

# The world revolution in economic policy 1945-1995

MC O'Dowd

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# Foreword

The purpose of FMF *Monographs* is to use the analytic method of political economy to shed light on how best the promotion of free markets will improve the workings of the South African economy. In particular, authors are urged to apply the microeconomic approach of studying how individuals, firms and households behave in response to either naturally occurring or regulatory induced incentives. This requires that they display a sound, institutional knowledge and understanding of their theme. Where macroeconomic aggregates are introduced into the discussion, FMF authors analyse them from the market perspective, namely from the foundation stones of economics itself, supply and demand, the interactions of countless individuals with differing preferences and intentions. This approach also requires that authors pursue their analysis in a logical fashion to policy proposals unencumbered by preoccupations as to what is or is not politically practicable at any given time. They should not be tailored simply to gain the approval of pre-existing (but from a historical perspective transient and ephemeral) vested interests or political groupings.

The author of this *Monograph*, Michael O'Dowd, writes within this framework. A senior businessman with a deep practical understanding of institutional and economic development he authored an earlier FMF *Book* (*The Industrial Revolution: Myth and Reality*, 1985). Here he refocuses his attention from the successes of capitalism in its early years to the Post-World War II decades. He argues that socialism (the central planning and direction of society's resources by government) was perceived to have been victorious after the 1939 – 1945 debacle. Furthermore, the "plans" could presumably achieve justice as well as efficiency.

O'Dowd's view is that these presumptions were dispelled by facts not theories. By the 1960s economic "miracles" (ie. events contrary to then received theories of most economists) had occurred in many countries, from Japan to Italy and (West) Germany. The remarkable growth of the United Kingdom and the United States in an earlier period had in fact been nothing different.

By contrast socialist and planned economies proved (empirically) to be significantly less satisfactory in the provision of either wealth, justice or equity. But why? O'Dowd rejects "miracles" and rather seeks theoretical explanations. He argues that good science demands that inadequate theories be dispensed with and replaced by those better able to explain events.

O'Dowd's preferred theory is both simple and profound. If individuals have proper incentives they will behave in ways which enrich both themselves and society. The crux of the matter is the right to own and exchange property. The state is therefore essential to O'Dowd – it must protect and enforce property rights.

If the state does have a role, however the right balance is difficult to achieve. At the extreme, the balance can be tilted towards confiscation and "terror" (Stalin's Russia and Mao's China are cited as but two examples). Both of these countries are now redressing the balance through large scale privatisation programmes.

But perhaps even more alluring to those who have not yet discarded the theories of the 1960s, is to tilt the balance towards "moderate" socialism, not terror. Mixed economies is an inappropriate term. (O'Dowd has already underlined the importance of the state). Rather it is the mildly *dirigiste* economies of Britain in the 1960s and 1970s and India to the middle 1980s which seem still to attract attention, together with heavily welfarised economies such as Sweden (which otherwise has little economic *dirigisme*). O'Dowd also dispenses with those on empirical grounds. These economies were unsuccessful, compared with others at the same time. Today India is dismantling its host of regulations while welfare is being reduced in Britain to relatively more affordable levels. (The National Health Service "cradle to grave" philosophy has already been slashed at its point of heaviest spending – the elderly. Frail care is now provided for the indigent only, all others must pay). Privatisation in those countries has accelerated and is taking on a role equivalent in the twentieth century to the private enclosures of common land in the eighteenth and nineteenth.

O'Dowd concludes with policy conclusions for latter day South Africa. He argues for maximising the role for spontaneous evolution and minimising the potential for planned and discrete change. Such planned change tends to be based on ignorance of future market supplies and demands. It is usually argued for by those (bureaucrats, politicians and interest groups) whose incentives are career, power and patronage driven rather than profit driven in response to wants in the market place.

O'Dowd writes in his private capacity. The views are not those of the FMF (which has no corporate view), nor of its Council Members or Directors. But the broad sweep of his argument stretches across the globe through half a century and draws on a wide range of scholarship and references (a selection of which concludes his essay). As such the FMF believes it is an important contribution to the current economic and political debate within South Africa.

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## The author

Michael Conway O'Dowd is an Executive Director of Anglo American Corporation of South Africa Limited. He is Chairman of the Anglo American and De Beers Group Chairman's Fund. Born 1930, in Johannesburg, and educated at the University of the Witwatersrand, where he graduated with a BA and LL.B cum laude. He received the honorary degrees of Doctor of Social Science from the University of Natal, Doctor of Laws from the University of the Witwatersrand, and Doctor of Laws from Rhodes University.

In 1974, he was appointed Chairman of the Anglo American and De Beers Group Chairman's Fund. He is Chairman of the Free Market Foundation, a member of the Human Sciences Research Council, a member of the South African Council for Education, a Trustee of the Joint Education Trust, and a Fellow of the Institute of Directors. He takes a keen interest in education and is a member of the Councils of the University of the Western Cape and the University of Fort Hare, and Chairman of the Foundation of the University of Bophuthatswana. He was a member of the Human Sciences Research Council Inquiry into Education 1980/81 and was a member of the Council of the University of the Witwatersrand 1982 – 1993.

For the FMF he wrote: *Industrial Revolution: Myth and Reality*, 1985.

# 1

## The success of capitalism since 1945

In 1945 it was almost universally believed throughout the world that socialism – implying here an economic system where the means of production are owned and controlled by the state and the economic process is centrally planned and directed – was a more advanced and desirable system than any form of capitalism, and that there was an inevitable movement in the world towards such a system. The main area of difference of opinion was whether the transition to socialism should take place by sudden and drastic change (revolution) or by relatively gradual and incremental reform. There were people on both sides of this argument who contended their approach was the only possible one while others believed both were possible but argued about which was the least costly or the most effective.

It was generally assumed that a socialist system would be a great deal more productive and would produce a vastly more just social system than capitalism had done. It should be emphasised that at this stage nobody saw a trade-off between justice and economic efficiency; it was claimed that socialism was greatly superior on both counts. It is also notable that the belief in the inevitability of the movement towards socialism was accepted by some people who did not hold that it was a superior system but nevertheless conceded that there was some inevitable law of nature that was bound to bring it about.

The matter was indeed seen in terms of laws of nature, and so it was considered to be as impossible that a socialist system should change internally into a capitalist system as that water should run uphill or that an oak tree should shrink into an acorn. It is for this reason that recent developments in Eastern Europe and China, where in one case an extreme form of socialism has been abandoned in favour of capitalism and in the other a socialist system is progressively reforming itself in a capitalist direction, have had such a profound effect on theoretical thinking in the world. The old theory is no longer tenable and has, in fact, been disproved.

The disproving of this theory did not begin in 1989; it began very shortly after 1945. The historical experience which shows capitalism to be a highly viable system – extremely effective and much superior to socialism for the purpose of increasing wealth, and not inferior, and probably superior for the purpose of benefiting the poorest has been accumulating over the last fifty years.

The revolution in economic thinking in the world was not led by theorists. The theorists, having been most reluctant to see the evidence and having clung to obsolete theory long after practical people, including in particular practical politicians, had learned better. This fact is amusingly illustrated by the constant use over the last fifty years of the term “miracle” to refer to highly successful capitalist development. Now, a miracle means something which happens contrary to the laws of nature. If we observe that miracles constantly happen, this tells us (if we believe in the principles of science) that our understanding of the laws of nature is wrong and has to be changed. In other words, our theories have to be revised.

This was precisely the position regarding economic theory at any time after about 1960, but most theorists obstinately refused to revise their theories and persisted in using the term. It is exactly as if a physicist had continued to propagate the nineteenth-century belief that atoms cannot be split and, every time a nuclear device went off, had called it a miracle.

The successful capitalist development did not begin after 1945. In fact, the first spectacular capitalist development was that of Britain in the early part of the nineteenth-century, followed by the still more spectacular development of the United States from about 1866 to 1929. What happened after the War was simply a resumption of what had happened before. Nevertheless, in the atmosphere of the time it was seen as if it were a new phenomenon, and it is certainly true that the rates of economic growth achieved in the so-called “miracle” economies exceeded anything which had ever been seen before in history.

The first “miracle” developments after 1945 were those of West Germany and Japan. The case of West Germany is complicated both by the phenomenon of Marshall Aid and by the fact that what was taking place was largely reconstruction of a devastated but already advanced economy, since it is well established that reconstruction is always easier than new growth. However, the facts remain spectacular. West Germany rose from a per capita income less than half of that of Great Britain in 1945 to more than double by 1980. Before the War the western part of Germany had been only modestly wealthier than the eastern part but by the time of unification the per capita income of East Germany was a quarter of that of West Germany. If Marshall Aid played an important role in this (which is doubtful), it raises another issue: the fact that the United States was both willing and able to give aid to West Germany whereas the Soviet Union was either unwilling or unable to provide aid to East Germany seems in itself to demonstrate the superiority of capitalism to socialism.

The case of Japan is both more spectacular and less complicated. In 1945 Japan was almost totally devastated but at the beginning of the War, before any such devastation, it was what we would today call an upper Third World country, comparable perhaps to South Africa in 1960, with the majority of the population living in great poverty. Today Japan is one of the richest countries in the world, with a per capita income comparable to that of the rich countries of Western Europe and only slightly below that of the United States. The distribution of income in Japan is unusually equal, much more equal, for example, than in Sweden. The expectation of life is the longest in the world and infant mortality the lowest. There was never any equivalent of Marshall Aid to Japan.

After Japan came the so-called “four little tigers” of the Pacific Rim: Hong Kong, Singapore, South Korea and Taiwan. The economic development of these countries has been comparable with that of Japan at an earlier stage, and they are all growing at rates which, if continued, will bring their per capita incomes equal to those of Japan and the countries of Western Europe within about fifteen years. They have all shown decreases in the incidence of absolute poverty; disproportionate benefit from growth having accrued to the poorest.

These countries have a particular additional interest in that, with the exception of Hong Kong which is a colony to this day, they are all former colonies – Singapore having obtained independence from Britain at about the same time as most of the countries of Africa, and Taiwan and South Korea having obtained independence from Japan in 1946. Malaysia, another former colony, has shown growth less spectacular than that of the four tigers but nevertheless very respectable indeed, having averaged growth exceeding 6% per annum for a considerable number of years.

Another major capitalist success story which had attracted less attention is Italy. At the end of the War Italy too resembled what we would today call an upper Third World country, with a very high illiteracy rate, a considerable proportion of children not attending school, even at the primary level, great poverty and widespread unemployment. Italy suffered relatively little devastation in the War but by the time this had been fully made good (by 1960) the per capita income was less than half of that of Great Britain. By 1980 it was equal.

Other countries in which there has been spectacular growth under capitalism include Spain, Chile and (in recent times) Thailand and Indonesia.



# 2

## The poverty of the alternatives since 1945

The history of the countries cited is sufficient to prove that capitalism is a viable and effective system but, of course, it does not in itself prove the superiority of capitalism to its rivals. The other side of the historical record from 1945 to 1995 reflects the dismal and sometimes catastrophic failure of both of the two alternatives. The one is the fully planned economy, usually referred to in modern times as Communism. The other is a mixed economy with a high degree of state control and a basically socialist thrust.

The failure of the centrally planned economies is now so well known and so well documented that it hardly needs to be elaborated. The recognition of this failure was long delayed because of the practice of the centrally planned economies of systematically falsifying their economic data, but it is now perfectly clear that the claims regarding economic achievement, economic growth and social justice that were put out by the governments of, for example, the Soviet Union and East Germany, were false. A considerable amount of the fall in national income recorded since the change of government in these countries reflects a fall from a position which never existed. A Polish politician, when asked the cause of the apparent fall in the national income of Poland, said, "The first and most important cause is that you stop lying".

The failure of the centrally planned economies was an economic one. The centrally planned system does not work. It is now generally accepted that this is so for two reasons. The information required for the purpose of planning an economy is not available. A market economy is coordinated by prices which are created by the interaction of countless individuals, each of whom is acting on information, some of which he alone possesses. All this information is effectively fed into the price. There is simply no way in which planners can obtain this information. The second reason, which is an important one, is that it is not possible to maintain the degree of discipline which a centrally planned economy would require. While everybody in such an economy is theoretically a functionary, carrying out instructions derived from a plan, in reality this is not so. Even if the instructions could always be efficiently conveyed (which is by no means the case), there is no way of ensuring that they are obeyed. Individuals, in fact, act in their own interests as they see them, and the plan is not carried out.

In the absence of private property and markets, the pursuit of self-interest by individuals does not serve the public good but undermines it. This explains the link between socialism and terror. The notorious terrorism of the Stalin era in the Soviet Union reflected an attempt to overcome the discipline problem. At gigantic social cost it appears to have worked up to a point in that the Soviet economy appears to have performed best at the height of the Stalin era. Its deterioration began as soon as it was decided that the price was not tolerable. This is not to say that a socialist society has a choice between terror and efficiency or the absence of terror and economic collapse. Even with terror the level of efficiency obtained is quite low. Compared with capitalist countries, the achievement of the Soviet Union was never impressive.

The practice of measuring the Soviet Union's growth against that of the United States was inappropriate since the Soviet Union was a developing country, and there is overwhelming evidence that developing countries can grow faster than highly developed countries. The appropriate comparison was between the Soviet Union and Japan which began their industrialisation at about the same time, around 1860. (The Soviet Union was, of course, vastly better endowed with natural resources than Japan.) Among the facts that have come to light since the collapse of the Soviet government is that in the last years of the Soviet Union the expectation of life was falling, the infant mortality rate was rising and, in some parts, was significantly worse than among black South Africans under apartheid. Japan, it will be recalled, has the longest expectation of life and the lowest infant mortality rate in the world.

It is perhaps necessary to make the point in passing that nobody claims that all is now well in the former socialist countries which are attempting, to varying degrees and in varying ways, to adopt capitalism. Capitalism cannot be created by waving a wand or by decree; it requires a whole host of institutions and practices which have to be learned not by a few people but by virtually the whole population. The transition from a centrally planned economy to a viable capitalist economy is bound to be painful and protracted, and the more thoroughly former capitalist institutions were destroyed in the previous era, the more painful it will be. The problem that these countries face, however, is that they have no option. They cannot return to a system which has failed because it would simply fail again.

There remains to be considered the case of China. In the longer historical perspective there can be no question of the spectacular difference in the economic development of Taiwan and Hong Kong on the one hand and mainland China on the other. Taiwan, having been first a neglected and backward province of China and then a Japanese colony, now has a per capita income five or six times that of mainland China and foreign trade exceeding that of mainland China in volume (mainland China having fifty times the population of Taiwan). Nevertheless, all observers agree that mainland China (or at least some parts of it) is now making spectacular progress.

The fact that China has been ruled since 1948 by what has purported to be the same regime serves to conceal the fact that in that time it has undergone four changes of policy so drastic that they can only be regarded as revolutionary. First, after the revolution of 1948, the Chinese government pursued a policy of total socialist revolution modelled to a significant extent on the practices of the Soviet Union. This led (as happened in the Soviet Union in the 1930s) to a famine in which 30 million people are reputed to have died in the euphemistically termed “difficult years” of 1959 to 1961. This was followed by a radical change in policy. Deng Xiaoping was put in charge of the government and embarked on a policy which was subsequently described and, indeed, denounced as the “capitalist road”. The retreat from socialism was radical in the countryside and brought about a recovery of agricultural production such as was never achieved at any time by the Soviet Union.

This policy was ended by the so-called “cultural revolution” which seems to have been rather a collapse of order than the pursuit of any coherent policy. It led, among other things, to the closing for six years of all Chinese universities and most Chinese schools and the almost complete collapse of industrial output. Its impact on the countryside appears to have been much less and agricultural production continued. The cultural revolution was finally suppressed by force. Deng Xiaoping, who had been disgraced at its beginning, returned to power and the capitalist road was resumed. The movement away from socialism has continued at a steady pace, to the extent that in 1993 China announced the privatisation of 13 enterprises, more than any other country in the world. In 1994 a further 23 major privatisations were planned.

The following are extracts from a document entitled *Policies on Encouraging Investment* issued by the government of Hainan Province in mainland China:

*“With regard to taxation, a 15% income tax rate is applied to the income of enterprises run by foreign investors and such enterprises are exempt from local income tax.*

*“Foreign investors are encouraged to involve themselves in the development of market systems.*

*“State-owned land may be transferred for a period of up to 70 years, and the land transfer contract may be renewed upon the expiration of the transfer period .... The land thus developed may be transferred during the valid period of land use right and may be used as a mortgage for applying bank loan.*

*“In business operation, the investors may set up exclusive, joint or co-operative ventures in Hainan. They may purchase stocks, bonds and other securities, take over enterprises, buy their shares for management or contract ... the businesses enjoy full autonomy in their operation.*

*“The Chinese government protects the lawful rights and interests of foreign investors and does not nationalise or requisition their assets or property.*

*“The foreign-invested enterprise may, on its own, adopt production and management plans, raise and use funds, purchase means of production, and market products.*

*“The invention patent, copyright and other intellectual properties will be protected.”*

If that is socialism, we are in favour of it.

It is quite clear that the rapid economic development now taking place in parts of China is fuelled mainly by capital investment from abroad, particularly Hong Kong and Taiwan but also other parts of East Asia, probably including Japan. There would appear to be discrimination against the indigenous inhabitants and in favour of foreign investors, and also a lack of institutions which facilitate the accumulation and investment of local savings. The Chinese may look forward to the reunification of China with Taiwan and Hong Kong and therefore not fear the foreign domination of their economy. It is nevertheless ironical in the extreme that the development of China is being brought about precisely by those institutions which the Communists were unable to destroy. The countries that formerly made up the Soviet Union no doubt wish that they, too, had a Taiwan.

We would conclude that it is perfectly clear that China is not an exception to the worldwide movement away from socialism but is in fact a spectacular example of it. What the case of China does prove is that the movement from socialism to capitalism can be carried out by a formerly socialist party and, indeed, it may well be that this is likely to be a better road than the highly disruptive revolutions which took place in Eastern Europe. There are other examples in the West of formerly socialist parties which have put themselves in the forefront of the new movement. So the Labour Party in New Zealand, formerly a socialist party, has presided over one of the most radical and far-reaching programmes of privatisation, and the Socialist Party in Italy has also been active in moving the economy in the direction of privatisation.

# 3

## The “moderate” socialist experiments

It remains to consider the “moderate” socialist experiments which have taken place in the world during this time. These are sometimes referred to as “mixed economies”, but there are difficulties about this term. First of all, in a strict sense, all economies are mixed since there was a significant informal market sector of the economy even in the Soviet Union and a small, but significant, formal sector in Poland and Hungary under Communism. On the other hand, even the most extreme capitalist economies have a public sector. It is also worth noticing that the idea that the mixed economy is some sort of compromise or a middle way is of recent origin. The original conception out of which these economies grew was the idea that they represented an alternative gradual road to socialism – alternative, that is, to revolution. The idea that they have a peculiar virtue is of very recent origin and seems to represent an attempt to defend them against demands for the rolling back of the public sector.

We also have to distinguish clearly between two different things which are usually both found in the so-called mixed economy but may have quite different merits. The one is the management or direction of the economy by the state. The other is the large-scale provision of welfare by the state. These have tended to go together, but, as we shall see, there is no necessary connection between them.

We will consider first the idea that without actually owning the greater part of the means of production, the government can broadly direct or manage the economy, producing a better result than would emerge in the absence of such management. In earlier years it was always claimed that the result would be better both in terms of economic efficiency and of equity. In more recent times, it is sometimes claimed that there is a trade-off between efficiency and equity, and that a price in terms of economic efficiency is willingly paid. This approach is sometimes called “dirigisme”, from a French word meaning to drive (a team of horses). The most extreme example of it in history was Hitler’s Germany, in which, while most of the economy was nominally in private ownership, practically all important decisions regarding investment and production were taken by the state. The system did not operate long enough to have shown whether it was viable, let alone whether it was desirable.

Dirigisme has also been practised with a varying degree of intensity in France since the days of Louis XIV. At no time in history has the performance of the French economy been remarkable, and it is probably true that the most successful era of economic growth in France was under the rule of General de Gaulle, when the intensity of dirigisme was at its lowest. At the same time, it is quite clear that in France the results of dirigisme have at no recent time been disastrous.

There are several examples from the Third World of attempts to create a highly dirigiste state, which have been disastrous, two of the most spectacular being Argentina, under Peron, and Ghana, under Nkrumah. In both these countries the national income per head fell by half within quite a short time and, as has always been the case in countries which have undergone severe impoverishment, totally irrespective of the political and economic system, the greatest sufferers were the poor. It can, however, be argued, and may well be the case, that the problem in these two countries, and in a number other Third World countries, was that they did not possess the expertise necessary to conduct a dirigiste economy.

Dirigisme certainly places great demands for technical expertise on the state machinery. Ever since Napoleon, France has maintained a highly elitist educational system and channelled a large proportion of its best-qualified people systematically into the state machine. It can well be argued that in doing so, while it has made dirigisme viable, it has paid a heavy price in diverting people from productive activity.

However, the most striking examples, and the ones which have had most influence on thinking in the world, are India from independence in 1946 to approximately 1987 and Great Britain from the Labour government in 1945 to the accession of Mrs Thatcher in 1980. Throughout this period both parties in Britain, while disagreeing on matters of detail, followed an essentially dirigiste economic policy. Britain also had an elaborate welfare state. India did not. Sweden had an elaborate welfare state but did not have a dirigiste economy.

India and Great Britain were both democracies, with an honest and competent bureaucracy. They had access to the very best economic advice, with a plentiful supply of highly trained, home-grown experts, yet in both cases their economic performance was dismal though not disastrous. Britain, over the time in question, moved from being the richest country in Western Europe to the poorest, with the exception of Portugal and Spain, and from a position where average wages were double those paid in West Germany to where they were half. While there can be no doubt that some of the institutions of the welfare state initially greatly improved the condition of the poor and brought about a number of important improvements in the life of the British people in general, there was no ongoing progress in these respects, and the deteriorating economic performance over forty years was accompanied by rising social tension, increasing labour militancy, rising crime and the emergence of an under-class which had not previously existed.

The rate of economic growth in India was little higher than the growth of the population so that the per capita income scarcely improved. Poverty increased enormously and the largest concentrations of people living in abject poverty could be found in India at any time between 1946 and the present. That the Indian economy had been a failure was universally recognised by the end of the 1970s.

An important new dimension was introduced into the evaluation of the merits of economic systems by the oil crises and the disruption of the international economy which they brought about, for they imposed on all the economies of the world a rigorous test of their ability to ride out crisis and adapt themselves to suddenly changed circumstances. Theorists might have predicted that dirigiste economies would be best suited to do this but experience showed the reverse to a most spectacular degree. Both Britain and Sweden were shaken to the core by the oil crises despite the fact that Britain was already an oil producer. Switzerland rode the crises and moved ahead of Sweden in per capita income during this time. The four tigers, all of which are entirely dependent on imported oil, maintained their growth rates throughout the 1970s, with hardly a hitch.

Sweden attempted to deal with the crisis by nationalising industries for the first time ever and substantially increasing economic controls. The Swedish economy has been in crisis ever since and the Social Democratic Party, which had ruled Sweden for fifty years, has since lost power twice. Great Britain responded to the crisis after some delay by initiating the privatisation, deregulation movement, which was followed by a period of rapid growth in which Britain again drew level with the other wealthy countries of Western Europe.

India has made a similar move, starting rather later. A very considerable degree of deregulation combined with some privatisation has brought in the last five years the highest growth rates India has seen since independence and, for the first time, India is coming to be seen in the rest of the world as an economy to be reckoned with.

# 4

## Policy lessons

In the above section we have provided the background to the new economic thinking which has spread through the world in the last ten years. The policy lessons drawn from this experience can be summarised as follows:

- Central planning of the economy is not possible and to attempt it is extremely damaging;
- Public ownership of means of production (as distinct from *means* of rendering social services) is inefficient and serves no useful purpose. Most productive assets owned by governments today were acquired by them in terms of economic theory which is no longer believed. It is not surprising, therefore, that there is a worldwide trend to privatisation. In 1993 30 countries announced new privatisation moves, in most cases following on others which had already taken place. First on the list in the value and scale of privatisation is mainland China. Russia and most of the former members of the Soviet Union are on the list, as also are Sweden, Finland, France, Italy and Israel. Countries with very little to privatise, like Japan, South Korea and Taiwan, are also on the list;
- Attempts to control an economy by means of detailed controls, that is, permits, are extremely harmful. This was the core of the Indian approach to dirigisme which came to be known in India as the “Permit Raj”. Up to now the reforms in India have been mainly concentrated on deregulation, which is also going on apace in other countries;
- Foreign trade is vital to economic growth. It has been particularly noted that the four little tigers are small countries with huge foreign trade. Hong Kong exports every year more than its gross national product, the difference being made up by goods which are imported for re-export. The pursuit of self-sufficiency, which was fashionable in the previous era and tended to be associated with dirigisme, is highly undesirable;
- While the pernicious nature of permits and detailed regulation, and also rather particularly of price controls, has been universally accepted, the possible role of the state in giving broad guidance to the economy is much more controversial, for here the evidence does not speak with one voice. The extent to which successful economies have been characterised by a government with an active industrial policy varied enormously. Britain and the United States in the nineteenth century and Hong Kong at the present time had no such policy. Italy is generally considered to have succeeded despite rather than because of its government’s policies, the Italian government having been notoriously weak and ineffectual. Attempts to introduce a more positive policy in the United States since the 1960s have been accompanied by a deterioration in economic performance, but this could well be because of the particularly inappropriate nature of the system in the United States which, with its use of regulatory agencies, smacks more of the Permit Raj. On the other hand, South Korea and Singapore have at all times while they were successful had such an active policy directed centrally; so has Taiwan but to a markedly lesser extent.

The position in Japan is highly controversial. The Ministry of International Trade and Industries (MITI) has long conducted an institution where big business consults with the government on economic policy, and some economists have claimed that this was a form of state guidance of the economy. The extreme opposite view is that this represented the

dominance of the government by big business; business controlled the government, not vice versa. What is clear is that MITI had no coercive power. There are well documented and spectacular examples of individual Japanese companies acting contrary to MITI's advice and being proved correct. The important point is that nobody prevented them from doing so.

It would seem quite clear that MITI is not an organ of dirigisme. It would seem to be much more analogous to a South African forum. We do not positively know, but we rather suspect that the economic steering that takes place in Taiwan and Singapore may also be much more in the nature of consensus-building than of ruling or direction in the familiar Western sense. The development of the forums in South Africa may represent an independent discovery of the same potentially winning formula.

It is not possible to argue that an active government policy is necessary for economic growth. There are too many cases to the contrary, particularly Hong Kong, which has grown as fast as either Singapore or South Korea. There are two views regarding such government policies, both of which are compatible with the evidence. The one (argued by Professor Deepak Lal) is that all government interventions come at a cost; it is merely that if the rest of the economy is doing well enough, a country can afford some of it. Professor Lal points to some major and costly errors which were manifestly made by the South Korean government in terms of economic policy.

The alternative view is that provided it is sufficiently well conceived and sufficiently competently executed, an active economic policy can make a positive contribution to the economic growth of a country, but it cannot be denied that such successful policies have been very much in the minority. It would follow that those who are in favour of such policies need to give their attention – indeed, all their attention – to determining precisely what makes a successful industrial policy. It is no use for them to point to South Korea and say that South Korea proves that an industrial policy is necessary for success, for their opponents can point to Ghana or India or a number of other examples and say that an industrial policy makes for failure.

Generally, in seeking to determine what makes for economic success, one must obviously ask what factors do all, or nearly all, of the successful cases have in common. An activist government is clearly not one of these. The following can be said with some confidence to be common factors found in all successful capitalist economies, both in the last and present centuries:

- The economy was essentially market-driven. This means that, above all, investment decisions are made on market and not on political grounds;
- The total share of the national product handled by the government was low. It follows that taxes were low;
- There was a high degree of economic freedom at micro level, that is, an absence of permits or other detailed and *ad hoc* interventions which prevented entrepreneurs from making their own decisions. (Note the emphasis in the Chinese document on the *autonomy* of enterprises.);
- There was a high degree of openness to foreign trade. There is one major exception to this. The United States in the nineteenth century practised a high degree of protectionism, a fact which misled many countries in the twentieth century to believe this was a valid road to growth. It would appear that the United States was so well endowed with natural resources of all kinds and its domestic market was so large, that trade was unimportant to it. There is almost certainly

no other country in the world of which this is true, and it is doubtful if it is true of the United States at the present time;

- Prices were determined by the market, and not by the government. There is a great deal of evidence that price controls are particularly pernicious;
- Property rights were clearly established, unambiguous and respected. The market depends on property. If property is not respected, the whole market mechanism is subverted;
- A successful economy is not incompatible with a welfare system provided that the productive economy can afford the cost. An elaborate welfare system is in fact a luxury for a wealthy country.

What follows from all this is that the economic success of a country is indeed determined by the government. Other explanations in terms of natural resources, history, culture and religion are not compatible with the evidence that we now have at our disposal. The difference in performance of East and West Germany, of North and South Korea, of Hong Kong and Taiwan and mainland China can be accounted for only in terms of the economic system. The people concerned were the same people, with the same history, the same traditions and (until coercive attempts were made to change them), with the same religion. Many of the most successful countries have few or no natural resources while some countries rich in natural resources have done notably badly, for example the Soviet Union and Argentina. Spectacular responses by populations with a long history of stagnation to changes in the economic system have cast serious doubt on economic theories based on culture and religion. The most spectacular example in recent times was South Korea for, while the Chinese have always had a tradition of entrepreneurship, the Koreans never have.

So it does depend on the government, but not on the government's entrepreneurial brilliance. Indeed, it would appear that those in government have to accept that they have to leave entrepreneurship to others. Success depends at least as much on what government refrains from doing as on what it does and, indeed, it would seem from the case of Italy that success can still follow even when the refraining is a result of default and not of decision.



# 5

## Postscript: The false idea of the superiority of socialism

The above discussion raises a question which, while it falls outside the main line of argument, seems too important to neglect. Where did the idea of the superiority of socialism so widely accepted around 1945 come from? The answer is in two parts. It was partly based on theory going back to the end of the eighteenth century and partly on recent historical experience.

To deal with the second (which is much the more important) first: between the two world wars, for the 21 years from 1919 to 1939, capitalism did not appear to be working. Because of the enormous influence this experience had on thinking in the world it is important for us to note that capitalism has been producing spectacular economic development for about two hundred years. During this time it appeared to fail for twenty years. What accounts for this failure? There is no consensus among theorists as to the causes of the economic tribulation of almost the whole world between 1919 and 1939, but certain facts are clear.

During the First World War there had been an enormous increase in economic control by governments, undertaken for purposes of the War. At the end of the War the new bureaucracies which had been created for this purpose were not demobilised but sought new justifications for their existence. The result was an enormous increase in dirigisme, undertaken to a large extent by people with no useful experience of directing an economy in peace-time conditions.

The first thing we can say about the years between the wars was that they were marked by a great deal of extraordinarily inept government intervention, not only in Europe but in the United States as well. Although the degree of intervention in the United States was slight compared with other countries and compared with the United States today, it nevertheless appears to have been harmful. One of the few matters on which most theorists agree is that the interventions of the Federal Reserve in the United States between 1929 and 1932 were harmful and made a major contribution to first causing and then prolonging the Great Depression.

During the 1930s, the time of the Great Depression, dirigisme was at the highest level it had ever reached in modern history. After 1945 it was greatly diminished in West Germany and Italy, somewhat diminished in Japan and the United States, and increased in Britain and France. In the years which followed, Britain and France did badly; West Germany, Italy, the United States and Japan did well. This evidence is very suggestive but it cannot be regarded as conclusive.

On another point, however, the evidence is overwhelming. The period between the Wars was marked not only by a high point of dirigisme but also by a high point of protectionism. The United States had grown most successfully behind a tariff barrier, and nearly all governments believed that this showed that protectionism was part of the road to growth. The view was plausible at the time, but it is an excellent illustration of the danger of trying to imitate a particular aspect of a particular country's success without checking on the experience of other countries.

It should also be noted that protectionism, with the drive towards self-sufficiency which it implies, has a particular appeal to militarist governments as international trade is always a problem in case of war. All governments in Europe between the Wars were more or less militarist, and many of them extremely so.

So, during the 1920s, protectionism was raised to unprecedented levels and, as economic conditions grew worse, the reaction was to raise tariffs still higher so that by the end of the 1930s the levels of protection were much higher than in the 1920s. After the Second War, the degree of protectionism practised by the major economies was decisively rolled back under the General Agreement on Trade and Tariffs. Just as during the 1920s and 1930s international trade had shrunk and world output had shrunk with it, so, in the 1950s and 1960s, international trade grew and world output increased at an unprecedented rate. Trade grew faster than output. Most of the Third World

countries which did not join in the prosperity of the time continued to practise protectionism, notably India.

We believe, then, that the unsatisfactory performance of the world economy between the two World Wars is attributable to heavy and inept dirigisme and widespread protectionism.

It remains to be asked, then, if protectionism is so damaging, why was the United States able to grow behind a tariff barrier? We would suggest that there were three conditions which existed in the United States, all of which are necessary to make this possible.

The first was that it was a huge economy, with potentially huge markets. This meant that any industry could grow to an optimum size without serious involvement in foreign trade. The second was that the exporting industries of the United States (mainly temperate agriculture) were so competitive that they could carry the costs which were imposed on them by protection and continue to earn ample foreign exchange for the United States economy which, in any case, required very few imports because the United States possessed its own fully competitive resources of most raw materials. Finally, the United States was in a position to attract a large and continuing inflow of foreign capital, thus reducing the importance of the generation of domestic savings by domestic industry.

Of these three requirements, India had the first but not the second; Saudi Arabia has the second but not the first; Russia potentially had all three but the Soviet economic system destroyed agriculture, which was Russia's potential earner of foreign exchange, and excluded foreign capital.

The theoretical aspect is probably much less important, for a theoretical case for socialism does not appear to have carried much weight until the economic experience between the Wars appeared to support it. Nevertheless, there are issues worth mentioning.

The idea that socialism or, more specifically, central planning, must necessarily be a superior system grew up in the nineteenth century on the basis of the views of science which were dominant at the end of the eighteenth century and the beginning of the nineteenth century. Some of these were already obsolete by the end of the nineteenth century. Some of the most important of these ideas were the mechanistic view of the universe, the theory of determinism and the theory of rational constructivism. The mechanistic view saw the whole of reality as being analogous to a simple machine, like a clock – a process of levers in terms of which power was transmitted in a simple manner and in a single direction. Determinism taught that everything that happened was a matter of detectable causes and effect, so that everything that happened was determined by preceding causes.

These two ideas together led to the belief that everything could be controlled fairly simply provided one had the necessary knowledge. Rational constructivism followed from this. It was the belief that human reason is capable of constructing systems for any purpose, superior to those which exist in nature or which have come about without such construction. The idea was widely held at the end of the eighteenth century that anything that had not been rationally constructed was necessarily “primitive” and “superstitious”, and that everything that had not been rationally constructed must be replaced by something which had been.

The fact that capitalism is not a rational construction – it was never invented but evolved – and those who developed a theory of capitalism did not propose a new system, but like grammarians or music theorists, described what already existed, was regarded as an unanswerable case against it. Socialism, as a rational construct, was to be the “modern” thing which would replace “primitive” capitalism.

None of these ideas are compatible with present-day scientific thinking and knowledge. The mechanistic view of the universe has been replaced by systems theory. A system is infinitely more complex than a machine, although many of the most recently developed machines simulate important aspects of systems. The most crucial point about systems is that cause and effect are not transmitted simply in a single direction but typically feed back in a circular manner so that the effects affect the causes. The most familiar example is an ecosystem.

Determinism is no longer credible in its early simple form. On the one hand, the uncertainty principle and chaos theory show that in huge areas of reality there are no simple and determinable causes. Either there is random chance, which is now believed to exist on a very large scale, or

causation is so complex and depends on such fine differences that it defies every possibility of prediction or control. This is chaos theory.

In addition, it is now widely believed that human beings, and probably other living things, are capable of creative new responses to solve their problems, so that they cannot be managed or manipulated in a mechanistic manner. The management of human beings takes on the nature of a competitive game rather than resembling the construction and operation of a machine.

Finally, the development of the theory of evolution has led to the realisation that that which has evolved over time may be superior, and even greatly superior, to that which has been rationally constructed, both because the intelligence and creativity of vast numbers of people have entered into its development in contrast to the handful who participate in rational construction and because it has been tested in reality. The belief that even in evolution the new is always superior to the old can no longer be sustained – even in biological evolution, where thousands of newer species have become extinct while other older species have survived.

We repeat that we do not believe that these theoretical considerations have in fact played an important role in the development of economic thinking. It is, however, interesting and reassuring to know that the new economic thinking is compatible with the most up-to-date scientific views.

## Further reading

The revolution in economic policy which has occurred in the last 10-15 years is well illustrated by the policy stance adopted by The World Bank towards privatisation and deregulation. For example:

World Bank (1993) *The East Asian Miracles: Economic Growth and Public Policy*, Oxford University Press, Cape Town.

World Bank (1994) *World Development Report*, Oxford University Press, Cape Town.

World Bank (1995) *Bureaucrats in Business: The Economics and Politics of Government Ownership*, Oxford University Press, Cape Town.

The breakdown in belief that government planning could aid rapid and appropriate development in the formerly so-called “third-world” is addressed in a book by Deepak Lal:

Lal, D (1993) *The Repressed Economy: Causes, Consequences and Reform*. Edward Elgar, Aldershot.

The world-wide trend towards privatisation is continuously monitored by the Reason Foundation in their *International Privatisation Update*. A good book covering the field is:

O’Leary, John (ed) (1995) *Privatisation*, Reason Foundation, Los Angeles.

The role of government in exaggerating, perhaps even initiating, so-called “crises of capitalism”, through mismanagement of the central banking system is well illustrated by the following book:

Rothbard, M (1972) *America’s Great Depression*, Sheed and Ward, Kansas City.

The failure of alleged industrial policy “successes” such as Japan’s MITI is appraised with substantial source material in:

Reekie, WD (1995) *Industrial Policy: A Review*, South African Journal of Economics.

Two encyclopaedic books, contrasting economic freedom and prosperity, and each showing strong linkages between the two are:

Gwartney J, Lawson R, and Block W (1996) *Economic Freedom of the World 1975-1995*, Free Market Foundation, Johannesburg.

Johnson BT and Sheehy TP (1995) *The 1996 Index of Economic Freedom*, Heritage Foundation, Washington DC.

The economic and political lies and deception which emanated from the Soviet Union and were believed in the West have now been seen, even by former credulist observers such as the US Central Intelligence Agency, for what they were. One of the first historians to illustrate the “terror” involved in Soviet planning, once derided, now acknowledged, was Robert Conquest. His book is now a classic:

Conquest R (1969) *The Great Terror*, London.