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Institutional divergence in economic development

Jonathan B. Wight[1]

Introduction

The Anglo-American capitalist model (AACM) encompasses a set of theories and policies that advance the classical objectives of individual autonomy, wealth acquisition, and economic growth. In the twentieth century, the neoclassical goal of short-run Pareto efficiency was added yet remains in possible tension with these other aims. The AACM generally upholds the primacy of markets as the means for achieving its normative ideals through private, decentralized actions, with some exceptions. In the modern political arena this ideology is associated with the Reagan-Thatcher revolution of the 1980s and provides a framework for many who oppose statist solutions to social problems (Steger and Roy 2010). The AACM has come under attack from a variety of perspectives because of its assumptions of perfectly rational traders, competitive markets, incentive compatibilities, low transaction costs, informational symmetries, and no externalities (Stiglitz 2007; Kay 2004). This paper examines a different critique arising from the a-historical and a-institutional manner in which the AACM has been adopted by some neoclassical policy makers. This criticism, incidentally, also applies to statist models adopted in the 1950s that likewise ignored institutional constraints and path dependency issues.

While the AACM ideology traces back in various forms to Smith, Ricardo, and other writers of the classical era, its principles are widely known in Latin American and other developing countries by the label *neoliberalism* – associated with neoclassical economic policies adopted during the last two decades of the twentieth century. After the Second World War, virtually all developing countries had embraced statist ideologies and economic interventions in order to overcome perceived market deficiencies. While state planning and protectionism resulted in rapid industrialization and GDP growth in many countries, these policies often increased inequality and ultimately proved to be unsustainable, as evidenced by Latin America's debt crisis of 1982. The neoliberal economic revolution, known as the 'Washington Consensus', arose to provide a coherent set of policies used to restructure countries experiencing external debt crises (Williamson 1990). The first fundamental welfare theorem (the so-called 'invisible hand' theorem) that

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developed in neoclassical economics during the 1950s supported the view that laissez-faire markets could maximize the satisfaction of all feasible consumer preferences. While neoclassical economists make numerous assumptions and qualifications in deriving this result, in simplified form the first fundamental welfare theorem seemed to validate the simplistic and stereotypical view of Adam's Smith's non-interventionist approach to development. For Smith, however, economic analysis and institutions are deeply intertwined; hence, the neoliberalism of the 1980s and 1990s was in many ways quite different from Adam Smith's conception of the invisible hand or the development process he envisioned.

In particular, Smith did not emphasize short-run efficiency but rather long-run growth. Moreover, Smith did not insist that long-term growth required any particular set of policies or institutions, such as those promulgated in the Washington Consensus. While Smith would share much in common with the ideology of neoliberalism, this paper develops the thesis that Smith's approach to policy making is informed by and imbedded in culture, ethical norms, power structures, and other institutions. Smith, who chided François Quesnay (the 'speculative physician') for a similar mistake, argued that diversity of institutions is both expected and desirable for the unfolding of development. Attempting to implement an ideal or perfect system would be a fool's errand, because history and path-dependency can suggest acceptable alternatives that work reasonably well, and often better than those derived from pure theory. Smith's rhetoric was soaring and ideological, but his policy prescriptions were incremental and context specific, reflecting concern for justice and process.

The following section outlines the fall of AACM as a credible ideology during the first half of the twentieth century and its replacement with statist development thinking. The third section explores the rise of the neoliberal model in Europe in the 1930s, and its application to the neoclassical model in the 1980s. The fourth section demonstrates that Smith's AACM model is nuanced and substantially different from the neoliberal model in terms of policy implementation. The final section provides conclusions on the usefulness and survivability of the AACM.

The fall of AACM and the rise of development planning

By mid-twentieth century, the Anglo-American capitalist model was in serious disarray following the Great Depression and World War II (Plehwe 2009; Lewis 1969). The depression had shown the fallacy of Say's Law that markets would self-correct, and had been replaced by Keynesian counter-cyclical fiscal policies to combat falling aggregate demand. The world war, meanwhile, had demonstrated the capacity of central planning in the Pentagon to mobilize vast resources for investment, production, and distribution. The Soviet Union also emerged from the war using a growth model that seemed superior due to high rates of investment. In this post-war milieu, many developing countries gained their independence (such as India) and others concluded civil wars

(such as China). Other countries in Latin American, which had been independent since the early nineteenth century, sensed an opportunity to break neocolonial relationships with Great Britain and the United States. The world was ripe for economic experimentation using the levers of central government authority to force along the development process.

Since the late nineteenth century, a number of economists had been preparing the intellectual groundwork for the movement away from AACM through arguments known today as the "socialist calculation debate" (Levy and Peart 2008). Could a planned economy replicate the efficiency of a market system? More importantly, could it do better? The AACM relied upon the epistemological belief that no policy maker could ever amass or process enough information to make centralized interventions sensible (Hayek 1945). According to this view, millions of consumers and producers – acting in their own best interests – would generate the superior wisdom of the decentralized market process. However, in addition to theoretical work on planning, Wassily Leontief's research on input-output models in the 1930s and 1940s seemed to supply policy makers with the practical information needed for planning execution. Not coincidentally, the Second World War produced a shift in economics research toward interventionism because economists – no longer simply theorists – were given wartime positions in government. One of the founders of linear programming recalls how many economists came away from this applied experience with the notion that development was a mechanical process that could be controlled through central planning:

> Linear programming can be viewed as part of a great revolutionary development which has given mankind the ability to state general goals and to lay out a path of detailed decisions to take in order to 'best' achieve its goals when faced with practical situations of great complexity.
> (Dantzig 2002: 42)

Even as computers and linear programming were in their infancy, developing countries optimistically adopted socialist approaches to address wealth creation and poverty mitigation. In 1951, Prime Minister Jawaharlal Nehru of India released the first Five-Year Plan that led to government investments in dams and other agricultural infrastructure. In 1956, India's second Five-Year Plan pushed government investments into steel and other heavy industries – following the lead of Stalinist and Maoist development plans. A subsequent Five-Year Plan nationalized banks and imposed price controls in key sectors.

In Latin America, meanwhile, prominent economists contested the notion that trade based on comparative advantage would lead to greater wealth in the long run. Argentine economist Raúl Prebisch became in 1948 the director of the Economic Commission for Latin America at the United Nations and, in 1964, the founder and first secretary-general of the UN Conference on Trade and Development (UNCTAD). These positions offered a bully pulpit

in which he highlighted the key failings of the Ricardian trade model upon which the AACM relied.

In *The Economic Development of Latin America and its Principal Problems* (1950), Prebisch outlined the theory which became widely known as the Prebisch-Singer hypothesis. According to this view, rich Western countries export industrial products that experience rapid technological innovation. These products also have high income elasticities of demand. By contrast, developing countries export agricultural and mineral commodities with low income elasticities of demand and low potential for technological innovation. As world income rises, industrial good demand grows much faster than commodity demand. In addition, industrial producers can gain market power through oligopolies and patents while it is more difficult for commodity producers to acquire any long-lasting leverage, given high price elasticities of supply. The prediction that emerges from this structural analysis is that the terms of trade for developing countries will inevitably fall over time (Prebisch 1950: 9). Empirical evidence in the 1950s and 1960s supported the terms of trade pessimism that developing countries had to export more commodities each year simply to retain the same level of real imports as they had previously; in other words, developing countries were riding a downward economic escalator. Prebisch urged them to jump off, by rejecting the AACM in favor of protectionism.

Other researchers argued along different lines that developing countries had been *forced* to acquire a comparative advantage in commodities as part of a deliberate imperialistic strategy by developed countries. For example, British merchants financed, built, and then operated the railroads in Argentina in order to open up the pampas for beef and wheat exports (Wright 1974). The emphasis was entirely on enhancing exports and not on developing an integrated transportation network that would lead to balanced growth. A hodgepodge of rail lines emanated from Buenos Aires to the hinterland, but these were often of different gauges and could not interact with each other (Duncan 1937). The introduction of railroads substantially altered the production possibilities curve for Argentina in favor of agriculture and away from industry because rural areas could trade only with the port city, but not laterally with each other. The lack of planning and uncoordinated competitive efforts that led to this outcome are cited as a major failure of Argentine development in this period (Duncan 1937: 578). Similar examples of 'export-enclave' production investments were made throughout Latin America and Africa. Hence, the view that comparative advantage arose from historical accidents of climate and natural resource endowments needs to be reconsidered, especially since some resource endowments were not accidents at all – they were designed by imperial powers.

The anti-trade conclusions of Prebisch's structural approach also coincided with those of dependency theorists such as Paul Baran, Paul Sweezy, and Andre Gunder Frank (Frank 1966). Dependency theory posits that 'center' countries use their power to exploit 'periphery' areas for resources and to

provide markets for finished industrial products. Both Britain and the United States intervened overtly and covertly (with the complicity of local elites) to thwart political efforts to create balanced developmental policies, thereby creating dependency according to critics (Lewellen 1995). Disruptions to the global trading system during World War I, the Great Depression, and World War II revealed that developing countries could naturally develop industries in the absence of free trade (Frank 1966). Dependency theory became a major intellectual counterpoint to the AACM in major universities in Latin America and elsewhere in departments of political science, sociology, and anthropology. The narrative story of colonial and neocolonial oppression in Latin America and Africa fueled the belief – along with Prebisch's empirical evidence – that the AACM was simply an ideological tool adopted by those who stood to gain from it.

With these factors as the intellectual backdrop, the AACM had few adherents in the early 1950s in the Latin American capitals of Rio, Buenos Aires, and Mexico City – or, for that matter, in Delhi, Djakarta, and other Asian political centers. In their quest to jump-start growth, governments established or nationalized public monopolies in telecommunications, petroleum, airlines, and other strategic investments; stimulated infant industry manufacturing for domestic consumption via high tariffs (Import Substituting Industrialization or ISI); fixed exchange rates (generally overvalued); imposed capital controls; forced private and public banks to loan at below-market interest rates to selected industrial borrowers; set price controls on basic goods; and provided substantial tax subsidies for investments.

ISI in Latin America involved successive waves of industrial planning and promotion using imported capital and technology (Franko 2007). In Stage 1, high tariff barriers were imposed on finished consumer products such as automobiles. In Brazil, almost all the major American and German manufacturers (GM, Ford, Volkswagen, Mercedes, and others) jumped the tariff wall to set up assembly plants, using capital and parts imported with no duties. In Stage 2, high tariffs were placed on intermediary inputs (steel, glass, tires, and motors) to encourage Firestone, Pirelli, and other suppliers to similarly make the jump. In Stage 3, high tariffs on machinery gave infant industry protection to Brazil's nascent capital goods industry. While private foreign direct investments and infrastructure loans from the World Bank supplied the initial capital, by the mid-1970s commercial banks from around the world were pouring hundreds of billions of petrodollars into Latin America and earning high returns in these markets.

On the surface at least, Latin America's rejection of the AACM had paid off. Today, Brazil is a major exporter of industrial products, from cars to commercial airplanes. Yet the cost of this accomplishment was high. Because ISI emphasized the domestic manufacture of products previously imported, it *ipso facto* meant disregarding the insights of comparative advantage for lowest cost production. Industrial products were initially of poor quality and commanded high prices in the domestic market, often exceeding world prices

by more than 100 per cent (Franko 2007: 63). Huge government deficits run up by state-owned companies swamped fiscal budgets, leading to bouts of hyperinflation. Fixed or pegged exchange rates were not able to adjust, and vastly overvalued currencies resulted. The high price of domestic currency impaired the traditional export market for agricultural commodities, resulting in a diminished ability to earn hard currency. Meanwhile, the huge value of imports required to maintain the burgeoning domestic industry meant that most countries used state favoritism to allocate scarce foreign exchange. Bribery and corruption followed. When world interest rates climbed steeply because of US monetary contractions in the early 1980s, Latin America went into a deep financial crisis. The 'lost decade' of the 1980s in Latin America is a testament to the problems of state intervention and the ultimate collapse of ISI (Franko 2007: ch. 4).

Many East Asian countries followed similar interventionist policies in the 1950s, yet are credited with being much quicker to switch to export-led strategies (World Bank 1993). East Asian countries also tended to have more balanced fiscal budgets, so that inflation was less of a concern. In addition, East Asian societies generally financed investment from domestic savings and were less prone to external financial shocks (but there are exceptions, such as South Korea in the 1970s and the East Asian crisis in 1998). Starting in 1978, China gradually began to free resources for private use and for international trade, while India remained highly interventionist until 1991. One by one, developing countries that had discarded the AACM found themselves returning to the fundamental doctrines of global trade, fiscal stewardship, and wealth creation through markets. We turn now to this transformation with a focus on Latin America.

The rise of neoliberalism

The AAC ideology had been a dominant feature of many Latin American countries in the nineteenth and early twentieth centuries under the neocolonial influence of the United States and Great Britain. Economic collapse in the 1980s forced the reintroduction of the AACM to policy making (under the label neoliberalism) – using the visible hand of the World Bank and IMF as levers. These institutions provided advice and emergency funds, and were the score keepers whose adjustment loans provided a signal to private investors that reforms were underway. Before addressing neoliberalism in this modern usage it is necessary to briefly consider the origins and transformation of the term (for a thorough discussion, see the essays in Mirowski and Plehwe 2009).

Alexander Rüstow, the German economist credited with coining the term 'neoliberal' in 1938, was disillusioned with Germany's hierarchical, corporatized economy that restricted liberties; at the same time, he rejected the failed laissez-faire policies he associated with Adam Smith (Hartwich 2009: 6). The German imperial economy at the start of the twentieth century

had been highly protectionist and cartelized, serving the interests of heavy industry and the Kaiser's political and military objectives. The goal of catching up and surpassing Britain required the antithesis of the AACM: in Germany the invisible hand of markets was thought to produce the chaos of 'ruinous competition' (Hartwich 2009: 11). By contrast, state-led (or 'organized') capitalism was thought to produce methodical and predictable progress. Three decades later, Hitler's obsession with state-led industrialization and militarizing represented continuity with this past.

Rüstow and other German economists such as Ludwig Erhard, Walter Eucken, Wilhelm Röpke, and Alfred Müller-Armack proposed a new liberalism, a 'Third Way', which was a mix of the best parts of free markets and socialism. In line with the AACM, government would provide and enforce the economic rules, but would otherwise not pick the winners. In line with socialism, the state would provide various safety nets, such as unemployment insurance, wage subsidies, and various types of redistributions, such as free public education and high taxes on inheritance. The state would also ensure competition by preventing monopolies (Hartwich 2009: 17). These neoliberal economists participated in the Mont Pèlerin society, provoking serious arguments with Ludwig von Mises and others (Hartwich 2009: 21). The envisioned 'Third Way' eventually became West Germany's 'Social Market Economy' after the Second World War (Ptak 2009).

As originally invoked, neoliberalism is indeed quite different from the AACM, and equally different from the neoclassical efficiency programs pushed by the Washington Consensus in the late twentieth century. Moreover, the term 'neoliberal', in its modern pejorative incarnation, has often come to mean the *imposition* of AACM policies in developing countries. Imposition implies coercion, and one must ask, to what extent were Latin American countries in the debt crisis of 1982, and East Asian countries in the crisis of 1998, forced to adopt neoliberal policies against their wills? From an AACM perspective, coercion would not be possible in a situation of secure property rights, freedom to engage in or refrain from trade, and other basic liberties. Yet from a dependency theory perspective, none of these basic rights was assured.

The Third World debt crisis of 1982 was mainly a Latin American crisis, since the predominance of commercial bank loans had been to this region, amounting to more than $300 billion (Franko 2007: 79). Much of this was dollar-denominated floating rate debt, tied to world spot rates. The rapid rise of interest rates in the early 1980s pushed up debt servicing payments to unsustainable levels. In addition, Latin American commodity exports had collapsed in the world-wide recession. When Latin American countries could no longer earn the foreign exchange needed to service their loans, these bank assets were technically in default. But Latin American borrowers were 'too big to fail' because writing off these loans would have essentially bankrupted all of the world's major banks, who did not have sufficient reserves to cover these losses. To keep the world financial system afloat, major banks were

pressured by regulators to issue new loans so as to keep debtor accounts afloat.

As the lenders of last resort, the IMF and World Bank played important roles in bringing commercial banks to the bargaining table. Without this clearinghouse, each bank would have been left to muddle along by itself. It is likely that the world's major multinational banks would have quickly gone bankrupt had they individually and simultaneously tried to negotiate loan restructuring with the multitude of debtor countries. Competition among banks would lead to a Prisoners' Dilemma: private banks would have little incentive individually to cooperate and release new funds unless all banks cooperated. As the convener and enforcer of loan conditions, the IMF had huge bargaining power to enforce cooperation.

By being cajoled to band together under the aegis of the IMF, commercial banks could thus act as a banking cartel. The terms and conditions imposed on debtor countries were unilateral and could be considered coercive given the circumstances. From the perspective of the poor in developing countries, the rolling over of old loans with new loans constituted 'involuntary' borrowing since the benefits accrued to banks and elites, but the obligations for repayment fell to workers (Franko 2007: 91). It is ironic that the conditions imposed (later known as the Washington Consensus) would be associated with the AACM, since the terms were created by a closed process of financial elites acting in collusion. Little wonder that the neoliberal revolution came to acquire a solidly derogatory connotation, at least in the 1980s and 1990s in debtor developing nations. In the East Asian crisis of 1997–98, for example, neoliberal policies were again used by the IMF playing the role of a financial gatekeeper. The image of this coercive power was visually captured by IMF Director-General Michel Camdessus (with folded arms) overseeing Indonesian President Suharto's signing of a letter of agreement in 1998 (Chang 2008; Getty Images 1998).

The three pillars of the Washington Consensus were to stabilize, liberalize, and privatize markets in countries experiencing fiscal deficits, inflation, and current account deficits. Stabilizing the macro economy required cutting government spending and reducing monetary growth. As real income fell and real interest rates rose, the induced recession would lower imports and constrain wages, making imports less attractive and exports more attractive. Rising real interest rates would stem capital outflows and potentially attract capital inflows. The second pillar of reform was to liberalize markets by reducing tariffs, eliminating price controls on food, currency, and other sectors, and by opening up financial markets to the free flow of capital (although not labor). The third pillar addressed the privatization of government-owned enterprises (GOES). Injecting the profit motive in GOES would in theory reduce costs by eliminating bloated payrolls, increase product and service qualities by responding to consumer demands, and attract foreign investment and technology, thereby alleviating the external disequilibrium.

It is hard to imagine that Adam Smith would object to any of these policies as guiding principles. But what he likely would have questioned is the rigid

implementation, ignoring time and circumstance. We turn now to this discussion.

Smith's pragmatism in development policy

Viner (1927) noted the numerous ways in which Smith veered from a dogmatic adherence to laissez-faire policy making. That is, while Smith's rhetoric soared in defense of the inalienable rights of persons to seek their own fortunes through individual effort, he did not assume that actually bringing about a system of perfect liberty would ever be feasible or desirable. Moreover, there were specific instances in which individual liberty needed to be restrained by the state in order to promote the goals of stability or growth. This section develops these points in the areas of financial markets, labor markets, international trade, and the path dependent nature of the development process.

Financial markets

Financial market liberalization was a key tenant of the Reagan-style AACM in the 1980s and played an importunate role in the neoliberal reforms endorsed by the IMF and World Bank. Larry Summers, former chief economist at the World Bank (and subsequently Secretary of the Treasury), believed that free markets in capital and foreign exchange improved the overall efficiency of global markets. While there were occasional currency collapses, Summers equated these to the infrequent but spectacular crash of a Boeing 747. Efficiency would dictate that we keep flying such planes because the risks were low and the benefits large. In what seems paradoxical today (given the USA's present reliance on Chinese and Brazilian capital inflows) Summers noted in 1999 that 'there are few things with as great a potential to raise human welfare as the creation of a safe and sustainable system for the flow of capital from the developed world to the developing one' (cited in Wolf 2002: 46).

A plethora of critics attacked this fundamental tenet of AACM. The analogy of free capital flows to flying a jumbo jet is mistaken: developing countries have thin financial markets and an appropriate analogy is that of flying a single propeller Cessna: the death rate in such small planes is tenfold higher than in jumbo jets. Joseph Stiglitz, who was also chief economist of the World Bank, notes that in practice capital market liberalizations have not worked as advertised to stimulate investment and growth. Stiglitz posed this question:

> Given the overwhelming theory and evidence against capital market liberalization, one wonders: how could the major international organization responsible for promoting growth and stability have promoted a policy that seemed so contrary to its objectives?
>
> (Stiglitz 2002: 221)

The answer, according to Stiglitz, is that the directors of the IMF were instilled with AACM ideology and became blinded to facts. Ideology trumped science. Wolf states the problem astutely and with prescience for the great global contraction of 2008: 'Too many countries have been devastated by financial crises that have resulted from throwing open poorly regulated financial systems under-pinned by comprehensive government guarantees. While liberalization is desirable, *it has to be done in the right way*' (Wolf 2002: 51, emphasis added).

Adam Smith had similar reservations about liberal financial markets. Britain had endured the South Sea Bubble of 1720 and the Scottish banking crisis of 1772 (Rockoff, this volume). Smith was thus concerned about financial speculation as a cause of imprudent lending and financial meltdown. In *The Wealth of Nations* Smith advocated government regulations that would prevent speculators from squandering capital that could be better employed. Institutional regulations were needed (in this case) to harmonize private passions with the public interest. Smith noted that the natural flow of capital will largely be toward investments creating the greatest individual opulence, which when summed over the nation produce the greatest national opulence. Private and public interests thus converge. But some lenders can make more money offering loans to 'profligates' whose activities contribute more to consumption than to growth. Smith thus favored an interest rate ceiling of 5 per cent that would create a shortage of loanable funds (Smith 1976b, WN II.iv.14–15). Since risk-taking would be constrained by lower returns, banks would advance credit only to their most trustworthy clients, weeding out speculative borrowers whose private aims were not in keeping with society's objectives. Smith also advocated limiting paper bank notes issues to £5 and higher, which would restrict their circulation to wealthier merchants (Rockoff, this volume). Such mild paternalism would keep the poor from suffering 'a very great calamity' in the case of bank failure (WN II.ii.90) but clearly would violate the modern principle of Pareto efficiency.

In a related discussion in which the invisible hand appears, Smith considered the problem of capital flight. He theorized that security concerns would lead merchants to congregate funds domestically, hence no regulations on capital exports would be needed to harmonize private with public interests (WN IV.ii.3–6). The preference for home country investments is not a necessary feature of all economies, however. That is, the incentives that give rise to the trust, character, and legal system required to create such preferences are idiosyncratic to the confluence of events, institutions, and individuals populating a time and place. Were Smith to offer advice to Latin American countries with weak existing financial markets, poor legal systems for protection of property, and a long history of capital flight, it is at least debatable as to whether he would have recommended some controls on short-run capital flows to discourage speculation. The two preceding points make clear that Smith was not promoting global market efficiency but rather dynamic growth

in the *home* country. Smith was willing to sacrifice some freedom and some short-run efficiency to promote this end.

Labor markets

In the area of labor markets, Smith's aims and those of AACM coincide in theory and only partially in practice (Levy and Peart 2009). Smith called attention to the plight of workers facing monopsony employers:

> We rarely hear, it has been said, of the combinations of masters [employers], though frequently of those of workmen. But whoever imagines, upon this account, that masters rarely combine, is as ignorant of the world as of the subject.
>
> (WN I.viii.13)

To some extent the neoliberal reforms called for by the World Bank address the problems of monopsony in labor markets. In *Why Africa Had to Adjust*, the World Bank (1994) highlighted numerous government marketing boards that produce a large wedge between the world price of commodities and the price paid to peasant producers. Special interests, notably government leaders, earn this rent and use it to solidify their power to block reforms. Smith would have both understood this situation and applauded the Bank's attempts to redress it.

Yet the neoliberal reforms in Latin America of the 1980s were largely perceived to be anti-union and anti-labor. Moreover, they failed to address land reform, perhaps the key issue in the region at that time: huge hereditary estates (*latifundios*) held by 1 per cent of the population controlled 72 per cent of the land under cultivation (Todaro 2000: 373). Adam Smith labeled large European feudal landholdings 'barbarous institutions' that formed only in response to disorderly times. As with estates in Latin America, Smith predicted that large landholdings would produce lower yields than smallholdings:

> To improve land with profit, like all other commercial projects, requires an exact attention to small savings and small gains, of which a man born to a great fortune, even though naturally frugal, is very seldom capable. The situation of such a person naturally disposes him to attend rather to ornament which pleases his fancy, than to profit for which he has so little occasion.
>
> (WN III.ii.7)

Evidence for lower productivity in Latin America's *latifundios* has been found by numerous researchers (Todaro 2000).

Because neoliberal reforms emphasized a return to commodity exports, they increased the demand for rural labor and would in theory raise real wages. But in situations where labor markets are uncompetitive, land

distribution highly skewed, and indigenous property rights weak, such reforms often produced unintended negative consequences for the poor that Smith would have found objectionable (Wight 2001). Military rulers in Guatemala, for example – like those in other Latin America countries – often used state violence to suppress worker organizations and to expropriate peasant lands for mining and other purposes controlled by elites. A tight oligarchy dominated political and economic life (Viscidi 2004). Acemoglu and Robinson (2008: 20) note that:

> The conclusion ... seems to be that to change the political equilibrium there needs to be changes in both de jure and de facto power. For instance, if there is an elite that is structuring institutions to its benefit with adverse aggregate effects, then to engineer a transition to a better equilibrium both their de jure and de facto power must be simultaneously reformed.

When Adam Smith wrote that 'The natural effort of every individual to better his own condition ... is so powerful a principle that it is alone ... capable of carrying on the society to wealth and prosperity. ... ' he added the key qualifying phrase, 'when suffered to exert itself with freedom and security' (WN IV.v.b.43). By security Smith meant the legal reforms introduced by Magna Carta, the English Revolution, and other institutional safeguards of justice. A key property right was to one's person:

> That security which the laws in Great Britain give to every man that he shall enjoy the fruits of his own labour is alone sufficient to make any country flourish, notwithstanding these and twenty other absurd regulations of commerce.
>
> (WN IV.v.b.43)

If Smith were advising Latin American countries in the 1980s, it is unthinkable that he would proceed without first devoting considerable attention to the history of property and labor rights. Smith's reforms would proceed according to what the circumstances would permit, not according to ideological or theoretical beliefs about ideal market situations.

International trade

Adam Smith was well aware of the nuances of the gains and losses from opening to trade. Smith's defense of free trade is well-known, exemplified by this quote:

> By means of glasses, hotbeds, and hot walls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought

> from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines merely to encourage the making of claret and burgundy in Scotland?
>
> (WN IV.ii.15)

As with labor markets, however, Smith's trade policies were not constructed in isolation. They addressed existing realities of the time, place, and institutions. Smith cynically remarked: 'To expect, indeed, that the freedom of trade should ever be entirely restored in Great Britain is as absurd as to expect that an Oceana or Utopia should ever be established in it' (WN IV.ii.43). In particular, Smith was sensitive to injustices that could arise from a rapid re-introduction of free trade (or 'shock therapy' in modern parlance). Smith argued for gradualism:

> Humanity may in this case require that the freedom of trade should be restored only by slow gradations, and with a good deal of reserve and circumspection. Were those high duties and prohibitions taken away all at once, cheaper foreign goods of the same kind might be poured so fast into the home market, as to deprive all at once many thousands of our people of their ordinary employment and means of subsistence. The *disorder* which this would occasion might no doubt be very considerable. It would in all probability, however, be much less than is commonly imagined. ...
>
> (WN IV.ii.40, emphasis added)

As if following Smith's advice, Chinese communist rulers (fearing political disorder) proceeded cautiously to open select markets after 1978, 'fording the river by feeling for the stones'. Smith also noted his concern for owners of capital who would be hurt by new trade rules:

> The undertaker of a great manufacture who, by the home markets being suddenly laid open to the competition of foreigners, should be obliged to abandon his trade, would no doubt suffer very considerably. ... The equitable regard, therefore, to his interest requires that changes of this kind should never be introduced suddenly, but slowly, gradually, and after a very long warning.
>
> (WN IV.ii.44)

In these passages Smith makes two points: that efficiency should be balanced with justice for workers and for investors; and that maintaining order is a social objective worthy of important consideration.

Developmental process

Smith's policy making is thus incremental, geared to allowing slow and achievable progress rather than radical revolution. Policy making should

not be driven by ideological purity, but by pragmatic considerations of what would, at the margin, move society forward with equity and the least disruption. Hence, in commenting on an export revenue bounty, Smith writes:

> With all its imperfections, however, we may perhaps say of what was said of the laws of Solon, that, though not the best in itself, *it is the best which the interests, prejudices, and temper of the times would admit of.* It may perhaps in due time prepare the way for a better.
>
> (WN IV.v.b.53, emphasis added)

In *The Theory of Moral Sentiments* Smith explicitly addresses the character of a virtuous leader who contents himself with moderating laws and regulations, consistent with the prejudices of the times. A virtuous leader would 'respect the established powers and privileges' of individuals and orders, and content himself with restraining 'what he often cannot annihilate without great violence' (Smith 1976a, TMS VI.ii.2.16). While a general idea of the 'perfect' policy is necessary to inform the statesman, 'to insist upon its establishing, and upon establishing all at once, and in spite of all opposition, every thing which that idea may seem to require, must often be the highest degree of arrogance' (TMS VI.ii.2.18). Smith's reserved approach could easily have inspired Abraham Lincoln, who abhorred slavery yet argued that it should be 'tolerated and protected only because of and so far as its actual presence among us makes that toleration and protection a necessity' (Lincoln 1860). One should not infer that Smith would himself be as tolerant of slavery.

These points highlight the role that process plays in Smith's conception of economic development. Seen from the perspective of millennia, the advance of society from hunting and gathering to herding, then to agriculture, and finally to industry appears as a seamless advance. Yet at any point in time there are wrenching institutional changes to be experienced. The invisible hand does not produce perfect results because human instincts work within human institutions that must constantly evolve. 'Ghost institutions' linger, serving no purpose (Wilson 2007). Smith provides two examples of feudal property rights – primogeniture and land engrossing – that anachronistically survived for centuries and failed to adapt to the needs of the present (WN III.ii.3–4). Hence, while human instincts for betterment lie behind the invisible hand, human institutions sometimes 'thwarted those natural inclinations' (WN III.i.3). Historical circumstances and path dependency limit how well the invisible hand can work at any particular point in time (Nozick 1994: 314).

As noted by a number of authors, the beneficial spin ascribed to the invisible hand is thus premised on specific institutional, social, and ethical constructs (Wight 2007; Grampp 2000; Evensky 1993; Persky 1989). In considering limitations of time and place, Smith observed that 'If a nation

could not prosper without the enjoyment of perfect liberty and perfect justice, there is not in the world a nation which could ever have prospered' (WN IV. ix.28). Policies work through imperfect institutions, and Smith was unwilling to promote reforms derived merely from ideology and abstracted from local context.

Smith's concerns have been borne out by the widespread disillusionment with the cookie-cutter restructuring carried out by the IMF under the guise of AACM (Stiglitz 2003). Dani Rodrik writes that 'What [countries] need is not a laundry list [of reforms], but an explicitly diagnostic approach that identifies priorities based on local realities' (Rodrik 2007: 5). History, culture, and politics flatten a path and limit the range of options and potential methods that can be used effectively. Rodrik thus distinguishes between ideal principles and practical policies:

> First-order economic principles – protection of property rights, market-based competition, appropriate incentives, sound money, and so on – do not map into unique policy packages. Reformers have substantial room for creatively packaging these principles into institutional designs that are sensitive to local opportunities and constraints.
>
> (2007: 6)

Adam Smith, who greatly respected the Physiocratic reformers in France who advocated laissez-faire, gently chided their leader (Dr. François Quesnay) for advocating doctrinaire policies. Smith was ideologically supportive but pragmatically distant:

> Some speculative physicians seem to have imagined that the health of the human body could be preserved only by a certain precise regimen of diet and exercise. ... Mr. Quesnai, who was himself a physician, and a very speculative physician, seems to have entertained a notion of the same kind concerning the political body, and to have imagined that it would thrive and prosper only under a certain precise regimen, the exact regimen of perfect liberty and perfect justice. He seems not to have considered that, in the political body, the natural effort which every man is continually making to better his own condition, is a principle of preservation capable of preventing and correcting, in many respects, the bad effects of a political economy. ...
>
> (WN IV.ix.28)

General principles are guiding lights, but when applied unthinkingly can do harm. Smith is equally critical of command economy dictators ('the man of system') (TMS VI.ii.2.17) as he is of laissez-faire. The linking of Adam Smith to the general aims of the AACM is obvious at the surface but troubling for reasons of policy design and implementation elaborated in this section.

Conclusion

Adam Smith's soaring rhetoric was written for all ages, yet his explicit policy proposals were grounded in the reality of circumstance. This paper offers evidence that Smith would have found good and bad aspects of the AACM as it was applied to neoliberal policies in the late twentieth century. Smith would likely be critical of economic reforms that focused on short-run efficiency and failed to address issues of justice. Smith was also an incremental reformer; he understood the problem of path dependency, which blocks the implementation of perfect states. He would have found it unacceptable to design economic policies in the absence of a careful elaboration of historical, cultural, and political constraints.

Smith's physiologic-based critique of Dr. Quesnay in *The Wealth of Nations* provides a metaphor for understanding why, despite his rhetorical flourishes, Smith avoided utopian economic policies. Time and place create a context in which particular policies need to be crafted. Ideology inspires one's principles, but practicality grounds one's practice. The human instinct for betterment remains stable over time but institutions must evolve to address changing circumstances. However, a particular institution suitable for one period can be assumed to become obsolete. Ghost institutions act as a brake on progress and carve out a number of different evolutionary solutions. Smith's model supports the view that diverse approaches to mixed-market capitalism are feasible and desirable given different historical, cultural, and political circumstances.

This understanding provides two possible responses to the question, 'Is the Anglo-American style capitalism passing away?' The response is yes, if by this we mean the blind application of neoclassical theory without regard to context. The response is no, if we consider the dedication to freedom and justice that lie behind Smith's version of the AACM.

Note

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