

## Third World Economic Development

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### Abstract

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The development experiences of Third World countries since the fifties have been staggeringly diverse – and hence very informative. Forty years ago, the developing countries looked a lot more like each other than they do today. Take India and South Korea. By any standards, both countries were extremely poor: India's income per capita was about \$150 (in 1980 dollars) and South Korea's was about \$350. Life expectancy was about forty years and fifty years respectively. In both countries, roughly 70 percent of the people worked on the land, and farming accounted for 40 percent of national income. The two countries were so far behind the industrial world that it seemed nearly inconceivable that either could ever attain reasonable standards of living, let alone catch up. This article examines the experiences of different countries.

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### **Background to the Study**

If anything, India had the edge. Its savings rate was 12 percent of GNP while Korea's was only 8 percent. India had natural resources (Bergsman, 1974). Its size gave its industries a huge domestic market as a platform for growth. Its former colonial masters, the British, left behind railways and other infrastructure that were good by Third World standards. The country had a competent judiciary and civil service, manned by a highly educated elite. Korea lacked all that. In the fifties, the U.S. government thought it so unlikely that Korea would achieve any increase in living standards at all that its policy was to provide "sustaining aid" to stop them from falling even further (Bergsman, 1974).

According to Coke (1989), Less than forty years later—a short time in economic history—South Korea's extraordinary success is taken for granted. By the end of the eighties, its per capita income (in the same 1980 dollars) had risen to \$2,900, an increase of nearly 6 percent a year sustained over more than three decades. None of today's rich countries, not even Japan, saw such a rapid transformation in the deep structure of their economies. In contrast, India's income per capita grew from \$150 to \$230, a rise of about 1.5 percent a year, between 1950 and 1980. India is widely regarded as a development failure. Yet over the past few decades, even India has achieved more progress than today's rich countries did over similar periods and at comparable stages in their development (Coke, 1989).

This shows, first, that the setbacks the developing countries encountered in the eighties—high-interest rates, debt-servicing difficulties, falling export prices—were an aberration, and that the currently fashionable pessimism about their future is greatly overdone. The super achievers of East Asia (South Korea and its fellow "dragons," Singapore, Taiwan, and Hong Kong) are by no means the only developing countries that are developing. Many others have also grown at historically unprecedented rates over the past few decades. As a group, the developing countries—134 of them, as conventionally defined, accounting for roughly three-quarters of the world's population—have indeed been catching up with the developed countries (Coke, 1989).

According to Grais (1984), the comparison between India and South Korea shows something else. It no longer makes sense to talk of the developing countries as a homogeneous group. The East Asian dragons now have more in common with the industrial economies than with the poorest economies in South Asia and sub-Saharan Africa (Grais, 1984). Indeed, these subgroups of developing countries have become so distinct that one might think they have nothing to teach each other, that because South Korea is so different from India, its experience can hardly be relevant. That is a mistake. The diversity of experience among today's poor and not-so-poor countries does not defeat the task of analyzing what works and what doesn't. It is what makes the task possible.

### **Lessons of Experience**

The hallmark of economic policy in most of the Third World since the fifties has been the rejection of orthodox free-market economics. The countries that failed most spectacularly (India, nearly all of sub-Saharan Africa, much of Latin America, the Soviet Union, and its

satellites) were the ones that rejected the orthodoxy most fervently. Their governments claimed that for one reason or another, free-market economics would not work for them. In contrast, the four dragons and, more recently, countries such as Chile, Colombia, Costa Rica, Ivory Coast, Malaysia, and Thailand have achieved growth ranging from good to remarkable by following policies based largely on market economics (Grais, 1985).

Among the most important ideas in orthodox economics is that countries prosper through trade. In the sixties and seventies, the dragons participated in a boom in world trade. Because the dragons succeeded as exporters, they had an abundant foreign exchange with which to buy investment goods from abroad. Unlike most other developing countries, the dragons had price systems that worked fairly well. So they invested in the right things, in ways that reflected their comparative advantage in cheap, unskilled labor.

Some economists still dismiss the dragons as special cases, but for reasons, I find specious (Crook, 1989). They argue that Hong Kong and Singapore are small (hitherto smallness had been regarded as a disadvantage in development); that they are former colonies with traditions of excellence in public administration (like India and many others); that they have been generously provided with foreign capital (like Latin America). These economists also argue that Taiwan and South Korea received generous foreign aid (like many other developing countries), and have even argued that their lack of natural resources was an advantage. What was most unusual about these countries was a relatively market-friendly approach to economic policy.

The countries that failed, often guided by "experts" in the industrialized world, are the ones that gave only a small role, if any, to private enterprise and to prices that are unregulated by the government. Government planners concentrated on broad aggregates such as investment, consumption, and savings. Their priority was an investment – the more, the better, regardless of its quality.

Most governments also thought that their economies were inflexible and could not adjust to changing conditions. The export earnings of developing countries were regarded as fixed, for instance, and so was the import requirement for any given level of domestic production. The possibilities for substituting one good for another in response to a change in price were denied or ignored. The idea that workers respond to changes in incentives was likewise dismissed. This assumed lack of responsiveness led the planners to believe that prices, rather than providing signals for the allocation of resources, could serve other purposes instead. For instance, with direct controls, they could be kept low to reduce inflation, or raised here and there to gather revenue for the government.

Taken to the limit, this "fixed-price" approach leads to regulation by input-output analysis. The idea is to tabulate the flow of primary, intermediate, and finished goods throughout the economy, on the assumption that each good requires inputs of other specific goods in fixed proportions. When all the cells in the table have been filled in, a

government needs only to decide what it wants the economy to produce to know exactly what the country needs to import, good by good.

India went in for this sort of planning in a big way. More than a few of today's leading free-market economists have worked with in India's planning system or have studied it in detail, and intimate contact with it leads them to one inescapable conclusion: government planning of the economy does not work. Professor Deepak Lal of London University, a leading proponent of market economics for the Third World, mentions his experience with India's planning commission in his book *The Poverty of Development Economics*. He calls the antimarket approach favored in so many countries the "dirigiste dogma."

### **From Peru to Ghana**

In the noncommunist world, the most striking recent example of this dogma at work is in Peru. When Alan Garcia's government came to power in the summer of 1985, Peru was already in a bad way, thanks largely to high tariffs and other import barriers, restrictive labor-protection laws, extensive credit rationing, high taxes, powerful trade unions, and an extraordinarily elaborate system of regulations to control the private sector. One result was Peru's justly celebrated black market, or "informal economy," described by Hernando de Soto in his modern classic, *The Other Path*. The other result was a great vulnerability to adverse economic events. The early eighties delivered several, including a world recession, high-interest rates, a drying up of external finance, and declining commodity prices (Pfeffermann, 1989).

Garcia's policy was based, he said, on two words: control and spend. After imposing price controls, he sharply increased public spending. The program succeeded at first. Gross domestic product (GDP) grew 9.5 percent in 1986 and 7 percent in 1987. But by the spring of 1988 inflation was running at 1,000 percent a year; by the end of the year, it was 6,000 percent. After that, output and living standards collapsed. In 1990, the economy was a wreck, Garcia was voted out of office (Grais, 1984).

The dirigiste dogma has proved equally damaging in Africa. Take Ghana. When it became independent in 1957, it was the richest country in the region, with the best-educated population. It was the world's leading exporter of cocoa; it produced 10 percent of the world's gold; it had diamonds, bauxite, and manganese, and a flourishing trade in mahogany. Its income per capita was almost exactly equal to South Korea's at \$490 (in 1980 dollars). By the early eighties, however, Korea's income per capita had risen fourfold, while Ghana's had fallen nearly 20 percent to \$400 per head. Investment slumped from 20 percent of GDP in the fifties to 2 percent by 1982, and exports dropped from more than 30 percent of GDP to 4 percent (Grais, 1984).

The country's leader at independence, Kwame Nkrumah, was a spokesman for the newly independent Africa. He said the region needed to develop its style of government, suited to its special circumstances. He spent vast sums on mega projects. As economic troubles mounted, he nationalized companies and followed with capital repression. Under his

regime capital flew abroad, and people with skills and money did the same. The kleptocrats (government officials who steal large amounts) ran the country into the ground. In the early eighties, a new government came to power and at last began to steer the economy along orthodox lines. Until then, Ghana had been to Africa what Peru is to Latin America: a distillation of everything that has gone wrong with the continent's economies.

In the Third World, where so many people live off the land, agricultural development is crucial. Ghana provides a startling case study in how to wreck the farm sector. The means was the agricultural marketing board – a statutory monopoly that bought farmers' crops at controlled prices and resold them either at home or abroad. The prices paid to farmers were kept artificially low, on the assumption that farmers ignored price signals.

Between 1963 and 1979 the price of consumer goods went up by a factor of twenty-two in Ghana. The price of cocoa in neighboring countries went up by a factor of thirty-six. But the price paid by the cocoa marketing board to Ghana's farmers went up just sixfold. In real terms, therefore, the returns to cocoa farmers vanished (Soto, 1989). The country's supposedly price-insensitive farmers responded by switching to production of other crops for subsistence, and exports of cocoa collapsed. Peru and Ghana are extreme cases, but they show in the starkest way that prices do matter in the Third World and that rejecting market economics carries extremely high costs. The essential elements of a development strategy based on orthodox economics are macroeconomic stability, foreign trade, and strictly limited intervention in the economy. With policies under these three headings, governments can foster enterprise and entrepreneurship, the irreplaceable engines of capitalist growth.

### **The Macroeconomic Foundation**

Experience shows that high and unstable inflation can harm growth. A non-inflationary macroeconomic policy is, therefore, a prerequisite for rapid development. Control of government borrowing is the crucial element in such a policy. When public borrowing is excessive, governments are soon obliged to finance it by printing money, and rising inflation then follows. That is why the conventional approach to stabilization (a term that covers steps to reduce an unsustainable trade deficit as well as anti-inflation policies) usually advocates lower public spending and/or higher taxes. The International Monetary Fund has long made programs of this sort a precondition for financial assistance to countries in distress.

These so-called austerity programs have aroused two sorts of controversy. First, some economists question whether big changes in fiscal policy are needed. In Latin America, for example, some governments sought "heterodox" policies to reduce inflation without the recession that the orthodox approach almost always brings on. The heterodox approach argues that in high-inflation countries, the budget deficit is caused mainly by inflation, not the other way round. The argument is twofold. First, because there is a lag between when people earn income and when they must pay taxes on it, high inflation reduces real tax revenues. Second, inflation increases the nominal interest rate (and hence the budgetary cost of servicing past government debt) (World Bank, 1987).

Hence the heterodox logic: reduce inflation with direct controls on prices and incomes and currency reform, and the budget deficit will shrink of its own accord. This method has been tried repeatedly in Brazil and Argentina, where brief success has generally given way to a worse mess than at the outset, and in Israel, where the results were more encouraging. Israel shows that the heterodox can work—that falling inflation does cut public borrowing. What matters is whether the deficit that remains after the heterodox measures are in place is low enough to be noninflationary. In practice, the remaining deficit is almost always too high, and the program fails. Countering inflation almost always requires a dose of austerity.

The second controversy over austerity concerns the costs of this remedy. Many economists argue that orthodox programs put too much of the burden on the poorest parts of society. To cut their budget deficits, governments can either raise taxes or cut spending. Raising more revenue—even if that could be done without harming incentives—is hard because of weak tax administration. So stabilization nearly always involves cuts in public spending. If the cuts fall on food subsidies and welfare spending, goes this argument, they hurt the most vulnerable.

This argument sounds plausible, but in many countries it is wrong. A study by Guy Pfeffermann of the World Bank shows that the beneficiaries of social spending in developing countries are not the poor. First, more public spending of any sort means more public employment. Bureaucracies in developing countries do not give many jobs to the landless rural poor, too small street traders, unskilled manual workers, or the urban unemployed. They recruit from the middle classes, who are, therefore, the first to benefit from public spending (Pfeffermann, 1990).

They often are the second and third to benefit as well. In some countries, subsidies have amounted to more than 10 percent of GDP. These mainly go toward making electricity, gasoline, housing, and credit artificially cheaper for consumers. Quite apart from the massive microeconomic damage that these price distortions cause, such subsidies do not reach the poor.

Many of the poor do not live in houses, which greatly reduces their need for electricity, and most do not own cars. (Gasoline subsidies alone in Ecuador and Venezuela have been equivalent to several percentage points of GDP.) Although some of the poor would benefit from the credit, subsidized credit is not aimed at them and makes the unsubsidized kind harder to get and a lot more expensive. Spending on education is also, as a rule, heavily biased toward the middle classes. In some developing countries, spending per capita on university education exceeds spending per capita on primary education by a factor of thirty. Most poor lack access to even the most basic primary education, while the universities remain the publicly funded preserve of the middle class. And in most developing countries the coverage of heavily subsidized social security systems is strongly skewed against the poor. In Brazil in 1984, only 8 percent of workers in the poorest broad sector of the economy (farming) were covered by a social security system. Nearly 80 percent of workers in the most prosperous sector (transport and communications) were covered (Pfeffermann, 1990).

By and large, the scope for cutting public spending in developing countries without hurting the poor is more than enough for stabilization to succeed. In some cases (subsidized credit, for example) a reduction in public spending would help the poor directly, even before the broader benefits of macroeconomic stability began to flow back. Admittedly, this is not much help in political terms. It is easy to neglect the poor. That is precisely why this vast system of subsidies does not help them. But the middle classes can shout when the economic distortions that help them are taken away. So the political barriers to getting economic policy right are formidable.

### **The Gains from Trade**

For its *World Development Report* in 1987, the World Bank classified forty-one developing countries according to their openness to trade since the sixties. It classed economies as either inward-looking (exports were discouraged) or outward-looking (exports were not discouraged), with a further division according to the strength of any trade bias. The World Bank then plotted these groups against a variety of economic indicators.

Growth in income per capita was highest in the strongly outward-looking economies and lowest in the strongly inward-looking ones. The same was true for growth in total GDP and in value-added in manufacturing, and for the standard measure of the efficiency of investment. On all these criteria the moderately outward-looking countries also outperformed inward-looking economies, although by a smaller margin. The failure of a strong inward orientation to promote domestic manufacturing—not just exports of manufactures—is particularly striking. The whole point of looking inward had been to industrialize faster.

The three strongly outward-oriented countries in the World Bank's report were Hong Kong, Singapore, and South Korea. Taiwan would have been the fourth if it had been included in the sample and would have reinforced the message. The four dragons, however, have been more diverse in their policies than is usually assumed. Hong Kong's outward orientation is due to unalloyed free trade. The other three have been interventionist to varying degrees, using export incentives to offset the export-discouraging effects of domestic protection.

South Korea, by some measures the most interventionist dragon, is often cited as proof that intelligent dirigiste, rather than a broadly outward-looking trade policy, is the key to rapid development. This judgment is often based on the false premise that Korea has protected its domestic producers as much as if not more than the inward lookers have protected theirs, with the difference that it has then piled on a lot of incentives for exporters. This is incorrect. In reality, South Korea has had a moderate and declining degree of domestic protection with just enough export promotion to achieve broad neutrality in trade incentives (World Bank, 1989).

Korea's growth surge began in the mid-sixties. The policy began to change in the late fifties. At that time Korea's government placed quantitative restrictions on almost all imports, but the restrictions were looser than in many other developing countries. The

government began to provide export incentives to offset its protection for producers of import substitutes. At first, this failed to work, perhaps because the currency was overvalued, leaving too great a bias against exports. In the early sixties, the government dismantled its multiple exchange-rate systems, devalued the currency, and (because devaluation helped exporters) reduced its export subsidies.

These liberalizing reforms were the turning point. Exports began to grow rapidly. In 1967 the government reformed its import control system, greatly reducing the number of imports subject to quotas, and began to reduce its tariffs. So as the miracle proceeded in the late sixties and seventies, the background was not just outward orientation (domestic protection offset by export promotion), but a low average level of domestic protection, with relatively little variation in the rates of protection from one sector to another. Toward the end of the seventies, when Korea did increase its support for heavy industry, the economy began to run into trouble. Policymakers acknowledged their mistake and moved back toward liberalization.

The clear consensus among mainstream economists is that outward-looking trade policies are one of the keys to development. But why? The answer from orthodox economics is that trade allows countries to exploit their comparative advantage. Trade enables a country to consume a mix of goods that is different from the mix it produces—with prices in world markets acting as the mediator between the two. The conventional theory proves that trade, as a result, makes both partners unambiguously better off. So long as import barriers and other policies do not drive domestic prices too far away from world prices, market forces are enough to push production and consumption in the right direction. But trade does more than bring about the right mix of products. It also eliminates the inefficiencies in production caused by protection.

Protection may make some domestic producers monopolists or near monopolists, thus introducing an inefficiency directly (because monopolists exploit their market strength by producing less and charging more) and indirectly (because lacking competition, they have no incentive to keep costs low).

Two of the world's top trade specialists, Professors Jagdish Bhagwati of Columbia University and Anne Krueger of Duke University, have emphasized yet another source of inefficiency pervasive in developing and industrial countries alike: "rent-seeking," or more generally, "directly unproductive profit-seeking." This springs from the effort of business to exploit or evade the distortions caused by protection. For instance, import licensing may drive a wedge between the official price of an intermediate good and the price that a domestic producer is willing to pay.

This "rent" is a potential source of profit for somebody. Resources will be spent in trying to corner the market in licenses, or in bribing the bureaucrats who decide which firms will get them, or lobbying governments to alter the pattern of protection in ways that favor the lobbyists. Worst of all, resources will be spent in trying to win an increase in the overall level of protection. A study of Turkey (see Grais et al.) found that the costs of rent-



seeking in the late seventies were between 5 percent and 10 percent of GDP. Because the study made no allowance for the effect of protection on domestic monopoly power, this is an underestimate of the cost. A study by Joel Bergsman, which did take monopoly effects into account, found that the annual costs of protection were 7 percent of GDP in Brazil, 3 percent in Mexico, 6 percent in Pakistan, and 4 percent in the Philippines. Such results speak for themselves. The evidence shows that trade works; orthodox theory shows why.

### **Where to Intervene**

It is often argued that all the dragons (except Hong Kong) have had highly interventionist governments. Even on the assumption that these interventions, by luck or judgment, left the economies with outward-looking trade regimes, this poses a question. Might their success be due to nothing more profound than the fact that good intervention is better than bad? It is not the extent of intervention that matters, the argument goes, but the skill with which it is done.

It is true that these countries, especially South Korea, have had interventionist governments. This they have in common with almost all developing countries. The difference is not only that they pursued an outward-looking approach to trade (broad lesson number one), but also that this approach molded the forms of intervention they undertook in the domestic economy (broad lesson number two). The net effect (broad lesson number three) was to leave the price system largely intact as a signaling device for the private sector.

More generally, an outward-looking approach to trade does not require laissez-faire (though laissez-faire does require an outward-looking approach to trade). The state has a vital role in development. Paradoxically, however, most of the Third World's highly interventionist governments neglect this role because they are too busy doing things they should not.

Government has several vital jobs to do and no spare resources to waste on other things. The cost of an effective legal system, for instance, is public money well spent. This means countries need rules that define property rights, contracts, liability, bankruptcy, and so on (which most developing countries already have). It also means enforcing those rules effectively (which fewer manage to do). Spending on physical and social infrastructure is essential, for there are good (orthodox) reasons to think that the private sector will provide too little. Numerous studies have shown that the economic returns to spending on primary education, especially for girls, are extremely high. Governments need to do more in such areas, not less, though none of these tasks requires the government to be a monopolist.

Governments have done too little in the areas where they can do some good because they have spread themselves too thin and been far too ambitious in areas where intervention is, at best, unnecessary. Instead of building roads, schools, and village health centers, Third World governments have built prestigious airports, universities, and big-city hospitals. Instead of letting businesses compete, they have created state-run industries and sheltered their extraordinary inefficiencies from foreign and domestic competition.

Advocates of state intervention often claim to be realists. Markets are not perfect, they say, so governments have to step in, especially in developing countries. They are right up to a point. The price system never works perfectly, least of all in developing countries. But it is important to be realistic about governments, too. The past forty years of development experience have shown that no resource is in scarcer supply than good government and that nothing market forces could devise has done as much harm in the Third World as bad government.

### **Two Myths**

A common argument is that many developing countries will be condemned to economic stagnation, regardless of the economic policies their governments pursue, by two factors beyond their control: their insupportable debts and their lack of home-grown entrepreneurs. Both ideas are wrong.

First, consider debt. The costs of the debt crisis of the eighties have indeed been great. At the margin, foreign capital matters a lot – not just in quantitative terms, but because of the foreign expertise that often comes with it. But the problem of debt, serious though it is, is by no means an insuperable obstacle to growth in the Third World. Even in good times, foreign capital has financed only a small part of the investment undertaken in developing countries. Debt needs to be kept in perspective.

In its *World Development Report 1989*, the World Bank compiled data on financial balances for a sample of fourteen developing countries (some now "highly indebted," others not) for which sufficiently detailed data were available. The figures suggest that the biggest source of capital, by far, in these economies during the seventies and eighties was household savings. This was equivalent, on average, to 13 percent of GDP in the countries in the sample. Businesses saved 9 percent of GDP. The domestic supply of capital – the sum of household savings and business savings – was 22 percent of GDP, while the inflow of foreign capital was only 2 percent of GDP (World Bank, 1989).

After the debt myth comes the myth of the missing (especially African) entrepreneur. The idea that the Third World lacks the spirit of enterprise is laughable. Peasant farmers who switch to another crop in response to a change in their government's marketing arrangements are entrepreneurs. So are the unregistered taxi and minibus operators who keep most Third World cities moving. So are street vendors, perambulating water vendors, money changers, and informal credit brokers. So are the growers of illegal crops such as coca, who in many countries are denied the opportunity of making a decent living by legal means. So are the smugglers of just about anything that do such a roaring trade across Africa's borders, profiting from the massive price distortions that government policies create (World Bank, 1989).

Entrepreneurship admittedly is partly a matter of skills – in choice of technique, in management, in finance, in the ability to read the label on a bag of fertilizer. Skills have to be learned, and in many developing countries they are in short supply. But this supply is not fixed. The success of the green revolution in India and elsewhere shows that farmers

are willing to learn new skills when they can see an advantage in doing so. (The green revolution involved the introduction of high-yielding crop varieties that required different methods and more sophisticated inputs such as fertilizer and an assured water supply.)

To see what entrepreneurship in the Third World can achieve, consider the flowering of the garment export business in Bangladesh, one of the poorest countries in the world. This started with collaboration between Noorul Quader, a bureaucrat-turned-entrepreneur, and the Daewoo Company of South Korea. Quader's new company, Desh, agreed to buy sewing machines from Daewoo and send workers to be trained in South Korea. Once Desh's factory started up, Daewoo would advise on production and handle the marketing in return for royalties of 8 percent of sales. Daewoo did not lend to Desh or take any stake in the business. But it showed Desh how to design a bonded warehouse system, which the government agreed to authorize. This was crucial. In effect, it made garment exporting a special economic zone – an island of free trade within a highly protected economy (World Bank, 1989).

At the end of 1979, Desh's 130 trainees returned from South Korea with three Daewoo engineers to install the machines. Garment production began in April 1980 with 450 machines and 500 workers. In 1980 the company produced 43,000 shirts with a value of \$56,000. By 1987 sales had risen to 2.3 million shirts and a value of \$5.3 million – a growth rate of 92 percent a year (World Bank, 1989).

Desh did so well that it canceled its collaboration agreement with Daewoo in June 1981, just eighteen months after the startup. It began to do its marketing and bought its raw materials from other suppliers. It achieved most of its success on its own. Also, the company has suffered heavy defections of its Daewoo-trained staff. Of the initial batch of 130 who visited South Korea in 1980, 115 had left the company by 1987 – to start their garment-exporting businesses. From nothing in 1979, Bangladesh had seven hundred garment-export factories by 1985. They belonged to Desh, to Desh's graduates, or others following their example (World Bank, 1989).

### **Conclusion**

There is no lack of entrepreneurship in the Third World. To release this huge potential, governments first need to do much less. Above all, they must stop trying to micromanage the process of industrialization, whether through trade policy, industrial licensing, or direct control of state-owned enterprises. But they also need to do more. They must strive to keep public borrowing and inflation in check while investing adequately in physical and nonphysical infrastructure. In the early nineties, spurred by the collapse of the socialist model in Eastern Europe, a growing number of developing countries are trying to reorder their economic priorities in this way. If they persevere, the coming decades will be a time of unprecedented advance in the developing world.

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