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Edited by
François Bourguignon and
Boris Pleskovic

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1818 H Street NW
Washington, DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

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The Evolution of Development Thinking: Theory and Policy

GUSTAV RANIS

This paper makes an effort to trace the course of development thinking and associated development policy over the past six decades.

The first section focuses on the early postwar consensus, with theory focused largely on a revival and extensions of classical dualism theory, and policy concentrating on creating the preconditions for development and the severing of colonial ties viewed as market related.

The following section traces the increasing awareness of the role of prices, the rejection of various types of elasticity pessimism, and a diminishing reliance on the developmentalist state as the main actor. This is also the period when the international financial institutions (IFIs) moved toward increased reliance on structural adjustment lending associated with conditionality and reform at both macro and micro levels of policy, as embodied in the Washington Consensus and its extensions.

The third section illuminates the search for "silver bullets" over time, in both the theory and policy arenas. It demonstrates the never-ending search for dimensions of development in both the theory and policy realms that can be identified as critical (or key) to achieving success.

Finally, the concluding section presents the author's rather personal assessment of where we are at the moment and where we will be, or should be, heading in the effort to achieve the Third World's basic development objective of human development fuelled by equitable growth.

I intend to first review the early postwar consensus on development thinking in both its theory and policy dimensions, proceed to take up the period of the Washington Consensus, trace the search for "silver bullets" that has taken place more or less consistently over the past two decades, and conclude with an assessment of where we now are and are likely to be heading in the future.

Gustav Ranis is the Frank Altschul Professor of International Economics at Yale University in New Haven, Connecticut. He was director of the Yale Center for International and Area Studies from 1996 to 2004.

The Early Postwar Consensus

In the 1950s and 1960s, the previously neglected subfield of development economics was rediscovered. Available economic models seemed to offer only limited insights into the practical problems facing the so-called Third World. The dominant one-sector macro models of the day, from Keynesian to Harrod-Domar (see Harrod 1939, and Domar 1957) to Solow (1956), seemed to have relatively little relevance for societies not primarily concerned with business cycles or steady state properties. Most contemporary growth models, in other words, were seen as advanced country-related, relatively abstract theoretical constructs that were faithful to the dominant assumptions of neoclassical macro-theory: full employment, market clearing, and perfect competition, all of which seemed to have little relevance for the segmented commodity, labor, and credit markets of the poor countries.

Against this background, the concept of dualism attracted considerable attention. Sociological dualism associated with the name of Boeke (1953) emphasized differences between Western and non-Western objectives and cultures; and technological dualism pointed to by Higgins (1956) and Eckaus (1955) focused on the difference between variable factor proportions in traditional and fixed coefficients in modern sectors. A third and increasingly dominant strand focused on the coexistence of sectors that were basically asymmetrical in behavior and thus dualistic in some key analytical dimensions. The first clear manifestation of this third version of dualism undoubtedly appeared in the *tableau economique* of the physiocrats who emphasized the importance of an agricultural surplus to support nonproductive activities elsewhere; but it was classical dualism, coinciding more or less with the advent of what was erroneously termed the industrial revolution in Western Europe, that provided the raw materials for the renewed emphasis on dualism in early post-World War II development theory.

It was classical school concepts, owing much to Ricardo (1951), which focused attention on the coexistence of a still overwhelmingly large agricultural sector subject to diminishing returns to labor on basically fixed land, and nonagricultural activities growing as a consequence mainly of the accumulation of fixed capital and labor drawn out of agriculture that were central to the story. While the classical school did not really model the interaction between these two sectors, it is clear that the main fuel for the reallocation of labor and for the accumulation of industrial capital was seen as coming from the profits of agricultural capitalists. It should, of course, be noted that the assumption of the near-fixity of land was combined with Malthusian population pressures (see Malthus 1815) and with the notion of an institutionally determined agricultural real wage, even though, in contrast to the physiocratic view, the laboring class was now free and in a position to bargain with capitalist landlords in setting the level of that wage. As is well known, Ricardian/Malthusian pessimism with respect to the ultimate stagnation of agriculture in the absence of marked technology change was a dominant feature of their analytical work. Whether innovations in industry, reflecting Adam Smith's relative optimism, would be strong enough to provide sufficient industrial profits to rescue the situation remained a controversial issue.

The first modern theorists to build on classical dualism were undoubtedly Rosenstein-Rodan (1943), Mandelbaum (1945), and Nurkse (1953), each of whom, in their own way, pointed to the existence of surplus labor as a potential resource that, once reallocated from agriculture to higher productivity pursuits in nonagriculture, would constitute a major fuel for development. But it was Arthur Lewis (1954) who, in this seminal article, built on some of the main ingredients of the classical tradition, focusing more precisely on dualism in labor markets (i.e., a competitive wage in nonagriculture tied to a bargaining or institutional wage in agriculture). Lewis, moreover, found himself allied with Smith (1880) in seeing the relatively small nonagricultural commercialized sector as the dynamic partner, expanding and fed by the mobilization of the hidden rural savings that Nurkse and Rosenstein-Rodan had identified. In Lewis's view, the reallocation process would continue until all the surplus agricultural labor (i.e., not necessarily zero marginal product labor but, as emphasized by Fei and Ranis [1961, 1964], all those whose remuneration exceeded their low marginal product) had moved out of agriculture into commercialized nonagriculture, marking a turning point at which time dualism would atrophy and the economy become fully neoclassical.

It is fair to say that the theoretical elements of this early postwar consensus focused on capital scarcity and savings-pushed growth, with relatively minor emphasis on technology change in either sector. Moreover, both Rosenstein-Rodan and Nurkse very much emphasized the need for balanced growth, not only between agriculture and nonagriculture, but also on the need for balance within each sector, so that Say's Law could come into play and not only shoes but also socks would be produced, feeding each other on both the supply and demand sides. It is also noteworthy that there was a good deal of elasticity pessimism in the air during those years, both with respect to agricultural response mechanisms, as already noted, and with respect to the open economy (i.e., export opportunities). The international trade scene, dominated by Prebisch (1962), Singer (1950), and Myrdal (1957), was painted in colors unfriendly to development. There were, of course, some early critics of various aspects of dualism, on the one hand, and of structuralism, on the other, represented by adherents to the neoclassical paradigm. To one degree or another they rejected the notion of labor surplus (Schultz 1964) and the nonresponsiveness to price signals of various actors (Haberler 1988; Bauer 1957). But they were clearly voices in the wilderness.

The prevailing theoretical winds indicated that, on the policy side, there was a strong inclination to turn to the interventionist state as a key instrument of development. The motivation for this trend was at least twofold. One was the desire to cut pre-independence colonial ties which were identified with the market mechanism; and second, there was a felt need to create an economy out of what was often still viewed as an agglomeration of agents and resources requiring, first of all, the creation of the so-called "preconditions of development." At home, the interventionist state accordingly felt the need to create infrastructure, or the institutions required to permit the functioning of a national entity; plus the subsidization in various ways of newly created nonagricultural entrepreneurs, complemented on the international side

by the infamous and indefinite import substitution syndrome protecting these entrepreneurs. Typically, governments thus tended to overcommit by deploying a vast array of direct and indirect policy instruments to shift resources toward themselves and favored private groups, all in the effort to promote growth. These were usually under-the-table transfers that tended to manufacture profits for the state or the favored new entrepreneurial class. The motivation was to promote industry, with relatively less attention paid to what was viewed as a stubbornly stagnant agriculture portrayed as a drag on the economy, and with peasants seen as nonresponsive to prices and profit opportunities. Industrialization was generally viewed as equivalent to development, with policymakers in search of a second industrial revolution.

A logical accompaniment of this view of the world was "planning models" that focused on the flow of resources, domestically financed investment supplemented by foreign capital, and paid relatively little attention to changes in the behavior of the system or the relevance of technology. Such planning models, often based on simple Harrod-Domar foundations, started with exogenous population growth, per capita income targets and focused heavily on how—given certain input-output relations—necessary savings, domestic and foreign, would be sufficient to reach politically required targets. There were, of course, also fancier models, including those of Mahalanobis (1955), modified later by Chenery and associates (1971), all of them relatively silent on price flexibility, exchange rate flexibility, and other dimensions of the market mechanism.

It should be noted that, while there was always some recognition of the importance of distributive issues, the predominant view of policymakers at that time was that growth and efficiency should take priority and that issues of equity, such as income distribution and poverty alleviation, would be taken care of at a later date. Clearly, high profit and savings rates were viewed as paramount instruments and any premature redistribution was viewed as a trade-off with the objective of growth.

The planning school may be characterized by relative formalism in methodology, usually envisioning a multi-sector production function with multiple inputs and international variables, often exogenously postulated. In this way economic plans could be seen to portray the operation and growth of the economy in a wholistic perspective, with all sectors tending to be viewed as homogeneous and symmetrical. A related trait of the planning school was the systematic application of mathematical models in order to determine the magnitude of all the relevant variables consistently through time. Such "planning for resources" was really based on a belief in the appropriateness of the existing policy rails on which the economy found itself.

However, by the 1970s it had become increasingly clear that the development problem was one of transition from one regime to another, during which changes in structure lie at the very heart of the process, coupled with the realization that five-year plans can quickly become political albatrosses around the necks of governments—as exogenous shocks inevitably occur. The real focus of planning consequently shifted gradually from a resource focus to devising strategies for policy change to accommodate the changing requirements of transition.

It is undoubtedly correct to say that Solow (1957) and Kuznets (1955) provided the most important transitional mechanisms in the realm of both theory and policy as we move from this postwar consensus into what later became known as the era of the Washington Consensus. Solow's 1957 signal contribution was to emphasize, really for the first time since Schumpeter (1959), the importance of technology in generating growth, spawning a huge literature focused on measuring and quantifying the effects of technology change. This provided a new point of departure for neoclassical growth theory, not only replacing Harrod-Domar with a substitutable production function, but also enthroning exogenous technology change, plus the ensuing effort to whittle down the Solow residual as much as possible. It introduced critical flexibility into the system and spawned a good deal of applied work on the role of research and development (R&D), patents, and other forms of scientific endeavor, leading at a later stage to the so-called "new growth theory" (discussed later) which moved to try to endogenize technology change.

It was, however, Kuznets (1971), though mainly concerned with describing modern growth rather than analyzing the transition process in getting there, who provided another essential ingredient focused precisely on the developing world at the end of the postwar consensus era. Kuznets was interested in why some developing countries were successful and others not, and placed major emphasis on the sources of structural change over time as between agriculture, industry, and services. Chenery and his associates (1974) took up the cudgel, using regression analysis to depict dimensions of average structural change in less developed countries, first by the use of cross-sections, and later through increasing resort to time-series analysis and pooled regressions. The basic question being addressed was how productivity gains and increments in output are allocated among sectors as income per capita rises, and how one explains deviations from average patterns. Kuznets always insisted that such structural changes resulted from the interaction of underlying changes in final demand and capacity conditions, with deviations from any normal pattern largely attributable to differences in the underlying state of nature. He viewed policy as either basically accommodative or obstructive to the play of underlying economic forces, and did not view it as an exogenous variable. This is in contrast to Chenery's inclusion of differences in policy among his typological categories.

Over time there was a growing recognition of the potential relevance of flexibility in factor proportions and of the importance of labor-using or capital-saving technology change. Observers began to realize that distortions in relative factor prices, overvalued exchange rates, low interest rates, and biased internal terms of trade, all instruments of import substitution, not only discouraged agriculture, encouraged industrial capital and import intensity, and limited the generation of employment, but also created windfall profits for favored elites long after such support was no longer necessary for infant industry reasons. The realization that the enhanced use of the market needed to be complemented by institutional reforms (at least to the extent that small-scale rural development actors could obtain an adequate share of credit, foreign exchange, and infrastructural attention) was but one indication of that

gradual change in the development paradigm, applied most pronouncedly at first in East Asia.

The Washington Consensus as Initially Conceived and Subsequently Amended

It is undoubtedly unfair to attribute the realization that policy change is the key ingredient of successful development to the international financial institutions (IFIs). I rather would give credit for the realization that prices matter and that macroeconomic stability matters to Little, Scitovsky, and Scott (1970), as well as to Bhagwati (1978), Krueger (1978), and Cohen and Ranis (1971), among others, who insisted that a restructuring of the rails of development was required.

Once easy import substitution of the nondurable consumer goods type had run out of steam, most developing countries increasingly faced a critical choice: continued import substitution while moving toward more capital and technology intensive output mixes, or export orientation testing competitive international markets. Trade liberalization was generally accepted as an instrument, but its timing was subject to large differences across the developing world. Export promotion often came first, accompanied by a shift from quantitative restrictions to tariffs, the subsequent unification of tariffs and their gradual reduction, even if the timing was differently implemented. But performance lagged almost everywhere except in East Asia, which had moved further than other regions in rejecting the continued import substitution alternative.

There can be little doubt about the important facilitating role of exports, extending beyond the handmaiden role emphasized by Kravis (1970), even if one does not accept the notion that exports constitute the principal engine of growth and that export promotion, especially of nontraditional goods, represents the solution in virtually all circumstances. It should be noted that even in small open economies that have been successful, such as Taiwan, initial development success was determined largely at home, via balanced domestic growth and the subsequent export of, first, traditional (agricultural) goods, before testing the international waters for nontraditional exports. Trade and the associated international movements of technology and capital have increasingly been seen as of potentially great help but still as representing only an assist to the basic domestic development effort. It should again be emphasized that the East Asians encouraged exports long before they opened their domestic economies to competitive imports in a sustained fashion. One causal chain ran from exports to growth by way of enhanced competitiveness as well as the direct impact of imported technology through patents, human capital, and capital goods incorporated in foreign direct investment (FDI). But another important causal chain also runs from domestic growth generated via R&D back toward the enhanced capacity to take advantage of export opportunities.

One basic ingredient of the new emerging consensus was the need for macroeconomic stability, increasingly accepted as a basic necessity by both orthodox and

heterodox observers, whether inflation at 20 percent or 5 percent is viewed as the tolerable limit. Avoidance of large-scale deficits as a percentage of gross domestic product (GDP), along with too rapid monetary expansion, were seen as critical components, with tax reform and the shifting of public expenditure patterns usually part and parcel of the package. With the gradual rejection of structuralism (i.e., the belief in the nonresponsiveness of agriculture), and of export pessimism, attention focused instead on an enhanced reliance on liberalizing markets. The original list of Washington Consensus objectives included other items such as privatization and unified and competitive exchange rates, both still under dispute today, and the simultaneous liberalization of financial markets, both domestic and international, the latter certainly with caveats now attached. What has stood the test of time is the relative openness to FDI and the acceptance of the notion that the gradual deregulation of various control systems is essential for the full mobilization of the private sector.

While not usually included on the Consensus agenda, the realization that technology choice and the choice of direction for technology change could be of major importance for successful development played an increasingly important role (see Stewart 1977; Evenson and Ranis 1990). The importance of public sector research, especially on export-oriented cash crops such as sugar, cotton, and coffee, had long been recognized; but its role in basic food crops, in nontraditional agriculture, and in nonagricultural exports came about only gradually. The Green Revolution, after all, represented an imaginative combination of international and adaptive domestic research (see Griliches 1957; Evenson and Kislev 1975). It became increasingly clear that food-producing agriculture cannot be neglected, that peasants do respond to their economic environment, and that industry cannot pull an economy into modern economic growth if agriculture remains stagnant. It is also interesting to note that R&D in medium- and small-scale firms that typically cannot afford to conduct their own R&D, such as in China's TVEs and Taiwan's small- and medium-scale enterprises, had a large payoff. The productivity of carefully selected public sector research has come to the fore, even as horror stories can be told in reference to the white-elephant aspect of many LDC science and technology institutes setting their own agendas not related to the actual needs of the economy. But such stories do not obviate the point that, when increasingly hard budgets become credible, R&D as a public good can have an important role in permitting the continued realization of domestic balanced growth, combined with an export drive powered by dynamic comparative advantage.

Most R&D, of course, takes place in the private sector. One need only point to the substantial discrepancy among developing countries in terms of levels of total factor productivity or, as some observers prefer, the differential efficiency of investment allocation, to be convinced that an increased emphasis on indigenous applied science and technology is bound to pay off. Tax codes can be modified to encourage greater risk-taking, and increased flexibility in the legal implementation dimensions of intellectual property rights can be paid attention to as a country begins to move up the development ladder. Some countries resort to a different kind of patent, the utility model, with a shorter period of protection and a lower threshold for discovery, one way of

encouraging the potentially important, if not spectacular, adaptive (or blue-collar) type of technological change. This clearly also relates directly to the new growth theory literature (discussed below).

Privatization was part of the macro package generally accepted in the 1980s, partly because of the enhanced efficiency it promised and partly because of the fiscal boost it provided, at least in the short run. On the other hand, critics of privatization have been able to point to the accompanying corruption in some of the transition countries of Eastern Europe as well as the all too frequent exchange of private for public monopoly power (see Fischer, Sahay, and Vegh 1996; Stiglitz 1991).

It is fair to say that, while there was consensus about the basic macroeconomic ingredients of the development policy package needed to ensure economic restructuring, there was also, from the beginning, a considerable difference of views concerning what additional changes were needed at the micro level, which is clearly much more differentiated by country. These included enhanced labor market flexibility, legal, financial, and other institutional reforms. Nevertheless, it is a fact that bilateral agencies, especially the U.S. Agency for International Development (USAID), which termed its 1960's instrument "program lending," and subsequently the World Bank and International Monetary Fund (IMF), which termed similar instruments "structural adjustment lending," combined policy packages incorporating both macro and a variety of micro ingredients with fast-disbursing loans. This device has become the subject of lively debate, ranging from the cost-effectiveness of the resources spent in support of country policy reforms all the way to the implications of extensive conditionality lists infringing on recipients' sensitive internal affairs.

Undoubtedly, today the bloom is off the rose of structural adjustment or program lending. Given the mixed record of aid conditionality cum reform packages compiled by the World Bank's own internal evaluation unit (see also Easterly 2001), the argument currently being made is that now may be the time to abandon the instrument altogether and either return to project lending (including those big bad dams), or move to the poverty reduction strategy papers (PRSPs) currently being fashioned for the poorest LDCs. In theory, policy-based lending can help countries achieve any objective, even if one has to admit that in the case of a multi-cook operation it is extremely difficult to precisely judge the contribution of such packages. The counterfactual is typically unknowable. But before disenchantment takes over completely, we should recall that there are historical USAID cases, such as Pakistan and Taiwan in the 1960s, and a number of World Bank cases, including Chile, Ghana and Poland in the 1970s and 1980s, where such packages worked well.

I would argue, therefore, that, before the policy-based loan instrument is abandoned, it is preferable to see if enhanced decentralization by the World Bank, coupled with an effort to achieve real ownership by recipients, can still rescue it. In my view, the structural adjustment loans of the past and the closely related PRSPs of today continue to be negatively affected by the rush to judgment on both sides, in the attempt to put together packages that can be signed off on so that the money can flow. IFI staff and loan recipients are similarly motivated, the former seeing their rewards and promotions in terms of the volume of commitments made, the latter in

terms of the relief expected from fast-disbursing loans. All the rhetoric about the importance of quality and ownership still lacks bite, with both parties not as concerned as they should be that the reform package is more than superficially a part of the body politic of the recipient.

The IFIs, in other words, all too often don't act like banks; and the countries all too often have a strong incentive simply to go through the motions of borrowing in order to obtain quick economic relief. With the desire to lend still overwhelmingly strong and the attached list of conditions too long and insufficiently differentiated, it is no overstatement to comment that both parties have reached a level of reform fatigue that clearly needs to be addressed. In the wake of the debt crisis of the 1980s this problem became particularly acute. Just as it is impossible for U.S. bilateral aid to the Republic of Egypt, for example, to secure both the support of the so-called peace process with Israel and improved economic performance, it is difficult to use one instrument to achieve both balance of payments (BOPs) crisis support and improved long-term economic performance. There is no doubt that the disenchantment with the structural adjustment experience of the 1980s and 1990s and the nascent disenchantment with the PRSPs on virtually the same grounds has led to a reassessment not only of development thinking, but also of development policy. With old certainties under pressure, the oscillating search for some "silver bullet" continues.

The Oscillating Search for a "Silver Bullet"

With policy-based loans and conditionality under attack, development thought has entered an era of disarray, with a substantial number of competitive concepts in play. Some of these concepts focus on the search for a more appropriate objective of development, others on a reassessment of how to achieve this. Turning once again first to theory, viewing per capita income growth as "the" key objective has been questioned for some time (see for example, Srinivasan 1994, Streeten 1994, Sen 1992, and Sugden 1993). In fact, as early as the 1950s and 1960s, both India and Sri Lanka focused on poverty and employment in their five-year plans. In the 1970s a "basic needs" approach, zeroing in on the direct provision of essential commodities and thus short-circuiting income, made an appearance but was short-lived—partly because it never fashioned firm theoretical links to what else we know about development, and partly because it was never really accepted abroad, where it was seen as a device for explaining away lower levels of aid. But serious mainstream attention to the distribution of income, to the extent to which private income poverty is being reduced, and, more recently, to the extent to which public income poverty (i.e., the distribution of public goods) is being addressed came later, in the late 1970s. During the 1990s, the achievement of improvements in various dimensions of human development (infant mortality, life expectancy, literacy) came to the fore as the appropriate fundamental objective of development. All this, of course, does not mean that income has been dethroned, only that it is now increasingly seen as an essential means to societal ends rather than as an end in itself.

But the concern with distribution has had a long and useful life, ever since Kuznets in the 1950s worried about the possibility that income growth might have to be bought at the cost of an initially worsening distribution (i.e., the basic efficiency-equity trade-off, see Okun 1975). Aside from the large theoretical literature on inequality and growth in developing countries (such as Banerjee and Newman 1993, and Aghion and Bolton 1997), there has been a continuing lively debate ever since on whether or not travel along the so-called inverse U-shaped Kuznets curve was inevitable or avoidable. During his tenure as World Bank president Robert McNamara initially moved the Bank in the direction of discussing distributional issues. And while Dudley Seers talked about “dethroning the GNP,” what followed was “Redistribution with Growth” (Chenery and others 1974), a collaboration between the University of Sussex and the World Bank, and a string of research projects including “Growth with Equity” (Fei, Ranis, and Kuo 1979) financed by the World Bank. Current assessments are that, while most countries seem to experience some deterioration in income distribution during rapid growth, this is by no means a necessity and there are quite a few counter-examples, even outside of the well-known East Asian cases. (For example, see Fields 2001, Bourguignon and Pereira da Silva 2003, Deninger and Squire 1997, and Ravallion and Chen 1999). Certainly, we have gotten away from using pooled cross-sections of historical data and are focusing more on country cases that, over time, yield a variety of patterns. Fei, Ranis, and Kuo (1979) illustrate the case of Taiwan with rapid growth associated with improving distribution (see also Persson and Tabellini 1994).

More controversial is the relationship between growth and income poverty alleviation. It seems quite clear from the evidence that per capita income growth is a necessary but not sufficient condition for poverty reduction (see Ravallion and Datt 1999; Lipton and Ravallion 1995), the necessary rate of growth depending on its character. For example, with respect to the production of primary commodities, what matters is whether they are generated by small farmers on fairly equally distributed plots of land or on large, land-intensive plantations (see Deninger 1999). In nonagriculture, much depends on technology and output mix choices yielding more or less labor-intensive outcomes (see Evenson and Ranis 1990).

Among theoretical revisionisms has been the recent effort to revive import substitution models, supported initially by the “new trade theory” ideas of Paul Krugman (1994), and, more recently, the challenge to openness spearheaded by Stiglitz (2002) and Rodrik (1996, 1999), encouraging a revival of populism in the south. Krugman emphasized the role of economies of scale and externalities in trade which was—in spite of his insistence that the concept was to be applied mainly to trade among rich countries—eagerly taken up by some adherents of a return to the “picking winners for the long run” view. Yet more influential and popular have been the recent attacks on globalization by Stiglitz and Rodrik, in which they question the firmly held position among Washington Consensus adherents that increased openness correlates positively with higher rates of growth. I acknowledge that infant industry protection has been deployed by every developing country in the post-World War II era, as well as by currently developed countries during their earlier economic history. Contrary to

members of the Chicago School, I believe that such interventionism is necessary in the early stage of a country's development; but it is also clear to me that the regime must be strictly time constrained, providing assurance of a more or less reliable trend in the direction of a gradual reduction of the large interventionist policy paraphernalia.

Stiglitz and Rodrik, along with Wade (1990), Lall (1992), and Amsden (1989), assign the favorable results achieved by Korea and Taiwan, among others, to that large array of government interventions generating hot-house conditions for a new and relatively inexperienced entrepreneurial class; but they fail to pay adequate attention to the seemingly inevitable hardening of protectionist arteries if the signals for a gradual but persistent lowering of these hot-house temperatures are not made transparent and credible. Developed countries are sometimes accused of “kicking the ladder” that brought them developmental success in the past. My reading is that, while this may be true, the more successful countries used a ladder that did not consist of continued and increasingly expensive secondary import substitution policies but was consistent with the expectations of a liberalization trend that enhanced both domestic and international competitiveness over time.

More recently, the emphasis on human development, building on the work of Amartya Sen (1985), Mahbub ul Haq (1992), and the Human Development Reports of the United Nations Development Programme (UNDP), have attracted a good deal of theoretical attention, including, in particular, the two-way relationship between growth as the necessary engine and human development as the bottom-line objective. The relationship between growth and improvements in infant mortality, life expectancy, or literacy—preferable to any necessarily arbitrary index—represents a still somewhat underdeveloped set of production functions (see Behrman 1996; Birdsall 1985). The feedback from increments in human development back to growth comes closer to being captured by the conventional macroeconomic production function as amended over time (i.e., including both conventional Solow-based and unconventional “new growth theory”-related approaches).

This two-way relationship has been studied carefully by Ranis, Stewart, and Ramirez (2000) and in more recent work (Boozer and others 2004). We find convincing evidence across all developing countries over time to the effect that, in order to reach a virtuous cycle of sustained growth, accompanied by continuous improvements in human development, priority attention must be given to the latter. It is difficult, if not impossible, to reach the “promised land” of mutual reinforcement between growth and human development from an asymmetric position favoring growth as a temporal priority.

In the 1980s a new branch of growth theory came into vogue which, based on some well-accepted earlier notions in the literature (Arrow 1962), tried to endogenize technology change through credible models of market externalities to explain some stylized facts in both developing and mature economies. This literature, pioneered by Romer (1990), Lucas (1988), Grossman and Helpman (1991), and, more recently, Aghion and Howitt (1998), shares the Solowian view of technology change as the driving force of output growth, but, while emphasizing constant or even diminishing returns of scale at the individual firm level, sees increasing returns of scale (i.e.,

externalities) at the economy level. Grossman and Helpman analyzed the open economy implications of such endogenous growth theory models and focused largely on R&D that actually serves two functions (i.e., accelerating the introduction of new capital goods and providing spillovers by reducing the cost of manufactured goods). While LDCs undertake relatively little R&D, at least of the formal or white collar variety, the transition to economic maturity in the developing world requires an ever increasing competence to adopt and adapt new technologies (see Pack and Westphal 1986).

On the policy front, guided by the somewhat uncertain search for theoretical advances, we continue to worry about the relative importance of market failure and government failure, while moving from "market friendly" government interventions to focusing increased attention on the institutions needed to repair both inadequate government infrastructure and the functioning of markets. Perhaps the most important change in development thinking in recent years has been a renewed emphasis on the importance of such institutions—ranging all the way from property rights, to civil service reform, to the financial system, with priorities dependent on the pre-existing state of play (i.e., the initial conditions emphasized by Kuznets and others many years ago).

Much current thinking and modeling focuses on the reduction of transactions costs as a result of relevant investments, following the path outlined by North (1990, 1991), Williamson (1975), and others. This renewed emphasis on institutional economics also has relevance for the argument between "big bang" and gradualism approaches attending any developing country reform package. If, for example, institutional changes affecting domestic financial markets have to be put in place before a system can proceed to open itself up to international capital movements, especially of the short-term portfolio variety, both the timing and the sequencing of reforms are clearly materially affected. Early efforts in the transition countries of Eastern Europe to do virtually everything at once, while neglecting the institutional dimensions, have, in fact, led to the conclusion that this is a riskier choice than the gradualism exhibited in East Asia, including Mainland China. A prominent contrast is the way privatization was organized in many other parts of the developing world as well as in the transition countries of Eastern Europe, i.e., in the absence of adequate provision for regulatory institutions to ensure a workably competitive, post-privatization private sector, as well as the reduction of corruption in the very process of transferring public goods into favored private hands.

More recently, in fact mostly in the past decade, there has been a strong emphasis among development economists—academicians as well as those on the policy scene—on the micro foundations of development issues. Development economists and policymakers have become more concerned with micro-level decisions, realizing their role in the growth of an economy. For example, the role of women in household decisionmaking, and the effects of the proportion of household resources controlled by women on the health and nutrition of their children, has been empirically documented in a number of micro studies (Behrman and Wolfe 1987, and Hoddinot and Haddad 1991).

The role of microeconomics in understanding poorly functioning markets has also come to the forefront of development economics research. The importance of poorly

functioning land, labor, and credit markets is being studied extensively. And the role of informal networks and institutions in dealing with such market failure is now the focus of much research, relating directly to the more macroeconomic literature on both the role and the formation of relevant institutions.

A seminal paper in this area was by Townsend (1994), who looked at whether households in India are able to pool risk across space in the presence of poorly functioning capital markets. He directly tested the general equilibrium implications of such a consumption-smoothing model, using household-level data for India, and found that households do indeed pool risk across space. What is fascinating about this paper (and subsequent work) on consumption smoothing is that it is not all that different from the income pooling ideas behind models of dualism that were at the forefront of development economics research a few decades ago. This literature has also subsequently fueled a large microeconomic literature in development economics on credit institutions and their efficiency (see Rosenzweig and Wolpin 1993, Udry 1994, and Deaton and Paxson 1994).

There are also various microeconomic studies on the impacts of differential labor and land markets on bottom line outcomes. The interlinkage of contracts and the two-tiered nature of labor markets in developing economies and their efficiency has been studied extensively (see Eswaran and Kotwal 1985, Mukherjee and Ray 1995, Foster and Rosenzweig 1996, and Rosenzweig 1988). Again, this literature is closely tied to the earlier models of surplus labor and dualism. The aim of this literature has been to understand the implications of market failures, the institutions that may arise at a micro level to cope with such failures, and how best to structure policy to make allowance for these institutions (see, for example, Greif 1993).

Finally, we have recently seen a large increase in the active role played by micro-credit institutions and nongovernmental organizations (NGOs) in developing countries, in almost every possible policy sphere, ranging from credit (such as the Grameen Bank and Bangladesh Research Action Committee in Bangladesh), to health (Internationaal Christelijk Steunfonds in Kenya), education, and even intellectual property rights and codes of conduct. Both the macro- and microeconomic impacts of such NGOs are being evaluated. A very active future area of development economics promises to assess the effects of NGO policies and social policy programs. For example, Pitt and Khandker (1998) and Morduch (1999) analyze the Grameen Bank program in Bangladesh; Kremer and Miguel (2001) assess the impacts of deworming health programs in Kenya; and Skoufias (2001) and Schultz (2001) examine the impact of the Progresca schooling initiative in Mexico.

Best Guesses as to the Way Forward

In this concluding section, I intend to unabashedly ride several hobby horses, hopefully moving in the same general direction with respect to where development thinking and policy are (or at least should be) heading.

First, on the methodology or theory front, I think we will be moving away from large *n* Barro-type (see Barro 1991, 1997) cross-sections, which have included more

and more variables, including geography and religion, accompanied by diminishing robustness, and toward a set of small *n* comparative historical studies encompassing typologically "neighboring" countries. Second, we need to pursue much more carefully the aforementioned two-way relationship between growth and improvements in human development, especially with respect to the preferred sequencing, if sustained long-term improvement in both dimensions is to be attained.

Third, I believe we will need to take a much closer look at the pros and cons of decentralization and its relation to democratization and decisionmaking by the broader body politic. Such analysis of decentralization should clearly not only be of the customary vertical type, i.e., focusing on local government and its fiscal and other functions, moving from deconcentration and delegation to the still rare case of devolution, but also horizontal decentralization, moving from the domination by the executive branch of government, especially the ministry of finance, to the legislative and the judiciary, representative of the critical rule of law dimension of democratic governance.

There can be little doubt that greater local control over fiscal resources is bound to lead to larger expenditure on the social sectors as well as on small-scale infrastructure. Given the benefit principle of taxation, it is also likely to lead to larger total resources being available for all purposes, while the promotion of national standards and the support of equity objectives across regions will continue to require central government action. Central resource transfers for health, education and infrastructure, in lieu of actual fiscal devolution, have, nonetheless, significantly enhanced both growth and human development indicators whenever we have observed at least delegation in both unitary and federal government systems (see for example, Ranis and Stewart [1994] for the case of Indonesia, and Habibi and others [2003] for the case of Argentina).

Fourth, I view plentiful natural resources and relatively easy access to foreign capital as extensions of the Dutch Disease problem, more serious than its narrower exchange rate implications, since they focus on decisionmaking with respect to reforms that may be needed but can be avoided. Not being "up against it" represents a prescription for not making the necessary political effort to overcome vested interests. I have observed a marked contrast between the more or less linear trend toward the depoliticization of policymaking in countries with relatively poor natural resource endowments and a consistently more oscillatory pattern of policy evolution in countries with good natural resources, including much of Latin America, Nigeria, and Indonesia. Policymaking in such resource-rich countries illustrates a tendency toward excessive activism during good times, followed by attempts to artificially maintain growth by government action when times are relatively bad. Moreover, there exists substantial evidence that an important indicator of the differential quality of policy response to the inevitable exogenous shock resides in the manner in which growth is financed. In other words, the critical distinguishing characteristic is not just the size of the tax effort relative to the GDP, but also the relative reliance on covert versus overt means of transferring resources.

The typical natural-resource-rich-country case demonstrates that liberalization efforts initiated at the beginning of an upturn cannot be sustained once the improvement in the external environment encourages the government to expand expenditures

additionally through money creation and budget deficits, inevitably leading to inflationary pressures and balance of payments (BOP) crises down the road. The basic point here is that policy evolution over time, while not completely endogenous, is intimately linked to an economic system's initial conditions, a point well supported by both the empirical record of contrasting countries in Latin America and East Asia and the intermediate cases of Southeast Asia (see Ranis and Mahmood 1992). As a long-time observer of Indonesia, for example, I noted that whenever the price of oil was high, state oil firm Pertamina was favored by policymakers, which culminated in policies unfavorable to growth or equity; while, when the price of oil was relatively low, development planning agency Bappenas's advice was accepted and reforms had a much better chance of being pursued and implemented.

Initial conditions, in other words, affect not only income levels but also policy responsiveness and flexibility over time, i.e., the extent to which policies can be seen as accommodating or obstructing the gradual changes that all societies must undergo if they are to have a successful transition into modern growth. It is not only the relative strength or weakness of a system's natural resource endowment but also the strength or weakness of that system's ability to attract long-term foreign capital "for the asking" which is relevant here. The common culprit is the large rents emanating from the primary export sector and/or foreign capital inflows and the resulting animated struggle for these rents among various interest groups. Foreign capital flows, especially those not of the direct investment type, are often strongly correlated with the size of natural resource bonanzas and thus reinforce oscillations rather than acting in a counter-cyclical fashion. My basic argument is that once the relationship between initial conditions and policy responses can be made more transparent the chances for a better understanding and support of the entire development process are enhanced. After all, liberalization in monetary, fiscal, and foreign exchange policies over time is not a function of religious belief but required by the need to maintain dynamic efficiency in an increasingly interdependent global economy.

What we can do about natural resource bonanzas is to recognize their impact, *à la* Norway and Botswana, and try to neutralize them by prudential fiscal and monetary means. What we can do about foreign capital inflows, especially of the public variety, is to insist on much greater passivity by donors, accompanied by real ownership of reform programs on the part of recipients. In spite of protestations to the contrary, the IFIs today still dominate the composition of reform programs and still try to assert their own views and impose some level of conditionality to get them accepted by recipients. Can the recipient really be allowed to take the initiative, with the international donor community willing to respond? Realistically, this would also mean accepting a generally lower level of lending of the "business as usual" type. Passivity on the part of the IFIs and enhanced initiative by the developing countries does not, of course, mean that the international community would sign on the dotted line; but if the credibility of multilateral development bank policy-based lending is to be restored, current cynicism about the annual ritual dance, i.e., demanding conditionality and promising aid flows early in the year and then being driven to disburse later on regardless of what has been delivered, has to be overcome.

The new millennium seems to me a propitious moment to reexamine the way our foreign aid business is done. I do not believe, for example, that the PRSP process focused on the poorest countries is sufficiently recipient-driven, given the fact that it still requires extensive IMF and World Bank tutelage *ex ante*; in fact, the IMF has prepared a voluminous book of instructions outlining just how a PRSP is to be prepared (see Ranis and Stewart 2001). Nor do I believe that the new window of the U.S. Millennium Challenge Account, intended to reward countries that have already done well, is going to be very helpful to those who most need help. Developing countries have to be able to enter into an adjustment dialogue with an increased sense of initiative, involvement, and ownership, complete with "self-conditionality." And public capital inflows must be commensurate in volume, and especially in time, with the exposure to risk and the threat from veto players in the course of reform.

Fifth, the current trend toward gradual liberalization, of course, implies an increasing substitution of indirect for direct controls and a reduction of such controls generally, as we have seen in the case of foreign trade. With respect to the macro policy picture, the general conclusion from experience is that the state's ability to print money and the compulsory purchase of foreign exchange are more damaging than the temporary retention of high import duties during the development process. The acceptance of a monetary philosophy according to which money supply and foreign exchange reserves are increasingly regarded as mediums of exchange, instead of as purchasing power that can be artificially manipulated to achieve socially desirable goals, is gradually being adopted. At the same time, generally low tax/GDP ratios can be enhanced, in tandem with fiscal reforms, moving the system from indirect border taxes to indirect domestic taxes *en route*, and, ultimately, to domestic taxes that are more income-elastic and less regressive.

With respect to the related question of the most appropriate exchange rate policy, this is apparently one of those areas on which it is especially difficult to pontificate as one assesses the experience of the past and attempts to look into the future. There seems to be a clear bias toward floating rates, with more or less dirty interventions as a realistic companion. This stance avoids the need to accumulate large foreign exchange reserves in defense of the peg and gives a larger role to market determination—which is, in essence, similar to monetary decontrol moving the system in the direction of an equilibrium interest rate.

Sixth, on the hoary question of the role of the state relative to the role of markets, the above discussion indicates that policy interventions should be focused more on institutional construction and certainly should not follow Amsden's 1989 advice to move purposely against price signals. In short, I find the Acemoglu, Johnson, and Robinson (2002) rejection of geography in favor of institutions, by reference to the reversal of fortunes in different parts of the pre- and post-colonial world, utterly convincing. Secondly, interventions on behalf of a particular industry or even individual firms should undoubtedly be minimized even as selective state intervention to correct market failure undoubtedly played a role in both the historical Japanese and postwar East Asian "miracle" cases. The 1997 *World Development Report* (World Bank) recognized the importance of the state as part of the "new institutional economics."

But favorite episodes of where directed credit policies went right, as in the Pohang steel company in South Korea or the automobile industry in Brazil, are still likely to be swamped by the admittedly large herd of industrial white elephants that are trampling the small folks and potential newcomers in all parts of the developing world.

The point is sometimes made, by Rodrik and others, that Latin America, following Washington Consensus prescriptions, has done poorly, while interventionist East Asia has done well. This conclusion is challengeable on several counts. First of all, as we have already noted, natural-resource-rich Latin America has been famous for a continuous stop/go pattern as between enhanced liberalization and increased interventionism, probably yielding the worst of both worlds, private and public, on average. Secondly, the secular trend toward the reduction of political power in various markets has been much clearer in East Asia, even if, on average, tariffs for example, might have been higher. Gradualism in East Asia seems to have done better than shock therapy in Eastern Europe. What also matters, I believe, in comparing development experiences over the past 30 to 40 years, is the relative extent of isolation or cohabitation between industry and a meritocratic public service, the basic competence of a bureaucracy capable of pragmatic course reversal, as well as the extent to which the government is concerned about ensuring workably competitive conditions in the private sector.

The current emphasis on organizational and institutional change decidedly does not imply a diminished role for government or some sort of *laissez-faire* prescription, but a different and undoubtedly more effective role for policymakers. Gradual but persistent depoliticization in the monetary, fiscal, and foreign exchange arenas requires sensitivity to differing local conditions and the willingness and ability to stay the course.

Last, on the international scene, current negotiations on trade, intellectual property rights, and other issues, both multilateral (WTO-related) and regional, are under intense scrutiny. To examine each of these in detail in terms of current thinking and policy would take us too far afield; but it seems clear that overloading the World Trade Organization circuit with issues such as labor and environmental standards, just because it is the only organization with teeth, will only result in immobilizing the organization. A clear and present danger to trade emanates from the mounting "spaghetti bowl" of free trade agreements, as well as the current escalating debate on outsourcing. On the latter, I would enter a plea for urgent international action providing for vastly improved national adjustment assistance programs, possibly financed out of foreign aid budgets, which would establish consistent rules for countries facing the inevitable adjustment costs accompanying trade liberalization. Adjustment assistance, of course, has been tried before in many countries, but in very few cases has it really focused not so much on extending unemployment insurance to those affected by job losses as on ensuring the portability of benefits and encouraging emerging new industries, including non-traded and export sectors, to hire displaced workers with the help of temporary subsidies. The mutual benefits of freer trade are indisputable, but if "trade not aid" is to become more than a catchy slogan, we urgently need to imaginatively address the political fallout from displaced workers.

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Comment on "A Half-Century of Development" by Richard N. Cooper and "The Evolution of Development Thinking: Theory and Policy" by Gustav Ranis

ABHIJIT V. BANERJEE

I have the privilege of commenting on two enormously rich essays: one by Richard Cooper, on what has happened to developing countries during the past 50 years; and the other by Gus Ranis, on what has happened to the economics of developing countries. Both essays draw from the authors' ringside views of the "unfolding" that they each describe, in their roles as leading thinkers about development policy and as advisers to the governments that were implementing the policies discussed. What they have produced are unique documents that are part intellectual autobiography, part personal testament.

With something so personal, I do not believe that it is even appropriate for me to do what a commentator usually does, which is to try to make the papers more "correct." Instead, my goal here is to retell the history they describe, but only keeping what I see as the essentials—and converging on what I hope are the key points for thinking about what is to come. In other words, I offer what one might call a cartoon history of the past 50 years of development.

A Cartoon History of Economic Development

In the beginning (circa 1950), there was import substitution and planning. The presumption was that markets did not really work in poor countries, and therefore state action was needed in order to mobilize dormant resources.

Development economists wrote about dual economies, where economic activity somehow slowed down once we crossed the boundary between the modern and traditional sectors.

Multi-sector plans based on giant input-output models designed to drag the recalcitrant peasants into the production of steel, electricity, and other wonderful things, were the rage of the day.

Abhijit V. Banerjee is the Ford Foundation International Professor of Economics, and Director of the Poverty Action Lab, both at the Massachusetts Institute of Technology in Cambridge, Massachusetts.