

The Real Lessons for Developing Countries from the History of the Developed World: 'Freedom to Choose'

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Executive Summary

- For the last two decades or so, the developing countries have been under great pressure from the developed countries and the international institutions that they control – such as the International Monetary Fund, the World Bank, the World Trade Organisation – to adopt a set of “good policies”, especially free trade, and “good institutions”, such as strong patent law, in order to foster their economic development.
- The historical fact is that, today’s developed countries did not develop on the basis of the policies and the institutions that they now recommend to, or even force upon, the developing countries.
- Virtually all of today’s developed countries used tariff protection and subsidies to develop their industries, and in the earlier stages of their development, they did not even have such “basic” institutions as democracy, a central bank, patent law, and a professional civil service.
- Given that the adoption of “good policies” and “good institutions” has failed to generate the promised acceleration of economic development in the developing world, and has in some cases even led to economic and social collapses, a radical re-thinking of the development orthodoxy is required.
- Above all, the conditions attached to bilateral and multilateral financial assistance to developing countries should be radically changed, on the recognition that the orthodox recipe is not working, and that there can be no “best practice” policies that everyone should use.
- Second, the WTO rules should be re-written so that the developing countries can more actively use tariffs and subsidies for industrial development.
- Third, improvements in institutions should be encouraged, but this should not be equated with imposing a fixed set of (in practice, today’s – not even yesterday’s – Anglo-American) institutions on all countries nor should it be attempted in haste, as institutional development is a lengthy and costly process.

The last two decades have been a bad time for the developing countries. Their average annual per capita income growth rate has been halved (from 3% to 1.5%) between the 1960-80 period and the 1980-2000 period. In particular, Latin America has virtually stopped growing, while Sub-Saharan Africa and most ex-Communist

countries have experienced a fall in absolute income. Economic instability has increased markedly, as manifested in the dozens of financial crises we have witnessed over the last decade alone. Income inequality has been growing in many developing countries and poverty has increased, rather than decreased, in a significant number of them.

To most of those who govern the global economy today – the developed country policy-makers, international business leaders, and the international economic organisations (the IMF, the World Bank, and the WTO) – the solution to this problem is clear. What the developing countries need, they argue, is the “good” economic policies and institutions that the developed countries themselves used in order to develop – such as liberalisation of trade and investment and strong patent law. Their belief in their own recommendations is so absolute that in their view it has to be imposed on the developing countries at all cost through strong bilateral and multilateral external pressures.

As is well known, there have been heated debates on whether these policies and institutions are suitable to the developing countries. The curious thing is that even those who are sceptical of their suitability rarely question whether these are the policies and the institutions that the developed countries actually used in order to become rich. However, the historical fact is that the rich countries did not develop on the basis of the policies and the institutions that they now recommend to, and often force upon, the developing countries.

Widespread Use of Tariffs and Subsidies

Almost all of today’s rich countries used tariff protection and subsidies to develop their industries in the earlier stage of their development. It is particularly important to note that Britain and the USA, the two countries that are supposed to have reached the summit of the world economy through free-market, free-trade policy, are actually the ones that most aggressively used protection and subsidies.

Contrary to the popular myth, Britain was an aggressive user, and in certain areas a pioneer, of activist policies intended to promote its industries. Such policies, although limited in scope, date back to the 14th century (Edward III) and the 15th century (Henry VII) in relation to woollen manufacturing, the leading industry of the time. At the time, England was an exporter of raw wool to the Low Countries, and Henry VII for example tried to change this by protecting woollen textile producers, taxing raw wool exports, and poaching skilled workers from the Low Countries.

Particularly between the trade policy reform of its first Prime Minister Robert Walpole in 1721 and its adoption of free trade around 1860, Britain used very *dirigiste* trade and industrial policies, involving measures very similar to what countries like Japan and Korea later used in order to develop their economies. During this period, it protected its industries a lot more heavily than did France, the supposed *dirigiste* counterpoint to its free-trade, free-market system. According to a study by Joseph Nye, average tariff rate of France was significantly lower than that of Britain throughout the first half of the 19th century. Germany, another country frequently associated with state interventionism, had much lower tariffs than Britain during this period, although the German states tended to use other means of economic intervention more actively. Given this history, argued Friedrich List, the leading German economist of the mid-19th century, Britain preaching free trade to less advanced countries like Germany and the USA was like someone trying to “kick away the ladder” with which he had climbed to the top.

The USA, today's supposed champion of free trade, was even more protectionist than Britain throughout most of its history before the Second World War. According to the authoritative study by Paul Bairoch, between the Civil War and the Second World War, it was literally the most heavily protected economy in the world.

In this context, it is important to note that the American Civil War was fought on the issue of tariffs as much as, if not more than, on the issue of slavery. Of the two major issues that divided the North and the South, the South had actually more to fear on the tariff front than on the slavery front. Abraham Lincoln was a well-known protectionist who had cut his political teeth under the charismatic politician Henry Clay in the Whig Party, which advocated the "American System" based on infrastructural development and protectionism (thus named on recognition that free trade was in "British" interest). On the other hand, Lincoln thought the blacks were racially inferior and slave emancipation was an idealistic proposal with no prospect of immediate implementation – he is said to have emancipated the slaves in 1862 as a strategic move to win the War rather than out of some moral conviction.

The USA was also the intellectual home of protectionism throughout the 19th century. It was in fact American thinkers like Alexander Hamilton, the first Treasury Secretary of the USA, and the economist Daniel Raymond, who first systematically developed the so-called "infant industry" argument that justifies the protection of manufacturing industries in the less developed economies. Indeed, List, who is commonly known as the father of the infant industry argument, started out as a free-trader (he was an ardent supporter of German free-trade customs union – *Zollverein*) and learnt about the Hamiltonian infant industry argument during his exile in the USA during the 1820s.

In heavily protecting their industries, the Americans were going against the advice of such prominent economists as Adam Smith and Jean Baptiste Say, who saw their country's future in agriculture. However, they knew exactly what the game was. They knew that Britain had reached the top through protection and subsidies and therefore that they needed to do the same if they were going to get anywhere. Criticising the British preaching of free trade to his country, Ulysses Grant, the Civil War hero and the US President between 1868-1876, retorted that "within 200 years, when America has gotten out of protection all that it can offer, it too will adopt free trade". When his country later reached the top after the Second World War, it too started "kicking away the ladder" by preaching and forcing free trade on the less developed countries.

The UK and the USA may be the more extreme examples, but almost all the rest of today's developed countries used tariffs, subsidies and other means to promote their industries in the earlier stages of their development. Cases like Germany, Japan, and Korea are well known in this respect. But even countries like Sweden, which later came to represent the "small open economy" to many economists, also strategically used tariffs, subsidies, cartels, and state support for R&D to develop key industries, especially textile, steel, and engineering.

There were some exceptions like the Netherlands and Switzerland that have maintained free trade since the late 18th century. However, these were countries that were already on the frontier of technological development by the 18th centuries and therefore did not need much protection. Also, it should be noted that the Netherlands had deployed an impressive range of interventionist measures up till the 17th century in order to build up its maritime and commercial supremacy. Moreover, Switzerland did not have a patent law until 1907, flying directly against the emphasis that today's

orthodoxy puts on the protection of intellectual property rights (see below). More interestingly, the Netherlands abolished its 1817 patent law in 1869 on the ground that patents were politically-created monopolies inconsistent with its free-market principles – a position that seems to elude most of today’s free-market economists – and did not introduce a patent law until 1912.

The Long and Winding Road to Institutional Development

The story is similar in relation to institutional development. Contrary to what is assumed by today’s orthodoxy, most of the institutions that are regarded as pre-requisites for economic development emerged after, and not before, a significant degree of economic development in the now-developed countries. Without claiming to be exhaustive, let us examine the six categories of institutions that are widely believed to be pre-requisites of development: democracy, bureaucracy, intellectual property rights, institutions of corporate governance, financial institutions (including public finance institutions), and welfare and labour institutions.

Whatever one’s position is on the relationship between democracy and economic growth in today’s world, it is indisputable that today’s developed countries did not develop under democracy. Until the 1920s even universal male suffrage was a rarity. It was not until the late 20th century that all developed countries became truly democratic. Spain and Portugal were dictatorships until the 1970s, votes were given to all ethnic minorities in Australia and the USA only in 1962 and 1965 respectively, and women in many countries were given the suffrage only after the Second World War and in Switzerland as late as 1971. Until the Second World War, even when democracy formally existed, its quality was extremely poor. Secret balloting was introduced only in the early 20th century even in France and Germany, and corrupt electoral practices, such as vote buying, electoral fraud, and legislative corruption, lasted in most of today’s developed countries well into the 20th century.

In terms of bureaucracy, sales of offices, spoils system, and nepotism abounded in most countries until the early 20th century. Modern professional bureaucracies first emerged in Prussia in the early 19th century, but much later in other countries - even Britain got a modern bureaucracy only in the mid-19th century. Until the Pendleton Act in 1883, none of the US federal bureaucrats were competitively recruited, and even at the end of the 19th century, less than half of them were competitively recruited.

A similar story emerges in terms of intellectual property rights institutions, which have become a key issue following the recent controversy surrounding the TRIPS (trade-related intellectual property rights) agreement in the WTO. Until the late 19th century, many countries allowed patenting of imported inventions. As mentioned earlier, Switzerland and the Netherlands refused to protect patents until the early 20th century. The US did not recognise foreign citizens’ copyrights until 1891. And throughout the 19th century, there was a widespread violation of British trademark laws by the German firms producing fake “Made in England” goods.

Even in the most developed countries (the UK and the US), many key institutions of what is these days regarded as a “modern corporate governance” system emerged after, rather than before, their industrial development. Until the 1870s, in most countries limited liability, without which there would be no modern corporations based on joint stock ownership, was something that was granted as a privilege to high-risk projects with good government connections (e.g., the British East India Company), and not as a standard provision. Until the 1930s, there was

virtually no regulation on company audit and information disclosure. Until the late 19th century, bankruptcy laws were geared towards punishing the bankrupt businessmen (with debtors' prison being a key element in this) rather than giving them a second chance. Competition law did not really exist in any country until the 1914 Clayton Act in the USA.

As for financial institutions, it would be fair to say that modern financial systems with widespread and well-supervised banking, a central bank, and a well-regulated securities market did not come into being even in the most developed countries until the mid-20th century. In particular, until the early 20th century, countries such as Sweden, Germany, Italy, Switzerland, and the US lacked a central bank.

A similar story applies to public finance. The fiscal capacity of the state remained highly inadequate in most now-developed countries until the mid-20th century, when most of them did not have income tax. Even in Britain, which introduced the first permanent income tax in 1842, Gladstone was fighting his 1874 election campaign with a pledge to abolish income tax. With limited taxation capability, local government finance in particular was in a mess. A most telling example is an episode documented in Cochran & Miller, where the British financiers put pressure in vain on the US federal government to assume the liabilities of a number of US state governments after their defaults on British loans in 1842 – a story that reminds us of the events in Brazil following the default of the state of Minas Gerais in 1999.

Social welfare institutions (e.g., industrial accident insurance, health insurance, state pensions, unemployment insurance) did not emerge until the last few decades of the 19th century, although once introduced they diffused quite quickly. Germany was a pioneer in this respect. Effective labour institutions (e.g., regulations on child labour, working hours, workplace safety) did not emerge until around the same time even in the most advanced countries. Child labour regulations started emerging in the late 18th century, but until the early 20th century, most of these regulations were extremely mild and poorly enforced. Until the early 20th century, in most countries regulation of working hours or working conditions for adult male workers was considered unthinkable. For example, in 1905 the US Supreme Court declared in a famous case that a 10-hour act for the bakers introduced by the NY state was unconstitutional because “it deprived the baker of the liberty of working as long as he wished”.

One important conclusion that emerges from historical examination is that it took the developed countries a long time to construct institutions in their earlier days of development. Institutions typically took decades, and sometimes generations, to develop. Just to give one example, the need for central banking was perceived at least in some circles from at least the 17th century, but the first “real” central bank, the Bank of England (founded in 1694), was instituted only by the Bank Charter Act of 1844, some two centuries later.

Another important point emerges from historical comparison of the levels of institutional sophistication in today's developed countries in the earlier period with those in today's developing countries.

For example, measured by the (admittedly highly imperfect) per capita national income level, in 1820, the UK was at a somewhat higher level of development than that of India today, but it did not even have many of the most “basic” institutions that India has today. It did not have universal suffrage (it did not even have universal *male* suffrage), a central bank, income tax, generalised limited

liability, a generalised bankruptcy law, a professional bureaucracy, meaningful securities regulations, and even basic labour regulations (except for a couple of minimal and hardly-enforced regulations on child labour).

For still another example, in 1913, the US was at a level of economic development similar to that of Mexico today, but its level of institutional sophistication was well behind that we see in Mexico today. Women were still formally disenfranchised and blacks and other ethnic minorities were *de facto* disenfranchised in many parts of the country. It had been just over a decade since a federal bankruptcy law was legislated (1898) and it had been barely two decades since the country recognised foreigner's copyrights (1891). A (highly incomplete) central banking system and income tax had literally only just come into being (1913), and the establishment of a meaningful competition law (the Clayton Act) had to wait another year (1914). Also, there was no federal regulation on securities trading or on child labour, with what few state-level legislations that existed in these areas being of low quality and very poorly enforced.

These comparisons can go on, but the point is that the developed countries in earlier times were institutionally *less* advanced compared to today's developing countries at similar stages of development. Needless to say, the quality of their institutions fell well short of the "global standards" institutions that today's developing countries are expected to install.

The Real Lessons of History: Freedom to Choose

If the policies and institutions that the rich countries are recommending to the poor countries are not the ones that they themselves used when they were developing, what is going on? We can only conclude that, whether intentionally or not, the rich countries are effectively kicking away the ladder that allowed them to climb to where they are now. It is no coincidence that economic development has become more difficult during the last two decades when the developed countries started turning up the pressure on the developing countries to adopt the so-called "good" policies and institutions. What can be done to change this? First, the historical facts about the historical experiences of the developed countries should be more widely publicised. This is not just a matter of "getting history right", but also of allowing the developing countries to make more informed choices. This is not to say that every developing country should adopt an interventionist development strategy. Some of them may indeed benefit from following the Swiss or Hong Kong models. However, this strategic choice should be made in the full knowledge that historically the majority of the successful countries did the opposite in the past when they faced the same international competitive challenge from more advanced countries which the developing countries face now.

Second, the conditions attached to bilateral and multilateral financial assistance to developing countries should be radically changed. It should be accepted that the orthodox recipe is not working, and also that there can be no single "best practice" policies that everyone should use. More specifically, in terms of policies, the "bad policies" that most of today's developed countries used with so much effectiveness when they were developing countries themselves should be at least allowed, if not actively encouraged, by the developed countries and the international development policy establishment that they control. While it is true that activist trade and industrial policies can sometimes degenerate into a web of red tape and corruption, this should not mean that these policies should never be used.

Third, the WTO rules should be re-written so that the developing countries can more actively use tariffs and subsidies for industrial development. They should also be allowed to have less stringent patent laws and other intellectual property rights laws.

Fourth, improvements in institutions should be encouraged, but this should not be equated with imposing a fixed set of (in practice, today's – not even yesterday's – Anglo-American) institutions on all countries. There need to be more serious attempts, both at the academic and the practical levels, to explore exactly which institutions are necessary, or at least beneficial, for what types of countries, given their stages of development and their economic, political, social, and even cultural conditions. Special care has to be taken in order not to demand excessively rapid upgrading of institutions by the developing countries, especially given that they already have quite sophisticated institutions when compared to today's developed countries at comparable stages of development, and given that establishing and running new institutions is costly.

By having the freedom to choose policies and institutions that are more suitable to their conditions, the developing countries will be able to develop faster. This will also benefit the developed countries in the long run, as it will increase their trade and investment opportunities. That the developed countries cannot see this is the tragedy of our time.

Further Readings

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