamic in relation to the collapse of the GDR, see Hirschman, "Exit, Voice and the Fate of the German Democratic Republic: An Essay on Conceptual History," *World Politics* 41 (January 1993): 173–202. We discuss the Kadar quote in greater detail in the chapter on varieties of post-totalitarianism (chap. 17).

Post-totalitarianism had probably less legitimacy for the ruling elites and above all the middle-level cadres than had a more totalitarian system. The loss of the utopian component of the ideology and the greater reliance on performance (which after some initial success did not continue) left the regimes vulnerable and ultimately made the use of massive repression less justifiable. Passive compliance and careerism opened the door to withdrawal into private life, weakening the regime so that the opposition could ultimately force it to negotiate or to collapse when it could not rely on coercion.

The weakness of post-totalitarian regimes has not yet been fully analyzed and explained but probably can be understood only by keeping in mind the enormous hopes and energies initially associated with Marxism-Leninism that in the past explained the emergence of totalitarianism and its appeal.<sup>18</sup> Many distinguished and influential Western intellectuals admired or excused Leninism and in the 1930s even Stalinism, but few Western intellectuals on the left could muster enthusiasm for post-totalitarianism in the USSR or even for perestroika and glasnost.

As we shall see in part 4, the emergence and evolution of post-totalitarianism can be the result of three distinct but often interconnected processes: (1) deliberate policies of the rulers to soften or reform the totalitarian system (detotalitarianism by choice), (2) the internal "hollowing out" of the totalitarian regimes' structures and an internal erosion of the cadres' ideological belief in the system (detotalitarianism by decay), and (3) the creation of social, cultural, and even economic spaces that resist or escape totalitarian control (detotalitarianism by societal conquest).

### "SULTANISM"

A large group of polities, such as Haiti under the Duvaliers, the Dominican Republic under Trujillo, the Central African Republic under Bokassa, the Philippines under Marcos, Iran under the Shah, Romania under Ceaușescu, and North Korea under Kim Il Sung, have had strong tendencies toward an extreme form of patrimonialism that Weber called *sultanism*. For Weber,

*patrimonialism* and, in the extreme case, *sultanism* tend to arise whenever traditional domination develops an administration and a military force which are purely personal instruments of the master. . . . Where domination . . . operates primarily on the basis of discretion, it will be called *sultanism* . . . The non-traditional element is not, however, rationalized in impersonal terms, but consists only in the extreme development of the ruler's discretion. It is this which distinguishes it from every form of rational authority.<sup>19</sup>

18. On the ideological and moral attractiveness of revolutionary Marxist-Leninism as a total system and the "vacuum" left in the wake of its collapse, see Ernest Gellner, "Homeland of the Unrevolution," *Daedalus* (Summer 1993): 141–54.

19. Max Weber, *Economy and Society: An Outline of Interpretive Sociology*, ed. Guenther Roth and Claus Wittich (Berkeley: University of California Press, 1978), 1:231, 232. Italics in the original.

Weber did not intend the word *sultanism* to imply religious claims to obedience. In fact, under Ottoman rule, the ruler held two distinct offices and titles, that of sultan and that of caliph. Initially, the Ottoman ruler was a sultan, and only after the conquest of Damascus did he assume the title of caliph, which entailed religious authority. After the defeat of Turkey in World War I and the proclamation of the republic, the former ruler lost his title of sultan but retained his religious title of caliph until Atatürk eventually forced him to relinquish even that title. Our point is that the secular and religious dimensions of his authority were conceptually and historically distinguished. Furthermore, the term *sultan* should not be analytically bound to the Middle East. Just as there are mandarins in New Delhi and Paris as well as in Peking and there is a macho style of politics in the Pentagon as well as in Buenos Aires, there are sultanistic rulers in Africa and the Caribbean as well as in the Middle East. What we do want the term *sultanism* to connote is a generic style of domination and regime rulership that is, as Weber says, an extreme form of patrimonialism. In sultanism, the private and the public are fused, there is a strong tendency toward familial power and dynastic succession, there is no distinction between a state career and personal service to the ruler, there is a lack of rationalized impersonal ideology, economic success depends on a personal relationship to the ruler, and, most of all, the ruler acts only according to his own unchecked discretion, with no larger, impersonal goals.

Table 3.1 gives substantial details on what a sultanistic type is in relation to pluralism, ideology, mobilization, and leadership. In this section we attempt to highlight differences between sultanism, totalitarianism, and authoritarianism because, while we believe they are distinct ideal types, in any concrete case a specific polity could have a mix of some sultanistic and some authoritarian tendencies (a combination that might open up a variety of transition options) or a mix of sultanistic and totalitarian tendencies (a combination that would tend to eliminate numerous transition options).

In his long essay, "Totalitarian and Authoritarian Regimes," Juan Linz discussed the special features that make sultanism a distinctive type of nondemocratic regime.<sup>20</sup> Since the sultanistic regime type has not been widely accepted in the literature, we believe it will be useful for us to highlight systematically its distinctive qualities so as to make more clear the implications of this type of regime for the patterns of democratic resistance and the problems of democratic consolidation.

In sultanism, there is a high fusion by the ruler of the private and the public. The sultanistic polity becomes the personal domain of the sultan. In this domain there is no rule of law and there is low institutionalization. In sultanism there may be extensive social and economic pluralism, but almost never political pluralism, because political power is so directly related to the ruler's person. However, the essential reality in a sultanistic regime is that all individuals, groups, and institu-

20. Linz, "Totalitarian and Authoritarian Regimes," 259–63.

tions are permanently subject to the unpredictable and despotic intervention of the sultan, and thus all pluralism is precarious.

In authoritarianism there may or may not be a rule of law, space for a semi-opposition, or space for regime moderates who might establish links with opposition moderates, and there are normally extensive social and economic activities that function within a secure framework of relative autonomy. Under sultanism, however, there is no rule of law, no space for a semiopposition, no space for regime moderates who might negotiate with democratic moderates, and no sphere of the economy or civil society that is not subject to the despotic exercise of the sultan's will. As we demonstrate in the next chapter, this critical difference between pluralism in authoritarian and sultanistic regimes has immense implications for the types of transition that are *available* in an authoritarian regime but *unavailable* in a sultanistic regime.

There is also a sharp contrast in the function and consequences of ideology between totalitarian and sultanistic regimes. In a totalitarian regime not only is there an elaborate and guiding ideology, but ideology has the function of legitimating the regime, and rulers are often somewhat constrained by their own value system and ideology. They or their followers, or both, believe in that ideology as a point of reference and justification for their actions. In contrast, a sultanistic ruler characteristically has no elaborate and guiding ideology. There may be highly personalistic statements with pretensions of being an ideology, often named after the sultan, but this ideology is elaborated after the ruler has assumed power, is subject to extreme manipulation, and, most importantly, is not believed to be constraining on the ruler and is relevant only as long as he practices it. Thus, there could be questions raised as to whether Stalin's practices and statements were consistent with Marxism-Leninism, but there would be no reason for anyone to debate whether Trujillo's statements were consistent with Trujilloism. The contrast between authoritarian and sultanistic regimes is less stark over ideology; however, the distinctive mentalities that are a part of most authoritarian alliances are normally more constraining on rulers than is the sultan's idiosyncratic and personal ideology.

The extensive and intensive mobilization that is a feature of totalitarianism is seldom found in a sultanistic regime because of its low degree of institutionalization and its low commitment to an overarching ideology. The low degree of organization means that any mobilization that does occur is uneven and sporadic. Probably the biggest difference between sultanistic mobilization and authoritarian mobilization is the tendency within sultanism (most dramatic in the case of the Duvalier's Tonton Macoutes in Haiti) to use para-state groups linked to the sultan to wield violence and terror against anyone who opposes the ruler's will. These para-state groups are not modern bureaucracies with generalized norms and procedures; rather, they are direct extensions of the sultan's will. They have no significant institutional autonomy. As Weber stressed, they are purely "personal instruments of the master."

Finally, how does leadership differ in sultanism, totalitarianism, and authoritarianism? The essence of sultanism is *unrestrained personal rulership*. This personal rulership is, as we have seen, unconstrained by ideology, rational-legal norms, or any balance of power. "Support is based not on a coincidence of interest between preexisting privileged social groups and the ruler but on interests created by his rule, rewards he offers for loyalty, and the fear of his vengeance."<sup>21</sup>

In one key respect leadership under sultanism and totalitarianism is similar. In both regimes the leader rules with undefined limits on his power and there is great unpredictability for elites and nonelites alike. In this respect, a Stalin and a Somoza are alike. However, there are important differences. The elaborate ideology, with its sense of nonpersonal and public mission, is meant to play an important legitimating function in totalitarian regimes. The ideological pronouncements of a totalitarian leader are taken seriously not only by his followers and cadres, but also by the society and intellectuals, including—in the cases of Leninism, Stalinism, and Marxism (and even fascism)—by intellectuals outside the state in which the leader exercises control. This places a degree of organizational, social, and ideological constraint on totalitarian leadership that is not present in sultanistic leadership. Most importantly, the intense degree to which rulership is personal in sultanism makes the *dynastic dimension of rulership* normatively acceptable and empirically common, whereas the public claims of totalitarianism make dynastic ambition, if not unprecedented, at least aberrant.

The leadership dimension shows an even stronger contrast between authoritarianism and sultanism. As Linz stated in his discussion of authoritarianism, leadership is exercised in an authoritarian regime "with formally ill-defined but actually quite predictable" norms.<sup>22</sup> In most authoritarian regimes some bureaucratic entities play an important part. These bureaucratic entities often retain or generate their own norms, which imply that there are procedural and normative limits on what leaders can ask them to do in their capacity as, for example, military officers, judges, tax officials, or police officers. However, a sultanistic leader simply "demands unconditional administrative compliance, for the official's loyalty to his office is not an impersonal commitment to impersonal tasks that define the extent and content of his office, but rather a servant's loyalty based on a strictly personal relationship to the ruler and an obligation that in principle permits no limitation."<sup>23</sup>

We have now spelled out the central tendencies of five ideal-type regimes in the modern world, four of which are nondemocratic. We are ready for the next step, which is to explore why and how the *type* of prior nondemocratic regime has an important effect on the democratic transition paths available and the tasks to be addressed before democracy can be consolidated.

21. Ibid., 260.

22. Ibid., 255.

23. Ibid., 260.

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# CHINA'S DEMOCRATIC FUTURE

*How It Will Happen and Where It Will Lead*

BRUCE GILLEY

*Columbia University Press New York*



Columbia University Press  
*Publishers Since 1893*  
New York, Chichester, West Sussex  
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Library of Congress Cataloging-in-Publication Data

Gilley, Bruce, 1966–  
China's democratic future : how it will happen and  
where it will lead / Bruce Gilley.  
p. cm.  
Includes bibliographical references and index.  
ISBN 0-231-13084-8 (cloth. : alk. paper)  
1. Democracy—China. 2. China—Politics and  
government—1976— I. Title.  
JQ1516.G55 2004  
320.951—dc22 2003061124

Columbia University Press books are printed on permanent  
and durable acid-free paper  
Printed in the United States of America

c 10 9 8 7 6 5 4 3 2 1

References to Internet Web Sites (URLs) were accurate at  
the time of writing. Neither the author nor Columbia Uni-  
versity Press is responsible for Web sites that may have ex-  
pired or changed since the articles were prepared

## Resources for Change

### *Tocqueville's Paradox*

I hope to balance the gloom of the previous chapter with a great deal of optimism in this one. For just as the depredations of the Maoist era provided fertile soil for the birth of modern-day liberalism in China, so too the flawed nature of reform has fostered the development of forces that will bring democracy to life.

Most regimes will choose to empower society in order to avoid immediate overthrow, as the CCP did in 1978 and reiterated after its near-death experience in 1989. It is, however, the essential paradox of all reforming authoritarian states that the very changes the regime undertakes to stave off its immediate overthrow ensure its eventual demise, as Tocqueville noted with respect to Louis XVI's belated attempts to create representative institutions in the year before the French Revolution.

The liberalization of society in China's reform era has given actors at every level the means to begin shaping the state. Private businessmen demand open and fair policymaking. Market-driven media introduce new ideas and uncovers political malfeasance. Global democratization brings unprecedented "border effects" crashing into the country. Inside the Party, an emphasis on the rule of law gives proto-democratic groups new life in backing drives for constitutionalism.

At the same time, the state has been forced to transform and weaken its totalitarian powers in order to foster reforms. Government ministries handling health, education, the economy, defense, and civic society are driven more and more by professional demands, less and less by the ideological demands of the Party. Doctors seek to cure patients rather than prove the superiority of socialism. Younger diplomats try to manage global issues rather than export revolution.

The relinquishing of authority has a snowball effect as society reshapes its newfound privileges in its own interests. Ideas and organizational resources

in the economic, social, political and international realms are mixed together for achieving society's goals. The imperatives of competition emerging from the market economy, for example, have spilled into newspaper rivalries for readers. This in turn has provided a platform for political reformers to publish their articles in hot-selling publications like *Southern Weekend* newspaper or *Caijing* magazine.

Beijing's remit over society is thus already "inhibited" by society. Attempts to retake that control come at huge cost, as shown by the attempted extermination of the Falun Gong religious sect from 1999. Some regional governments have embraced this newfound weakness as a relief from the travails of governance: "small government, big society" was the strategy pursued in southern Hainan province in the 1990s and later taken up in varying degrees elsewhere. But that relief will be shortlived. For society will soon demand to be the master of the state, not merely its equal.

To take one well-known example, Poland was one of the economically fastest growing and socially freest countries in Eastern Europe in the 1970s. Yet it was also the first to experience major unrest and then democratic transition in the 1980s. Popular resources and expectations eventually outran the absolute gains provided by reforms. In China, as in Poland, absolute gains may simply empower society without reducing demands for democracy.

In some countries, like Taiwan, South Korea, Greece, and Spain, society was empowered as part of an explicit program of democratic change. Not so in China, where it has happened as part of a strategy to prevent such change. But the results will be the same. Notes one Chinese scholar: "Further economic progress will necessarily deepen changes in state-society relations, which will push China toward democracy."<sup>1</sup>

Of course, the CCP retains formidable resources. Its six million men in military and police uniforms can be deployed with brutal efficiency when needed. Its significant control of information allows it to set the tone of debate and attack alternative views. The pervasive role of the state in economic and social life has stunted the growth of civil society. Any linking up of social actors to demand democracy is resolutely repressed by the CCP. Evidence from around the world reminds us that delegitimated authoritarian regimes can survive simply by mustering more threats than can a demobilized and scattered society.

Yet the paucity of "diverse alliances," in present-day China need not lead us to conclude, as two leading Western scholars did, that it "bespeaks a fundamental weakness in their capacity to challenge state power beyond the realm of the single issues and local grievances."<sup>2</sup> Such alliances need not be formed prior to the critical moment of democratic transition—the subject of

Part 2. Bulgaria, Cambodia and Romania, to take a few examples, had similarly fragmented societies but experienced a burst of organization at the critical moment. We need not be able to identify a “government in waiting” to know that actors and networks are everywhere that could rise to the occasion—as they did in the early Republican era and again in 1989.

What may be more important is the development of multiple, often contending social forces all with an equal claim to fairness and attention and roughly equal resources to pursue it. For it is the “prolonged and inconclusive political struggle” among increasingly powerful social forces that can give birth to democracy.<sup>3</sup> Not only the struggle between society and state, but also the struggle *within* society provides the critical foundations for democratic breakthrough. To return to our metaphor of the intersection, it is the quest for fairness not only from the traffic policeman but also from fellow drivers that fuels the transition.

The resources for democratic transition described in this chapter are also critical resources for building and consolidating democracy later on. The creation of a market economy, a society with wide social freedoms, a political system using the rhetoric of legality, procedure, voting, and even democracy, and extensive interactions with the world—all these provide a solid foundation for China’s future democracy. In stark contrast to Russia, where democratization occurred with an unreformed state economy, a near totalistic control of society, international isolation, and political ossification, China will have begun transitions in these areas already. That alone may not outweigh the downside of China’s reform sequence—liberalization before participation. But it certainly provides a measure of consolation, as well as hope for the future.

#### *The Privatization of Economic Life*

Lu Guanqiu is a former rural cadre from Mao’s days who took over his village’s machinery company and turned it into one of the country’s biggest auto parts makers, the Wanxiang Group. At the annual meeting of the National People’s Congress in 2001, Lu submitted a motion demanding that the central government take new measures to enhance law enforcement and market regulation. Rule-breaking was so widespread in the economy, he charged, that it was threatening his company’s future. There needed to be courts and government inspectors with the independence to crack down on malfeasance, no matter who was behind it, his motion said. Asked later about the motion, Lu said it required one thing above all: political reform.<sup>4</sup>

The example of Lu and thousands of other restless made-goods of the post

Mao business boom are a reminder that economic change is the bedrock of the supply-side revolution in China. The resources created by economic reform have empowered society, creating powerful agitators for change. The impact is slowly making its presence felt in the political realm.

Even if China's economy had not grown one bit in the reform era, the reintroduction of markets would have had a profound effect on politics. Properly working markets share many of the underlying principles of democracy—the equality of actors, fair and open competition, law-abidance, and freedom of choice. By fostering autonomous interactions among individuals, markets also stimulate social mixing and build up norms of compromise and tolerance. Everyone's interests, not just the majority and certainly not just the minority, are taken into account by markets. They are a powerful bulwark of freedom.

China's move to markets was largely completed by the turn of the century. More than 90 percent of commodities, virtually all labor, and probably two-thirds of the capital stock were bought and sold in free markets. The state no longer told people where to work, what to buy, or who to deal with. Shanghai's elites came into close contact with Anhui peasants whom they hired as maids. Shenzhen became one of the first truly national cities as workers flocked to factories there from every province. In the cities, markets became a stage of "transgressive" activities against authoritarianism as consumers and marketers did their own thing.<sup>5</sup>

Whatever the flaws of the markets—and they are many—the impact on society was great. Researchers in China now talk openly about how the market economy "opens the door to political reform" and is "a training ground for democracy."<sup>6</sup> Under a communist regime reluctant to compromise its writ over society, writes one scholar, "a flourishing market economy is the most effective way to limit government power."<sup>7</sup> Or as another professor at the government's top training school wrote:<sup>8</sup>

Through the experience of markets, there is a basis for civic consciousness and political participation. The power for democratization grows. People begin to think of paying their votes in return for the services of politicians, who are expected to engage in open competition among rivals to prove their worth and win office. In the end, people demand to be full citizens, not subjects, in politics just as they are in the economy. . . . In China, the principle of competition is leaking into the political system.

The creation of new wealth is another way that economic reforms have had a positive impact on democratic prospects. Economic development has long been considered the single most important factor in political liberaliza-

tion worldwide. With it comes a middle class seeking protection for its assets and a voice for its interests. Wealth can also act as a sort of universal solvent in the political arena: as people use their wealth to gain education, they become more aware and tolerant of competing claims of their diverse society. In addition, greater absolute wealth reduces not only the relative costs of compromise (even if the absolute amounts at stake rise) but also fears of losing out from democracy.

Authoritarian governments can also gain legitimacy and power from economic growth, of course. But as the strong global correlation between wealth and democracy reminds us, the exceptions only prove the rule. The much-maligned modernization paradigm—where development leads to democracy—remains empirically if not necessarily true.<sup>9</sup> In Asia as well as in Latin America and Europe, democracy came earliest and fastest where there was strong and broad economic development. Africa's democratic woes are a reminder of the opposite.

Several attempts have been made, using empirical studies, to guess when democracy will sprout. Scholars have argued that above a certain GDP per capita a country enters a “transition zone” where democratic pressures resulting from economic and associated social development grow. Some say the entry point into the danger zone occurs around \$3,200 (in 2002 dollars adjusting for price differences across countries). Another researcher found that political pluralism became highly likely once a country reached \$4,500. Yet another research project found that the probability of democratization in a given year doubles as income per capita grows from \$1,700 to \$8,400.<sup>10</sup>

With a price-adjusted GDP per capita of \$4,500 by 2003, China is clearly in the danger zone. Even discounting to take account of measurement problems, the amount of wealth in China is probably already sufficient to finance democratic transition. With every passing year, that is even more the case. In cross-country and cross-time comparisons, the CCP regime is living on borrowed time.<sup>11</sup>

Another widely studied indicator of democratic prospects is the size of the middle class. In China, as elsewhere, the middle class seeks a recognition and protection of its growing interests from the state, mainly through improved legal guarantees and openness. While the middle class rarely embraces the idea of democracy per se (fearing the votes of the poor), historically its agitation on its own behalf has led to just that. Using pure income and asset measures, China's middle class probably accounted for between 10 percent and 15 percent percent of the population at the turn of the century. Researchers in China have estimated that this compares to 17 percent in the United States in 1950 and 14 percent in Japan in 1975, suggesting that China is

already in a position to sustain nascent democracy. If a broader definition is used to include all administrative and service staff, government clerks and teachers—essentially everyone who's not a worker, peasant, unemployed, or below the poverty line—then the middle-class figure rises to around 30 percent. On this basis, the share will rise to about 35 percent by 2010, according to one estimate.<sup>12</sup>

The political implications are already being seen. As one mainland scholar wrote in a Beijing-published book:<sup>13</sup>

The middle class has already had a lot of impact on one-party rule, as shown by the [CCP policy since 2001 of expanding its constituency to include the middle and business classes]. . . . The middle class is increasingly in control of information and power resources in China, which is changing the CCP's past monopoly of these things. . . . In that sense it provides a safe pavilion and strong force for political, economic and social modernization. . . . Given their demands for political participation, the middle class will certainly promote political reforms within the CCP as well as domestic democratization.

Or as one long-time Western student of democracy wrote:<sup>14</sup>

As it gathers more momentum and begins to generate a more urban, educated, wired, and middle-class society over the next two decades, **economic development is going to generate enormous pressures for political change in China**. People are going to want more say over their own affairs. They are going to expect less hierarchical control from the state and ruling party, and more accountability of political leaders to the citizenry. There will be decidedly less tolerance for corruption and abuse of power, and more readiness and ability to organize in protest of it. There will be significantly greater aspirations for personal and political freedom, and for greater pluralism in sources of information and choices of leaders. . . . If the more politically aware, autonomous, and resourceful social actors that economic development will generate do not find channels for participation and protest within China's political system, they will mobilize outside the system, possibly to bring it down.

**Business leaders are one group that may mobilize for change. They played a key role in the democratizations of Spain, Brazil, South Korea, and the Philippines.** Prior to transition, they organized into powerful business lobbies that brought new openness from the state. At the time of crisis, they defected to the side of reform.

Of course, democratization can also be delayed when business interests

collude with the authoritarian state. This was long the problem in South America. It has also been an impediment to change in China, where the private sector got its start in the 1980s and 1990s by forging close alliances to the state.<sup>15</sup> Beijing's private computer company, Stone Group, which funded political reformers and supported the 1989 protestors, was anomalous.

Yet by the turn of the century, China's new business elite was showing signs of following in the well-worn footsteps of its counterparts worldwide. As bureaucratic (and military) control over the economy waned and the number of new entrants in each sector grew, the payoffs of pursuing patronage declined steeply. Not everyone could be a "privileged entrepreneur" when there were two million private companies and 100 million people in the private sector accounting for 50 percent of GDP. State favoritism was now a grounds for legal action. The new generation of private entrepreneurs is also more educated and more worldly than the first. They have more self-respect and less tolerance for engaging in demeaning *guanxi*. They also have reputations to protect from an increasingly aggressive business press. As a result, many entrepreneurs have begun to agitate for equality and openness from government. Private industry associations once thought a handmaiden of the local Party committee have begun to seek political change. Attempts by Beijing to control the rapidly proliferating local business groups are failing for the simple reason that at the local level, power resides more and more with the companies and not the bureaucrats.<sup>16</sup> "Private business owners have begun to express strong desires for political participation and a consciousness of their group interests," says one government researcher. "They're looking to take part in public affairs."<sup>17</sup>

The trends will continue. World Trade Organization entry and financial reform will increase bank lending to private companies (which are 90 percent self-financed at present), further dampening crony ties. A constitutional amendment on the table since 1998 would make private property "inviolable" and "protected" alongside state property. That change, if combined with tax and spending policies aimed at redistribution, would be a powerful agent in support of democracy by undergirding equality in both political and economic spheres.

The CCP has tried to expand its cooptive powers by inviting private entrepreneurs to join the Party. As a Party Organization Department book said: "We cannot afford to lose this camp."<sup>18</sup> But the change in 2001 was greeted with indifference. In one survey, just 8 percent of entrepreneurs expressed a desire to join the CCP.<sup>19</sup> In short, China's new breed of entrepreneurs have little interest in saving a dying regime. They prefer to stay on the outside. At a certain point, one hardline Party journal warned, "the capitalists will rise up and destroy the Party lock, stock, and barrel."<sup>20</sup>

Declining state economic power, both productive and fiscal, is the flipside of the move to markets and the emergence of an empowered middle class. In the past, state factories were the main channel through which the state exercised totalitarian control over society. State employees are vulnerable to ideological education and bureaucratic controls. With the state sector now accounting for only 30 percent of GDP—the private sector accounting for 50 percent and agriculture 20 percent—and just 10 percent of total employment, this tool is seriously degraded.

Fiscally, the rise of a private sector, ad hoc decentralization, and the increasing costs of governing a complex and growing population have eaten away at central finances. State revenues fell from 31 percent of GNP in 1978 to 11 percent in 2000. Income, sales, and social security taxes—typically half of total state revenues in market economies—account for just a few percent of tax revenues. Government debt is the equivalent of more than 100 percent of GDP when unfunded pension promises, local government debt, and bank restructuring costs are included. In mid-2002, premier Zhu Rongji publicly begged the country's richest private entrepreneurs to begin paying taxes, an echo of the shifting balance of power between lords and vassals in early modern Europe and a reminder that the management of public debt has been historically closely tied to the rise of democracy. Ultimately, short of engaging in a fire-sale of state land and infrastructure, Beijing will be forced to find a new accommodation with its “heroic” citizen-creditors that respects them as equals.<sup>21</sup>

With the loss of state resources goes the loss of the regime’s ability to “buy” support from urban residents. Since one-off gains from marketization and sectoral shifts are nearly exhausted and state fiscal, banking, and corporate resources are depleted, the “social contract” of urban residents accepting CCP rule in return to material benefits will soon be broken. Notes one Chinese scholar: “The social contract has helped the communist regime insulate itself from pressure for democracy but will ultimately undermine its rule.”<sup>22</sup>

Finally, foreign economic linkages are also acting on balance to undermine Party rule. To be sure, the CCP has managed to corral some of these resources for itself. PRC state firms now raise millions of dollars on overseas stock exchanges and foreign companies in China, which crowd out more politically active domestic entrepreneurs, account for about a fifth of corporate taxes. As one Party book stated baldly: “The foreign-related economy holds great potential for providing resources for the political system.”<sup>23</sup>

But whatever early impact globalization had in bolstering one-party rule in China, that impact is changing. The influx of foreign investors is weakening the cronyistic ties that local governments once had with foreign companies.

Large portfolio investors in mainland securities like the California public employees pension fund (Calpers), overseas labor rights activists, and regulators in Western markets have begun using their leverage to pursue openness and accountability. As this happens, the “normal” pro-democratic impact of business—which promotes meritocracy, transparency, rules-based systems, information opening, codes of practice, and competition—is coming to the fore.<sup>24</sup> As one political reformer in China noted of the new generation of foreign executives in the country: “They don’t know how to speak Chinese or take local cadres to lunch. They expect to work hard and enjoy the results. That is going to change everything.”<sup>25</sup>

Just as Spain’s quest for entry into the European Community from 1977 to 1986 encouraged the formation of government structures that reflected the imperatives of democratic rule, so too China’s entry into the WTO will put unprecedented pressures on the political system. China’s stock market regulator, the China Securities Regulatory Commission, intends to hire foreign nationals to improve its operations. The same impetus will be at work across the entire regulatory system. As China’s semi-official annual political report of 2001 put it: “The secrecy and unresponsiveness of governments at all levels in China simply does not accord with the needs of WTO entry . . . We need to make all information public, make leaders compete for office, and increase public participation in political affairs in order to improve the efficiency of government to meet this challenge.”<sup>26</sup>

### *New Ideas*

In 1996, the newly established China Confucius Foundation filed a lawsuit against the Ministry of Culture alleging illegal interference in its activities. The ministry had tried to force the Confucian scholars to move their office from Beijing to Shandong province. When they refused, the ministry sent a gang of thugs to the office to haul away equipment and lock the door, “seriously encroaching upon the foundation’s legitimate rights and interests,” the suit alleged. In an out of court settlement, the ministry backed down.<sup>27</sup>

As with the economy, the dismal picture of social life under CCP rule is considerably enlightened by signs that society is finding ways to resolve the crisis. Tocqueville’s prophecy is being fulfilled in modern-day China through a burst of new ideas and the creation of new organizational resources with which to put them into practice. Tracing these changes in values and ideas is difficult, notwithstanding the occasional appearance of litigious Confucians. Yet they are arguably the motive force of political development. Ret-

rospective work on the failure of authoritarian regimes almost always dwells in the end on the ways that society quite literally outwitted the state.

New ideas of all sorts to replace the totalitarian values of the state are critical to the formation of an ideology for an opposition movement. By forging critiques and alternative views of central public issues, they disarm the regime's ability to lead by sheer will. These dissenting views need not be widely held. Only a small but critical mass of alternative opinion is necessary to provide the normative backing for the ad hoc solution of democracy when dictatorship reaches crisis.

Several surveys taken in the 1990s found mounting evidence that this critical mass already exists in China. According to one survey, "20 to 30 percent of the population of China have attitudes favourable for democratic behaviour," a level comparable to already functioning democracies in Italy and Mexico.<sup>28</sup> Another survey that compared democratic attitudes in Hong Kong, Taiwan, and China showed how China was already at a level comparable to Taiwan when it launched its successful democracy in 1988 and would continue to embrace democratic attitudes more widely as education expanded.<sup>29</sup> In cross-country comparisons of the strength of various values of toleration and self-expression, which are strongly correlated with democracy, China already enjoys levels that should sustain a democracy like those of Taiwan, Greece, or Poland.<sup>30</sup>

Even in the 1980s, as we saw, the Party was losing control of China's values as the pro-democracy movement grew. By the turn of the century, further liberalization and international integration, as well as rising education levels—60 percent of the labor force now has secondary schooling or higher—had created even wider space for new views. In rural areas, as we shall see, the conduct of direct elections has had a profound impact on widening the scope of ideas.

In the cities, the transformation is even more profound. In contrast to the "anti-social individualism" that gripped the cities with the first bursts of freedom in the 1980s, by the turn of the century, a genuine "sense of community built on rational individualism" was emerging to take its place.<sup>31</sup> Citizens are putting a greater value on notions of justice and equality over notions like authority and responsibility.<sup>32</sup> Artists who engaged in cheap political pop art in the 1980s are now concerned more with human inquiry, drawing attention toward the individual and away from the state.<sup>33</sup> Of course, as we saw in the last chapter, the spread of this responsible civic ethos faces real limits under the CCP system, where autonomous associational life is wrecked at every turn. But its appearance helps gird the forces that would bring about change.

So too does the appearance of liberal intellectuals. Rare is the country that has overthrown an authoritarian regime without an intellectual leader. Intellectuals can provide the critical rhetoric and moral backing to disarm opposition to democratic change. In their writings on both historical and present-day issues, intellectuals can create dissonances that undermine Party's hegemony over discourse. In the USSR, the flood of reappraisals about Stalin's rule that appeared in 1987–88 opened a window of truth, a "return of history" that made it impossible for the communist regime to carry on. Through such acts, "the demand for truth" becomes as important as "the demand for bread" within segments of society. Again, they need not be the majority—usually they are not—to have a great impact.

In both 1986 and 1989, university professors and students were at the forefront of political agitation in China. As with entrepreneurs, there is some evidence that they retreated from that role in the 1990s by seeking clientelist ties to the state. But the recognition of the problem is now open and arguably has caused a reversal, a "reawakening" of the liberal intellectual mission now celebrated in many Chinese books.<sup>34</sup> Writer Yu Jie's collection of essays, published in 2003, was called "Refusing Lies" (*Jujue huangyan*), echoing Lech Walesa's remark on the growth of "a communion of people who do not wish to participate in a lie." A healthy scepticism toward the state—one fostered by its repression—has allowed intellectuals to reemerge at the forefront of political change. Among them, noted one scholar in China, "the core concepts of Western democracy—namely elections, participation, equality, and freedom of expression—are now widely accepted."<sup>35</sup> Indeed, China is arguably better endowed with liberal intellectual leaders than was the Soviet Union or any Eastern European country. As a Chinese scholar put it: "The liberalism expressed by some non-Party intellectuals is a vital part of the ferment leading toward political change."<sup>36</sup>

Finally, diverse and often democratic influences are also flowing into China from abroad. By 2002, there were 350 McDonald's restaurants in China. The national soccer team went to the World Cup in 2002 under a foreign coach. The number of outbound Chinese tourists reached 6 million. Meanwhile, about 400,000 graduate students and scholars had gone abroad since reforms began. The creation of a large PRC diaspora, in addition to starving the CCP of resources, has a profound cosmopolitanizing effect at home. Attempts by Beijing to portray life in a democracy as dangerous and alienating increasingly fail. New ideas spill off the flight from Los Angeles along with boxes full of Hollywood films.

Many of these global cultural influences are embodied in the awarding of the 2008 Olympics to Beijing. Merely organizing such an event would bring

new people and ideas into China, not least the Olympic Charter's explicit "respect for universal fundamental ethical principles" and "preservation of human dignity." Citizens in Beijing quickly grasped the regular visits by IOC commissions as means to demand better treatment on issues like urban re-development. There are close parallels with South Korea, where the coming of the 1988 Olympics games was an important impetus for regime change. As in South Korea, China's people will be keen to show a "new face" to the world by 2008.

Of course, the cosmopolitanizing and liberalizing impact of globalization on Chinese society needs to be squared with the apparent emergence in the 1990s of a powerful nativist and illiberal nationalism. As mentioned, nationalism has a long and infamous history of being used by elites to discredit or subvert democracy in China. The CCP's launch of an official patriotism campaign in 1991 and its frequent resort in the 1990s to "nationalism on demand" from angry young males was nothing new in this respect.<sup>37</sup> Yet the mainstream, as opposed to official, nationalism in present-day China may be one of the most potent democratic forces.

Throughout the reform era, students protesting against foreign slights repeatedly turned their attentions to the failures of CCP rule. This transformation is latent in the nature of nationalism. The search for national dignity contains many of the same notions—equality, fairness, justice—that underlie the quest for personal dignity. The great political philosopher John Rawls contended that a people's demand for respect from other nations is rooted in the same moral philosophy that generates the individual's demand to be treated equally and fairly domestically.<sup>38</sup> In the process of seeking their due globally, people begin to seek their due at home as well. Notes one Western scholar: "The politics of individual dignity, far from being antithetical, appears to be parasitical on the idea of national dignity"<sup>39</sup>

We have seen evidence of this repeatedly. Wei Jingsheng wrote his famous democratic declaration to show that China's people were neither "spineless weaklings" nor "devoid of any desire to improve their lot"—a direct linking of democracy with national dignity. When Beijing won the Olympics in July 2001, the streets of the city were suddenly packed with celebrants, all of them acting with unaccustomed camaraderie, respect, and civility. "I haven't seen this sort of feeling since Tiananmen," one weeping young woman entrepreneur told me. National dignity and individual dignity are closely linked.

A second point is that the quest for national identity usually brings to light the diversity inherent in any culture, providing a new stimulus for democracy's equal treatment of all. Some of China's nationalists increasingly identify themselves with the long tradition of modern Chinese nationalism and Chinese

cultural pride, not with the CCP regime. Loving China no longer means loving the CCP, if it ever did. Especially in the south, a new egalitarian and cosmopolitan culture has taken root that challenges the CCP's northern autocratic culture.<sup>40</sup> The result is that people begin to reinterpret the regime's propaganda about the need to avoid democracy as the need to avoid an inclusive national identity. The new national narrative sees regionalism and federalism as a good thing to prevent dictatorship. Democracy is portrayed as a unifying force. It was no coincidence that the biggest demonstration against the June Fourth massacre occurred in Guangzhou, where 50,000 people held a peaceful protest on June 5, 1989, or that the flame of that movement burns brightest in Hong Kong at the annual June Fourth vigil there.

As India and Taiwan have shown most strikingly, nationalism can be a powerful force for both achieving and sustaining democracy. It provides resistance to despotism and glue to hold together a country during the transition. A sense of belonging, of national identity, is critical to creating a democracy. So too is a pride in one's cultural traditions. In China, nationalism is helping to tip the balance toward, not away from, democracy.

In all these respects, the burst of new thinking in contemporary Chinese society undermines arguments that China is trapped in a fossilized culture that cannot support democracy. Earlier we rejected notions of a deep-rooted antidemocratic strain in China's culture, arguing that its democratic potential was as great, if not greater, than elsewhere. Of course, the converse of the adage that democracy produces democrats is that dictatorship produces dictators, norms in society at odds with democracy. But it is clear that China has already escaped from the prison of antidemocratic ideas, a remarkable feat living under CCP rule.

As one mainland scholar concludes: "China has discovered that dissent, diversity, and plural ideas and values are not incompatible with social order. . . . [Thus] the major cleavage in Chinese political culture today may not be between the advanced intellectuals and the backward masses, but between a people ready for more freedom and political leaders afraid to grant it."<sup>41</sup>

### *New Societies*

New organizational resources—the media, civil society, rule of law, and open protest—are the other dimension of social change. Again, these remain deeply retarded by the communist state, with all the resulting negative consequences described in the last chapter. Yet we already see the emergence of a critical mass that has put the CCP on the defensive.

The explosion of the media in China is a tangible expression of the Party's

loss of control of ideas. Consider the numbers in 2003: close to 7,000 newspapers and magazines, of which maybe a fifth have their own Internet sites; more than 500 publishing houses, of which only a third are directly controlled by the central Party or state; more than 3,000 broadcast and cable television stations; 70 million regular Internet users; and the world's largest mobile phone population: 250 million chatterboxes talking up a cacophony of competing ideas.

As a result, China is now awash with information that would have been considered seditious as recently as the early 1990s. Chat sites created to support the Party, such as the Strong Country Forum of the People's Daily, are used to launch criticisms of the Party. About three quarters of respondents to one survey said that the Internet gave them "more opportunity to express their political views," while 68 percent said it gave them more opportunities "to criticize government policy."<sup>42</sup>

Beijing tries to stem the flow through periodic crackdowns on newspapers and magazines and the blocking, according to one study, of 19,000 politically sensitive Internet sites.<sup>43</sup> But it is a losing game, especially given the impact of the Internet and mobile phones in creating the socioeconomic and geography-defying "communities of understanding" that are so inimical to dictatorships. The failing controls—the blocked Internet sites account for only 8 percent of the total potentially subversive sites—have increased calls for an end to censorship since it is insulting to a society already in-the-know. As one scholar noted: "The only effective way to stop [press] liberalization would be to resume full-scale subsidies to all the media. But that is beyond the capability of government."<sup>44</sup>

The media have another organizing impact through the work of investigative journalists in uncovering political problems. Malfeasance in the corporate sector, as covered by magazines like *Caijing*, is an open field now. As one study noted, this new breed of journalists is remarkable in being concerned with issues of justice as well as truth.<sup>45</sup> Official corruption and misgovernance remain more sensitive, but still provide wide room for honest reporting. In two incidents in 2001—a mining disaster that killed 300 in Guangxi and a fireworks explosion that killed 40 schoolchildren in Jiangxi—the media rejected state lies and reported the truth, forcing officials to recant. Dogged reporting into the affairs of the China Youth Foundation's charity for poor areas, Project Hope, finally uncovered evidence of long-rumored corruption in 2002.

Of course, since the line is unclear, many journalists end up in jail. The CCP regularly tops the odious list as the regime with the most journalists under lock and key worldwide, two dozen in 2001.<sup>46</sup> But the Party faces a

losing battle. Journalists jailed for reporting corruption or misgovernance become causes célèbres at home and abroad.

Civil society, organizational life not controlled by the state, is critical to the lead-up, transition, and consolidation phases of democratic change. Authoritarian governments make little allowance for autonomous social groups because the state and its official social groups are supposed to represent all interests. Yet any degree of market and social freedoms will lead to a diversity of interests that seeks its own organizations. As they pursue those interests, social groups put dictatorships on the defensive, drawing attention to instances of poor governance and at the same time robbing them of their normal social support. Suddenly, two scholars note, the emperor “is seen not only naked but also unaccompanied by his usual retinue.”<sup>47</sup> At the critical moment, as we shall see, civic society presses elites to embrace democratic change, later helping to sustain it through the turbulence of early consolidation.

Given this importance, it’s no surprise that vast attention has been paid to the rise of social groups in China, both by the regime and by outside observers. At the end of 2002, there were 135,000 officially registered “social groups,” in China. More than half were sub-national level groups, reflecting China’s size and diversity. Of these, as one would expect, the most economically advanced provinces accounted for the bulk. Books about “civil society” (*shimin shehui* or *gongmin shehui*) and “civic organizations” (*shetuan* or *minjian zu-zhi*) now crowd the shelves in China.<sup>48</sup>

The variety and the scope of the civic groups grow by the day. Academic, business, and professional groups account for most of the officially recognized bodies, little surprise given the Party’s fears of losing their support. But the growth of associations representing women, environmental causes, homeowners, new religions, charities, recreational pursuits, and folk culture is astonishing. Taxi driver guilds, temple fair associations, soccer fan clubs, and female journalists’ groups have sprouted with the grudging endorsement of a state no longer able to manage every aspect of society. The Falun Gong meditation group that surrounded the CCP’s office complex in 1999 with 10,000 adherents to protest being de-registered was a stark reminder of a rapidly organizing society.

Some scholars argue that China’s civic groups cannot play the same role they did in other democratizations. That is because the ones that are politically engaged are closely controlled by the state, meaning they do not restrain or reclaim state power. Others advocate ideals that are highly undemocratic. But the standards of civic groups under democracy are not those we should use for those under dictatorship. As with so many aspects of the resources for transition, we should be concerned with showing merely that a “critical mass,”

not a fully developed, pro-democracy civic society exists. From this developmental viewpoint, civic society in China is already reaching the critical mass that will make it an effective resource for transition.

While Beijing officially demands that civic groups be state-sponsored and that their behavior be consonant with state policies, formal compliance often masks actual divergence.<sup>49</sup> Despite fantasies of an orientalist bonding between state and society, all evidence suggests that civic society in China is developing exactly as it did elsewhere—in opposition to state power. The best evidence is Beijing's frequent repression of groups. In 1998, Beijing passed new laws to crack down on groups that were "politically problematic, seriously interfering in social and economic order, or illegal," along with others that were "redundant" or "badly managed." Two years later, the number of groups had fallen by 30,000, or 20 percent.<sup>50</sup> If China's civic groups were indeed pioneering some new Asian values approach to helping the state, then why would the state react against them in this way? One Party hard-liner provides the answer: "Some social groups have tried to cast off or weaken Party leadership over them. In some cases a small number of groups have only focussed on their own interests, seriously affecting political stability and unity."<sup>51</sup>

The second issue is whether these groups are putting in place the foundations of democracy. Many worry that China's "uncivil society" would bring chaos or new dictatorship if it overthrew the CCP. To be sure, China has its fair share of antidemocratic groups—as every society does. As in developed democracies, many of them are avowedly unpluralistic. But it also has a large number of proto-democratic groups focused on women's rights, liberal intellectual thought, or public charity. More important, civic societies which grow up within a dictatorship often take on nondemocratic colors as a result, just as people do. Evidence from elsewhere shows that this changes quickly with democratic opening. For that reason, the proper focus should be less on the antidemocratic potential of some groups—a potential that like all cultural potentials can be used for good or evil—and more on the extent to which these groups are managing to reclaim and restrain state power. Much evidence suggests it is great. Civic groups, writes one scholar in China "are helping to lay the foundations for a diverse, rich and democratic human society."<sup>52</sup> Or to quote another: "The gradual creation of a civil society is creating favourable conditions for China's future democracy."<sup>53</sup>

In a similar way, the accidental openness in China's nascent legal system is being used by society to forge a new relationship with and even change the state. One example of this new relationship is the Administrative Litigation Law, under which 100,000 suits were brought against mostly low-level government officials and departments in 1999. Others laws, like the State Com-

pensation Law and the Administrative Penalties Law, have contributed to society's control of the state as well.

Like so much else, these seeds, planted to address a crisis of governance, have grown far larger than intended. Vigilante-like judges have appeared in localities where the crisis of governance is worst and made names for themselves by taking on powerful Party units.<sup>54</sup> The country's corps of 117,000 qualified lawyers and 10,000 law firms as of 2001 is also producing a whole new class of people who use the legal system to fight for justice, the entrepreneurs of legal limits on the state. People like Shenzhen worker's rights advocate Zhou Litai and Beijing-based lawyer's rights agitator Zhang Jianzhong appear by the day. While the CCP still imagines rule of law as a tool of legitimization and policy implementation, there are openings for law as a mechanism to bind the state and protect individuals. The norms it embeds are norms of fundamental, unalterable legal rights and of a state that is subject to limits.

Finally, the resort to organized and open protest has gone from a rare and daring act in the 1980s and early 1990s to a normal part of everyday life by the turn of the century. It is now a widely used and tolerated means of voicing protest. Party journals and books chronicle the rise of "sudden and mass incidents" which usually involved some degree of violence or disruption. In recent years, there have been frequent outbreaks of riots by peasants over taxes, minorities over religious repression, workers over unpaid pensions, parents over tuition fees, townsfolk over corrupt cadres, city-folk over urban redevelopment, taxi drivers over new license fees, and soccer fans over bribe-taking referees.

Protest is best known in rural areas, where anti-government riots have become so common that a Beijing University thesis called them the "mainstream" method of political participation.<sup>55</sup> One protest movement by relocated residents from the Three Gorges dam area began in 1979 and was still ongoing as of this writing.<sup>56</sup>

In cities, meanwhile, riots over urban housing and welfare and mass marches on government offices are commonplace. In one riot in 2000, residents of a township in Jiangsu burned 24 police cars and injured 50 policemen in a protest against the merger of their township with another. An informal movement of residents in Shanghai regularly foils heavy-handed urban redevelopment plans with protests, sit-ins, petitions, and even appeals voiced by the city's aggressive tabloids. Thousands of workers marched and picketed in Liaoning province the same year over unpaid pensions and state factory corruption.

For practical and normative reasons, police are increasingly allowing the protests to continue. Usually, the use of force makes things worse, as police

and Party manuals since Tiananmen have been at pains to stress. More important, within the police there is a growing sense of professionalism that portrays officers as upholders of public order, not Party rule. This change, to which I return below, is monumental. It is a prelude to the defection of coercive forces that is critical in democratic transitions. Prior to that, it helps to empower the organization of social protest by reducing the costs of protest, thus providing an important resource for democratic change.

Of course, one might argue, as some scholars have, that the growing incidence of open protest is likely to strengthen the authoritarian clamor for law and order. As social tensions grow and as armies of unmarried young men—30 to 40 million by 2020—emerge looking for release, the CCP will find new adherents to its calls for strong government.<sup>57</sup> Yet this conclusion goes against evidence of how China's people frame the problems and solutions to their crisis of governance today. More and more they frame it as a failure of strong government, not a call for more. In the words of prominent political reformer Li Fan:<sup>58</sup>

Since 1989, there has been a constant outbreak of small-scale protests, sit-ins and marches. But the state has not conceded any major political freedoms. It instead relies on out-of-date police-style repression. . . . If the state does not undertake political reforms to meet these needs, the results will be even larger turmoil. . . . At a certain point, society will simply rise up and break down the constraints on freedom.

#### *Democratic Diplomacy and U.S. Policy*

International factors are playing an important role in shifting the balance in favor of democratic transition in China. Indeed it may be said that the global environment for a successful democratic transition in China has never been better. We have already seen how international economic and social factors are working to promote change. Here we consider explicit political linkages.

International political factors can occasionally be all-important in democratic transitions. In some cases—Japan, Grenada, Afghanistan, Iraq—democracy was imposed from outside even though domestic democratic forces were weak. In others—Greece, Portugal, Argentina, and even the USSR—democracy resulted partly from a failed foreign war. Usually, however, international political factors play only an indirect if powerful role, magnifying and empowering forces already at work inside a country. This is the case with China.

It is unlikely that the CCP would be ousted by a foreign power for, say,

weapons proliferation, or by its own people, say after a failed attack on Taiwan. But global politics is being felt inside Zhongnanhai in other ways: through diplomatic policies, indirect border effects, and an increasingly active global civil society.

The diplomatic environment never imposed dictatorship on China of course. But as elsewhere, the uncertainty of the cold war bolstered the arguments of antidemocratic forces at home. With the cold war ended and new regional conflicts being solved through bipartisan global cooperation, this danger is removed. No longer can external threats be used to argue against democracy, as they have been throughout modern Chinese history. Just as the end of the cold war removed obstacles to democratic movements in the peripheries of the United States and the USSR, so too it has had a wider impact in Asia. A country can democratize today with excellent prospects of emerging with an independent foreign policy.

In China, this balmy international climate has encouraged policymakers to urge the government to cast off its discourse of threats and victimization in favor of a more mature and cooperative diplomacy.<sup>59</sup> It was just such a change in the external policies of the USSR, Gorbachev recalled, “that was the starting point for everything” that changed at home.<sup>60</sup>

Indeed, the end of the cold war marked the onset of a global diplomacy that explicitly favors democracy. “Democratic diplomacy” is of course rooted in normative ideals. But it is also hard-nosed realism: promoting democracy in other countries makes them more stable and open, thus protecting global security from militarist aggression; opening channels for international cooperation on transnational issues; and providing better prospects for global economic growth and redistribution. The EU has an explicit democratic condition for membership that has encouraged democratization in southern and eastern Europe. Several democratizations in Asia—Taiwan, South Korea, and Cambodia—have been greatly influenced by the quest for diplomatic acceptance from the West. In Africa, the old dictatorship-friendly Organization of African Unity was dissolved and replaced by a new democracy-friendly African Union in 2002 linked to an aid-for-democracy funding scheme from the West.

China thus finds itself confronting a diplomatic environment strongly tilted in favor of democracy. Democratic countries give significant support to village elections, people’s congresses, human rights dialogue, and rule of law initiatives in China. Beijing hopes these things can bolster its legitimacy and governance without compromising its power. Democratic countries hope otherwise. As Japan’s prime minister put it at China’s annual Asia development forum in 2002: “The three values of freedom, diversity and openness are the driving forces behind peace and development in Asia. . . . It goes without

saying that freedom refers to democracy and human rights politically," institutions whose coming to every country, he remarked, was "inevitable."<sup>61</sup>

China also finds that the United Nations system, long a friend of corrupt and brutal Third World dictators, is increasingly part of the same democratic diplomacy. Several UN programs and policies now have explicit democratic conditions attached to them. The agency's human rights commissioner, its covenants on human rights, and the "democratic governance" item which tops the UNDP agenda are all reminders of this. Nothing could be more upsetting to Beijing's argument that democracy and human rights are "Western" than to see UN democracy and human rights initiatives being pursued with vigor by an African secretary general and a Thai human rights commissioner, as in 2002. In the words of a U.S.-based scholar: "Beijing cannot escape the fact that the normative agenda of international society has expanded, as have the ambitions of China's domestic political reformers."<sup>62</sup>

The CCP thus engages the international system at its peril. China was a member of 55 international governmental organizations by turn of the century, up from 21 in 1977. While Beijing sought to maximize the publicity value and minimize the responsibilities of such engagement, the mere act of joining created new structures and powers for reformers in the state.<sup>63</sup> Domestic human rights advocates, for example, rushed into print a collection of international human rights standards the moment that Beijing signed the two UN covenants on human rights, calling it a "citizen's reader."<sup>64</sup>

As with domestic rule of law, the CCP's embrace of international rule of law has tied its hands. By involving itself more and more in the UN system, notes one scholar, Beijing has "crossed the Rubicon," in which it can no longer provide any coherent rejection of global democratic norms while simultaneously seeking to be a part of them.<sup>65</sup>

Like all democracies, the United States has a strong self-interest as well as moral compulsion to promote democracy in China. Merely by keeping the peace and encouraging openness throughout Asia, the U.S. makes a major contribution to China's democratization. Indeed, a U.S. policy that focuses assiduously on encouraging and supporting democracy in Asia as whole is perhaps the best friend of democracy in China.

From a prescriptive point of view, if one accepts the normative underpinnings of democracy as well as the practical evidence of the international costs of dictatorship, then the single overarching aim of U.S. policy toward China should be to bring about as rapid and smooth a transition to democracy as possible. While there is wide scope for reasonable differences on policy means, there is little scope for differences of aims. Every policy needs to be framed with reference to helping China's people to achieve their long dream

of a free and democratic country. It is important to keep in mind that in China democracy accords with popular wishes. Too often, U.S. policy specialists imagine the PRC as a representative government whose policies reflect an essentialized “Chinese worldview” that is “deeply rooted and readily apparent.”<sup>66</sup> Yet in light of recurrent pro-democracy protests and demands and in the absence of any popular legitimization of the CCP government through free elections, there is no basis for this assumption. The CCP’s policies in all likelihood do not represent a “Chinese worldview,” whatever that is, but a struggling regime’s last-ditch attempts to stay in power. As two scholars note, referring to the essentializing views of Harvard University professor Samuel Huntington, authoritarian regimes the world over exist because they crush democratic urges, not because those urges are absent: “U.S. policy should not fall prey to Huntington’s inability to distinguish between the regime line of the moment and the underlying dynamic that gives hope to so many Chinese people.”<sup>67</sup>

To be sure, a democratic China would have its own distinct “worldview,” as do democratic Japan, India, and France. But it would be one grounded in shared norms and ideals that have popular backing, in other words one both moral and legitimate. Moreover, as with U.S. policy in Latin America, a failure to pursue democracy as the primary goal risks undermining Washington’s future credibility. A United States which is not a friend of democratization in China cannot expect to be a friend of a democratic China. One prominent Chinese democrat suggests the establishment of a “China Reform Promotion Fund,” a sum of money promised to a newly democratic China with funds earmarked for poverty alleviation, farmers, unemployed, and the retired.<sup>68</sup> This idea follows closely the Bush administration’s establishment of a Millennium Challenge Account in 2002 to reward democratic reforms in aid-giving.

Democratization theory suggests that this kind of “ethical engagement” with China is the best means to foster change. The Clinton administration pursued an admirable policy of low-level engagement with China but one that often fell prey to unethical behavior. High-level summity with Beijing—culminating in a plan to build a “constructive strategic partnership”—as well as incautious business and military exchanges meant that the purposes of engagement were often forgotten. Much of this changed under the administration of George W. Bush. But the Bush policy erred in the other direction: useful engagement on health, rule of law, and military openness was put on hold along with the inadvisable summity and military technology exports. Meanwhile, the 2001 terrorist attacks on the United States had a baleful influence in moving Washington’s global policy away from the encouragement of political pluralism toward narrowly defined security aims.

In high-level dealings with the CCP, the United States should be open and unremitting in its calls for political liberalization. Washington should make it clear that while it respects China and its people, it cannot engage CCP leaders in any meaningful partnership. High-level contacts should be used to raise the costs of repression, proliferation, or aggression by Beijing. Washington should press for the release of dissidents and the relaxation of controls on religious freedom in return for modest concessions on high-level exchanges. Such exchanges would include careful but consistent engagement with reformist individuals in the military, government, Party, media, judiciary, and scholarly communities. As we posit in Part II, the CCP will likely be “extricated” from power by a breakthrough elite composed of reformist individuals inside the regime. Investing in them makes sense.

Of course, practical necessity means that Washington needs to have some degree of contact with the conservative leaders of the CCP regime. Matters of trade, the environment, crime, weapons proliferation, and the like need to be tackled at high levels. Yet there seems little justification for extensive summity with Beijing. Investing in the current leadership risks underinvesting when preparing to deal with a post-CCP government. As one U.S. scholar commented: “We seem to be simultaneously betting on the current regime and recusing ourselves from any consideration of the crisis it will almost certainly face before long.”<sup>69</sup>

This “post-CCP-oriented” policy would also include making it clear that the United States would be a friend of a democratic China and would welcome its role in sharing the burdens of Asian security and leadership. Even if a rump CCP emerges as the dominant party after democratic transition, something we predict in part 2, this would not prevent high-level engagement, for it would be a legitimate government.

At lower levels, engagement should be fuller *and* more ethical. Business should be encouraged, but under the rubric that it helps to make China a more free country. U.S. companies should be barred from outfitting or co-operating with China’s coercive forces. Chinese companies that raise capital in the United States should be vetted closely. Overall business ties would not likely suffer: Beijing has proven to be thoroughly pragmatic in matters commercial. Beyond commercial policy, U.S. government agencies should be encouraged to engage with China. At present, many of them, such as the National Endowment for Democracy and USAID are hampered by their ban on involvement with a country whose government is not officially committed to democracy. This restraint makes little sense, as many observers have noted. In the philosophy of global justice of Rawls, China would be a “burdened society” where weak liberal political and cultural traditions—kept that way by

dictatorship—struggle to gain preeminence. Low-level assistance to China in terms of education, health, welfare, rule of law, and much else is not only practical but also just. Withholding it on the grounds that China is burdened by dictatorship is both unjust and illogical.

Low-level engagement can and should include an explicit and open commitment to democracy, for two reasons. First, any democratic country has to be true to itself, to meet the same standards of openness and explicit policy aims in foreign policy as it must at home. Otherwise, those policies can go dreadfully wrong, as they did in Vietnam. Foreign policy experts soaked in Sinology who argue for a soft, face-giving approach often forget that they represent democracies that demand accountability to their own people, a fact they might find troublesome but that is there exactly to keep tabs on that desire to be freed from popular control. The “domestic interests,” in the United States which many a Sino-U.S. relations specialist bewails is exactly the point of representative government.

Second, as with business, there is no evidence that such a commitment would adversely affect most programs in China. Building a “democratic” China is an explicit goal of the CCP leadership, even if it intends to remain the sole party. On the ground, meanwhile, as we have seen there is already a strong growing consensus on the need for real democracy. The head of the UNDP reports that while Beijing diplomats opposed the agency’s “democratic governance,” initiative in 1998, local officials in China embraced the notion as a real solution to their governance crisis.<sup>70</sup>

China’s people, and many of its reformist elites, recognize that peaceful evolution from dictatorship to democracy offers the best hope for building the strong and prosperous China of their dreams. The United States, along with the rest of the world’s democratic majority, should help them in that quest. To a great extent, they already are. With a more focused and enlightened policy, much more could be accomplished. To quote one congressional leader: “We should feel free to talk past the regime and directly to the people.”<sup>71</sup>

#### *Border Effects and Global Civil Society*

We live in an age in which the norms of democracy have become the gold standard of our time. This atmosphere has a significant impact on China that goes beyond diplomatic policies. The “border effects” of global democratization and the rise of a powerful pro-democracy global civil society are widely felt. As one Party hard-liner wrote about the “Third Wave” of democratizations

of the late twentieth century: "The so-called Third Wave theory has had an impact on China, causing some liberal scholars to become quite active and in society a wave of liberal democracy thinking has spread."<sup>72</sup>

Traditionally, the "border effects" of nearby democratic change have been the most powerful international factors in democratizations; indeed this is one of the explanations of the three "waves." The near-simultaneous democratizations of Eastern Europe and Russia in the Third Wave are the best examples. But similar effects have been seen in Latin America, southern Europe, and Southeast Asia.

China is feeling those same effects. Of course, democracy in Western countries exerts a constant influence, not least because of the economic and technological prowess of the West. Those affects have been deeply reinforced by the Third Wave. Beijing now finds itself looking in from the outside on conferences such as the Annual Conference of New and Restored Democracies and the annual conference of the Community of Democracies. In Asia, democracy has become the mainstream system, accounting for 24 of 39 governments by the turn of the century. Attempts to erect a cover for dictatorship under the rubric of "Asian values," as with the attempts in the past to subvert democracy in Africa through appeals to tribalism, now lie discarded. The Council of Asian Liberals and Democrats (CALD) brings together democratic parties of Asia into one forum and helps to share indigenous experiences with democracy, further evidence of the pan-human universality of democracy. As one Chinese liberal writes: "China has no reason to miss the opportunity to join the mainstream of human civilization."<sup>73</sup>

China's people look abroad and see those in allegedly inferior tributary nations like Cambodia, the Philippines, and Thailand lining up to choose their leaders and wonder why they cannot do likewise. When a newly democratic South Korea jailed two former presidents in 1996 for subverting democracy and taking bribes, it caused a sensation in China. "The trial was of great significance to all of Asia. It told us that modernization must have political standards," wrote He Qinglian.<sup>74</sup>

Within Asia, the examples of Taiwan and India stand out. Taiwan's successful democratization launched by Chiang Kai-shek's son on his deathbed in 1986 has proven to be a powerful example to people on the mainland. Not only has democracy sustained an economic powerhouse, but it has also endeared Taiwan to the global community. U.S. backing for Taiwan is singularly helped by its democratic and free system.

Beijing's attempts to discredit democracy in Taiwan by showing the occasional fist-fights in its legislature have boomeranged with the developing pop-

ular admiration for the Taiwanese ability to struggle over policies. Attacks on corruption in Taiwan serve to draw attention to far greater and less manageable corruption in China.

Scholars frequently point to differences between the democratizations of Taiwan and China. Yet on close inspection, those differences are narrowing rapidly. Taiwan's need to gain U.S. support in the wake of the diplomatic defections to the PRC in the 1970s is today paralleled by Beijing's need for international recognition in the post-Third Wave democratic environment. Taiwan's emerging opposition parties and civil society of the 1970s is today paralleled by China's nascent civil society, growing middle class, and reformist regime insiders. The KMT's legitimacy crisis on Taiwan was no worse than the CCP's legitimacy crisis on the mainland.

Indeed, some enlightened CCP leaders may see the Taiwan example as a model of how to retain power for as long as possible during democratic transition, as the KMT did until losing out in 2000. As one scholar sums up: "If one needs to find an example that points a way out of repressive authoritarianism for the CCP, there is not better choice than that of the KMT."<sup>75</sup>

The example of India is less politicized but arguably more profound. Asia's two great ancient civilizations are a study in contrasts today. Both are poor and populous. But India's flourishing democracy and extensive freedoms serves as a contrast to China's callous dictatorship and repressive environment. As mentioned, India almost single-handedly refutes arguments that large, poor countries cannot sustain democracy. It takes a Herculean effort for anyone to argue that India had better conditions for democracy than China because of, say, a British colonial heritage or a tradition of society being separate from the state, embodied in people like Gandhi. According to most estimates, India had far worse objective conditions given its extensive poverty (two-fifths of the population), unparalleled ethnic and religious diversity, and neighboring nuclear threat in Pakistan. "For opponents of democracy in Asia," writes one Indian intellectual, "the history of this experience is a warning of what can be done."<sup>76</sup>

A more pressing matter is whether India is an argument that China *should* embrace democracy. Certainly, many a Western investment banker, conservative academic, or stability-minded diplomat has replied in the negative. But that line was increasingly being challenged in China by those who see the benefits of democracy in India. Materially, India has improved as much as China in the Human Development Index since 1980, even though it began economic reforms a decade later. On the issue of sustainability, India's entrenched and stable constitutional order, its less extreme environmental degradation, and its lesser income inequalities suggest its gains are also more

lasting. If India's impressive growth rates of the first years of the new century continue, this side of the argument will look stronger yet. Credit ratings agencies are making those points already.<sup>77</sup>

More important, there is a growing sense that India's protection of rights and freedoms and justice makes it a bigger miracle, given the obvious lack of expansion of these in China. One domestic critic of CCP rural policies returned from a trip to India in 2002 and praised the country for not unjustly forcing the burdens of reforms onto its farmers.<sup>78</sup> Likewise, the leader of Hong Kong's biggest pro-Beijing political party returned from a trip to India in February 2002 "struck by the upbeat outlook that almost everybody seemed to have" despite the country's poverty and communal tensions. "Indians," he wrote, "believe in their system of government. . . . If democracy means a slower pace of reform . . . Indians seem to recognize this as a price worth paying. . . . People do not easily find fault with a system built on common values."<sup>79</sup>

Beyond Asia, the democratic experiences of Russia and Eastern Europe have had a significant impact. Beijing's eager propaganda about the rough start for democracy there in the early 1990s had given way to grim silence by the turn of the century as the countries emerged with functioning democracies and strong economic growth. Of the 28 new democratic states created in 1989–91, 25 were considered either consolidated or moving in that direction a decade later.<sup>80</sup> Even those in China who express shock at Russia's loss of great-power status are being challenged by others who point to China's failure to achieve even middle-power status because of its political system.

Beijing's line that Russia shows the importance of delaying political reforms is today widely refuted in China by academics and some liberal leaders. A Chinese Academy of Social Sciences book on the collapse of the USSR issued in 2001 asserted that an over-concentration of power, not political reforms, caused the USSR's collapse. As one liberal writes: "Those who say the USSR and Eastern Europe show that we must not undertake political reform have got cause and effect mixed up; it was because of their lagging political reform that the system failed and resulted in collapse."<sup>81</sup>

Border effects also result from an increasingly well-organized and influential global civil society that takes democratic norms as its basic principles. This includes human rights groups like Amnesty International, labor rights groups like the International Confederation of Free Trade Unions, or democratic and legal-building institutions like the Carter Center or the Soros Foundation. The influence can be seen in an internal speech in 1992 by senior leader Luo Gan on reforming China's internal migration controls: "Some Western human rights organizations have raised this as a human rights issue,

which has seriously harmed our country's reputation. In order to take away this excuse for attacking China as well as meet our own development needs, it makes sense to reform the system.”<sup>82</sup>

As part of this global civil society, the overseas Chinese democracy movement has remained a factor in Chinese politics since 1989. U.S.-based groups like the China Alliance for Democracy, China Democracy Federation, and the Chinese Federation Development Committee push for a nonviolent overthrow of the CCP. Hong Kong, meanwhile, is home to the 1989-era Alliance in Support of Patriotic Democratic Movements of China which organizes an annual June Fourth vigil—the biggest annual political protest in the ex-colony—and to the Democratic Party, the most popular party in Hong Kong, which argues frequently and fervently for democratic change in the mainland.

Beijing would like to think, and its propaganda organs frequently write, that the overseas democracy movement is divided, weak, and discredited. Yet the positive coverage of its activities in virtually all mainstream Chinese-language newspapers and magazines published in Hong Kong and overseas gives the lie to that claim. Elitists may wash their hands of the boisterous groups. But on the ground they are invariably viewed with respect by the Chinese publics.

If the story of democracy in the nineteenth and twentieth centuries was one of closed polities in which lord and peasant battled for supremacy, political development today takes place in open polities where the peasants are backed by a militia of international forces. Border effects, no less than diplomatic policies and international economic and social exchanges, are helping China's people to cast off centuries of feudal domination. Notes one mainland scholar: “With China now joining the world political and economic systems, democracy has attracted a lot more attention from the people. Realizing a democratic reality in China is now an inevitable trend that no man can stop.”<sup>83</sup>

#### *Political Decompression*

In the Spring of 2000, an article appeared in the popular *Southern Weekend* newspaper written by Ren Zhongyi, a former Guangdong province Party chief closely associated with the pioneering spirit of the reform era. In it, the wizened Ren declared that the Party had become dictatorial and conservative. The country needed laws that applied to everyone and a parliamentary system that wielded real power, he wrote. “The people are the boss. There should be no personality cults and no dictators.”<sup>84</sup>

Two years later, a former top aide to Mao, Li Rui was making similar noises.

The Party should be subject to a new constitutional court and the national legislature should meet more often to consider laws. Freedoms of speech and assembly should be enforced, while censorship of the media should be lifted. "Only with democratization can there be modernization," wrote Li.<sup>85</sup>

While the CCP's harsh rhetoric and repression of open dissent makes it seem a formidable force, on the inside there are many signs of change. Since reforms began and with only a brief interruption after 1989, the CCP has been undergoing a quiet internal transformation that has fatally weakened the cohesiveness essential to its long-term survival. At the same time, quiet proto-democratic changes have been sprouting inside its own political institutions. This "creeping democratization" is a critical resource for change, one that disarms the Party's opposition to democratic transition and creates the institutional foundations that will help to consolidate a new democracy.

Of course, other changes have enhanced the internal vigor of dictatorship. The CCP's ideological collapse has given it more flexibility in pursuing any and all means to stay in power—including, for example, colluding with big capitalists and raising funds by privatizing state industry. Its new generation of technocratic leaders can talk the talk of modern leaders, gaining popular commendation. Professionalized army and police are more adept at crushing popular protest by deploying hi-tech tools.

But on balance, the very attempts by the CCP to appear and act more democratically while jealously preserving its monopoly of power appear to be sinking, not saving, its rule. Within the regime, the collapse of communist ideology has created a state more attuned to the needs of professional governance than revolutionary rule. One Western scholar has talked of the "quiet revolution from within" as cadres turn their attention away from political-ideological education toward attracting foreign investment, running local companies, and levying taxes.<sup>86</sup> A parallel process of professionalization driven by the demands of governance has sapped the revolutionary ethos out of the Party as bureaucrats seek to grapple with pressing needs to manage healthcare reforms, expand schools, and balance the books.

Cadres who join the Party today find that while its ideology is a "living lie," it has yet to be replaced by an alternative vision. There is no longer any moral claim on Party members, most of whom join the Party in order to boost their job prospects. In most surveys, fewer than 10 percent say they want to bring about communism. Popular perceptions of the Party as a closed oligarchy of rent-seekers hurt the esprit de corps of members. This is like the loss of social capital in society: cooperation becomes impossible because there is no longer a shared understanding of "what it's all about."

As a result, inside the Party there is now a market of competing ideas.

Various factions seek to ground their views in their own interpretations of society's needs, leading to a diversity inside the Party that reflects the diversity in society itself. The result is a polity that increasingly resembles the "authoritarian pluralism" that existed in South Korea, Hungary, or Taiwan prior to their democratic breakthroughs. Internal advocates of democratic change compete on an even footing, and gain support. Such pluralism grew quickly in the 1980s, leading to a rupture and a defeat for reform advocates in 1989. Since then, the hard-line forces have weakened considerably, symbolized by the retirement in 2002 of Tiananmen mastermind Li Peng and the demotion of his top representative to last place on the nine-member Politburo standing committee. The death of most Party veterans of the civil war has removed another significant barrier from the road to change.

One of former Party chief Jiang Zemin's top advisors admitted openly in a 2001 interview that there existed a "freedom faction" within the Party that believed in launching democratizing reforms.<sup>87</sup> That faction has gained adherents as a consensus has grown on the need to restart political reforms, stalled since 1989 and has issued several clarion appeals for political liberalization.<sup>88</sup>

The resurgence of the liberal faction was heralded in 1995 when former vice premier Tian Jiyun called for direct elections for government officials, eventually all the way to the top. "Some people want multi-candidate elections. This would be a very good idea through which the people can express their will. . . . I think this kind of system will become a trend in China."<sup>89</sup> Former Politburo standing committee member Li Ruihuan, meanwhile, echoed that appeal in internal speeches and called for partial media privatization to gird the new political opening. "This is the natural trend of the times and history," he said.<sup>90</sup> Cues like these from the top have encouraged a host of reform-minded thinkers in Party institutes like the Central Party School, the Chinese Academy of Social Sciences, and the Central Office (or General Office) to tender a number of proposals for serious democratic change.

On the opposite side, there have also been calls for the creation of a neo-authoritarian state, a dictatorship completely stripped of its ideological baggage and focused on rule of law, efficient civil service, and rule by highly educated and competent technocrats. This model is highly attractive to many regime insiders since it holds the prospect of resolving the legitimacy crisis without a loss of power. Most Party cadres, while putting political reform at the top of their agenda, want administrative streamlining and inner Party liberalization rather than a freer media or stronger legislatures.<sup>91</sup> A senior researcher in the Central Office broached the idea of a "legal democracy," in China under which the CCP would gradually introduce a Singapore-styl

democratic system ruled by laws.<sup>92</sup> Another highly publicized proposal came from a vice minister of economic reform, whose blueprint for transforming the CCP into a broad ruling party under the supervision of media, laws, and limited public participation excited much debate in 2001.<sup>93</sup>

Democrats respond that such proposals fail to solve the key problem of over-concentrated power. Others call the system elitist or unworkable. In any case, the main importance of this debate inside the Party is that it creates the very balance of forces, the pluralism, that makes the later choice of democracy more likely. In that sense, the elitist neo-authoritarians—along with the orthodox ideologues, the corrupt economic reformers, and many other factions in the Party—play a positive role in bringing about democracy because they encourage debate and fragmentation. It is, as one Western scholar noted, “evidence both of the uncertainty that haunts China’s political future and of the serious possibility that a democratic transition might be in store.”<sup>94</sup>

The impact of this pluralism can be seen in the increasingly popular and inclusive nature of political discourse. The discourse of authoritarian regimes is typically one that draws a clear line between rulers and subjects, producing an identity among people as residual subjects (like the masses, or *qunzhong*, and the “old hundred names,” *laobaixing*) outside the ruling elite. At the same time, authoritarian discourse telegraphs a strictly apolitical “unity” of the interests of the subjects (in China, the focus on the “big picture,” or *daju*, and as well as on universal concerns of “eating one’s fill,” *chibaofan*, or “raising children,” *sheng haizi*). Regime oligarchs use stylized language and a preponderance of third person nouns (the state, the people, the Party) in speeches to signal these relationships. A democratic discourse, by contrast, considers rulers as simply chosen representatives of the people (in Chinese the word representative, or *daibiao*, or even politician, *zhengke* which remained a dirty word in the CCP lexicon) and society is assumed to have its various partisan interests (another dirty word, *jubu liyi*) and personal viewpoints (ditto for *geren guannian*).<sup>95</sup>

While the complete transition to a democratic discourse awaits the transition to democracy itself, the signs of this move are already apparent. The breakdown of the authoritarian discourse in the PRC has been heralded by the likes of Zhu Rongji, premier from 1998 to 2003, who spoke in an off-the-cuff vernacular and often referred to himself and to his role as a politician. Official scholars, meanwhile, breaking from the tradition of court literati, increasingly write of the state and Party in the third, not first person, which breaks down the unified identity of the “rulers.”

In this and dozens of other ways, the CCP has created a hall of mirrors in which it can no longer focus the attentions of its members. Whatever the

news from the battlements erected against the plebians, inside the castle the knights are losing patience with the king. Talk of democracy inside the castle is seen by many knights as the way to democracy throughout the kingdom

The failing belief in the CCP's god-sent right to rule and the rise of internal pluralism are fateful changes. Attempts to replace one form of autocracy with another become impossible with so many competing interests. Two Western scholars note, in light of the internal differences which brought down communist rule in the Soviet Union, that "there is no transition whose beginning is not the consequence—direct or indirect—of important divisions within the authoritarian regime itself."<sup>97</sup> Notes one Chinese democrat: "The best hope for democracy in China is the evolution—or corrosion or split—inside the Party itself."<sup>98</sup>

Alongside this internal decompression is a pageant of new external political devices. Expanding local elections, stronger people's congresses, and various moves to entrench constitutional norms had gained wide currency by the early 2000s. Meanwhile, a gallery of outside remonstrators has restarted a lively and open debate in society on political reforms. The existence of this debate is a powerful resource for change, even if its predictive value may be limited. Just as we are looking for a "critical mass" of economic and social factors to support a democratic breakthrough, so too in politics a rumbling debate is the critical ingredient for wider systemic reform.

Village elections have been widely and rightly celebrated inside and outside China for showing the effectiveness of democracy in improving governance, not least because they are conducted among the great unwashed who elitists frequently deride as unfit to choose their leaders. By the turn of the century, 13 years after the village election law was passed, about half of the country's 730,000 village committees (representing about three-quarters of all villages) had been formed through popular multi-candidate elections. What began as a halting experiment has been embraced by peasants, who use elections to oust corrupt leaders, monitor the local Party chief, and improve governance. Party interference prompts petitions to higher level authorities, even mass resignations of village leaders. TV shows appear celebrating proactive elected village heads who confront Party officials. Border effects are evident as some candidates begin open campaigning from the back of blaring trucks, as in Taiwan. As one Chinese scholar wrote: "The country hicks who are always disparaged as being politically immature by urbanites are already electing their own leaders and enjoying the benefits of democracy. They have proven to be quick studies in the intricacies of elections and voting. Village democracy is the great starting point for the whole process of democratization in China."<sup>99</sup>

While they remain technically illegal, direct elections of governments in the country's 45,000 townships had "erupted," in a dozen places by the turn of the century. Much of the pressure is a direct result of village-level elections; peasants who have a say over village affairs demand the same say over township affairs. But there is also a welter of political reasons, from factional jostling in Beijing to local level careerism and bureaucratic rivalries. Many local cadres simply want to be on the right side of history—those in Walking on the Clouds (Buyun) in Sichuan province want to erect a sign commemorating their historic first township election of 1998.

The official endorsement of township elections, if forced on Beijing to resolve pressing governance needs, would be a major step. The sheer size of the areas—the average township has 13,000 registered voters—would require the creation of organizational structures, in other words nascent political parties. They would also require a freer press because not everyone could attend a campaign rally. In addition, the elected governments would likely leech significant responsibilities and resources from the township Party committees. No doubt this accounts for the reluctance to endorse township elections. Yet governance needs are pushing them forward anyways, heralding what would be a pivotal change in China's democratization.

The growing muscularity of local people's congresses is happening in parallel to elections. Like life in the universe, the appearance of vigilante congresses and delegates is made possible by sheer vastness, a reminder that a country's size can also be an asset to overthrowing dictatorship because of the variety of breakthrough points it can provide. Nationwide, 3.2 million people serve as delegates to people's congresses, an enormous resource for change. Of these, 3.0 million serve in the 51,000 directly elected township and county level congresses while the rest serve in the appointed congresses of major cities, provinces, and the national center. A law enhancing the powers of delegates is due to be passed by 2004. All this provides fertile soil for experimentation, just as it did in the Soviet Union where delegates to the local-level Congresses of People's Deputies began to find their voices in the mid-1980s, or in the late Qing dynasty where provincial legislatures ended up turning on the emperor.

Examples of local congresses exploding into action are now common. The congress of the northeastern city of Shenyang rejected the annual report of the local court in 2001, complaining of corruption. The Wuxi city congress stripped the local government of environmental protection powers the same year on the grounds that Party officials were involved in most of the polluting businesses. Congresses in many localities now use the term "order" (*zeheng*) rather than "suggest" (*jianyi*) when they comment on government policies, a

signal that they are taking their promised legal status as “the highest organ of state power” seriously. The congresses are now awash with “political entrepreneurs” who are redefining the meaning of the bodies from tools of regime legitimization to tools of popular control.<sup>100</sup> Thus in a strange way, life is imitating art. The pageantry of democracy created by the Party to legitimate its rule is transforming into democracy itself. Since the congresses have both the constitutional and the moral high ground, the Party finds it cannot control its own creation. As the stature of the congresses grows, so does pressure to democratize them. Even conservative scholars agree that all the congresses should eventually be directly elected, even the national congress. As a frightened Party submits to the “supervision” of the congresses, it raises doubts about who the Party is supposed to represent, and why it alone holds power.

Surrounding all the institutional changes is a more general public debate about political reform. This is both a stimulus to institutional innovation as well as a result of it. Through it, scholars, journalists, and reform-minded officials have been able to set the agenda for political modernization in the country, portraying the Party as unwilling or unable to change. We can group commentators into two camps: constitutionalists and transformers.

The constitutionalists favor a gradual build-up of democratic foundations within the existing party-led system. They are the children of the great legacy of “change within tradition,” in the Chinese state that goes back to the imperial era. Taking their role as remonstrating with the emperor on his own terms, they seek to guide him onto an enlightened pathway. In the PRC, that means reminding the leadership of the democratic laws and goals that remain in the political canon. This includes expanding direct elections for governments, empowering the people’s congresses, enhancing the independence of courts, and liberalizing the internal administration of the Party.

The constitutional camp includes both “romantics” who believe such moves would consolidate CCP rule and “strategists” who believe it is the best way to undermine it. The romantics are concerned to stay ahead of the wave of change, preserving their perquisites while maintaining legitimacy. The strategists see internal reform as a more plausible path to CCP demise than external overthrow. Their idea is to recognize the CCP as a monarchy in a constitutional system while limiting its remit in government affairs in the interests of better rule. This would bring China closer to democracy even if the Party—like a Latin American military—is allowed to remain as “the power behind the throne.” While awaiting the day when the CCP’s ultimate prerogatives can be ended, this would also provide an important foundation for democracy by implanting the norms of constitutional behavior.

In the schizoid political atmosphere of the PRC, many activists dart unwittingly or not between the two poles of constitutional romanticism and strategy. But in the end, as we shall see in part 2, the difference may not amount to much. A drastically reformed CCP that managed to hold power in democratic elections would satisfy the wishes of moderates on both sides. Indeed, an argument could be made that the constitutional path is exactly the one that the CCP set out upon after Tiananmen, rejecting immediate change but embracing a host of fundamental changes in the relationship of the Party to state and society that took China closer, though still far, to the constitutional ideal. Citizens gained more legal rights and more control over social and economic life, the state was more constrained by the law and more professional in its behavior, the military was almost entirely removed from politics, and the Party showed signs of weariness in running the nation's life. Like the traffic cop of our earlier metaphor, it appeared worn down by the burdens of authoritarian rule. Hu Jintao urged a "comprehensive implementation" of the constitution shortly after taking over as Party general secretary in 2002, adding that "no organization or individual can have special powers overriding the constitution and the law." Little surprise that many already look to a post-CCP China.

Alongside the constitutionalists are the transformers, political reformers who urge more radical surgery on the body politic of China. Their main appeal is for a rapid transition to free and fair elections of all governments. "Ruling out direct elections might be accepted by people for a short time but as time goes by, this prohibition will increasingly not wash," note a group of Shanghai scholars.<sup>101</sup>

Of course, this group lives on the edges of official tolerance. In the late PRC era, Beijing held about 3,500 people prosecuted under the State Security Act plus at any given time about another 50,000 in three-year labor camp sentences for "disturbing public order." After initial tolerance, the Party crushed attempts by activists in the late 1990s to establish nascent opposition groups like the China Development Union and the China Democracy Party. But by the first decade of the new century there was a surprising amount of space for open debate on political transformation, such as existed in late-authoritarian Indonesia or Taiwan. As long as they did not use the phrase "overthrow the CCP" or seek to establish formal organizations, the transformers were free to make their point. Consider this quotation from a public magazine in China:

The precondition for competitive elections within the Party must be that the ruling party allows competition among parties. If the Chinese Communist Party does not allow other competitive parties (jingzheng-

xingde dangpai) to exist, then it will lack internal competitiveness and the pressure to reform itself. Like every other organization, the Party can only become competitive in a competitive environment. At present, the [officially approved] democratic parties are not competitors and so cannot help the CCP to become more competitive. Can't we let them be more independent and compete with the CCP? Leadership is service [Mao said] and in any service you should have a choice. The CCP represents the interests of the greatest number of people so it should be confident that if it sticks to the truth and corrects its errors it can win victory in a multi-party competition.<sup>102</sup>

As more and more of a real “opposition” emerges in society among the constitutionalists and transformers, a real political system of “democrats” and “the regime” is emerging, the very polarity whose existence was so critical to democratic breakthroughs in countries like Russia and Poland. As with the wider community of intellectuals, artists, crusading journalists and jailed dissidents, it is not a question of whether they have the power to overthrow the state. In China as elsewhere, as we shall see, they almost certainly do not. Rather their influence is a more subtle one. They create a market of ideas and empower reformers inside the regime.

Thus the stage is set. Democracy as practiced throughout the world has proven to be the best known means of organizing political activity. It transcends cultures and conditions for the simple fact that it is sensitive to all. China's people have struggled to throw off the chains of dictatorship for more than a century. As the century turned, the possibilities for transition were immense. Society widely recognized the need for fundamental political change, and was for the first time in a position to bring it about. “The tragedies of China's history and of the lives of Chinese people have generated problems and issues which have forced Chinese liberals to try to bring democracy to China,” writes one mainland scholar.<sup>103</sup>

There is an unprecedented opportunity for breakthrough. How will it happen?

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# **China Into the Future**

## **Making Sense of the World's Most Dynamic Economy**

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#### **Library of Congress Cataloging-in-Publication Data:**

ISBN 13: 978-0-470-82244-9

Typeset in 12-13 point, Perpetua Regular by Superskill Graphics Pte. Ltd.  
Printed by Saik Wah Press Pte. Ltd.  
10 9 8 7 6 5 4 3 2 1

# China: Socio-Political Issues

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## Introduction

In recent years, the policy contours of the Hu Jintao–Wen Jiabao leadership have become clear. The main thrust is a form of populist authoritarianism, with policy gestures to those who have not benefited as much as others from China's reforms to date combined with attempts to tighten control over state and society, in the name of preserving social stability as the key foundation for continued economic growth. There is no evidence to suggest that President Hu intends to introduce the kinds of political liberalization that some had hoped for before his appointment. From the outset, the new leadership has strived to show that they were leaders of a different stripe, concerned about the rural and urban poor and determined to get to grips with the inequalities

that have accompanied reforms. It was noticeable that Hu and Premier Wen's pre-and post-promotion visits were not to the glitzy cities of Shanghai and Shenzhen, but to the poorer parts of China, including the rural base areas where the CCP built its pre-1949 support and which provided the launch pad for it to take national power.

There are three significant discontinuities and one continuity in the Hu-Wen policy emphasis compared with the previous leadership of Jiang Zemin. First, current policy is more people-centered and populist. There has been a noticeable shift in the discussion of economic policy, with a greater emphasis on sustainability, the quality of growth, and dealing with the significant inequalities. Second, Hu is more orthodox in the political realm than Jiang. There is no doubt that the atmosphere has become tighter under his leadership. Hu has emerged to date as a strong Leninist leader who has sought to clamp down on dissent and to limit the range of ideas expressed in the public sphere. A more optimistic interpretation might be that this stance is necessary for Hu to consolidate power by showing his conservative credentials—before adopting more liberal reforms once his power is consolidated after the next CCP Congress. Both Deng Xiaoping and Jiang Zemin moved to the left on occasion to shore up their position, and after Jiang consolidated his position he became more sympathetic to loosening control over society and talking about political reform. However, there is a general sentiment among reformers that Jiang often mouthed "leftist" sentiments out of necessity; he did not really believe them, whereas Hu does and is a strong believer in Leninism. Third, Hu does not share Jiang's pro-U.S. disposition in foreign affairs. Essentially whenever it was politically feasible, Jiang tried to move China to a position of accommodation with U.S. interests and established his foreign policy in terms of the relationship with the U.S. By contrast, Hu seems much more suspicious of the U.S. and its intentions and has tried to build

alliances with other countries and to build linkages with countries that are not close to the U.S.

One continuity with the past is the belief in the paramount position of the Party in the system and the idea that only the Party can be trusted to carry out reforms. Hu has continued Jiang's policy to reassert Party control over as much of state and society as is feasible. The reforms of the late-1980s to separate Party and state were rolled back after 1989 and have not been seriously discussed since then. **Hu clearly does not trust the state to carry out effectively Party policy** (and in this he might be correct).

Thus, in the absence of external shocks, policy direction is liable to follow along these lines, until a new generation of leaders can consolidate their power in a decade or so. **However, the key question is whether simply trying to crack down on dissent, eradicating political alternatives, and placing primacy on maintaining social stability will be sufficient to deal with the issues confronting the Party over the medium-term.** It is clear that unrest is increasing, particularly among those who have had their land seized in the countryside, or have been charged exorbitant illegal fees, or have not received their pay, or who have been deceived by employers defaulting on pension obligations. Incidents of unrest have been responses to corrupt and illegal actions by authorities, and this combined with significant government corruption have fuelled social unrest. The central leadership is aware of this, and has responded with calls for better and more transparent government and for the Party to monitor itself and the government more effectively. However, without allowing any external monitoring, the effect will be limited. The key question is whether the Party can develop the governing capacity to deal with these multiple challenges or whether the disturbances will reach such a level that the politico-administrative system will be overwhelmed.

## Key Socio-Political Issues

First, we outline four social issues that have evolved into acute policy challenges in China. Second, we look at leadership responses and constraints on political reform, before concluding with three scenarios for future developments.

### *Social Developments and Issues*

During the reform period, China has undergone four sets of transitions that have shaped socio-economic evolution. First, it has moved its workforce from low-productivity agriculture to higher-productivity manufacturing and service work, following the pattern of universal development, including that of its neighbors in East Asia. Thus, there is nothing magical about the economic development of China other than it was retarded for so long by faulty Maoist policies. Second, unlike its East Asian neighbors, China has undergone a second economic transition from a planned economy to a more market influenced economy. This has brought enormous benefits, but also has created new problems of unemployment, as inefficient state-owned enterprises have closed down or shed workers. Third, during these double economic transitions, China has undergone a demographic transition from a very young population to a quickly aging population. This has major consequences for dependency ratios and the number of elderly who will have to be supported in the future. Fourth, there has been a transition from reliance on the collective to a belief in the individual. Socialism rests on the principle that the individual can derive more from the collective than he/she can by working alone. Markets place individual choices and their regulation at the center. China's reforms have seen a shift from the collective as the organizing focus to one based on individual choice. This creates a problem for the Party as its ideology is based on the former

premise and it cannot offer effective guidance in the new society. The resultant conflicted morality—a raw capitalist outlook with the rhetoric of an existing socialist system—presents a problem for future leaders, as there is no civil society that might provide a bond in the event of CCP collapse.

For the individual, this contradiction creates confusion as official rhetoric bears little resemblance to reality as lived on the streets. The result is distrust of government, an attitude of putting oneself first, and a subsequent moral vacuum.

Out of these transitions four pressing issues have arisen.

### **Demographics**

With China's rate of population growth declining significantly, the population is aging rapidly, presenting rising pension and medical obligations and severe problems for care of the elderly. In some rural areas, there are serious gender imbalances that will lead to a high number of unmarried males (see also Chapter 3). The future population will be increasingly urbanized, as surplus labor is moved off the land, leading to the question as to whether employment can be generated sufficiently quickly to prevent unrest.

China's stringent family planning policy has been geared to limiting population to 1.6 billion by 2050. The birth rate dropped dramatically from 33.43 per 1,000 in 1970 to 12.40 in 2005, with a corresponding drop in the natural growth rate from 25.83 per 1,000 to 5.89 per 1000 in 2005. Mortality rates have also been dropping and stood at 6.51 per 1000 in 2005. The overall trend will not significantly impact on aggregate economic growth, but there will be other important effects due to the changing structure of China's demographics.

First, the population will age significantly. Research has shown that, for example, there are links between aging populations and savings rates. Overall, China's median age will increase 13.8 years

during the first half of this century. With a lower fertility rate there will be a lower domestic savings rate, but there will also be a higher return to labor because of its relative scarcity and a lower return to capital. China will be the first society to grow old before it grows rich. At the end of the twentieth century, China officially entered the aging stage in terms of internationally recognized criteria, with 10% of its population over 60 years of age. By the end of 2005, there were almost 144 million people over 60, accounting for 11% of the population. A total of 16 million were aged over 80.

Second, China will grow old while continuing to industrialize and urbanize with the consequence that there will be an even greater need to maintain rapid and sustainable economic growth. According to the China National Committee on Aging, those over 60 years of age will account for an estimated 16% of China's population in 2020 (248 million) and 31% (437 million) in 2050. The population over 80 years old is expected to reach 22 million in 2020 and 83 million in 2050. The rise in the number of aged will put tremendous pressure on medical expenditures. An aging population will also bring serious consequences in terms of dependency ratios and pension obligations that the state will have to meet. In 2000 there were 15.60 people over 60 years old for each 100 at work and this is predicted to rise to 29.46 in 2025 and 48.49 in 2050. The ratio of the working to non-working population is also dropping fast, from 6:1 in 1991 to a projected 2:1 by 2020. Thus, whereas pension contribution rates for workers were only 3% of payroll when China began this system in 1951, they had risen to 20% by the mid-1990s. Unless something is done (and certainly policy will change), by 2033 Chinese estimates suggest that payroll rates of around 40% will be needed to fund pensions. Pension non-payment has been a key cause of urban protest and the image of the new leadership as a "caring" government, which Hu Jintao and Wen Jiabao have sought to project, will be severely damaged by not looking after the nation's pensioners.

In addition to aging, another adverse consequence of the one-child policy has been a distortion of male-female ratios. The 2000 census reported the ratio of males to females as 106.74:100, or 41.27 million more men than women. However, at birth the ratio was 119.92:100 and by age four it was 120.17:100. In some counties the reported discrepancy between female and male children was alarmingly large. Jiangxi and Guangdong had ratios of 138.01:100 and 137.76:100 respectively with rural Guangdong at a rate of 143.7:100. This clearly indicates a strong trend to further imbalance in the ratio over the next 10 to 15 years and beyond. Ratios like these mean that at least 1 million men per year will not be able to find a marriage partner, while the *South China Morning Post* (25 August 2003) suggested that there could be as many as 100 million Chinese bachelors by the year 2020. This will drive up the bride price in the rural areas and will result in increased illegal trade in women and in prostitution. The thought of large numbers of males who cannot find a bride and drifting into cities looking for work is a potential cause for unrest, and the increase in clientele for commercial sex workers will increase the potential for the spread of HIV/AIDS.

Over the next decade, urbanization will proceed apace with an estimated 300 million to 500 million people expected to migrate from the rural areas to towns and cities by 2020, providing an urban population of around 800 million. Urbanization is seen as the best way to provide a long-term solution to the problems of inequality that stem primarily from urban-rural differences. In world terms, China is "under-urbanized" as a result of controlled urbanization and the household registration system. In rate of urbanization, China lags behind several transitional societies, such as Hungary (64%) and Russia (73%), as well as the remaining socialist countries Cuba (75%) and North Korea (59%). Meeting the urbanization goals of shifting at least 300 million to the cities and suburbs will present major challenges for the government in terms of investment in urban infrastructure and planning. It will also present significant

challenges for job creation. The programs for infrastructure will provide employment opportunity, but whether the manufacturing and service sectors can be expanded sufficiently to deal with this expanded urbanization and accommodate the estimated 150 million to 200 million surplus rural laborers remains to be seen.

### ***Employment***

The future employment trend for China will be to boost the underdeveloped service sector of the economy as a part of the process of urbanization. Yet, a recent World Bank study suggests that China needs to maintain a 10% growth rate in order to provide sufficient employment opportunities. This is above the Chinese government's stated desire to regulate GDP growth at around 8%, a target it has failed to meet in recent years as growth has repeatedly topped 10%.

There is a range of estimates of unemployment in China. Official figures show registered urban unemployment rising from 3% (6 million) in the mid-1990s to only 4.2% (8.4 million) by 2005, despite employment in the state-owned enterprises (SOEs) sector dropping by around 40 million. These figures exclude those who have not registered as unemployed, including the large number of workers "laid off" (*xiagang*) by still functioning SOEs. Thus, a more realistic estimate for the real urban unemployment rate was 9.36% for 1997 and 12.3%<sup>1</sup> for 2002. Even this does not take into account the 150 million to 200 million more surplus rural workers acknowledged by China's leaders.<sup>2</sup> Scholars at the Rand Corporation estimated an open and disguised unemployment rate (urban and rural) of around 23% or 170 million.<sup>3</sup> In any case, unemployment is a more important issue than the official figures suggest.

Not surprisingly the unemployment is worse in the Northeast and the West, homes to much heavy and manufacturing industry.

It is clear that the state sector will never again be the main engine for urban employment, either for those laid off or for the estimated 11 million to 12 million new entrants each year on the job market. Even with an improved growth rate, increases in employment generation have been dropping as enterprises have been forced to become more efficient. Employment growth over the next decade is projected at 1.4% per annum, slightly up from the 1.1% in the 1990s, but well below the annual employment growth of 4.2% in the 1980s.

There is a clear policy priority to expand other avenues for employment growth, but producing sufficient jobs will remain a major headache for China's leadership over the next decade. According to official accounts, SOEs shed 3 million jobs a year until 2006. Tian Chengping, Minister for Labor and Social Security, reported in a September 14, 2006 speech that China needed to create 24 million urban jobs per year to absorb the new labor force, including migrants and college graduates, but was creating only around 11 million jobs per annum. Lu Zhongyuan of the Development Research Center of the State Council does not see the employment pressure alleviating for 20 to 30 years. Yet while the former major sectors of the economy have been shedding jobs, the more vibrant sectors of the economy are prevented from sufficiently rapid expansion because of the lingering state bias against the non-state sector of the economy. How destabilizing these trends will be depends in part on the continued growth in the economy, the ability of the non-state sector to generate sufficient employment, and the capacity of the authorities to keep unrest in check.

The best option for employment growth is the service sector, which in China employs a smaller percentage of employees than other countries at a similar level of development. Allowing effective foreign investment into this sector could generate a boom of 40 million to 50 million jobs. The other main option for employment expansion is enhanced development of the private

sector. Geographically, private enterprises are heavily concentrated in the coastal areas with Jiangsu, Guangdong, Zhejiang, Shanghai, and Beijing home to 54% of the national total, and the Western provinces with only 14%. It is clear that those cities and provinces with a higher growth rate and standard of living are also those with a higher level of private enterprise. For example, in Wenzhou and Taizhou, where the private economy is dominant, there is little unemployment, in contrast with towns like Mudanjiang in the Northeast that are dominated by old SOEs.

### *Inequality*

Such employment and demographic trends have inevitably fed into increasing inequality in China and to the creation of new pockets of poverty. China's post-Mao development strategy has consciously eschewed social equity and sought to use inequality as a stimulant for economic activity and growth. There is a clear urban bias to development, as well as a coastal bias, and a conscious exclusion of migrants from integration into many urban services.

Inequality has been rising under the reforms, with the Gini coefficient rising from 0.33 to around 0.49. This means that China has shifted from being one of the more egalitarian countries in Asia to becoming one of the least. Not surprisingly, wealth has become more concentrated. In June 2005, the National Statistics Bureau noted that the 10% most affluent households in the country enjoyed 45% of the country's wealth, while the poorest 10% shared only 1.4%. The disposable income of the richest group was 11.8 times greater than that of the lowest 10%, up from 10.9 times a year before. For a country that still describes itself as socialist, these trends are difficult to justify and could provide an easy rallying point for the opposition. The Ministry of Labor and Social Security even stated that the growing income gap was likely to cause instability by 2010 if no effective solutions were found.

Inequality in China goes beyond just income to include access to public goods and services. Access to health and education services was still widely available in the 1980s, but became more dependent on income in the 1990s. For example, in 1998, 22.2% of those in high-income areas were covered by cooperative medical facilities, but only one to three percent of residents in poorer areas were covered. With rising health costs, it is not surprising that illness is one of the most cited reasons for poverty among the poor, something exacerbated by the collapse of the pre-paid collective medical system with the disbanding of the communes in the early 1980s. As a result, some 90% of rural households have to pay directly for almost all of the health services used. Thus, not surprisingly, illness has a close correlation with poverty.

Given such problems, it is not surprising that poverty is another major issue for China. The Asian Development Bank (2001), using the norm of USD 1 per day in purchasing power parity (instead of China's figure of USD 0.66) and the preferred consumption norm, suggested China had about 230 million poor residents, some 18.5% of the population. If one applied a norm of USD 2 per day, the number was 53.7% of total population. This put China roughly on a par with Indonesia (15.2% and 66.1%, respectively) and considerably better off than India (44.2% and 86.2%, respectively). Despite rapid economic growth, Chinese officials acknowledged in May 2004 that 56.17 million residents were living on below USD 1 per day and officially some 23.6 million were living on below USD 0.85 per day at the end of 2005. On the other hand, the World Bank estimated that some 135 million people, nearly 10% of China's population, were living on USD 1 per day in 2004. Official Chinese poverty statistics do not cover urban China, but the number of urban residents who received the minimum subsistence support was 22.34 million in March 2005. Such figures clearly underestimate urban poverty and do not include the migrant population.

What such figures reveal is that despite tremendous progress, China still confronts a number of policy challenges moving forward. First, there is a significant group of rural poor who have not responded to policy measures, market openings, and the benefits of "trickle down." Second, there is a very large group that is vulnerable to economic downturn and liable to recidivism. Third, there is a smaller but rising number of urban poor whose poverty is the product rather than beneficiary of reform.

Does the inequality matter? Yes, for both economic and political reasons—and while a certain rise in inequality is inevitable, some has been the result of concrete policy choices. There is a general consensus among economists that rising inequality can be detrimental to long-term economic growth. In China, a major focus of future development strategy will have to be consumption-driven growth and this will require better integrated domestic markets and a more equitable spread of purchasing capacity. The lack of access to adequate education and health facilities will also retard growth by denying effective opportunities to many of China's young. Last but not least, there is political risk associated with this strategy as the Chinese leadership still claim to be socialist and to represent all sections of the population. The inequality, particularly if it becomes a major cause for unrest, could be a rallying point for opposition. The current leadership has tried to address these concerns through populist measures to raise rural incomes, provide free rural education, and to provide support to those badly affected by lay-offs in the West and Northeast. However, these rising pressures for redistribution can heighten inefficient allocations of scarce resources through the state sector in order to provide what can only be short-term benefits at the expense of sound long-term growth. Jiang Zemin's plans to develop the West and Wen Jiabao's strategy to revive the Northeast largely through transfer payments and state support are good examples of this.

### **Social Unrest**

Given the trends outlined above and the tremendous scale of transition that China is undergoing, it is not surprising that social unrest is on the rise. In fact, the government's stance encourages people to be unruly when they have a grievance. Since the political system lacks effective channels to express genuine grievances, citizens are driven to extra-legal means such as demonstrations and strikes. The overwhelming concern for the central leadership to maintain social stability makes the situation worse. Given that the origins of most social unrest lie with the illegal actions of local governments or those with powerful connections, citizens are unlikely to receive redress through official channels that are controlled by the local Party bureaucracy. This reduces options to either sitting at home peacefully waiting for redress that is unlikely to come, or taking to the streets and creating a public disturbance that will get the attention of government at higher levels. If the disturbances receive sufficient attention, then the higher levels are liable to direct their subordinates to resolve the issue swiftly in order to maintain public order. This resolution could be repression, buying people off, or actually solving the problem. The chance of achieving a result through civil disorder is higher than simply waiting at home for an enlightened leader to come by.

At present, the protests are not a threat to regime survival as the vast majority are not overtly political, and derive from economic grievances that are a product of the reforms. Major causes of unrest are industrial restructuring, financial pressures on local governments that lead to illegal levies, manifest increases in inequality, and high-handed behavior of local officials. Respondents' attitudes in a national survey conducted across China by the Kennedy School of Government in the Fall of 2003 about the way policy is implemented by local governments should raise concern. Irrespective of place of residence, the general view among respondents was that, when implementing policy, local

officials and governments are mainly concerned with their own interests, are more receptive to the views of their superiors rather than those of ordinary people, favor those with money, and are formalistic in implementing policy rather than dealing with actual problems. These feelings are held even more strongly by those living in villages than those with an urban household registration. For example, in our sample, only 19.7% who live in villages think that local governments bring benefits to ordinary people when implementing policy, while 52.6% see them as mainly concerned with their own interests. In major cities, 41.4% felt that policy execution favored those with money, while only 39.3% thought that it took care of individuals in difficulty. By contrast, in the villages these percentages were 54.7 and 23.6 respectively. Clear majorities also felt that when implementing policy, local officials sought to move closer to their superiors rather than thinking about looking after ordinary people.

In the urban areas, most collective protests have come from the forced demolition of homes for redevelopment, the failure to meet payments either for salary or pensions, or from lay-offs. In the countryside, the main bones of contention have been the imposition of illegal fees, land seizures, and resistance to unpopular policies such as family planning. What has been interesting in the recent period has been the rise in protests because of environmental issues.

The levels of unrest have been increasing and have created concern among China's leadership. According to the Ministry of Public Security, there were 58,000 recorded protests, or "mass incidents" in China in 2003, 74,000 in 2004 (involving 3.76 million people), and 87,000 in 2005.<sup>4</sup> This increase of discontent was not restricted to protest alone. In the first quarter of 2005, the State Council Petitions Bureau in Beijing reported an increase of over 90% in the number of letters and visits requesting government redress of grievances compared to the same period the previous year. However, it is apparent that the senior leadership does not

know how to respond effectively. The leadership has recognized that, on the whole, the protests are not political and do not deserve a harsh response. For example, Minister Zhou, while calling for vigilance, noted that "extreme measures" should be avoided and that the problems were "internal conflicts among the people." Even more remarkably, Chen Xiwen (who oversees agricultural policy), while criticizing violent protest, saw the rural protests as a sign that farmers were recognizing how to protect their rights and interests. That said, there is no doubt that the leadership remains concerned about the possibility of unrest getting out of hand and will seek to repress such incidents. This was forced home by a *People's Daily* commentary on July 28, 2005 that warned that no illegal attempts to disrupt social stability would be tolerated, and that the protection of stability comes before all else. Also, the leadership has curtailed the right of citizens to petition the central government directly. Combined with the message that conflicts should be resolved through the existing system, this is not encouraging and puts considerable power in the hands of the local authorities—who have been responsible for much of the disturbance in the first place.

## **Developments and Milestones**

### ***Prospects for the Future***

These issues have caused the central authorities to respond through the kind of populist authoritarianism noted above. Without external shocks there is no reason to believe that this policy approach will change. It will affect, however, the general attitude to economic development and policy choices. As noted, the leadership has tried to introduce policies that benefit those who have not benefited as much as others from reform, such as dropping the agricultural tax on farmers and subsidizing agricultural production. This is a

major policy shift, but it is leaving local governments strapped for cash and they will resort to other measures to raise funding, which may well increase social unrest. Thus the problem of funding local governments will be exacerbated by measures that have been introduced to alleviate rural poverty. In March 2005, Premier Wen announced that school fees would be abolished for 14 million students in the poorest counties and by 2007 all rural students would receive free primary education. In August 2005, the central government decided to expand the pilot program to provide subsidized healthcare to rural residents. The central government was to expand its subsidy to 20 per *yuan* per person per annum and local governments were to increase their contributions similarly. In the same month, the State Council announced that the threshold for individual tax payment would be raised to 1,500 *yuan* from 800 *yuan*.

Unfortunately, the system needs more extensive structural reform and better representation for disadvantaged groups to make such measures effective and sustainable. Stopgap measures that are introduced should not be at the cost of productive investment. China's investment patterns and preferential fiscal policies have favored the coastal regions at the expense of the interior, while formal credit access is highly biased to capital intensive SOEs, and rural net taxes remain highly regressive. To change this situation would require a major reallocation of resources that, in turn, would require a significant shift in political sentiment. Despite the campaign to establish a "comfortable" (*xiaokang*) society since the Sixteenth Party Congress (November 2002), and Hu Jintao's and Wen Jiabao's populist disposition, a major reorientation is unlikely, given the structure of political power. The 16<sup>th</sup> Politburo, like its predecessor, has a strong provincial representation, but essentially represents the richer, coastal areas of China. Upon its election, it looked as if there was a limited attempt to appoint some leaders from the inland areas, but subsequent personnel shifts have taken away that illusion. Despite the campaign to develop the West,

Sichuan, the most important province in the west of China still enjoys no representation at the highest levels. The Party Secretary of Xinjiang does have a place on the Politburo, but this has more to do with the center's intent to maintain its territorial integrity and to resist any moves for autonomy rather than to address issues of poverty and inequality. This means that for all intents and purposes the current Politburo resembles its predecessor, with major municipalities (Beijing, Tianjin, and Shanghai—at least until the ouster of Shanghai Party Secretary Chen Liangyu over corruption charges in late 2006), and the wealthy coastal province of Guangdong enjoying representation, while the inland and poorer areas of China are excluded. This is unlikely to change in the future. Given this, one may presume that policy will continue to be biased in favor of the "haves" while rhetoric will continue to be paid to the needs of the "have-nots."

Is meaningful political reform likely under Hu? While hope springs eternal and observers both inside and outside China expected significant political reforms to be introduced at the last two Party Congresses, they have been disappointed and are likely to remain so. It should not be forgotten that the primary purpose of the CCP is to remain in power for as long as possible and its leaders are not going to introduce any changes that might threaten their position and foment instability. This viewpoint has been strengthened not only by their own domestic challenges in 1989 (and the split that these caused within the Party elite), but also by their observations of post-Soviet Russia and the problems that they feel market economics and democratic politics have brought. In particular, the fall of Suharto in Indonesia and the "color revolutions" in former Soviet satellites have caused many in the elite to re-think any significant political opening. The message seems clear—keep economic growth booming and a tight lid on any potential dissent.

Despite long-term benefits that would come from significant political reform in terms of ameliorating corruption, providing

institutionalized outlets for dissent and protest, and increasing transparency, there are strong countervailing pressures. First, China's leaders interpret democratic reforms as essentially destabilizing, undermining both social stability and economic growth. It is important to remember that the bottom line of CCP legitimacy is its capacity to deliver the economic goods. It has sought to buttress this with a strident nationalism that is popular with urban elites and through reliance on reviving traditional Confucian views toward benevolent authority.

Second, the Party's monopoly on power allows it to dispense patronage, fuelling the corruption that is a feature of contemporary Chinese political culture. Gradualism in reform has brought significant economic benefits, but has allowed the Party to co-opt new elites into the power structure, thus reducing external pressure for political change. The Party is now seen by many as a bastion of privilege that represents the new haves over the have-nots.

Third, the Chinese system is extremely decentralized and it is often difficult for the center to control activities of local officials even if they should wish to. The theft of state assets, the corruption, and the use of official position to pursue private wealth are all most marked at the local levels of government. Thus local governments have little incentive to make their activities more transparent or accountable to the public at large.

Fourth, with rapid economic growth continuing, the new urban elites appear to have little interest in more democratic reform. Not surprisingly, as they have fared well under the existing system, they see no compelling reason to change it. There is no strong constituency that favors political change. Private entrepreneurs benefit from connections to the Party, or indeed may be former Party officials themselves. The laid-off workers are politically marginalized and while there has been an upsurge in farmer protest there is no evidence that the protests have gone beyond the local realm. Indeed, most evidence supports the view that the protestors retain trust in the national leaders and see the

problems as purely local aberrations rather than systemic flaws. Our 2003 survey showed continued high levels of support for national leadership, but this dropped dramatically as government got closer to the people. Of the respondents, 86.1% expressed the view that they were relatively or extremely satisfied with the government work and the level of service of the central government. This dropped to 75% for the provincial level, 52% for the district and county, and to only 43.6% for the township, village, or neighborhood committee. This is important as it is distinct from many developed economies, where satisfaction levels tend to rise as government gets closer to the people, indicating that people feel that they have greater control over the decisions of local government and may be able to influence local policy and resource allocation.

### *Future Scenarios*

Future scenarios for China depend to a large extent on the capacity for the economy to keep developing smoothly. While economic growth will slow eventually, over the next five to ten years there is no reason why rapid growth cannot be maintained if correct policy choices are made. Growth should come down to around 6% by 2015 and between 4% and 5% by 2025. However, the Chinese economy is more integrated into the world trading system than ever before and this makes it more vulnerable to general trends within the global economy: a major slowdown in the U.S. economy or rapidly rising prices for natural resources could cause problems for the Chinese economy.

Domestically, the unrest that is local and isolated at the moment could always boil over into a major conflict between state and society. It should be noted that the Chinese economy does not need to slow by too much before the state will lose its capacity to dispense largesse to its followers and for the costs of

buying social peace to become problematic. There are a number of potential scenarios for China's political future and one cannot rule out systemic collapse, even though this seems least likely. History does not offer much comfort for a peaceful transition as communist regimes, unlike some other authoritarian systems, have only changed with the collapse of the *ancien régime*. There are two potential causes that could trigger systemic collapse and while both are possible they are not probable in the foreseeable future. The first would stem from economic collapse. While there are systemic distortions in the economy and an extremely vulnerable banking system, wise policy choices should ensure continued high levels of economic growth over the next decade. The second catalyst would be if the social tensions and inequalities led to sufficient unrest to force the leadership to undertake significant political reforms in order to retain control. Here we shall just sketch three possible scenarios.

1. The most likely scenario over the short to medium term is a continuation of the politics of muddling through. Bold initiatives are unlikely. An essentially technocratic approach will prevail, while the leadership tries to maintain an authoritarian political structure combined with growing economic liberalization. Minimal reform is likely in the political system, with a continued focus on strengthening the legal system and building capacity and skills within public administration. The main potential for promoting reform would lie with the ability of people and organizations to exploit the deliberate vagaries of official pronouncements to experiment with cautious reform initiatives. Here the national consensus will be weak, and the corruption will continue, as will the lack of social cohesion. The Party would still flirt with a strident form of nationalism in order to bolster the national consensus. This will mean that frictions with the U.S. and Japan will

continue and any genuine rapprochement is unlikely. Policy will continue to balance the tensions between appeasing the new economic elites and trying to provide support for those who have been left behind by the reforms.

2. This scenario would see the leadership responding to the increasing diversity in society and the rising protests by moving to accommodate with society and to try to form a new social compact. Instrumental in this process would be a re-evaluation of the events of 1989 and a return to the reform agenda put forward by Zhao Ziyang in 1987. Optimists would like to see China following in the footsteps of its East Asian neighbors with a transition to "soft-authoritarianism" followed by a democratic breakthrough ensuing as a natural corollary from economic growth. This would be a beneficial scenario not only for many in China but also for the international community, as the new leadership would adopt a much more friendly posture to the U.S. and Japan, and it would lead to considerably reduced tensions over Taiwan, providing a potential route to reunification.

For the reasons outlined above, this does not seem likely. It would require a segment of the ruling elite to be willing to break with the old system and to form a new compact with progressive forces in society. One could argue that there was such an opportunity in 1989 but that it was rejected by orthodox Party members. Some argue that economic growth is creating a middle class that will support change and that the increase of marketization will cause the rule of law to be taken more seriously. However, it is hard to see what would cause the current elite willingly to reject the current system.

3. A third scenario would see the current leadership becoming sufficiently disturbed by the potential for unrest and by what it interprets as U.S. attempts to isolate it internationally that it would adopt a more xenophobic nationalism combined with an inefficient authoritarianism domestically. In this case, the Party would be dominated by the new elites who would read any opening up of the political system as leading to an erosion of their privileges and benefits. The CCP maintains that without it chaos would ensue. By consistently cracking down on alternatives and restricting the growth of a vibrant civil society that could form the basis for a new system, the CCP has created the possibility that an “uncivil society” might take power—the most probable outcome would be rule by the new economic elites backed by the military, in the name of preserving social stability and national sovereignty. A strident nationalism might provide a minimal level of social glue to give the new regime a residue of support. A more likely variant would be the emergence of a pre-democratic Latin American-style political system. Under this scenario the inequalities would continue to rise, with the Party becoming the preserve of the elites and with their power backed up by the military. The lack of political reform would produce a permanent underclass in both urban and rural China that would be portrayed as a threat to stability and continued economic progress. The Party-dominated State would be in continual friction with society.

#### *Milestones in the Political Calendar*

A number of milestones in the political calendar will provide some indications of where China is going in the future. The 17<sup>th</sup> Party Congress in September 2007 will mark the expected mid-point

of the Hu-Wen leadership and will be the CCP Congress where they can have the most impact over the future direction of China. Most important will be the leadership promotions that take place, as these will give a good indication of both policy direction and also who the successors to Hu and Wen are likely to be. However, we should not look for all the promotions to be from the Fifth Generation of leaders as there are still those in Hu's own generation who could be promoted into the Politburo at this time.

The 10<sup>th</sup> National People's Congress will be held in March 2008. This Congress will introduce the next five-year development strategy and will provide an opportunity to assess how ingrained Hu and Wen's emphasis on equitable and sustainable growth has become. Traditionally in China, the lead up to the formation of a new Five-Year Plan has been a time when leadership tensions have come to the fore and have spilled out into the public arena. While policy differences can be papered over in normal times, when it comes to setting economic priorities into the new plan, the stakes become higher.

The Summer Olympic Games will be in Beijing in 2008. How the games come off will be crucial for China's future development and for how the international community views China. How the games are managed is entirely in the hands of Hu and Wen, and the approach China takes will reflect their attitudes and predisposition. While China wants to use the games to build national pride and to show off its new international status to the world, hosting the games contains many risks and will reveal much about just how far China has come in terms of integrating with international norms. If the leadership put security to the forefront because of their fears of unrest or actions by groups such as *Falungong*, the Olympics will be a public relations disaster for China and will set back reforms and damage its international prestige. If China is able to provide a secure but relaxed environment for the games where the international press enjoys a hospitable environment, it

will bode well for further reforms. At the moment the betting is on the former.

In addition to these major events, the direction of future policy will be gauged by a number of other specific events. For example, China will pass new regulations both for its domestic non-governmental organizations and also for international non-governmental organizations working in China. The kind of control that the Party wishes to retain over society will be indicated by these regulations. It is likely that the regulations will retain the need for each organization to find a sponsoring agency and they are likely to introduce more stringent financial and organizational requirements than currently exist.

Premier Wen has raised the possibility that, in the future, elections might be possible at the township level. Currently, elections operate at the village level. Raising elections to the township level would be a significant step forward and is important because unlike the village, the township forms an official part of the governing structure in China. The PRC Constitution recognizes national, provincial, and township governments. Villages are practical administrative divisions under the authority of townships for purposes such as the census and postal services, but without political decision making or administrative authority. Townships, on the other hand, have some real authority.

One thing that is certain is that the Fifth Generation of leaders, who will consolidate their power around 2015, will adopt different priorities to the current leadership. Each new leadership cohort has sought to stamp its mark on policy and they will be no different. They will take power at the time when demographics begin to sour, when the economy will start slowing, and when the pressures for more substantial political reform will mount. As described in Chapter 7, the educational background of the Fifth Generation is significantly different from its predecessor's and its training in politics, law, management, and economics will stand

them in better stead to deal with these challenges than the current leadership of trained engineers.

### Notes

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