On the surface, then, while Doyle appears to be setting forth a comprehensive and dramatic redefinition of the standards governing anticipatory self-defense, his new standards are not so different from our current ones. But because they are grounded in so thorough a study of the challenges to international peace and security in the modern era, the improvements at the margins produced by this study constitute a very high standard, and should help to reaffirm a broad presumption against preventive war.

Christopher Preble
Cato Institute

Economic Development and Transition: Thought, Strategy, and Viability
Justin Yifu Lin
New York: Cambridge University Press, 2009, 170 pp.

Justin Yifu Lin is senior vice president and chief economist at the World Bank. He is the first Chinese economist to hold those positions. He earned his doctorate in economics at the University of Chicago in 1986 and returned to China the following year—the first Ph.D. economist to return from abroad since the beginning of the reform movement in 1978. At Peking University, he founded the China Center for Economic Research in 1994, and has played an important role in educating a new generation of graduate students and advising top officials. His deep understanding of the institutional framework for a market economy reinforced his support for economic liberalization, which has increased the range of individual choice and allowed millions of Chinese to lift themselves out of poverty.

This is perhaps Lin's most important book. Although it touches on China's development process, it is much broader—providing a theoretical framework for understanding the fundamental determinants of development and the implications of alternative development and transition strategies. The book stems from the author's 2007 Marshall Lectures at Cambridge University. It is well written, tightly argued, and empirically grounded. Although the main body of the book consists of only 96 pages, each of the eight chapters (six of which are 12 pages or less) packs a powerful punch. The author also includes a mathematical appendix, which is where Alfred Marshall would have put the formal models—or he would have written them down and discarded them. They add little to the lucid reasoning in the main text.

The purpose of this book is to improve our understanding of how countries move from poverty to wealth—or, as Lin puts it, to help "developing and transitional countries jump from the kingdom of necessity to the kingdom of freedom" (p. 96).

The core of the book is found in chapter 4, which deals with "development strategy, viability, and performance," and chapter 6, which provides empirical support for the author's key hypotheses. Chapter 7 examines the lessons one can learn from East Asian economies, and chapter 8 provides a useful summary of the book's main findings.

In a nutshell, the author argues that the fundamental determinant of development is not natural resources or capital investment but the choice of institutions, which depends heavily on the government's development strategy and, thus, on the prevailing "social thought."

Following Word War II, the dominant development strategy relied on central planning of investment, state ownership, import substitution (that is, protectionism), capital and exchange controls, and other interventionist policies. Indeed, Nobel laureate Gunnar Myrdal, a pioneer in development economics, wrote in his classic book *An International Economy: Problems and Prospects* (1956): "The special advisers to underdeveloped countries who have taken the time and trouble to acquaint themselves with the problem . . . all recommend central planning as the first condition of progress."

Justin Lin labels this state-led, top-down, development model, which dominated the development literature in the 1950s and 1960s, "a comparative-advantage-defying (CAD) strategy." The drive to catch up to developed countries and the appeal of nation building led leaders in many underdeveloped countries to disregard the economy's "endowment structure"—that is, "the relative abundance of capital, labour, and natural resources"—and steer resources away from labor-intensive toward capital-intensive industries (such as iron and steel). Trade barriers were erected to protect infant manufacturing industries, while favored domestic firms were given cheap loans and other forms of government assistance. The goal was to build the "commanding heights" of the economy (heavy industries).

Conventional wisdom held that the fastest way to achieve that goal was to employ Soviet-style planning and suppress the spontaneous order of the free market.

Without real markets based on well-defined private property rights and a rule of law, there can be no discovery of relative scarcity values and no competitive allocation of resources reflecting consumer preferences. Planners' preferences will rule and impose an artificial structure on the economy. That strategy is costly. For an underdeveloped country where labor is the relatively abundant factor of production, it is wasteful to employ capital-intensive production methods. A capital-poor country has a comparative advantage (that is, a lower opportunity cost) of engaging in labor-intensive production. To deny the principle of comparative advantage reduces the wealth of a nation. More important, economic and personal freedoms are infringed.

Lin contrasts the CAD strategy, which protects "nonviable" firms—that is, firms that could not survive in a free market—with a "comparative-advantage-following (CAF) strategy," based on a bottom-up development model in which policymakers allow market prices, profits, and international competition to help guide resources to where they create the highest value for consumers.

Discovering comparative advantage requires getting rid of distorted prices, liberalizing trade, and allowing the nonstate sector to grow. Viable firms will then flourish, and people will have new opportunities to lift themselves out of poverty. That is the story of successful emerging market economies, especially in East Asia.

During the 1950s and 1960s, most development experts used the concept of "market failure" to justify interventionist policies. Justin Lin recognizes that strict adherence to a CAD strategy—"the dominant social thought at the time"—"resulted in pervasive government failures in developing countries." According to Lin,

> It is incorrect to refer to the lack of the spontaneous development of heavy industry in a developing country as a market failure. Advanced capital-intensive heavy industry does not fit with the comparative advantages of developing countries; firms in heavy industries will not be viable in undistorted, open, competitive markets [p. 28].

In making that distinction, Lin follows in the footsteps of Peter Bauer, Anne Krueger, and Deepak Lal.

After examining alternative development strategies, Lin devises a proxy for measuring the CAD strategy, which he calls a "technical choice index (TCI)." Countries that follow a policy of artificially promoting heavy industries will allow monopoly prices in the priority manufacturing industries, subsidize production costs, and favor capital-intensive production methods. The value added, therefore, will be high relative to the labor force in manufacturing, which means the TCI will be relatively high, other things constant.

Using the TCI and various indicators of institutional quality, including an index of economic freedom, Lin finds that countries that have adopted a CAD strategy have less economic freedom and more corruption than would otherwise be the case. Moreover, he shows that in countries where CAD policies/distortions persist over an extended period, there will be slower, more volatile economic growth, and greater income inequality than in countries that adopt a CAF strategy. He also finds that growth prospects for transition economies moving toward a market system will improve if the government "creates conditions to facilitate the development of formerly repressed labour-intensive industries" (p. 57).

For emerging market economies that start off with a large state sector and many distortions, like China, Lin recommends a gradualist, dual-track approach to making the transition from plan to market. He recognizes the importance of privatization, but he also thinks transition economies need to consider the problem of viability and let the nonstate sector grow spontaneously, while dealing with nonviable state-owned enterprises. Consequently, he does not fully endorse the so-called Washington Consensus—a list of policy recommendations for transition economies that John Williamson put forth in 1989.

Lin is critical of the idea that there can be a "blueprint" for development and transition. He argues for a "facilitating state" that could help create the institutional infrastructure for a market economy. In addition, he would have the government "collect and disseminate technology/industry information plausibly in the form of industrial policy" and "coordinate the enterprises' investment" (p. 45). He recommends that firms that would be viable under a CAF strategy receive "a small, limited subsidy" (p. 41).

But how does any government official know which firms will be viable? The fundamental problem of any industrial policy is that government officials are outside the market system—they are spending other people's money and suffer no value consequences for unprofitable investment decisions. The relevant information, which F. A. Hayek called "the knowledge of the particular circumstances of time and place," is only available to individuals in the market, not to central planners or bureaucrats. It is a pity that Lin did not draw on Hayek's work and explicitly recognize the knowledge problem whenever government suppresses the market discovery process.

In picking winners and losers, there is no substitute for competitive markets and prices that reflect all the relevant information. Politicizing investment decisions by allowing government to "coordinate" such decisions reduces economic freedom and increases the power of government. If the fundamental goal of economic development is to expand "the range of effective alternatives open to people," as the late Peter Bauer contended, then Lin's "facilitating state" could undermine development by interfering with economic freedom.

Lin provides examples from East Asia to support the case for a facilitating state, but he does not provide evidence that a facilitating state is superior to a minimal state. In particular, he points to Japan's industrial policy—which he views as supporting a CAF strategy—as a key factor in promoting the automobile industry in the mid-1960s. However, he does point out that the Ministry of International Trade and Industry only supported Nissan and Toyota while other firms, such as Honda, became viable without support and despite MITI's advice not to enter the industry.

MITI had some successes, but as Katsuro Sakoh has pointed out (in an article in the *Cato Journal* in 1984),

> Vigorous private traders, not government officials, have been a major source of Japan's economic strength. . . . It is true that the Japanese government contributed to the enormous economic success of Japan after World War II, especially during the 1950s and 1960s. Ironically, however, the government contribution is based not on how much it did for the economy but on how much it restrained itself from doing.

Lin would largely agree.

In chapter 7, Lin addresses the issue of why Japan, South Korea, Singapore, Hong Kong, and Taiwan followed a CAF development path rather than adhering to the prevailing CAD strategy. Leaders in those countries desired to catch up to developed nations but found that building up heavy industries would not be feasible, given the scarcity of capital and limited government resources. It would be better to specialize in labor-intensive production and gradually move to higher value-added manufacturing products, rather than subsidize nonviable firms.

It is important to recognize that these East Asian governments did not intentionally choose a CAF strategy, notes Lin. Rather, resource constraints forced them to recognize the economy's endowment structure and to allow a more spontaneous development of industry than in countries pursuing a CAD strategy.

I wish Lin had devoted more space to Hong Kong's emergence as a dynamic market economy. Its model of "small government, big market" is notable. Trade liberalization, limited government, and the protection of private property rights have allowed Hong Kong to become the freest economy in the world and one of the most prosperous. Much credit for that success can be given to Sir John Cowperthwaite and his idea of "positive nonintervention."

From 1945 to 1971, he persisted in blocking schemes to expand the size and scope of government, and fought to keep markets open and capital free to move to its highest valued uses. As financial secretary from 1961 to 1971, he kept tax rates low and budgets balanced. He believed that "government should not presume to tell any businessman or industrialist what he should or should not do, far less what he may or may not do."

No doubt, Sir John preferred a minimal state to a facilitating state. Like his fellow Scotsman Adam Smith and like Hayek, he understood the importance of freedom and the ability of markets to self-correct through myriad adjustments. As he wrote,

> In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralized decisions of a government, and certainly the harm is likely to be counteracted faster.[1]

[1]For quotations from Sir John Cowperthwaite, see Nancy deWolf Smith, "The Wisdom That Built Hong Kong's Prosperity," *Wall Street Journal,* July 1, 1997.

In examining China's transition to a market economy, Lin emphasizes that much of the reform process was due to pragmatism. Paramount leader Deng Xiaoping allowed experimentation from the bottom up. The rise of the household responsibility system, in which individuals could market their crops after satisfying a state quota, and the emergence of township and village enterprises were not planned. They arose spontaneously as individuals sought to make themselves better off and took advantage of new opportunities. When the state took no action, the market expanded—which is what Lao Tzu would have recommended, as would Sir John. Once the reforms were successful, the Chinese Communist Party sanctioned them.

At the same time, the large size of the state sector meant that the reforms were constrained by political factors and the fear of instability, as workers were weaned away from the "iron rice bowl" and individuals "jumped into the sea of private enterprise." That is why Lin supports China's dual-track approach to transition rather than "shock therapy."

Lin draws four major lessons from his study of emerging market economies in East Asia (pp. 89–90):

1. The government should provide incentives to follow a CAF strategy by granting state-owned enterprises (SOEs) more autonomy, introducing the profit motive, and undertaking agricultural reform that restructures property rights to encourage productivity. In doing so, "the government should pay special attention to spontaneous reform experiments arising from private and local initiatives." The reason is simple: "Fundamentally, it is the entrepreneurs among peasants, workers, and local officials who best understand the institutional constraints they face, and it is to them that the new profitable opportunities appear."
2. The government should move from a single-track pricing and allocation system (planning) to a dual-track system that introduces market pricing and allows the nonstate sector to grow. Some of the new value created should be used to support nonviable SOEs.
3. The government should allow full liberalization in those sectors that are firmly on the market track.
4. The government should undertake legal reforms "to strengthen market institutions" during the transition process.

Perhaps the most important conclusion Lin reaches from his study of East Asian economies is that "in a gradual, piecemeal reform . . . the government should not have a predetermined, grand blueprint" (p. 91).

In his concluding chapter, Lin reemphasizes the importance of "right ideas." He notes that underdeveloped countries that followed a CAD development strategy and disregarded the economy's endowment structure and the principle of comparative advantage suffered from poor performance, while those economies that opened to the market and to international trade fared much better.

East Asian economies were able to take advantage of their "backwardness" only when they adopted a CAF strategy and opened their economies to foreign trade and investment. Lin reiterates that leaders in those countries did not intentionally abandon a CAD strategy; they were forced to do so "due to their resource constraints" (p. 95). While there is some truth to Lin's argument, it does not explain why a capital-poor country like North Korea failed to make the transition to a CAF strategy. What is missing from Lin's analysis is the fact that dictators are not benevolent; they largely operate in their own self-interest, which is to gain power.

Lin assumes that developing countries chose state-led development (a CAD strategy) because they wanted to catch up to developed countries as fast as possible, and the prevailing "social thought" —that is, Western development experts—advocated such a strategy. According to Lin, "Many of the policies that eventually became so inimical to growth appear to have been adopted for idealistic motives, and not for the narrow self-interest of the groups in the ruling coalition" (p. 136, n. 33).

There is no doubt that the ruling elite wanted to engage in nation building and achieve economic growth, but they also wanted to maintain power. State ownership, central planning, financial repression, price controls, and other interventions allowed them to do so. As Peter Bauer wrote in his essay "Hostility to the Market in Less-Developed Countries" (1978), "Planning . . . has obvious appeal to politicians, administrators, and intellectuals, since it creates positions of power that members of these groups expect to fill." Lin neglects this negative externality of planning.

Deng Xiaoping changed China's course not primarily because of "resource constraints," but because he recognized the failure of central planning and personally experienced the devastating effects of the Cultural Revolution. China's current leaders cling to power while recognizing the importance of the private sector. That tenuous balance between the state and the market—between coercion and consent—will need to be resolved.

A crucial message in Lin's book is that economic freedom is an important determinant of development. Moreover, to "jump from the kingdom of necessity to the kingdom of freedom," one must understand the benefits of a free market and its institutional requirements. Lin provides many lessons from the failure of state-led development and from the success of market-led development. It is interesting that, in discussing the determinants of development, Lin (correctly) ignores foreign aid. Indeed, the term "foreign aid" does not even appear in the book's index. Clearly, Lin does not see foreign aid as a key to development—or at least did not when he wrote this book.

The current financial crisis has led to an anti-market mentality. It would be a huge mistake, however, if countries reverted to destructive protectionism. As Lin shows, global economic prosperity will depend on improving market institutions. That means people must be free to choose. The challenge for China will be for its leaders to allow political as well as economic reform, but doing so will require ending the Chinese Communist Party's monopoly on power. For obvious reasons, Lin does not address that sensitive issue. But he does note that "stability" in China depends on economic development, which depends not only on technological progress but also on institutional change. As market institutions strengthen and the middle class grows, there will likely be more limits on government power. China would then be closer to Lin's "kingdom of freedom."

Policymakers, development economists, and all those interested in how ideas matter in making poor nations rich will benefit from Lin's insights and experience.

James A. Dorn
Cato Institute