POLICY REFORM FOR BROAD-BASED GROWTH: A RESEARCH WORKSHOP

FINAL REPORT

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EXECUTIVE SUMMARY

A. The Workshop's Background, Purpose, and Scope

Numerous fora have stressed the importance of sound economic policies for broad-based economic growth and the efficient development of small enterprises.[1] Accordingly, A.I.D.'s Office of Small, Micro, and Informal Enterprise (SMIE[2]) has promoted analyses of the impact of economic policies upon broad-based growth, and particularly on small, micro and informal enterprises. Since the beginning of Fiscal Year 1985, this concern has been manifest through the Employment and Enterprise Policy Analysis Project (EEPA), contracted with the Harvard Institute for International Development (HIID) and subcontracts involving Michigan State University (MSU) and Development Alternatives, Inc. (DAI).

In the process of developing its future work program, with Devres, Inc.'s collaboration, SMIE arranged for outstanding leaders in the policy analysis field to assist SMIE with three principal tasks:

- o Reviewing the work by HIID, MSU, and DAI;
- o Synthesizing the state of the art relating to the impact of policies on broad-based growth; and
- o Identifying research priorities relating to the impact of policies on such development.

The present report represents the results of a workshop focused on those tasks.

The workshop was held on November 9, 1990, at the Department of State in Washington, D.C., and was attended by 60 participants from A.I.D., the World Bank, academia and the private sector (see Annex 6). After welcoming and introductory comments by the Asia and Private Enterprise Bureau, EEPA's project coordinator, Donald Snodgrass, presented his paper, "The Role of Small and Medium Manufacturing Enterprises in Industrialization and Economic Development" (included as Annex 1), summarizing the findings, conclusions, and recommendations of the EEPA project. Subsequent to the

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discussion of Snodgrass' paper, the four Devres papers were presented by their authors, all distinguished academicians well respected for their policy research and advisory capabilities:

- "EEPA: Research Critique", by Gustav Ranis, Department of Economics and Economic Growth Center, Yale University (see Annex 2);

- "Notes on the Political Economy of Policy Reform", by Stephan Haggard, Department of Government and Center for International Affairs, Harvard University (see Annex 3);

- "Policies for Broad-Based Growth", by Gary Fields, Department of International and Comparative Labor, Cornell University (see Annex 4); and

- "Broad-Based Growth: Concepts and Processes", by Henry J. Bruton, Department of Economics, Williams College (see Annex 5).

Each paper was followed by vigorous discussion, the essence of which is captured in the following sections.

B. Research Priorities for Policy Reforms Supporting Broad-Based Economic Growth

In the final session of the Workshop, participants discussed research priorities for policy reform to support broad-based growth. Those research priorities are presented here as sets of potential research questions which reflect key issues that threaded throughout the presentations and ensuing discussions. Approaching broad-based economic growth as a process, the priority research questions are organized to address the determinants of productivity and broad-based growth, and the strategies that can best influence those determinants to promote productivity and broad-based growth. The development of appropriate analytical frameworks for approaching the proposed research priorities is treated in Section C, below.

1. Determinants of productivity and broad-based growth

The emphasis placed on productivity growth in the Workshop discussion reflects a need to understand better what causes productivity growth and the nature of the linkages between growth in productivity and broad-based growth. Related research priorities focus on: (1) how productivity growth can be promoted, and (2) how it can be directed to facilitate more equitable distribution of income. Toward the achievement of these priorities, an initial set of research questions centers on the identification of the determinants of productivity growth and of broad-based economic growth. The research questions proposed include:

- Why does the productivity of factors of production increase in some country situations, but not others? Why does the productivity of factors of production increase in specific sectors of the economy and in the economy as a whole?

- What degree of consonance, if any, is there between the causes of productivity increases and of broad-based economic growth? Does balanced growth contribute to productivity increases and broad-based growth?

- What is the long-term role of SMEs in the process of productivity and broad-based growth? In generating employment?

- What factors (institutional matrix, policy set, access to education, etc.) are most closely associated with broad-based growth? Are some of these factors common in all instances of broad-based economic growth? Are there determinants of broad-based growth that are consistently more important than others?

- What institutional context most effectively supports broad-based growth? What is the impact of government institutions on broad-based growth?

- What is the function of the labor market as a determinant of growth and as a mechanism to spread the benefits of growth more broadly within society?

- What is the significance for broad-based development of the degree of openness which characterizes an economy? Is there a right mix of openness and closedness?

- What roles do exchange rates and exports play? How do exports feed back to productivity and income distribution? How does a concentration on exports affect productivity? What are the implications for productivity and broad-based growth of a focus on manufactured vs. raw material exports? What are the effects of undervalued exchange rates and donor imports of LDC exports?

- What mix of human capital investment and macro policies produces rapid growth in productivity and broad-based growth? What explains differences in country experiences?

- What infrastructure is necessary to achieve broad-based growth, i.e., for rural areas? What are the characteristics of private sector infrastructure support?

2. Strategies for achieving productivity and broad-based growth

Given a set of determinants of productivity, the next step is to determine whether and how those factors can be redirected to produce more broadly based growth. The following set of research questions focuses on the development of strategies that can generate productivity growth and broad-based economic growth.

- What strategies can increase the productivity of factors of production? Can the factors that cause productivity growth be directed to produce more broadly based growth? What strategies can increase the productivity of SMEs and other enterprises in LDCs? Do such strategies have essential elements or are they situation specific? How do possible donor interventions fit into such strategies?

- Does reduction of inequality of income shares of particular groups always accompany broad-based growth? Why does inequality go down or up? Can we do more to reduce inequality with growth via policy changes? To what degree does the legal framework and the legal system in place support or constrain desirable policy changes?

- What is the relationship between policy reform, political strategies and broad-based growth? How do we go about getting a reform through the political system? How do we make reforms that lead to broad-based growth last?

- What is the relationship between democracy and promotion of broad-based economic growth--and the sequencing of each?

- What educational strategy should be developed to disburse human capital more broadly?

C. Development of an Analytical Framework

Substantial attention was directed to methodologies and analytical frameworks to be applied in carrying out research on the selected priorities. It was agreed that case studies are important, but to be most meaningful, country case studies must be specific, comparative and should focus on successes. While there was agreement that analysis of successes is key to understanding productivity increases and broad-based growth in developing countries, the relevence of "good cases" such as Taiwan and Korea as a source of solutions for the problems of countries further back on the growth path was questioned. The need to increase the representativeness of the sample of countries examined was emphasized. Proposed analytical approaches included:

- o Case studies--e.g., comparative case studies where adjustments in the regulatory environment have taken place; examining second generation cases--what dialogue has occurred;

- o Pairs studies--e.g., comparative analysis of growth paths of similar countries such as Indonesia and Thailand or Zimbabwe and South Africa;

- o Reform efforts analyses--e.g., assessing the impact of a particular adjustment across countries;

- o Historical studies--e.g, what has happened longitudinally and why (focussing on the 1980s);

- o Specific market studies--couching research in terms of specific markets, such as examining the relationship between broad-based growth and labor markets;

- o Regional studies--e.g., comparative analysis of regions within a large country that has successes, focussing on how macro policies play out in a successful region as compared to in a poor region;

- o Broader perspective studies--e.g., encompassing the economic, political, labor market and other factors which have determined the extent of productivity and broad-based growth; and

- o Micro-level analyses--e.g., what happened within specific sectors, industries, businesses or other institutions in increasing productivity and broad-based growth.

D. Workshop Agenda

RESEARCH PRIORITIES FOR POLICY REFORMS SUPPORTING BROAD-BASED GROWTH AND DEMOCRACY

A WORKSHOP: NOVEMBER 9, 1990
(Room 1105, New State Building)

8:15-8:45	COFFEE and DONUTS	
WELCOME & OBJECTIVES (8:45-9:00)		Henrietta Fore, Asssistant Administrator, Bureau for Asia and Private Enterprise Michael Farbman, Director, APRE/SMIE Robert Young, APRE/SMIE
SESSION ONE: (9:00-10:30)		<u>Employment and Enterprise Policy Analysis Project (EEPA) -- Work completed and remaining questions</u> Chair, Clarence Zuvekas, LAC/DP
	***	Don Snodgrass, HIID: EEPA's perspective (25 min)
	***	Gus Ranis, Yale, Economic Growth Center: Review of EEPA and research priorities (25 min) DISCUSSION (40 min)
10:30-11:00	COFFEE BREAK	
SESSION TWO: (11:00-12:00)		<u>Economic and Democratic Reforms and Linkages -- Research priorities</u> Chair, Jan van der Veen, PPC/PDPR/RP
	***	Stephan Haggard, Department of Government and Center for International Affairs, Harvard University (25 min) DISCUSSION (35 min)
12:00-1:30	LUNCH (on your own)	
SESSION THREE: (1:30-3:00)		<u>Economic Policy Research Priorities</u> Chair, Stuart Callison, BIFAD
	***	Gary Fields, Department of International & Comparative Labor, Cornell University (25 min)
	***	Henry Bruton, Department of Economics, Williams College (25 min) DISCUSSION (40 min)
SESSION FOUR: (3:10-4:00)		<u>Small Group Discussions of Research Priorities</u> Rooms 1105 and 1408
4:00-4:15	BREAK	
SESSION FIVE: (4:15-4:45)		<u>Summarizing Session</u> Brief small group reports (maximum of five minutes for each of three groups) Final participant comments Concluding comments

At the end of the day, each participant will be asked to submit his own list of three priority research topics, one in the area of political economy and two in the area of economics.

All participants will receive copies of papers and the workshop final report.

Chairpersons have been asked to keep discussions crisp and focused on identifying important research priorities to support policy reforms for strengthening democracy and sustainable broad-based economic growth.

I. INTRODUCTION: THE PURPOSE AND OBJECTIVES OF THE WORKSHOP ON RESEARCH PRIORITIES FOR POLICY REFORMS SUPPORTING BROAD-BASED GROWTH AND DEMOCRACY

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II. THE EMPLOYMENT AND ENTERPRISE POLICY ANALYSIS (EEPA) PROJECT: WORK COMPLETED AND REMAINING QUESTIONS--COMMENTS BY DONALD SNODGRASS AND GUSTAV RANIS

A. Project Background

Donald Snodgrass (HIID) summarized the EEPA Project's findings, conclusions and recommendations to the Workshop. The Project grew out of A.I.D.'s concern with the slow pace of job creation in large, formal business enterprises in most developing countries. A.I.D. formulated the EEPA project based on the premise that promotion of small and medium enterprises (SMEs) could simultaneously attain the key objectives of income growth, employment generation and poverty alleviation. Another consideration behind the EEPA concept was the conviction that an increased emphasis on appropriate economic policies could complement, and even partially alleviate the need for, the usual project approach which, when applied to a large population of small firms, is prohibitively expensive.

B. EEPA's Approach and Findings

In undertaking the EEPA Project, HIID began by redefining the problem to be studied. Deciding that creation of jobs is not the real issue, the contractors decided to shift the emphasis of the project from developing a public policy framework that aims to merely create jobs to developing a policy environment conducive to the creation of jobs that would raise average levels of productivity and income and contribute to national economic growth. The revised definition of the problem is: To determine the role that SMEs can play in efficient industrialization and ways in which government policy can help them achieve their potential.

The EEPA Project has attempted to place the creation of productive employment and encouragement of SMEs within the broader context of economic development, asking what role SMEs play in the systematic restructuring of developing economies as they move along the continuum from an agricultural base to an industry and services orientation. Snodgrass noted that in low-income countries, much industrial production and most of the manufacturing employment takes place in small enterprises. Many of those enterprises are one or two person firms, representing survival strategies of the poor who, unable to find paid employment, create jobs for themselves. The EEPA Project's research has shown that the great majority of these "livelihood enterprises" disappear once their proprietors or workers find work elsewhere for reasonable wages.

The broad trend is for average firm size to rise as per capita GNP increases. As the economies of developing countries grow, most small firms are displaced because they are unable to survive in the increasingly competitive environment dominated by larger firms. However, a few small firms do survive by responding to the challenge of competition and increasing their efficiency.

Tracing the evolution of firm size structure in the industrial sector as economies grow, the EEPA Project research has revealed that distributions of employment by firm size in developing countries are typically bimodal. The largest amount of employment is accounted for by small enterprises (i.e. those employing 1-25), with a substantial amount of employment being generated also by large firms (employing 100 or more workers). In between there is a "missing middle" with few firms and little industrial employment.

In developed countries the distribution of industrial employment by firm size is typically unimodal, characterized by a smooth progression through the small and medium size ranges to a single peak at a relatively high average firm size. The industrial structure is unified. Snodgrass calls development the process of getting from the bimodal to the unimodal distribution.

C. Policy Implications for the Involvement of SMEs in the Development Process

The research of the EEPA Project suggests that while most small firms play a passive role in the development process, the few small firms that are able to grow have the potential to make active contributions to economic development. The EEPA Project asks whether it is possible to distinguish a priori the viable small firms that will "make it" from "survival firms", and what policies might promote and improve the participation of those dynamic small firms. EEPA Project studies of SME policy and development in South Korea and Taiwan suggest that the best way to assist those firms with growth potential is to provide performance-based incentives and then to maintain support only for those firms which demonstrate their capacity to grow. Since survival enterprises serve as major sources of income for many of the poor in developing countries, most policy makers agree that discriminatory policies against survival firms are not appropriate. However, EEPA Project studies conclude that survival firms are not a significant source of economic growth and policies which deliberately favor them tend to retard economic growth.

Other key issues confronted by the EEPA Project concern the degree and form of government intervention that is desirable. While most orthodox economists advocate policy neutrality among enterprises of different sizes, i.e. creating a level playing field by removing policy biases against SMEs but not actively promoting them, the EEPA Project has found that SMEs have been most productive in countries that have intervened actively in favor of growing firms through performance-based incentives. Citing the experiences of Taiwan and Korea, EEPA Project research suggests that the optimal degree and form of policy intervention is more a matter of political economy than economic theory. While promotion of industrialization has been successful in Taiwan and Korea, it has failed in many other countries. The EEPA Project's findings in the Philippines indicate that policies that favor small enterprises can actually create a "small firm death trap" by placing disincentives in the path of enterprise growth. The wide range of country experiences available suggests that policy advice for a particular country must be based on determination of whether benefits of government assistance can be targeted to firms which perform successfully according to a set of objective predetermined criteria or whether benefits intended for successful firms are likely to be expropriated by those with political influence.

D. Ranis' Critique of the EEPA Project

1. Constructive contributions

Gustav Ranis was charged with undertaking a critical examination of the EEPA project: to assess its strengths, shortcomings, and the related but important research tasks remaining. On the positive side of the ledger, he commended the EEPA Project for going beyond "the traditional relative prices story" and exploring the question of "the right degree of industrial concentration and workable competition". Among other "forward steps" attributed to the EEPA Project's research were:

- Analyses of government controls imposed differentially by scale of industrial activities and of the difficulty of meeting fixed costs of information and marketing;
- Efforts to link sectoral and macro-level evidence with specific micro-level data;
- Inquiry into the causes of the predominance of SMEs in Taiwan as compared to Korea, focusing on the initial conditions within these countries;
- Emphasis given to different types and qualities of traders as a way of explaining the differential importance of SME activities in Korea and Taiwan; and
- Emphasis given to niche markets associated with product innovation in Taiwan and with process innovation in Korea.

2. "Missed opportunities"

While Ranis credited EEPA with developing much useful and provocative analysis, he also elaborated on "perceived gaps" and dimensions which might have received more attention in the project's research. Future research priorities implied by EEPA's "missed opportunities" include:

- Development of a consistent approach--modeling and empirical examination to ensure systematic analysis of the relationship between the differential phasing of industry structure and of macro-economic policy;

- Increasing the representativeness of the sample of countries examined--studies of Latin American pairs (e.g. Brazil and Mexico), Southeast Asian pairs (e.g. Thailand and the Philippines) and African pairs (e.g. Ghana and the Ivory Coast);

- Further examination of the interactions between the SME sub-sector and the nature of agricultural development--more attention to the importance of linkages, especially between agricultural and non-agricultural activities (e.g. industrial activities);

- Increased emphasis on SME activities in the services sector--as an important user of labor in LDCs, this sector represents an important part of the economic growth with equity problem and its possible solution;

- Increased attention to the issue of technology choice and technology change--determining the legal and market structure which encourages the best technology selection, adaptation and diffusion processes (e.g., using a less expensive patent with a shorter life time and a lower threshold for discovery to reward innovation);

- Consideration of the impact on SMEs of centralized versus decentralized decision-making--especially with reference to the urban-bias embedded in the macro and micro policies of most LDCs and the implications of that bias for infrastructural allocations;

- Analysis of the reduction of transaction costs--e.g., comparing the efficiency of reducing transaction costs through vertical integration versus through linked markets and horizontal integration via subcontracting as in Taiwan; and

- Analysis of the role of human capital--paying special attention to how vocational education can be kept flexible enough to remain relevant over time and to how resources flowing to the education sector might be more efficiently reallocated.

Ranis' final comments addressed the political economy dimension of promoting broad-based economic growth, noting the influence of governments' motivations. He suggested focuses for policy research: The initial internal conditions which favor a policy transition; what sequence of policy changes is least painful; how to assure that policy change is actually followed by institutional changes; and the "nature of the reform-mongering process". He noted that generalizations drawn from country-specific cases can help to reveal the impact of policy biases against SMEs.

In conclusion, Ranis commended the EEPA Project of its high quality work, its good theoretical framework and its combination of hands-on and empirical work. He recommended, though, that in undertaking future efforts similar to EEPA, A.I.D. should agree in the early stages on the ideal scope and pattern of research, and then be prepared to deviate from that ideal.

E. Snodgrass' Response to Ranis' Critique

Snodgrass responded to Ranis' concern that the EEPA Project's research has paid too little attention to the service sector and agricultural-industrial linkages by noting that HIID had deliberately focused on the industrial sector, citing the positive correlation between industrialization and development and the practical necessity to limit the project's scope. Addressing comments on the short-comings of the EEPA Project design, Snodgrass cited A.I.D.'s core and buy-in funding mechanisms as not being conducive to good research. In particular, he noted, they do not encourage continuity, nor do they allow researchers freedom in selecting countries or topics of study.

F. Audience's Response to Snodgrass' and Ranis' Presentations

Key areas of interest which emerged from the discussion that followed Snodgrass' and Ranis' presentations focused on the role of policy with respect to the transitional process through which small and micro firms graduate to larger, more productive firms; the importance and the difficulty of distinguishing between survival and growth-oriented firms; and the use of performance-based assistance.

1. The transition from small/micro firm to larger, more productive firm

Carl Liedholm (Michigan State University) related the EEPA Project's findings relative to the dynamics of the individual firm overtime. One-person firms have both the highest birth rate and disappearance rate. Most disappearance occurs in the first four years. While about two-thirds of those one-person firms that survive will increase in size, Liedholm challenged the notion of graduation, i.e., that these micro firms of five- or ten-person size are the source of larger, productive firms. The evidence, he noted, shows that most of the larger firms in existence started with at least 10 or more workers and grew from there. He questioned whether that trend is the result of policy.

Frank Denton (A.I.D.) raised the question of whether there might be a conflict between the objectives of productivity and efficiency and the focus on SMEs on the basis of their size as opposed to their function. He also suggested that the notion of SMEs being either survival oriented or growth oriented might be usefully extended to the analysis of labor reservoir functions. He noted that different motivational structures--the need to secure basic human needs in the case of the "survival" firm vs. the profit motivation of growth oriented firms--distinguish the two types of firms and that this difference might explain the bimodality in firm size which characterizes low-income countries.

2. Policy support and use of performance based assistance

In response to the question of how policy can be used to encourage the transition of SMEs firms to larger, more productive firms, Tyler Biggs (HIID) remarked that policy should create a situation where winners pick themselves. He proposed that performance-based assistance can achieve such circumstances. He noted, also, that over time the market selects those firms that are efficient. As economies grow and reach the labor market turning point, wages start to rise faster than productivity in small firms and product prices fall. The closing of market distortions at this early stage of development then pushes the small firms that are to survive to upgrade themselves and to search for new technologies.

Brian Levy (World Bank) asserted the importance of being able to distinguish the two types of firms by their track record. He cited an example in Sri Lanka where a successful program which provided financial support, through the formal banking system, to SMEs with established track records was debased when, due to political pressures, it was applied indiscriminantly to micro enterprises.

Norm Nicholson (A.I.D.) questioned why performance based support is always referred to with respect to the export sector. Is it because it is easier to measure performance in the export sector or is it because in the domestic sector the purposes and motivations of the government are so mixed and complex that it becomes impossible to measure performance unless you can do so on a strictly commercial basis, which would be difficult in most developing countries.

Gus Ranis expressed skepticism toward use of specific programs, e.g., subsidized loans, to assist micro enterprises in making the transition from survival to growth-oriented firms. A more appropriate approach, he suggested, is to work through local structures, e.g., by providing a window in rural banking systems which provides information and subsidized technology assistance, rather than to merely increase lending capacity. Ranis also emphasized the importance of decentralization in providing an environment supportive of small and micro enterprises.

III. ECONOMIC AND DEMOCRATIC REFORMS AND LINKAGES: RESEARCH PRIORITIES--COMMENTS BY STEPHAN HAGGARD

A. The Relationship Between Democracy and Economic Reform

Stephan Haggard began by noting two perspectives from which the relationship between democracy and economic reform can be approached--(1) focussing directly on the promotion of political development and the consolidation of democracy or (2) concentrating on how politics affects the economic adjustment process. In pursuing the direct approach, Haggard warned, multilateral aid agencies assume the risk of being accused of political interference.

The indirect approach to promoting democracy focuses on advancing economic growth and equity based on the assumption that they are the necessary preconditions for democratic development. Operational efforts focus on economic, rather than political, development. The underlying premise is that broad-based economic growth increases the income of socially weak groups and the likelihood that they will become politically active creating new bases of support for democratic rule. Haggard referred to several studies which negate this assumption that "all good things go together" and noted that economic growth can actually be a destabilizing force.

B. Sequence of Policy Reform

Haggard summarized three stylized sequences of political reform. In the first sequence, as typified by the experiences of Korea, Chile, Turkey and Uruguay, the military begins structural adjustment prior to undertaking political reform and then initiates the transition to democracy "from above". This scenario has typically resulted in continuity of policy between governments. The new beneficiaries of the reforms instituted become supporters of the new regime. In the second scenario, political and economic reform take place simultaneously. This pattern, characteristic of Mexico, Nicaragua and the USSR, appears to result in instability. The third path is characterized by political reform preceding economic reforms, such as in Poland, Argentina and Brazil. In these cases, exiting authoritarian regimes leave serious economic problems for their democratic successors. Although studies have produced no conclusive evidence that links regime type and successful economic stabilization programs, Haggard proposed that authoritarian regimes may be more likely to stabilize when inflation and social conflict are high.

While the policy relevance of these observations is not clear since the parameters which define each scenario are not manipulatable, Haggard suggested that they might provide some guideline to donors on when to lend.

C. Implementation of Reform

Haggard pointed to two key issues in the analysis of the adjustment process: The relationship between the speed and comprehensiveness of the reform effort and its credibility; and the utility of compensation in contributing to sustainability of reform. He suggested a possible research focus would be for A.I.D. to draw on its experience with specific policy reforms to test the conflicting hypotheses which surround these issues.

1. The pace and size of reform

Haggard pointed to the emerging consensus within the development policy community that policy reforms are likely to be more successful when they are swift and comprehensive. Supporting this position is the hypothesis that the political success of an adjustment effort depends on whether the reform yields results quickly in terms of inflation reduction and aggregate growth providing support for those making the adjustments. The basic argument is that the economically optimal policy is also likely to be politically optimal. Another argument for swift and comprehensive reform relates to governments signaling commitment and building credibility. Government can build a reputation for reform and offset credibility problems by undertaking radical actions to signal its true intentions. The final argument for comprehensive reform suggests that large reforms such as privatization and tariff reduction will reduce the opportunities for groups to argue for exceptionalism, thus reducing rent-seeking behavior.

Haggard cautioned that each of these arguments can be inverted to make a reasonable case for a more gradualist approach. As a further caveat to the argument for comprehensive reform, Haggard warned that big reforms create big opposition. To be successful, the adjustment model must be correct in the first instance.

2. Compensation

The argument for compensatory measures, focusing on the distribution of economic benefits, proposes that targeted compensation for low-income groups might help off-set the political resistance which stems from unequal distribution of gains. The risk involved in pursuing compensatory measures is that they often end up subsidizing groups other than the targeted poor, in effect, establishing new rent-seeking relationships.

D. Role of Decision-Making Institutions

Haggard noted the importance of the legislature and the economic bureaucracy, as well as institutional control mechanisms, in emerging democracies. He asserted that reform is most likely to be sustained where decision-making has been institutionalized in relatively centralized and insulated bureaucracies and agencies. The extent to which a country's central bank is independent from the executive and decentralized agencies, for example, is reflective of the bank's ability to counteract pressures for fiscal expansion emanating from other parts of the political system. In the face of the political pressures that confront bureaucracies in democratic settings, Haggard advised that bureaucratic agencies that are leading reform efforts must construct networks of support, including countervailing groups with an interest in sustaining policy reforms.

E. Suggestions for Research

1. Methodologies

Haggard summarized the principal research methodologies being used to analyze policy reform--formal models of political-economic processes, cross national quantitative analysis and qualitative comparative analysis. He stressed the importance to A.I.D. of understanding the advantages and disadvantages of each approach and suggested that qualitative comparative analysis might be of most relevance to A.I.D.

Haggard advised against broad country case studies, studies that point toward things we already know, and overly broad topics such as the relationship between democracy and economic growth. He advocated undertaking comparative studies that isolate a particular reform, such as the elimination of price subsidies or the establishment of foreign exchange auctions, and studying its political dynamics across countries.

Haggard also advised against research studies that extract policy lessons from particular country experiences without analyzing systematically the politics of policy choice. He emphasized that we need to know why particular policies are pursued in one case and not in another.

2. Proposed areas of research

Haggard presented three areas of research as having the greatest potential:

- The tactics of the reform process--looking at attempted reforms, examine systematically how timing, scope and use of compensation have affected the success of reform efforts;

- Decision-making institutions--given the importance of creating viable decision-making institutions to sustain economic reform, there needs to be more research done on what works and what does not; and

- Policy areas in which A.I.D. is routinely engaged--a possible study would be to select an area such as price policy reform or trade liberalization, develop a set of orienting propositions based on the literature and survey A.I.D.'s experience in selected countries.

F. Audience's Response to Haggard's Presentation

Central themes around which subsequent discussion focused included the use of conditionality in the policy reform arena and the purpose of A.I.D.'s interest in the political economy of policy reform. Among other issues discussed were the need for isolation from political pressures of policy making institutions and the ethnocentric biases of our approach toward democracy.

1. How do we determine to whom and how we will provide assistance?

One question raised the implications of the policy disruptions that often accompany the transition to democracy. While realizing that funding provided to countries in such transition may not be well utilized without significant policy reform, our political interests may make it difficult to withhold aid. In Central America, for example, should we put large amounts of money into these countries immediately in an attempt to buy the conditions conducive to democracy or do we wait and see what happens? Haggard suggested the pursuit of a strategy whereby we give money to countries if they are committed to reform and give them nothing if they are not. The problem, then, he noted, is how to gage a country's commitment to reform.

2. Conditionality

There was a consensus regarding the high risks involved in an initiative which focuses on political reform. Gus Ranis referred to A.I.D.'s movement away from economic reform in the sense of using conditionality in economic reforms and cautioned A.I.D. to be wary in the application of conditionality to the very sensitive area of political reform.

Remarking that in imposing conditionality we often ask developing country governments to do things they simply cannot do (things we would not ask our own government to do), Henry Bruton raised the issue of the degrees of freedom a government might have at any given time. He proposed that careful consideration be given to a government's particular situation, evaluating how and where it can act without creating chaos. Clarence Zuvekas perceived a problem in differentiating between what governments really cannot do and what they say they cannot do.

3. Supporting an "environment" for political reform

Deborah Brautigan (Columbia University) articulated two key lessons that have emerged from the research conducted on structural adjustment and economic reform over the last ten years and, most recently, on political reform: (1) conditionality based reform in the economic arena has not been very effective and (2) political reform, where it has been successful, has been demand driven. Based on those lessons, Brautigan concluded, we should be looking at how we can help support conditions under which demand driven political reform can take place. Brautigan further suggested that the economist's paradigm of creating a level playing field might be extended to the creation of a level political playing field, remarking that condition-based lending that goes to politically determined countries does not create a level playing field.

In response to the emphasis given to creating an environment in which democracy can flourish, Haggard cautioned that we should not be too confident about economic conditions. He questioned the resilience of democracy in the face of real crisis and poor economic performance over the long run, noting that democracy has eroded at the top in the face of poor economic performance. Haggard advised a focus on the task of promoting growth as a condition of making democracy function, rather than focusing directly on fomenting democracy.

Sonia Hamman (A.I.D.) articulated the need to clarify the purpose of A.I.D.'s interest in the political economy of reform, asserting that A.I.D.'s interest, as a development agency should be in trying to understand the political process under which economic reform can take place--not in trying to find out how to promote democracy.

4. <u>Ethnocentric biases of our approach to democratic reform</u>

Ranis remarked on the ethnocentricity of our definition of democracy, commenting that the emphasis on Western institutional structures is folly in an LDC context. He cited the example of Taiwan which is ruled by an authoritarian regime under which the average rural citizen is given much more opportunity for participation than is his counterpart in Colombia, a democracy. Ranis urged a redefinition of democracy.

Stuart Callison (BIFAD) focused on our ethnocentric tendency to neglect the participation of indigenous researchers and policy makers. He raised the question of who should be conducting the proposed studies and affirmed the need to support improvement of indigenous capacity to deal with policy issuess. He suggested a potential area of research--the extent to which an indigenous capacity is needed to analyze, plan and implement a country's own reform programs and how a lack of an indigenous capacity to explain policy reform options to constituents hinders governments' ability to launch, implement and sustain political support for reform programs.

5. <u>Using the successes of past experience</u>

John Mathieson (SRI) raised the point that we know what to do to promote economic growth at the macro level and we know what the problems are at the micro level. The critical issue is the selection of strategies to be applied at the broad decision-making level and identification of the policy tools that have worked in the past.

6. Is there need for insulation of policy makers?

Martin Hanratty (A.I.D.), citing the insulation of the US Federal Reserve, asked whether is it easier to insulate policy makers for the purposes of making monetary policy, rather than fiscal policy decisions? Haggard responded that it is easier to insulate reforms that have a "low administrative intensity", rather than a high administrative intensity. Mathieson noted that experience indicates a need to insulate economic reform from political and military pressures.

7. Theory of the state

Norman Nicholson raised the concern that political scientists have forgotten the theory of the state, that they discuss democracy in terms of mechanisms, e.g., elections, institutional arrangements, instead of what the state should be doing and whether it is doing it efficiently. Haggard disputed the usefulness of the theory of the state remarking that we already know what the state is supposed to do. In fact, he argued, the theory of the state does nothing to explain why the state works in some cases and not in others.

8. Equitable distribution of public goods

Ranis pointed out that while the idea of creating a level playing field may be useful, with regard to broad-based development people must be reached by more than markets and participation in markets in a fair game. They must be reached by public goods, e.g., health and education. An important function of the government is the equitable distribution of these public goods. Ranis suggested targeted vs. non-targeted provision of public goods and food subsidies, where appropriate, as an issue for research where A.I.D. has the experience and wisdom to make a meaningful contribution.

9. Reform "packages"

Stuart Callison referred to Haggard's discussion of the dichotomy between rapid implementation of major reforms vs. a gradual approach, asserting the need to consider the synergistic relationship between different reforms. Callison noted that the magnitude of a package of reforms, rather than of a single reform, must considered. He emphasized that to move these reform packages through the system, difficult political decisions regarding the combination of reforms and their sequencing must be made within each country.

10. Institutional pluralism

Haggard's advice against the support of institutional pluralism provoked a contrary response that there is a need to further consider what kind of organizations outside of the government can aggregate and articulate their interests to pressure governments to implement and sustain reforms. Haggard agreed that there is room for strengthening those institutions that make democracy function, including interest groups, political parties, legislatures, courts, bureaucracies, and the press. The risk inherent in strengthening any of those institutions that might have partisan principles, e.g. unions, business associations, however, is that donors may be charged with political interference.

IV. ECONOMIC POLICY RESEARCH PRIORITIES-- COMMENTS BY GARY FIELDS AND HENRY BRUTON

A. Research Priorities for Broad-Based Growth--Comments by Gary Fields

1. Defining broad-based growth

Gary Fields began by defining broad-based economic growth in terms of achieving an improved "choice set" for all economic strata, i.e., raising the standards of living at all economic levels. Since the upper and middle classes typically have many mechanisms through which to benefit from economic growth, Fields' definition of broad-based growth focuses on policy targeted to ensure that the poor are reached by economic growth. The maximin principle, as Fields mentioned, holds that society's goal should be to maximize the well-being of the worst-off individual.

Fields offered two criteria useful in determining whether growth has been broad-based: (1) whether real incomes have risen and absolute poverty has fallen and (2) whether income inequality has increased, decreased or stayed the same. Applying these criteria to the empirical evidence, Fields addressed the questions of how poverty and inequality have changed over time.

a. How has poverty changed over time?

Looking at data on changes in income over time, the evidence points to aggregate economic growth raising real income of individuals and households and usually (but not always) lowering absolute poverty. In most instances where poverty has risen, aggregate economic growth has been very small or negative. These findings imply that more growth generally can be expected to help all income groups including the poor.

b. How has inequality changed over time?

Looking at change in relative income inequality, Fields found the available evidence to be "decisively indecisive"--there is no empirical tendency in the inequality-development relationship. He concluded that since inequality does not tend to increase before it decreases, to fall with economic growth, or to change systematically with the rate of economic growth, it must be the type of economic growth, rather than the volume or rate, that determines the extent to which the poor participate in the growth process. Without fundamental change in a country, relative income inequality tends to change very little. The policy implication that follows from this conclusion is that major reforms are needed if the poor are to increase their share of the benefits of economic growth. Fields concluded that politics is the critical determinant of whether benefits of growth are widely distributed.

2. What types of growth have been most broad-based?

Fields noted that for economic growth to have broad-based effects, there must be mechanisms for transmitting gains throughout the economy, especially to the poor. Given that the most important asset of the poor is their labor, it follows that economic growth which increases the demand for their labor will enhance the ability of the poor to share the benefits of economic growth.

a. Labor intensity of growth

Fields cited the experience of the East Asian Newly-Industrializing Economies (NIEs) as positive examples of broad-based economic improvement. As firms expanded output, they also increased their demand for labor. Labor-intensive growth led to full-employment and eventually an increase in wages when an additional supply of labor was no longer forthcoming at prevailing wage rates. Once labor surpluses were depleted, these economies moved to a more capital-intensive type of economic development. Research questions suggested by the NIEs' experience include how these changes were made and how to best create more and better jobs.

b. Distribution of productive assets: education

Given that education has the capacity to make people more productive, an important question in resource scarce LDCs is how to best spend funds allocated to education. Fields suggested more research is needed on the empirical effects of educational expansion and how labor markets adjust when more workers are educated.

c. Government regulation and private enterprise

Looking at the interrelationship between government regulation and private enterprise, Fields raised the question of how to achieve "the right balance between the legitimate interests of workers to earn fair wages and to work under decent conditions, of consumers to receive fair value for the prices paid, and of businesses to earn profits." Considering the regulation of labor markets as an example, the dilemma of competing interests is clear. Some economic growth in labor-abundant LDCs has not been labor-intensive. Efforts to legislate higher returns to labor (such mechanisms as the minimum wage and ambitious labor standards fall into this category), while well intentioned on behalf of workers, ignore the fact that higher wages mean higher costs for employers and provide incentive for firms to economize by hiring less people. Labor market policies that have been conducive to broad-based improvements are those that pull the poor along when the economy grows, rather than those that push wages upward and improve working conditions. Fields suggested research to determine when regulations have impeded desirable private enterprise adjustments and when they have prevented private enterprise from engaging in socially undesirable actions.

d. Trade and industrialization strategies

Empirical evidence strongly favors outward trade and industrial strategies over inward-looking strategies for both raising the rate of aggregate economic growth and for achieving more broad-based economic growth. Being able to export profitably benefits the export firms, their suppliers and their workers. The key to profitability, as reflected by the East Asian NIEs experience, is selecting industrialization and trade policies with careful attention to comparative advantage and being able to shift and adapt those policies as comparative advantages shifted.

3. Policy-relevant development research

In summary, the following research topics were proposed as meriting high priority for formulating appropriate development policies:

- Determinants of constraints on choices--Fields called for more research on how such factors as macroeconomic conditions, public policies and strategies, markets and institutions interact to influence choice sets and more work at the level of market and inter-market analysis;

- Coping strategies--How does behavior of individuals and households change in response to changes in choice sets which accompany economic growth and decline? What are the determinants of coping strategies?

- Labor market functioning--How do labor markets function? Areas for investigation include the extent of integration of various countries' labor markets; determinants of the amount of employment in major sectors or segments; interaction between education and labor markets;

- Informal sector--Beginning with a clear definition of the informal sector, we need to determine whether it consists of more than one tier and, if it does, to look at tiers separately in terms of their income determinants and income opportunities; and

- Dynamics of growth--New theoretical models of economic growth need to be adapted to conditions of non-steady growth dynamics to allow study of economies when they are out of equilibrium.

B. Broad-Based Growth: Concepts and Processes--Comments by Henry Bruton

1. Stylized facts of sustained growth

Henry Bruton began his presentation with a discussion the "stylized facts" of broad-based growth. He attributed the wealth of Western economies to slow, but regular, growth over the past couple hundred of years. Bruton termed this pattern of growth as indigenous, the result of a kind of steady, routine functioning of the economy, as opposed to growth in less developed countries which he labeled as derivative or imported. Among the principal characteristics of indigenous, sustained growth of economic welfare Brtuon included:

- A positive rate of growth of the productivity of both capital and labor;
- Investment rates that are generally ten percent or higher;
- Labor markets which work well, i.e., wages do not rise much in the face of unemployed or underemployed labor and labor moves easily from sectors of declining to sectors of rising productivity;
- A constant appearance and growth of new, non-traditional exports, reflective of an economy's flexibility and ability to create and exploit new opportunities;
- Macro conditions such that the economy does not have to slow down to correct a macro problem such as inflation or balance of payment deficits;
- A government that can resolve public choice problems, as well as maintain order and harmony; and
- Growth of per capita output consistent with the values, traditions, culture of the community.

2. Principal areas for more research

Using the characteristics of sustained economic growth as a departure point, Bruton outlined specific areas to target for continued research. These areas reflect issues key to our understanding of the "basic task of broad-based economic development". Bruton's priorities for study include:

- The question of why productivity of factors of production increases in specific sectors and in the economy as a whole; the relationships between exports and productivity growth and the exchange rate and productivity growth; the content of "social capacity";

- Analysis of accumulated studies of specific foreign investment projects;

- Detailed, empirical studies of labor markets in developing countries that consider how wages are determined and how labor market arrangements contribute to productivity growth and to the evolution of new technologies;

- Determining which macro models are most useful in understanding how hard we can push an economy against supply constraints without generating inflation and balance of payment problems;

- The role of institutions in determining how an economy can perform and can be influenced;

- The role of government in promoting growth and encouraging equitable distribution of income, including studies of the division of labor between the public and private sectors, and looking at the relative influence of forces inside and outside the market; and

- Determining the optimal degree of openness for an economy.

C. Audience's Response to Fields' and Bruton's Presentations

Substantial discussion was generated over the role of government in distributing public goods and the use of undervalued exchange rates and wage-setting mechansims.

1. The role of secondary distribution

Gus Ranis suggested that it is useful to distinguish between primary and secondary distribution. He noted that primary distribution, i.e. what results from the way output is generated, is "where the ball game is won or lost." If the primary distribution is worsening in spite of growth, then there is little that can be done with respect to secondary efforts by governments through transfers or public goods. However, he argued, secondary distribution can have an important role in improving the well-being of low income groups through improving their access to public goods. Suggesting a framework in which to define broad-based growth, Ranis asserted the need to go beyond income and income distribution, to consider the welfare of people in a more basic sense, i.e., life expectancy, nutritional and health status, and literacy. He stressed that income is the means to the end, not the end itself.

Ranis also addressed attempts to create a basic index to measure the quality of life. Key to this pursuit, he offered, is the recognition that different combinations of growth, distribution and how governments allocate public goods across income groups can lead to improved quality of life. Ranis concluded that broad-based growth is most appropriately analyzed in terms of the human being as the end of the process--not productivity.

Ranis noted that even the poorest countries have resources many of which are misallocated. Opportunities for reallocating those resources, Ranis charged, are often overlooked. For example, 80 percent of health budgets typically go toward hospital rehabilitation, while only 20 percent goes to preventative health which has far greater impact on the poor. Ranis proposed, as an important research area, understanding the production function which makes for a better life, considering such inputs as health, potable water, education and food.

Henry Bruton followed up on Ranis' discussion of primary and secondary distribution, asking whether governments' attempts to correct primary distribution through public goods reflect their economies' inability to generate the right kind of income distribution. If policy could be created that would create a high demand for labor, a high rate of investment and income of lower income groups rose, Bruton hypothesized, wage receivers would spend their money as they chose and public goods would become less important. What is critical, he proposed, is that, given that governments do not function well when they try to do too many things, they must make a choice between approaches. They can choose to follow the approach of pursuing a strategy that focuses on achieving high rates of growth of productivity, investment, growth and demand for labor <u>or</u> they can choose the option of concentrating on supplying public goods, recognizing that they can not get the economy to grow vigorously enough to resolve the problems governments hope to resolve by public goods.

In response to the question of whether there must be a trade-off between these two approaches, Bruton reiterated that governments' lack of resources, lack of energy and lack of capacity to organize make leave them unable to do many things at once.

Mancur Olson (University of Maryland) challenged the proposition that the choice of the "right strategy" would lead to a reduction in inequality. He commented that the implicit assumption that the government is striving for development and equality is not necessarily valid. The problem with depending on the right strategy to achieve equality, as Olson described it, is that the affluent and well established elements of society are best able to influence the way in which funds are spent within the context of a selected strategy, negating the strategy's potential for achieving equality and growth.

2. <u>Undervalued exchange rates</u>

In response to the charge that the use of an undervalued exchange rate worsens income distribution, i.e. it tends to benefit the already affluent segments of society rather than lower income groups, Bruton replied that the income distribution effect of such a policy depends on how much growth and demand for labor is generated as a result of the undervalued exchange. He offered Taiwan as a case in which a strong demand for labor and substantial growth accompanied the use of an undervalued exchange rate, offsetting the income distribution effect. There was agreement that technical efficiency, rather than allocative efficiency, should be targeted as an objective.

Jim Elliott (A.I.D.) noted that the promotion of undervalued exchange rates implies that countries who service their huge external debts do better than those who can not or refuse to do so. It might be appropriate then, he suggested, to find out whether that is actually the case. He also emphasized that the argument for undervalued exchange rates does not support the use of multiple exchange rates.

3. Investment

Brian Levy commented on the challenge of how to stimulate investment, referring to the fact that much recent work on investment has tried to link the absence of investment to the uncertainty about the sustainability of policies. He posed the question of how a country can induce entrepreneurs to invest and to take risks at the levels that are needed and how to create an environment that spreads those risks.

4. Wage-setting mechanisms--a dilemma?

Clarence Zuvekas (A.I.D.) turned the discussion to the consideration of wage setting mechanisms as a strategy to stimulate development. Referencing the example of the East Asian NICs, whose strategy of keeping real wages at a constant level until full employment was reached greatly contributed to the success of export development and the subsequent rapid rise in real wages, he suggested that it would be difficult for the U.S. to advocate the manipulation of wages as a strategy since it conflicts with the ideal of democratic decision-making and participation. Zuvekas asked whether it is possible to restrain real wages in the short-run to permit expansion of economic activity until full employment is achieved without creating a conflictive situation. He proposed that political scientists address this question in terms of what is politically feasible vs. what is politically unfeasible.

Gus Ranis identified this conflict as one between full employment and labor rights, asserting that the real issue is wage income for the many versus wage rates for the poor which, he asserted, presents no conflict when there is a large surplus of unemployed labor.

5. Collective action as a source of inequality

Mancur Olson responding to Fields' finding that inequality has increased even in the face of economic growth, suggested that such a result could not be achieved unless the government in question worked at it. Such a result could not occur from the operation of a free market. It would have to be the result of forces outside the market, such as the capacity to act collectively being disproportionately held in the upper reaches of society. He offered as a research hypothesis that government, as influenced by inegalitarian capacity for collective action, is the main source of inequality in societies where income inequality grows in spite of economic growth.

V. PRIORITY RESEARCH TOPICS FOR POLICY REFORMS SUPPORTING BROAD-BASED ECONOMIC GROWTH

In the final session of the Workshop, participants discussed research priorities for policy reform to support broad-based growth. Those research priorities are presented here as sets of potential research questions which reflect key issues that threaded throughout the presentations and ensuing discussions. Approaching broad-based economic growth as a process, the priority research questions are organized to address the <u>determinants</u> of productivity and broad-based growth; and the <u>strategies</u> that can best influence those determinants to promote productivity and broad-based growth. The development of an <u>analytical framework</u> for approaching the proposed research priorities is treated in Section B, below.

A. <u>Priority Research Topics</u>

1. <u>Determinants of productivity and broad-based growth</u>

The emphasis placed on productivity growth in the Workshop discussion reflects a need to understand better what causes productivity growth and the nature of the linkages between growth in productivity and broad-based growth. Related research priorities focus on: (1) how productivity growth can be promoted, and 2) how it can be directed to facilitate more equitable distribution of income. Toward the achievement of these priorities, an initial set of research questions centers on the identification of the <u>determinants</u> of productivity growth and of broad-based economic growth. The research questions proposed include:

- o Why does the productivity of factors of production increase in some country situations, but not others? Why does the productivity of factors of production increase in specific sectors of the economy and in the economy as a whole?

- o What degree of consonance, if any, is there between the causes of productivity increases and of broad-based economic growth? Does balanced growth contribute to productivity increases and broad-based growth?

- o What is the <u>long-term role of SMEs</u> in the process of productivity and broad-based growth and in generating employment?

- o What factors (institutional matrix, policy set, access to education, etc.) are most closely associated with broad-based growth? Are some of these factors common in all instances of broad-based economic growth?

Are there determinants of broad-based growth that are consistently more important than others?

- o What <u>institutional context</u> most effectively supports broad-based growth? What is the impact of government institutions on broad-based growth?

- o What is the function of the <u>labor market</u> as a determinant of growth and as a mechanism to spread the benefits of growth more broadly within society?

- o What is the significance for broad-based development of the degree of <u>openness</u> which characterizes an economy? Is there a right <u>mix</u> of openness and closedness?

- o What roles do <u>exchange rates</u> and <u>exports</u> play? How do exports feed back to productivity and income distribution? How does a concentration on exports affect productivity? What are the implications for productivity and broad-based growth of a focus on manufactured vs. raw material exports? What are the effects of undervalued exchange rates and donor imports of LDC exports?

- o What mix of <u>human capital investment and macro policies</u> produces rapid growth in productivity and broad-based growth? What explains differences in country experiences?

- o What <u>infrastructure</u> is necessary to achieve broad-based growth, i.e., for rural areas? What are the <u>characteristics</u> of private sector infrastructure support?

2. <u>Strategies for achieving productivity and broad-based growth</u>

Given a set of determinants of productivity, the next step is to determine whether and how those factors can be redirected to produce more broadly based growth. The following set of research questions focuses on the development of <u>strategies</u> that can generate productivity growth <u>and</u> broad-based economic growth.

- o What strategies can increase the productivity of factors of production? Can the factors that cause productivity growth be directed to produce more broadly based growth? What strategies can increase the productivity of SMEs and other enterprises in LDCs? Do such strategies have <u>essential elements</u> or are they situation specific? How do possible donor interventions fit into such strategies?

- o Does reduction of inequality of income shares of particular groups always accompany broad-based growth? Why does inequality go down or up? Can we do more to reduce inequality with growth via policy changes? To what degree does the legal framework and the legal system in place support or constrain desirable policy changes?

- o What is the relationship between policy reform, political strategies and broad-based growth? How do we go about getting a reform through the political system? How do we make reforms that lead to broad-based growth last?

- o What is the relationship between democracy and promotion of broad-based economic growth--and the sequencing of each?

- o What educational strategy should be developed to disburse human capital more broadly?

B. Development of an Analytical Framework

Substantial attention was directed to the methodology and analytical framework to be applied in carrying out research on the selected priorities. It was agreed that case studies are important, but to be most meaningful, country case studies must be specific, comparative and should focus on successes. While there was agreement that analysis of successes is key to understanding productivity increases and broad-based growth in developing countries, the relevence of "good cases" such as Taiwan and Korea as a source of solutions for the problems of countries further back on the growth path was questioned. The need to increase the representativeness of the sample of countries examined was emphasized. Proposed analytical approaches included:

- o Case studies--e.g., comparative case studies where adjustments in the regulatory environment have taken place; examining second generation cases--what dialogue has occurred;

- o Pairs studies--e.g., comparative analysis of growth paths of similar countries such as Indonesia and Thailand or Zimbabwe and South Africa;

- o Reform efforts analyses--e.g., assessing the impact of a particular adjustment across countries;

- o Historical studies--e.g, what has happened longitudinally and why (focussing on the 1980s);

- Specific market studies--e.g., couching research in terms of specific markets, such as examining the relationship between broad-based growth and labor markets;

- Regional studies--e.g., comparative analysis of regions within a large country that has successes, focussing on how macro policies play out in a successful region as compared to in a poor region;

- Broader perspective studies--e.g., encompassing the economic, political, labor market and other factors which have determined the extent of productivity and broad-based growth; and

- Micro-level analyses--e.g., what happened within specific sectors, industries, businesses or other institutions in increasing productivity and broad-based growth.

ANNEX 1

The Role of Small and Medium Manufacturing Enterprises in Industrialization and Economic Development--
Paper Presented by Donald Snodgrass

THE ROLE OF SMALL AND MEDIUM MANUFACTURING ENTERPRISES IN INDUSTRIALIZATION AND ECONOMIC DEVELOPMENT*

An Introduction to the Employment and Enterprise Policy Analysis Project

Donald R. Snodgrass**

I. Introduction

The Employment and Enterprise Policy Analysis Project (EEPA) is a sustained effort to improve understanding of the role that small and medium enterprises (SMEs) can play in the process of efficient industrialization, as well as of the effects of economic policy on the creation of productive employment and the growth of individual business enterprises in the developing countries. The project was commissioned by the Enterprise Development Division, then part of the Office of Rural Development, Bureau for Science and Technology, United States Agency for International Development in 1984 and will end on September 30, 1991. The Harvard Institute for International Development (HIID) is prime contractor for the EEPA Project; Michigan State University (MSU) and Development Alternatives, Incorporated (DAI) are sub-contractors.

The EEPA project comprises a complex set of research and technical assistance activities. Core funding provided by the Bureau of Science and Technology has been used primarily for research, dissemination of findings, and project management. Core-funded research has been carried out in the United States, Belize, Korea, Niger, Nigeria, and Taiwan. EEPA's primary research findings are available to interested readers through the 30 papers in the EEPA Discussion Paper series.

In addition to its core funding, the project has received buy-in funds to undertake long-term field activities in three countries (Bangladesh, Rwanda, and Sri Lanka) and short-term field activities in 17 additional countries (Bangladesh, Belize, Botswana, the Dominican Republic, Ecuador, Ghana, Honduras, Malawi, Morocco, Nepal, Niger, Nigeria, the Philippines, Senegal, Somalia,

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*An earlier version of this paper was presented to participants in AID's Workshop on Research Priorities for Policy Research Supporting Broad-based Growth and Democracy, held in Washington on November 9, 1990. The present version incorporates material presented orally at the Workshop. While the essay conveys the insights of many people who worked on the EEPA project, they would not necessarily agree with the way I have presented project findings here and should not be held responsible for this version. I am particularly grateful to Tyler Biggs, who substantially influenced my views on the role of small and medium enterprises in economic development.
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Sri Lanka, Tunisia and Zaire). It has also carried out buy-in work on behalf of AID's Bureau of Policy and Program Coordination, Africa Bureau, and Asia/Near East Bureau. The buy-in activities provided an important complement to the core-funded research, serving both as occasions to learn about job creation and enterprise development in varying settings and as opportunities to apply and test the research results by advising host governments and AID Missions on employment and enterprise policy.

As the project's name suggests, EEPA is concerned with the relationships among employment creation, the development of individual business enterprises, and the policies enacted by developing country governments. The project grew out of concern about the slow pace of job creation in larger, more formal business enterprises in most developing countries and was shaped by a conviction that SMEs can be an important part of the solution.

To help the reader understand the project's antecedents, we present in the following section a short history of the role of SMEs in industrialization. With that history as background, the remainder of this chapter presents an overview of the approach to the problem taken in EEPA and a summary of the project's main findings.

First, however, we need to clarify some important definitions:

1. SMEs. We follow the precedent of most previous work by defining enterprise scale primarily in terms of employment. This definition is standard not because employment is an ideal scalar but because employment data are much easier to obtain than data on invested capital or other possible indicators of enterprise scale. Other studies have used the terms Small-Scale Enterprise (SSE) or Small-Scale Industry (SSI), employing various definitions. Our preferred term is Small and Medium Enterprises (SMEs), which means firms employing fewer than 100 workers unless a different definition is specifically provided. This definition includes a fairly wide range of enterprises, from "cottage shops" or "micro-enterprises" with 1-19 workers up to medium-sized enterprises in the 50-100 worker range, which are frequently larger than the average for industrial sector firms, especially in the low-income countries.

2. Developing countries. Following the World Bank's current definitions (World Bank, 1990), developing countries are those with per capita GNP of less than $6,000 in 1988. They can be divided into low-income countries (per capita GNP in 1988 of less than $500, lower middle-income countries ($500-2,200) and upper middle-income countries ($2,200-6,000).

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II. Background to EEPA: A Short History of Industrialization and Views on the Role of SMEs

Economic development has always been closely associated with industrialization. An economist might define industrialization as a long-term rise in the relative importance of the industrial sector, including both an increase in the share of labor and other resources used by the sector and a rise in its share of Gross Domestic Product (GDP). But industrialization also entails important changes within the industrial sector, especially a shift from reliance on cottage shops and small factories to a much greater role for large factories, employing anything from one hundred to several thousand workers.

These patterns were established during the British Industrial Revolution of the late eighteenth and early nineteenth centuries. Such manufacturing industry as existed before the Industrial Revolution took place either in the workers' cottages or in small workshops. During its initial phases, the Industrial Revolution did not disturb this pattern. When Adam Smith (1776) pointed out the potential for raising industrial productivity by increasing the division of labor and linked that process to growth in the extent of the market, he did not have a modern factory in mind, but only a simple shop in which operations would be carried out by hand but a larger volume of production would permit the production process to be broken down into smaller component parts. It was only after the use of steam power became common and technologies such as the power loom were introduced that the modern factory was born. Thereafter, the locus of production shifted rapidly to the large factory. By the middle of the nineteenth century, the "dark Satanic mill" was indelibly associated with industrialization and economic development.

The countries that followed Great Britain into economic development -- France, Germany, the United States, Russia, and so on -- all emphasized industrialization in large factories. By copying the technologies introduced in Great Britain and other more advanced countries, they were able to grow faster than Britain had. In most cases, the economic development of these second-tier countries was strongly motivated by national power and security considerations and was more actively state-led than Britain's development had been (Gerschenkron, 1962). An interesting partial exception to the large-factory approach was Japan, which started to modernize and industrialize after the Meiji Restoration of 1868 but continued for several decades to rely heavily on small-scale industries with traditional bases. The dominant lesson of economic history, however, is that development flows from the adoption of modern technologies, especially in the industrial sector and frequently embodied in relatively large manufacturing plants.

Up to World War II, little industrialization occurred in Latin America, in Asia outside Japan, or in Africa. Most countries in

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these areas had been colonized by the European powers, and European influence was strong even where there were no formal colonies (e.g., most of Latin America, China, Thailand). The colonial economic system was based on a division of labor in which the mother country traded manufactured goods with the colony for foodstuffs and other primary commodities. In some cases -- most notoriously cotton textiles in India, but also cottage industry products in many colonies -- colonial policy actually deindustrialized the colonies in the interest of economic growth in the mother country, which was heavily dependent on exports (Birnberg and Resnick, 1975). Cotton textiles accounted for 40-50% of British exports each year from 1816 to 1848, and more than half of textile production was exported (Hobsbawm, 1977, pp. 49-58). Some industrialization occurred in Latin America in the 1930s, and in other areas during World War II, but these plants were established under highly protected conditions and seldom became efficient enough to thrive in the more open environment that emerged after the War.

The modern era of economic development dates from the national independence movements of the post-World War II era. The identification of economic development with industrialization and the history of denial of local aspirations by colonial policies led many nationalist leaders to give industrialization a prominent place among their national goals. In general, the theme was that the new nations in Asia, and later Africa, would advance in the footsteps of those nations which had aleady industrialized following the European model. Many leaders distrusted international trade, believing that it had been manipulated to their disadvantage during their colonial era and continued to be up to the present, despite the achievement of political independence. Accordingly, their definitions of industrial policy often had a strong autarkic flavor. Universally, however, they assumed that economic development was fundamentally a matter of industrialization, interpreted as replication of the kinds of factories and technologies that rich countries had. Nations that were able to build such factories and adopt those technologies would become rich and powerful. Countries that were unable to do so would remain poor and weak.

India, one of the first countries to achieve independence and embark on economic development in the modern sense, endorsed this line of thinking in its earliest five-year plans. After achieving some increases in agricultural output during its first five-year plan, it set out to industrialize during its second. Only agricultural setbacks during the second plan period brought home the realization that industrialization and structural change are much longer-term processes than had been assumed.

Although India sought to develop a modern, large-scale industrial sector, it was also strongly committed to small-scale enterprise. This commitment relied for ideological support on the

Gandhian tradition, but it derived its continuing vitality from the political dynamics of democratic India. Gandhi believed in village self-sufficiency and rejected elements of modernization on moral grounds, while democratic government forced policy makers to respond to the pleas of the numerous small producers who might suffer in the process of economic development. In adopting its Industrial Policy Resolution of 1956, the Indian Parliament argued that small-scale industry (SSI) should receive official encouragement and protection on the grounds that such a policy would provide four major benefits:

(1) employment creation (it was assumed that SSI is more labor-intensive that large-scale industry and other potential uses of capital);

(2) decentralization (it was assumed that SSI is more dispersed to small towns, rural areas, and remote parts of the country than larger-scale enterprise, or can be more easily dispersed to these areas);

(3) social and political advantages (small enterprises were thought to promote democracy and equality);

(4) development of latent reserves of scarce resources, especially entrepreneurship and capital (Dhar and Lydall, 1961).

At first, interest in SSI was virtually limited to India. Gradually, however, the benefits attributed to SSI became more attractive to other developing countries. In 1965 Staley and Morse wrote their standard treatise, Modern Small Industry for Developing Countries, which remains the most authoritative statement on what small industry can and cannot do and on how to realize its potentials through project activities.

During the 1970s a new justification for promoting SSI emerged when concern about employment prospects in developing countries became widespread. This concern was occasioned by a "labor force explosion." Mortality rates had declined in many developing countries, and after a lag of 15-20 years the labor force effects of improved child survival were beginning to be felt. Added to this in many countries was the impact of increased female labor force participation. Expansion of school enrollments blunted these increases for a while, but only partially and temporarily. On the demand side of the labor market, labor absorption in agriculture was observed to be very low. Moreover, jobs in agriculture were not attractive to the growing numbers of young, educated job seekers. Growth in the kinds of job opportunities that these people really wanted -- to work as employees in the government or established non-agricultural enterprises in the private sector -- lagged well behind the numbers of people seeking such jobs.

All of this was viewed by many in the 1970s as an "employment crisis," which might be ameliorated by a class of enterprise that could absorb the labor that the government and large private enterprises were unable to employ. As the World Bank's 1978 sector policy paper on small enterprises put it,

> "In most developing countries only a fraction of the new job seekers can be employed in agriculture. The scarcity of capital severely limits the number of new nonfarm jobs that can be created, because investment costs per job are high in modern industry. An effective development policy should seek to increase the use of labor relative to capital, to the extent that it is economically efficient" (World Bank, 1978, p. 5).

Predictions made in the 1970s indicated that massive unemployment in developing countries would result as ever-larger cohorts of job seekers entered the labor force. The failure of these dire predictions to materialize shows that the forecasters underestimated both the <u>need</u> for people who had no other means of survival than their own labor to create some form of gainful employment for themselves and their <u>ability</u> to do so.

Another reason for increased interest in SSI during the 1970s was the "small is beautiful" movement inspired by E. F. Schumacher (1973). Schumacher believed that large-scale capitalist enterprise was dehumanizing, even when it brought higher productivity and living standards. In its place, he championed "intermediate technology" better matched to the factor endowments of developing countries and best utilized in small, human-scale firms.

Less was heard about small-scale enterprise during the following decade, the 1980s. Now, however, more than three decades after the Indian Parliament's 1956 Industrial Policy Resolution, interest in SSI -- often redefined as micro-enterprises, the informal sector, or SMEs -- is reviving. The mood, however, is more critical than before. Many analysts question whether SSI has ever met the high expectations of its exponents and wonder what, in the light of the much greater amount of experience that has now been accumulated, is a realistic expectation regarding the role of SSI in development and what is the best way to realize that potential.

Doubt about the ability of SSE to deliver all that its enthusiasts have promised goes back at least to 1961, when Dhar and Lydall observed that Indian SSI realized only some of the benefits claimed for it. Although did appear to be labor-intensive, it was observed that in many industries enterprises employing 20 to 49 workers used more capital <u>as well as</u> more labor per unit of output than larger enterprises. In other words, they were indeed labor-intensive but inefficient. Moreover, smal firms were actually <u>more</u> concentrated in urban areas than large-scale

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enterprises. Yet SSI did seem to possess some of the advantages claimed for it -- those relating to income distribution and the promotion of entrepreneurship. Later assessments of Indian SSI found it to be disappointing in many ways. Developmental efforts repeatedly had to be supplemented by protective measures. Skepticism about SSI in India has recently been reinforced by the substantial studies of Mazumdar (1984) and Little, Mazumdar, and Page (1987).

More positive conclusions have sometimes been reached for other countries. Cortes, Berry, and Ishaq provided the best documentation yet of the role played by SMEs (defined by them as enterprises employing 5-99 workers) and reached sufficiently encouraging conclusions that they could entitle their book Success in Small and Medium-Scale Enterprises. The Evidence from Colombia (1987). Another indication that small firms can play a positive role in the industrialization process is the historical experience of Japanese SMEs, which have been widely acclaimed as contributors to economic growth. Before World War II they specialized in products and processes that depended for their competitive success on the availability of low-cost labor, but after the War they gradually modernized, raised wages, and became more complementary to larger-scale industry through an extensive system of subcontracting (Hoselitz, 1968). More recent examples of positive contributions from SMEs include the experiences of the two Chinas (Perkins, 1977; Ho, 1980; see also EEPA, forthcoming, Chapter 3).

The World Bank's 1978 sector policy paper, while arguing for SSE promotion, cautioned that generalizations should not be pushed too far, "since reliable data for making rigorous comparisons at the enterprise level and for identical products are scarce." This insecurity about the information base led to a number of studies which sought to document the nature and extent of small-enterprise activity in manufacturing and other non-agricultural sectors (e.g., Chuta and Liedholm, 1985). A common finding of these studies was that small-scale activity in many developing countries was more widespread than previously suspected, since industrial censuses and surveys frequently either define define the smaller units as outside their area of study or severely underenumerate them. Moreover, in many cases the smaller units appeared to be not only more labor-intensive than the larger ones but equally or more efficient. Although few studies of enterprise growth were carried out, there was at least some evidence that small firms had the capacity to expand.

These research findings were interpreted by some as arguments for intervention on behalf of small enterprise. Surely, they argued, a form of enterprise on which large numbers of people are dependent for their jobs and livelihoods, and which moreover is relatively efficient and dynamic, is worthy of official suport and promotion.

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However, Little, Mazumdar, and Page (1987) have attacked this line of reasoning. Based on intensive study of Indian experience and a review of work done on several other developing countries, they argue that enterprise scale is not a reliable guide to differences in labor intensity, which varies much more across industries than among firm-size groups within industries. Efficiency is also not clearly related to enterprise scale, although there is some tendency for capital productivity and total factor productivity to be highest in enterprises with 50-200 workers.

> The very small (less than 10 workers) should not be looked to for their efficient employment of factors of production. But at the same time they should not be discriminated against. They are there, and they still provide the bulk of employment in the lower-income developing countries" (Little, Mazumdar, and Page, 1987, p. 313)

> "In surveys of narrowly defined industries, the idea that small, especially very small, manufacturing enterprises are relatively efficient users of resources in labor-abundant economies has been found to have no general validity. If anything, medium-size firms come out best. But size as such, especially when measured by employment, is a poor indicator of any attribute of social importance." (Ibid., p. 230).

If, however, one were to grant -- if only for the sake of argument -- that SMEs deserve support from developing country governments and foreign aid agencies, the next question would be what form that support should take. Both developing country governments and foreign aid agencies have tended to take a project approach, concentrating on financial assistance to SMEs. Other common forms of assistance have included training, technical assistance, and the provision of facilities such as industrial estates.

Staley and Morse (1965) advocated an integrated service program, involving management development, development finance, industrial estates, common facilities, assistance in the procurement of materials and equipment, and marketing aids. They qualified their recommendations, however, by recommending (1) that selections be made of industries to be abandoned, adapted, or developed in their present state, respectively, and (2) that the government establish a suitable general environment for SMEs. While they thus laid the groundwork for some ideas examined under EEPA, the dominant impression created by their handbook was that an integrated service program was the primary need. The costs and benefits of this approach were not weighed explicitly.

The World Bank sector policy paper on small enterprise (1978) accepted that small-scale enterprise is generally more labor-intensive than larger-scale enterprise and argued that SSEs should be promoted through loan finance and other measures such as government procurement, subcontracting, industrial estates, technical assistance, and the training of entrepreneurs.

The effectiveness of such project-oriented approachs is likely to be strongly influenced by government policies. If the policies are not "right," the likelihood that credit and other types of project will succeed is substantially reduced. In many developing countries, while programs of various sorts have tried to promote SMEs, government policies have probably more than offset their effects by hampering the growth of SMEs and accelerating the decline in their relative prominence that normally accompanies economic growth.

III. The Approach and Findings of EEPA

A. Approach

USAID formulated the EEPA project on the basis of a series of observations about small non-agricultural firms in low-income countries. The first of these observations is that small enterprises are very numerous in developing countries, especially low-income countries. Second, they are frequently labor-intensive. Third, at least some classes of small enterprises have been found to be efficient users of labor and capital relative to larger firms producing similar products. These observations led the formulators of EEPA to believe that promotion of SMEs would be a promising way of simultaneously attaining the important objectives of income growth, employment generation, and poverty alleviation.

EEPA was also shaped by a conviction that the usual project approach to small enterprise promotion could usefully be complemented -- conceivably even replaced -- by increased emphasis on appropriate economic policies, especially a conscious effort to reduce policy biases which favor large enterprises over small and medium firms. A major reason for giving more emphasis to policies affecting SMEs was the high cost of extending project assistance to a large population of small firms. Appropriate policies might be able to reach more firms at lower cost. In any case, even the best projects are unlikely to work if the policy framework is unfavorable, as already noted.

In carrying out the EEPA project, the contractors chose to question the premises that gave rise to the project. This decision led to a redefinition of the problem to be studied which we believe has enabled EEPA to produce results that will be more constructive and helpful to policymakers in developing countries than would have been possible if we had simply accepted the premises that underlay the original definition of the project.

The redefinition of the study's objective began with the observation that creating jobs is not the real issue. In poor countries, as we have seen, when employers do not create enough jobs to employ all who want to work, people create jobs for themselves. With few institutionalized forms of support available, those who do not work must usually turn to their families for support. If, as is common, families lack the resources to support idle family members, everyone must go to work, however meager the remuneration. The alternative is starvation.

It follows that public policy in developing countries should aim not merely to create jobs that permit people to survive -- people will do that for themselves -- but to stimulate job creation that raises the average level of productivity and income, thus contributing to national economic growth. For this reason, our revised definition of the problem is to determine (1) the role that SMEs can play in <u>efficient industrialization</u> and (2) the ways in which <u>government policy</u> can help them achieve their potential.

We also tried to place concerns about the creation of productive employment and encouragement of SMEs within the broader context of economic development. It has long been recognized that economic development involves systematic changes in economic structure, especially a decline in the relative importance of agriculture as a producer of output and user of labor and other resources and a corresponding rise in the relative importance of industry and services. In the process of this restructuring, massive quantities of labor and other resources are transferred from lower-productivity uses to higher-productivity uses. Many, perhaps most, of the benefits of economic growth are derived from precisely this restructuring process.

B. Findings: The Role of SMEs in Industrialization and Employment Creation

What role do SMEs play in this restructuring? In analyzing this question, we asked, first, what the typical situation is in low-income countries, then what typically happens as a country develops.

1. SMEs in Low-Income Countries

Two characteristics of SMEs in low-income countries stand out. The first is the <u>prevalence of small firms</u>. Cottage shops and small enterprises typically account for two-thirds of manufacturing employment, itself typically ten percent or less of labor force. The distribution of manufacturing employment is typically bimodal, with the largest amount of employment accounted for by firms in, say, the 1-19 worker range. These countries also tend to have a substantial number of employees in large firms (100 or more workers). In between is a "missing middle," in which there are few firms and relatively little industrial employment. The industrial structure, in other words, is dualistic. There are many small firms with (perhaps) low productivity, a few large firms with

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(possibly) high productivity, and relatively few medium-sized firms in between (Biggs, forthcoming).

The second striking characteristic of SMEs in low-income countries is <u>diversity among firms</u>. There are often large productivity differences among firms of different sizes in these countries. These differences are evident in various measures: output per worker, output per unit of capital, total factor productivity, and wages. A lot has been written about which size group has the highest productivity. As noted earlier, Little, Mazumdar, and Page (1987) say several times that firm size is not a good discriminator of these differences, but they also assert that "medium, if anything, is beautiful." Some of Liedholm et al's measures for African countries suggest that small is as productive as large in these countries, if not more so. It seems likely, however, that any country in which this is true has a pretty inefficient large-scale industrial sector and probably is not developing very fast -- both of which are true for many African countries. In genuinely developing countries, larger firms are likely to be considerably more productive users of resources and pay considerably higher wages than smaller firms (Biggs, forthcoming).

Small firms are usually more labor-intensive than large firms, but not always. In any case, differences in labor intensity are greater among industries than among firm size classes. This suggests that promoting naturally labor-intensive industries would be a more effective way to generate productive employment than promoting small firms.

2. Changes in the Course of Development

As countries develop, two important things usually happen: average firm size rises in manufacturing and interfirm differentials in productivity and wages narrow considerably.

a. Rising Average Firm Size and Changing Size Distribution

A major contribution of EEPA has been to trace, in greater detail than has been done before, the evolution of firm size structure in the manufacturing sector as economies grow. Although there are many variations among countries, the broad trends are for average firm size in the manufacturing sector to rise as GNP per capita goes up and the firm size distribution to shift from bimodal to unimodal (Biggs, forthcoming). This means that labor is reallocated from smaller to larger units within the industrial sector, in addition to the well-known reallocation from agriculture to industry and services. As countries develop, the dualism that marked the size distribution of firms in their manufacturing sectors breaks down. Some of the small firms that were so prominent grow and hire more workers, but many more are displaced

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because they are unable to survive in an increasingly productive and competitive environment. As Joseph Schumpeter (1934) observed, capitalist development is a process of "creative destruction."

The rise in average firm size has two components: (1) industrial structure shifts in favor of industries in which firms tend to be large; (2) within industries, average firm size tends to rise, partly for compositional reasons (e.g., "transportation equipment" comes to mean cars instead of bicycles) and partly because of economies of scale and technological improvements made possible by growth in the market, capital accumulation, and the introduction of new technology. Both components -- interindustry and interscale resource shifts -- make important contributions to the growth of manufacturing productivity during the early and middle stages of development. Once a country becomes industrialized, such shifts cease to be important because interindustry and interscale productivity differentials have become small.

Our research (see Biggs, forthcoming, for detail) suggests that six factors contribute to rising average firm size:

1. Technology. Sophisticated technologies embodied in high-cost machines are often used more efficiently in larger plants.

2. Demand. Growth in the market and changes in the composition of demand, leading to increased specialization and higher-volume production. Exposure to export markets is important here. Protection from imports encourages domestic producers to "crowd in" to the market until further entry produces negative profits.

3. Declining transportation and information costs. These widen the scope of the market, letting the most efficient producers serve a larger area and destroying former local monopolies.

4. Firm strategies. Economies of scale enjoyed by large firms imperil small firms in the long run. Small firms can fight back by becoming good at a narrow task (finding a "niche") or by exploiting their greater cost flexibility in the face of demand fluctuations.

5. Government policy. Trade policy is the most important, but we will come to others shortly.

b. Narrowing Interfirm Productivity and Wage Differentials

The second major change that occurs in the manufacturing sector is that productivity and wage differentials narrow

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substantially among firm size classes (Biggs, forthcoming). This narrowing of inter-size class differentials accompanies similar narrowing trends among broad sectors of the economy and among individual industries within manufacturing. The narrowing of interfirm productivity and wage differentials generally reflects improved integration of markets as economies develop. Economies come closer to the neoclassical efficiency condition in which each type of resource makes the same marginal contribution to production in each of its uses.

c. The Role of SMEs in the Transition

What, then, is the contribution of small firms to this transition process? We believe they play two distinct roles.

First, small firms in low-income countries serve as reservoirs in which surplus labor is stored until possibilities for using labor more productively come along. When they are no longer needed for this purpose, they go out of business.

Second, a few small firms have the potential for developing into medium or large firms. But only a few: the great majority of small firms in low-income countries are "survival enterprises" with no realistic growth plans or potential. Those with potential are few and difficult to identify in advance. Although there are still small manufacturing firms in developed countries (more in some than others), it is important to see that they are very different from those in developing countries. For example, they are about as productive as large firms, may be high-tech and capital-intensive, may export, etc. They have survived the transition process because they somehow managed to offset the competitive advantages that generally accrue to large firms. These productive small firms are particularly prominent in certain developed countries, such as Japan and Italy. In these countries, more than 50 percent of manufacturing employment is in firms with fewer than 100 employees. This contrasts sharply with the more usual experience (in the United States, United Kingdom, France, etc.) where small firms make up only about 25 percent of manufacturing employment.

An EEPA discussion paper (Biggs, forthcoming) analyzes four kinds of reasons for the divergent path followed by countries like Italy and France: trade orientation, factor market distortions, prevailing institutions and contracting modes, and state intervention. Even though factors such as Japan's unusual labor relations system and the prevalence of the Chinese family firm may have helped small firms survive in some developed countries, it should be reiterated that these small firms are fully competitive with the large ones.

C. Findings: The Role of Policy

The survival, prosperity, and growth of SMEs in developing

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countries are all influenced significantly by government policy, including implicit policy -- that is, policies adopted for other reasons that have the effect of hampering or assisting SMEs (Haggblade et al, 1986). Some of the most common and significant influences are:

1. Capital market policies. Anti-SME biases are introduced by trade policies (which may give large firms preferred access to imported capital goods), credit policies (which may give large firms preferred access to credit), and tax policies (which may give large firms tax breaks based on capital invested).

2. Labor market policies. Pro-SME biases may be introduced by labor codes, minimum wage laws, payroll taxes, etc. if small firms are legally exempted or if the regulations are enforced on them less rigorously than on large firms.

3. Product market policies. The most important distortion here is protectionism, which raises the prices of import-competing goods which are usually produced by large firms. Another that bears mention is biasing the domestic terms of trade against agriculture and for industry; this may hurt small firms that depend on agriculture to supply either their inputs or their customers.

An important point is that policies that favor small firms (either explicit subsidies or implicit ones created by differential application of minimum wages, payroll taxes, sales taxes, zoning requirements, etc.) can inhibit the growth of these same firms into the medium size class by imposing high implicit tax rates on incremental profits. Examples are sales taxes, minimum wages, and other labor code regulations from which small firms are exempted, either by law or by enforcement practices. Such policies accentuate the bimodal size distribution or "missing middle" in countries like the Philippines.

Large firms have obtained influence over many of the mechanisms of policy intervention in most developing countries and have used this influence to their own benefit and the detriment of their competitors, including SMEs. This is one reason why the World Bank and many economists favor the "level playing field" as a policy prescription, suggesting that interscale "policy biases" (and, more important in their opinion, inter-factor biases) should be identified and then eliminated insofar as possible. The presumption is that competition would then encourage the most efficient scale of enterprise, whatever that might be, to emerge in each industry.

We do not object in principle to this approach and agree that it may be the most practical approach in many circumstances, but we do note that it is not what was actually done in any historical case of successful industrialization. South Korea and Taiwan, for example, both intervened (in somewhat different ways) to promote industrialization, including the participation of SMEs. We asked ourselves why government intervention apparently helped in these cases while it has been demonstrably harmful in India and many other countries. A big part of the answer is that intervention in Korea and Taiwan was generally performance-based. Assistance was not given automatically to firms just because they were small. Instead, it was made strictly conditional on performance, particularly in the export market, and withdrawn when the desired level of performance did not materialize.

How transferable is this approach to other countries? This is an issue of political economy. Under what conditions can governments develop policies that are rational from a social point of view, then stick to them in the face of interest group pressures? Policy advice for a particular country has to be based on a judgment of whether one is dealing with ar "hard state," in which the benefits of government assistance can be limited to firms which perform successfully according to rational predetermined criteria, or a "soft state," in which benefits intended for firms that perform are likely to be expropriated by those with politicaI influence (Myrdal, 1968; EEPA, forthcoming, Chapter 3). It may be that few developing countries qualify as hard states for this purpose, and one is more sympathetic with the World Bank's anti-interventionist stance when one thinks about the numerous countries in which government intervention has been counterproductive than when one thinks about the few countries in which it has made a positive contribution to development. But whether countries can industrialize while keeping the playing field level is also unclear.

We have been working on case studies of industrial development policy and the role of SMEs in several countries located in different parts of the world and at different stages of economic development.

1. Two famous NICs, Taiwan and South Korea, show not only how policy intervention can be used to promote industrialization but also how different strategies can lead to rapid development. Korea's large firms and bold entry into world markets with new brand names contrasts sharply with Taiwan's small-firm, component-parts approach. That both have succeeded with such different approaches to the question of scale calls into question the importance of scale as such.

2. At middle income levels, we have looked at two much less successful cases, the Philippines and the Latin American countries, typified in our studies by Ecuador and Honduras. In general, we find that import substitution policies in these countries were biased against SMEs and the implicit tax on firm growth was high, causing SMEs to remain small and/or informal. Desirable forms of

growth and structural change tend to be blocked off. These countries need to reduce anti-labor and anti-SME biases and open themselves to more foreign competition. But the political obstacles to reform are substantial.

3. At low income levels, we have looked at Bangladesh and Sub-Saharan Africa, typified in our studies by Malawi and Rwanda. These countries are at very early stages of the industrial transition, with small manufacturing sectors and an overwhelming preponderance of cottage shops and small enterprises. To the problems created by import substitution regimes have been added those of inefficient public sector enterprises. These economies need to be opened up to much more competition. Bangladesh has shown through the development of its garment industry with the cooperation of the Korea firm Daewoo that it can export, but it has not yet been able to put together the general policy framework that would permit such examples to be multiplied. Africa, which is stagnating or even declining at a low level of development, is an even more intractible case. The Michigan State University economists who worked on EEPA have extensive experience in Africa and believe that considerable micro-level intervention is needed to create the conditions for economic growth. But we at HIID are skeptical about micro-level interventions in general because they are unavoidably expensive (like the small farms served by agricultural extension agents, SMEs are numerous; but their products, technologies, and markets are much more differentiated than those of small farms, making the agricultural extension model hard to apply) and are frequently ineffective. But we do not have a good answer to the tough question of what should be done to create productive SMEs in the economically stagnant conditions that now exist in many African countries.

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ANNEX 2

EEPA Research Critique--
Paper Presented by Gustav Ranis

EEPA Research Critique

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This critique is based on a substantial but still only partial reading of the EEPA project output over the past five years. Papers read included EEPA Discussion Papers #1, 6, 7, 8, 9, 11, 12, 13, 14, 15, 16, 18, 20, 23, 24, 25 and 27, as well as the Philippine Small Business Policy Direction Study. Since I did not have the opportunity to absorb the full output of the Project, it is, of course, possible that, for that reason alone, I may well miss the mark in some of these comments. Nor was any effort expended to provide a summary of the findings--only to pick out some of the highlights. In the same vein, I thought it more productive to curtail the volume of obligatory laudatory comments and to focus instead on issues which I believe raise questions and require additional attention.

What I have consequently endeavored to do is approximately as follows: first (in Section I), I enumerate what I consider to be the main contributions, in terms of methodology as well as findings, made by the Project to our conceptual understanding of the basic issues under discussion. Second (in Section II), I list some perceived gaps and shortcomings, hopefully in a constructive fashion and in the context of offering suggestions for future priority emphasis.

I. Contributions to our Enhanced Understanding Resulting from the EEPA Project

1) I believe the overall results of this Project managed to reach substantially beyond the traditional relative prices story in terms of both the existence and persistence of the small and medium scale (S&M) industrial sector in various types of developing countries and the role it plays in terms of overall LDC performance.

The papers include a lucid analysis of how the S&M sector is affected by

a) various types of controls which governments choose to impose on the economy in general, industry in particular, and, most frequently, differentially by scale of industrial activities;

b) the differential difficulty of meeting fixed costs of information, marketing, etc., especially in export markets, which affect both the survivability and the contributory role of the S&M sub-sector;

c) the importance of differential delays, even in the implementation of automatic, uniform and across-the-board rules with respect to tariff rebates, etc., which again affect the S&M sector differentially and unfavorably.

It is not always clear whether the S&M sector is or is not intended to include both the formal and informal components of the landscape, especially when "informal" activities are defined simply as those beyond the reach of government regulation. Both in terms of directional controls which benefit specific enterprises, e.g. various kinds of direct allocations or across-the- board subsidies, and controls which inhibit some scale of enterprises across-the-board, e.g. minimum wage legislation, the conventional wisdom, i.e. that the S&M sub-sector faces a comparatively more competitive environment in which it is forced to try to survive, is undoubtedly borne out by the papers. Moreover, the evidence that such a "survival of the more fit" environment plays a more important role in the successful East Asian NIC's than in your "average" LDC is well documented.

2) The notion of historical phasing, with cottage industries giving way to S&M and, ultimately, to large-scale industry, is inherently attractive and is made use of in a number of the papers. Questions of graduation from one average size to another are raised. The progression seems to be from cottage to S&M to large scale in East Asia, while it is often from the large scale to S&M in some of the African cases. This may be a useful way of initiating the analysis, even though a full examination of this differential process under different initial conditions, e.g. as to expatriate multi-national and/or state enterprise presence, and as to the overall macro-economic and institutional environment over time is not presented.

3) The papers presented make good use of the recently rapidly growing literature on transactions costs, asymmetric information and

institutional change to help explain the differential fate of the S&M sub-sector in Korea and Taiwan. Moving beyond "getting relative prices right" and into the question of "getting industrial structures right", i.e the "right" degree of industrial concentration and workable competition, is indeed refreshing and useful. In my view, the Korea/Taiwan comparison provides an excellent laboratory for the examination of the trade-off between increased transactions costs and productivity gains which accompany different types of organizational change. Even if the papers do not provide definitive answers as to the comparative costs and benefits of the chaebol structure of Korea, in constrast to the preponderance of independent medium and small-scale firms in Taiwan, the research raises just the right questions and at least begins to address them.

4) Not surprisingly, the output mix and the changing structure of production in terms of product, process and attribute changes are treated as independent in determining the relative size of the S&M sub-sector in a comparative setting. The output mix is found to be relatively more important than intra-industry structural changes, presumably related to issues of the prevalence or non-prevalence of economies of scale and thus the under-representation of the S&M. Thus the "excluded middle" is seen largely as a consequence of output mixes biased towards industries whose output is sensitive to economies of scale and therefore dominated by large firms. But this "independence" can only be statistical, not substantive; the output mix obviously adjusts to the technology choices available and exercised, for example in determining trade patterns.

Moreover, linking all this to import substitution policies, while tempting, can also be misleading if one does not clearly differentiate between real economies of scale, i.e. of the technological variety, and "economies of scale" which are really a function of man-made benefits provided only to large firms, as frequently referred to in these papers. The authors rightly point out that the decision as to whether structure or composition matters most must be made at the industry level. But I would argue that the underrepresentation of S&M firms in some country cases cannot be explained by simply examining deviations from cross-sectional patterns without comparing the macro-economic policy setting to explain different individual country points, especially, of course, outliers, in the cross-section in some detail. The policy conclusions stated seem to be the same, regardless of whether structure or composition matters the most; this is an indication of the validity of my earlier observation, i.e. that while I am pleased with the emphasis on the micro-level at which these findings are made, the need to place the results within a differential macro framework should never be lost sight of. While most of the papers reside within the welcome confines of a methodology currently in ascendancy, which may be called comparative analytical economic history, there is also in evidence the occasional ambiguous return to more rigorous (if also more empty) cross-sectional analysis.

5) I would indeed give the Project high marks for its ability to link, at least across most of these papers, sectoral and macro-evidence with specific micro-data, even though this marriage is not fully consummated in all cases, as I have just pointed out. While there is no effort made to establish a tight causal chain, a large volume of evidence is presented to the effect that Taiwan has done better than Korea at the macro-performance level, as well as at the sectoral level, and that this is not unrelated to the greater relative predominance of the S&M sub-sector in Taiwan. In fact, even in five technologically intensive industries examined, as long as the capital outlay required is not too large, i.e. where economies of scale can be presumed not to be too pronounced, Taiwan has done better, certainly in terms of static efficiency. The overall notion that economies of scale are not as important as sometimes assumed, at least before 1980, even in the East Asian NIC's, which had by then already progressed substantially in terms of income and demand pattern changes, should be of substantial importance to other LDC's still much farther down the ladder. This is especially relevant in the context of recent arguments relating to the "new trade theory" of Helpman and Krugman which has given some LDCs a second chance to construct a theoretical defense on behalf of interventionist import substitution policies in the expectation of acquiring true strategic "winners"--if possibly competitive only in the long run.

6) The Project should also be given credit for trying to ask some more basic questions as to the causes of the predominance of S&M's in Taiwan, as compared to Korea, in the first place. Proceeding from initial conditions to intermediate indicators of performance to bottom line performance is, I believe, the appropriate way of assessing the problem before the house. While I do not necessarily agree with the emphasis placed here on the early post-independence Mainland/business community antagonisms in Taiwan in contrast to Korea, and am instead more willing to credit the comparative human capital stock and physical infrastructural situation in place at the end of the colonial epoch, it is, I think, appropriate and enlightening to focus heavily on these initial conditions. This is the kind of research which is often missing, including in the context of much of the above-referenced comparative analytical economic history literature which is now becoming more common.

7) In the same context, I found the emphasis given to the different types and qualities of traders, including trading companies, as a way of explaining the differential importance of S&M activities in Korea and Taiwan over time, both interesting and potentially useful. Of course, one has to take one step back and ask why the initial human capital in place in the early 1950's was all so different, if it is, in fact, to be an important explanatory variable. At some point such a legitimate--indeed necessary--search for exogeneity, of course, also has its limitations--and must stop somewhere short of Adam and Eve. But I did find its pursuit here both interesting and potentially useful. Were the trading companies

which grew up in Korea a response to the absence of dispersed small traders, and in turn caused the chaebol structure to predominate in Korea? Was the presence of large numbers of traders responsible for the prospering of large numbers of independent medium and small-scale firms in Taiwan? These hypotheses are broadly hinted at, even if the proof of the propositions and their generalizability cries out for further exploration. The origin of traders and the extent to which their appearance (or non-appearance) can be rendered endogenous would certainly seem to be a question worth pursuing.

8) Related to the previous point, I believe the niche approach, associated with the relatively more important role for product innovations in Taiwan, in contrast to the more homogeneous product approach associated with the predominance of process innovation in Korea, is both correct and promising as an avenue for future research. It has, moreover, substantial value in terms of potential generalization to other developing countries. On the other hand, the relationship between the niche approach and such factors as the size of the population, its geographic dispersal, the state of infrastructure and related transportation costs, plus the existence or non-existence of economies of scale for industries likely to become more important at different levels of development cries out to be more fully integrated conceptually and examined empirically (more on this below).

9) With respect to credit, usually given a lot of attention in the examination of the S&M sector's role and contribution, the papers here make an effort to reexamine the conventional wisdom and refute it, at least in part. Several of the papers point out that the relatively high savings rates in Taiwan proved to be possible in the presence of a preponderance of government-owned banking and within a modestly repressed capital market. Some of the papers also emphasize the importance of the curb market for the survival of the information intensive S&M sector and raise a number of valuable insights. This is in contrast to the role of large firms serving as financial intermediaries in what must be interpreted as linked markets, more typical in the Korean case. It is of additional interest to determine whether or not such linked market arrangements also extend to the observed differences in the wage bargain for similarly sized firms in the two countries, especially Korea.

10) Unfortunately, there was only one paper, at least in my collection, on the human resources dimensions of the problem. I do wish to commend the focus of that paper, particularly with respect to its emphasis on Taiwan's vocational education efforts. Some of Taiwan's policies in this general area were broadly similar to Korea's, e.g. to attempt to selectively reverse the brain-drain by overseas recruitment devices, establishing science parks, etc. But the comparison with Korea's overall educational strategy is unfortunately not made, in this paper or elsewhere. It might well have helped considerably in solving some of the puzzles before us.

11) I also welcomed the initial venture into the political economy arena in at least one of the papers. Unfortunately, however, the Korea/Taiwan contrast which lies at the heart of so many of the papers reviewed is again not subjected to a comparative approach. Moreover, I saw too little attention paid to the relationship between the type of government, or, better polity, relevant dimensions of policy change, and bottom line outcomes, with the role of donors/creditors in such a political economy context brought to bear as appropriate.

12) The papers in general exhibit a nice combination of analytical competence, empirical content, and policy sensitivity. In the above, I have purposely chosen not to comment paper by paper but rather theme by theme. The existence of a synthesis paper covering the entire Project would, of course, have facilitated the absorption and dissemination tasks, both for the general consumer, within A.I.D. and elsewhere, as well as for this reviewer - though I believe that such a paper may be currently under preparation.

II. <u>Perceived Gaps and Missed Opportunities</u>

I am fully aware of the fact that the research carried out under this Project is voluminous and of generally high quality, that there inevitably existed human and financial constraints and, most important of all, that it is altogether too "cheap" to suggest how things might have been done better or to list other issues that should have or might have been tackled. Nevertheless, I think it is my task as reviewer to emphasize what I consider to be missed opportunities rather than to simply applaud the substantial achievements made in the body of the work under discussion. In this section I therefore intend to elaborate on dimensions which might have received some (or more) attention.

1) Perhaps the most glaring gap, but by no means easy to repair, is the perceived lack of a consistent effort to model and empirically examine the relationship between the macro-level, on the one hand, and the sectoral and/or micro-levels, which constitute the main focus of these papers, on the other. For example, I believe there exists a close relationship between the phasing perceived in East Asia, in particular Taiwan, from virtual cottage industry, to medium and small, to large-scale, and the changing macro policy setting, from the relatively short period of flexible import substitution in the 50's, to early export orientation, which itself shifts from the labor-intensive to the more technology, capital and skill-intensive output mixes of the late 60's and early 70's. In other words, the relationship between the differential phasing of industry structure and the differential phasing of macro-economic policy (and the macroeconomic results in terms of growth and equity

etc.) cry out to be more fully examined and can, I believe, be established. Indeed, the time or historical dimension, brought out nicely in some of the papers, is all too frequently missing in others. For example, the view that the East Asian countries, which by and large did not try to "skip" the labor intensive industrial export phase, were more likely to provide scope for efficient medium and small-scale industry development--as compared to other countries which moved directly from "easy" import substitution to export promotion of intermediate, capital and consumer durable goods, more typical of the Latin American case--should and could have been supported conceptually and empirically.

2) The last comment leads into another general criticism, which is the lack of representativeness of the sample of countries examined. There seems to be a predominance of East Asian and some African experience in the sample, with a notable scarcity of Latin American cases and relatively little on the South-East Asian cases. Certainly the same problems are not examined systematically across the board. The kind of typological comparison carried on for Korea and Taiwan in a number of the papers, for example, would have been extremely useful, both in terms of some Latin American pairs, e.g. Brazil and Mexico, some South-East Asian pairs, e.g. the Philippines and Thailand, as well as some African pairs, e.g. Ghana and Ivory Coast. One has the impression that the subject to be tackled or the methodology to be deployed were left too much to individual researchers' preferences, interests and/or experiences; one sees no evidence of an effort--obviously limited if you have high quality researchers--to examine typologically different cases with respect to the same problem. The extreme version of this is illustrated by the fact, previously referred to, that I encountered but one paper on some dimensions of the human capital situation in Taiwan but nothing on Korea or any other country. The fact that this dimension, as a possible constraint on S&M development, was not examined comparatively in the context of, for example, Africa and other parts of the developing world strikes me as a potentially quite serious shortcoming. Both in terms of contrasting initial conditions and public policy over time, it is patently too critical a component to only touch on once over lightly.

3) With the notable exception of some of the Michigan State contributions, not enough attention seems to have been paid to the interactions between the S&M sub-sector and the nature and rapidity of agricultural development, both its food-producing and cash crop sub-sectors. This is related to my general comment about placing the S&M issue into a broader macro-context, but it is especially important to trace the interactions between agriculture and the S&M sector if we are to understand the contributions of the latter to solving the overall problems of employment, poverty, income distribution and growth. What I am referring to here is the importance of linkages, especially rural linkages as between agricultural and non-agricultural activities, which usually turn out to be predominantly relationships between agriculture and the S&M type of non-agricultural growth. These linkages run both from

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agriculture to non-agriculture as well as from non-agriculture to agriculture, the latter a much more neglected subject, even by the Michigan State group.

While a full analysis of forward and backward linkages might appear to some to lie beyond the scope of this particular Project, I really don't think so. Linkages make sense if the economy is producing inside its production possibility curve, i.e. there are clearly "bargains" to be had, in terms of underemployed resources, the removal of distortions, etc. Concretely this means that developing countries are not at the frontier and that an increase in agricultural output can be found empirically to be associated with an almost immediate increase in non-agricultural, mostly S&M, output; increasing the extent of modernization of rural non-agricultural activity, in turn, may raise agricultural productivity substantially by changing attitudes and incentives and improving markets as well as the supply of modern inputs.

The extent of these two-way linkage effects, of course, depends not only on the quantitative dimensions of productivity increase in each sector, but also on the nature of the technology and output mix. For example, in the case of agriculture to industry linkages, the distribution of assets in agriculture as well as the choice of technology and crop mix together determine the distribution of income, which in turn is bound to have a very important effect on the type of non-agricultural production which results. The more equally distributed land and the more labor-intensive the technology cum crop mixes the more are S&M-supplied non-agricultural product baskets likely to be the beneficiaries--as opposed to the large-scale producers of urban or even foreign goods. This not only increases the total level of consumption linkages, in other words, but, more importantly, the extent to which consumption expansion can be met by local production of niche-type goods as against imports or urban-produced import substitution types of elite goods. This is true to some extent also for backward linkages, e.g. the demand for inputs, as between the demand for large-scale tractors produced in large-scale urban enterprises or imported, while smaller implements are more frequently produced in S&M-type industries, often located in the rural areas.

The same kind of arguments can be offered for the impact of non-agricultural growth back on agriculture. Clearly, the demand patterns generated, in both directions, represent an important determinant of the potential for niche production in a domestic balanced growth context; niche production for export is usually much more limited by international specifications governing product quality and attributes. In that same connection, I believe that the development of Z-goods, from their colonial antecedents to their non-traditional post-colonial variety, possibly linked up with urban industry in a complementary rather than competitive fashion, constitutes one of the major contributors to the Taiwan success story (as well as to the earlier Japanese success story). This, it seems me, should very much play an integral role in the previously referred to historical three phases approach to industrial activity as presented in these papers.

In general, RNA (rural non-agricultural activities), Z-goods, or off-farm employment opportunities, as the phenomenon is sometimes called, really constitute such an important dimension of the total S&M problem that I was surprised to see so little done with it, except in the African context. In my observation, the vigorous growth of such activities is highly correlated with developmental success, not only in terms of growth, but also in terms of the equitable distribution of income and poverty alleviation. The contrast between, e.g. Taiwan, which has somewhere between 40% (in the 60's) and 60% (today) of total agricultural household income generated by non-agricultural activities, and the Philippines, where this amounts to about 16 or 17 percent--with Thailand, at 38 percent, somewhere in between--indicates the high correlation between developmental success and this particular phenomenon. While a full causal analysis is beyond the scope of this paper, I would argue that it is usually the landless and poorest (smallest) farmers who participate more than equally in this type of S&M activity, contributing substantially to efficient non-agricultural growth, while at the same time improving the distribution of income. Contrary to Kuznets' assumption, this means that, as income shifts from agricultural to non-agricultural activities, these activities can be sufficiently labor-intensive to effect a shift from a less equal to a more equally distributed productive activity. This phenomenon was one of the main reasons why rapid growth could be associated with improved distribution in Taiwan during the 1960's.

4) Still in this general context, but warranting special emphasis, is the relative neglect of S&M activities in the services sector. I realize that it is difficult enough to obtain data on S&M industry, in general, and on RNA in particular, but we must also recognize that the services sector, urban and rural, is usually extremely large, accounting for 40-50% of the total employment of typical LDCs, with substantial heterogeneity and a changing composition of output over the various phases of development. Much of this activity is informal, some of it is formal, but, in any case, the sector represents an important component of the growth cum equity problem and of its possible solution. Some services are linked to industrial activity in an input-output sense and are differentiated only by the critical choice between vertical integration and sub-contracting. Others are quite independent and abundant labor supply-pushed. Services are now recognized as important in international trade terms as well. At any rate, the bottom line performance issues of employment, growth and equity, to which this Project is presumably addressed, can't really be handled satisfactorily in the absence of any effort to fully include the services component of non-agricultural activity.

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5) In explaining the differential performance of S&Ms in different LDC contexts, much more attention should have been paid, I believe, to the issue of technology choice and technology change, from borrowing and search processes to domestic adaptation and diffusion. The kind of environment, both legal and market structure related, which encourages or discourages better, if not optimal, selection, adaptation and diffusion processes is critical to the question of the size and contribution of S&M's.

There, of course, exists a vast literature on these subjects and I am not suggesting that it be duplicated. In this particular context it is, however, necessary to remember that the absence of an environment forcing entrepreneurs to search for appropriate techniques and product attributes may be among the most important considerations in driving a wedge between private and socially optimal choices and impairing the appropriate role of the S&M sub-sector. The impact on S&M's arising from the distortion of relative factor and product prices which is emphasized in this Project, is probably dwarfed by the impact of differences in the extent of workable competition and thus the existence of unearned rents on the search for the most appropriate technology. This is certainly the conclusion I have come to in comparing both technology choices and the direction of technology change in the Indian and Japanese cotton textile industries historically. Import substitution policy, especially in countries which adopt a more inflexible version and persevere longer with it, tends to provide rents and levels of protection that become deeply encrusted. When private parties expect the continuous dispensation of all kinds of non-competitive favors to large-scale urban import substitution industries, both in terms of protection from foreign competition and the restriction of free entry in domestic markets, the result is satisficing behavior and the inappropriate choice of both scale and related technology and output mixes. The authors of the papers included here are generally reluctant, like most economists, to abandon the profit maximizing assumption on the part of industrialists. Thus scale economies are brought out, along with distortions in relative factor prices. But I am afraid the reality is that satisficing represents an important reason why the S&M sub-sector is underrepresented in many developing countries. The typical entrepreneur who is earning an 18 percent rate of return from rents and is, moreover, guaranteed their indefinite continuation is much less likely to search out "better" scales and associated technology choices.

While I fully agree that most of the attention ought to be paid to ensuring that there exists a strong and effective demand for appropriate technology and associated scales of industrial operation, it is also important not to ignore the supply side. By this I mean both information about alternative technologies, attribute mixes etc. as well as the system of incentives which permits the pool of relevant choices to be extended. Even if we assume that industrialists are "knocking on the door" and we have a propitious workably competitive macro-economic environment, there still exists a question of information, search costs, etc. There is little question that a lack of illumination limits the capacity to obtain relevant information which affects not only markets, mentioned in the Project, but also technological inputs. S&M entrepreneurs may not, in fact, have much access to information about what technology has been used elsewhere 20 years ago in some location abroad, in other developing countries last year, or even in another region of the country today. The so-called technology shelf is itself a basically mistaken concept; both internationally and even internally, there exists a lot of evidence of a remarkable lack of information at the disposal of most individual decision makers.

The relevant, interrelated, acts of technology selection, adaptation, and diffusion are often not easily separable, at least not empirically. They usually occur simultaneously, but require a combination of institutional, organizational and educational preparedness which lies at the heart of the supply side issue before us. On the organizational side, diffusion systems, including trade organizations and special windows of commercial banks, have proven helpful in some country contexts; this is less true of the official family of science and technology institutes which, as is well-known, often cater to very different internal objectives--though the time-phased withdrawal of government subsidies, as in the case of KIST, and the decentralization of technical assistance functions, as in the case of the JCRR structure in Taiwan, can encourage the diffusion of real world information and access to potential S&M actors. Enhanced "tinkering" capacity as well as policies designed to encourage firm size parity in the application of tax provisions that permit the current costing of R&D can provide supply-side help to the S&M sub-sector in this particular dimension.

I also would have included in the Project's range of inquiry the issue of the existence or non-existence of the legal alternative of a petty patent--which may serve to encourage non-dramatic scale-insensitive innovations, especially in medium and small scale firms. Such petty patent or "utility models" exist in a number of developing countries and provide for a lower discovery threshold, compensated for by a lower cost as well as shorter period of protection and reduced likelihood of legal challenges. The bottom line is that this institutional device apparently encourages the kind of blue collar innovations most relevant to the S&M sub-sector. Closely related to this are possible variations in the intra-firm hierarchical relations, i.e. the sociology of S&M firms related to the method of eliciting and rewarding suggestions for innovations arising from the factory floor, the machine shops, repair shops etc. There is evidence of a large variety of institutional alternatives in vogue across countries, with very different kinds of results. The overall point here is that the encouragement of technological tinkering for the system as a whole and the possibility of encouraging intra- as well as inter-country technology process and product information flows--which seem not to be addressed in this

Project--should get some attention. Clearly, the relationship between firm size and inventive activity should be at the heart of any such inquiry; whether one is a Schumpeterian or, as I am, a non-Schumpeterian on these matters, it is a subject which should not be neglected.

6) The importance of S&M's, especially in the rural areas, is undoubtedly also very much associated with the allocation of infrastructure and the locus of decision-making generally guiding such allocations in a developing economy context. In my view, the issue of centralized versus decentralized decision-making in reference to the amount and prioritization of various kinds of infrastructural allocations and public goods needs to be included in any discussion of the potential role of S&M activity. It is well known that line ministries are generally reluctant to allocate resources to dispersed rural areas and traditionally favor the concentrated and politically more powerful urban interests. In addition, even with respect to what is kept aside for rural allocation, the what, the where and the how are usually determined centrally. Moving beyond the obvious necessity of handling national or regional projects, the center is usually reluctant to "let go" of these determinations even with respect to mini-infrastructure, a situation which may well represent an impediment to S&M development as important as macro-economic price distortions. The effect on alternative output mixes (what), technologies used (how), as well as locational prioritization (where) can be major. And the question of whether distortions caused by local elites are quantitatively more or less harmful than those occasioned by central elites is an important live issue in every LDC I am familiar with.

There are specific issues that could be discussed in this context, for example, the pros and cons of using automatic block grants dispensed to local bodies, as in Indonesia, in terms of the benefits of transparency, universality and automaticity, pitted against the power of local elites and their supposed relatively lower administrative and technical competence. Such a devolution of both allocative and, possibly, related fiscal powers to local bodies must also be related to the question of the quality of the human capital available and, over time, the learning and educational processes in place outside the urban areas. The standard LDC response to suggestions about administrative and/or fiscal decentralization is that the rural population, both public and private, is "not ready"; this argument must be weighed against the combination of goldfish bowl transparency pressures and the benefit principle of taxation.

In any case, redressing various aspects of the so-called urban bias deeply embedded in both the macro and micro policies of most LDC's represents a potentially very important low resource cost component of any restructuring effect focussed on the S&M sub-sector, probably assuming an important complementary role to the macro-economic policy adjustments which are discussed. One

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historical example arising out of the case of Taiwan are the various functionally oriented farmers' associations not only diffusing technology on S&M agricultural processing to their members but also helping to allocate JCRR-financed infrastructure as an important assist to the continuous competitiveness of S&M activities. In these papers, several of which concentrate on a discussion of the contrast between Taiwan and Korea--with the latter representing a relatively much more centralized system--this entire subject is unfortunately not even referred to. Broader participation of a dispersed population and its benefits in terms of employment, growth and distributional outcomes undoubtedly depends heavily on an expanded role for the S&M sub-sector. The obstacles to that expanded role are legion. But the parsimony with which mini-infrastructural investments and maintenance allocations are customarily made--and the speed with which they are cut back under the pressure of government and/or IMF adjustment programs--should not escape our attention.

7) I also would have welcomed a more explicit analysis of why the reduction of transactions costs through vertical integration a la the Korean chaebol proved ultimately inferior to the reduction of transactions costs through linked markets and horizontal integration via subcontracting, as in the Taiwan case. I assume this is because the productivity increases in the Taiwan case swamped the transactions costs differential. This issue is once again tied up with formal and informal learning processes. Subcontracting, while it satisfies other, business cycle-related, risk reduction objectives, represents a viable option only when the required skills are sufficiently well and dependably distributed. Vertical integration constitutes, at least in part, a response to uncertainty about the maintenance of quality control by S&M suppliers. What is important about these large and small-scale firm interactions is not only the static dimensions of the extent of the division of labor, or of complementarity versus competitiveness, between them, but even more so the transmission of an improved capacity for process and design change. Indeed, the flow of technology which may be more uni-directional at an early stage usually becomes mutual later on. In either case, productivity increases ideally should overwhelm increases in transactions costs as the economy moves through various phases and industrial complexity increases. Empirical work here is difficult but even the conceptual issues would have been relevant to drive home. The issue of hierarchy versus markets and their benefits and costs is touched upon but really not fully explored in this Project.

8) I have already lamented the absence of balanced coverage of the human capital dimension which is central to so much of the S&M arena, in particular to the choice between sub-contracting and vertical integration. The relatively large emphasis on vocational education in Taiwan was indeed interesting. However, one would like to know much more about how such vocational education was kept sufficiently flexible over time to remain relevant, which is often not the case, e.g. in the Philippines. On a broader canvas, one

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would also want to know whether numeracy is an important dimension, along with literacy, in terms of the choice, private and social, among various possible orientations of the primary and secondary education structure. A major role can certainly be assigned to the competitive examinations and other institutional rewards systems in the East Asian NIC's, including the relative encouragement of non-academic pursuits at the secondary level, which stands in sharp contrast to other LDC types such as Latin America, Africa, and parts of South-East Asia. Clearly, the human capital requirements of a developing country undergo domestic change as the system typically moves through various sub-phases, e.g. from natural resource to unskilled labor to skill and technology-intensive product mixes. Just as clearly, absence of a flexible human capital policy can inhibit, or even totally thwart, a system's movement up the ladder, expressly with the help of a dynamic S&M sub-sector.

9) One or two of the papers use industrial census data to examine the importance of the sectoral composition of output and of intra-industry structural changes in determining the differential sizes of firms and then attempt to link this to government policy impacts, in one direction, and bottom line performance, in the other. While I applaud this and wish there had been more of it in the Project, I also had a concern with the implicit analytical treatment here. The composition of output seems to be generally viewed as if the economy were operating at some sort of full employment frontier. As I indicated earlier, in the context of the discussion of linkages, I prefer to think in terms of developing countries operating inside their frontiers and in a position to pick up "bargains" in terms of a "vent for surplus" kind of argument. In other words, the size distribution of enterprises can change partly because of changes in the composition of output, which is viewed as most important, partly because of intra-industry structural changes, including technology change of both the product and process types, and partly because "slack" is or is not being taken up. The possible elimination of such major distortions, with important dynamic consequences, seems to have been largely ignored here. I am not referring here to Harberger triangles but to substantial underemployed resources being mobilized, which are likely, ceteris paribus, to preponderantly take the shape of S&M activities.

10) Finally, a word on the political economy dimension of the problem at hand. As is increasingly being recognized in the literature, the wisdom of some of the findings of the economics profession, combined with that of policy makers in the LDC's and in the donor community, has far outdistanced our understanding of why such good advice based on such incontrovertible findings is not being readily accepted in many cases. We even know quite a bit about who benefits and who loses from a policy of continued discrimination against the "excluded middle" in the size distribution of firms. But what we still know relatively little about is what the initial internal conditions are which favor a relatively easier policy transition; what sequence of relevant policy change is less painful

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and more subject to carefully applied support of both the carrot and stick variety from the outside; and how one can best assure that policy change is indeed followed by the institutional and attitudinal changes usually required for implementation at the working level. The kinds of LDC governments that work best in this context is but one of the relevant issues; at least as important is the nature of the reform-mongering process that technocrats are willing and capable to engage in when they make their proposals to customarily somewhat myopic politicians. It seems to me that S&M sub-sector neglect, especially when viewed in the context of the relevant macro and institutional policy setting, is but part and parcel of a bigger political economy picture which needs to be better understood if real progress is to be made. The problem is no longer one of asymmetric wisdom or asymmetric information, if it ever was. It is more likely to be one of fundamentally asymmetric objectives among various components of the LDC polity which are papered over on the surface while under-the-table discriminatory practices continue unabated--with only the partial understanding of some of the major participants. While much knowledge in the political economy arena, no matter how precisely defined, is bound to be country-specific, there are some generalizations which can undoubtedly be derived even here to at least bring the costs and benefits of continued S&M neglect--and precisely for whom--to the surface where they can be debated and judged.

In sum, while a "critique" is bound to sound unduly "critical", it is also my considered opinion that the work undertaken under the EEPA Project was of generally high quality, has substantial weight, and advances our understanding. It is marked off from much of the relevant literature by combining a reasonable amount of up-to-date theoretical stage-setting with a willingness to get one's hands dirty on the empirical side. The researchers clearly possess the requisite combination of academic moorings and overseas experience to avoid some of the pitfalls represented by empty model-building, on the one hand, and misplaced "local" concreteness, on the other. I am also aware of the fact that good professionals customarily are not readily assignable to specifically defined research tasks but tend to focus on what they have been or are currently working on. Nevertheless, I still believe that the pay-off to the Project would have been considerably higher had there been some effort made to identify specific problems beforehand and then attempt to obtain agreement on tackling them in some generally agreed-upon fashion, using whatever methodologies and/or human resources were available and, of course, avoiding premature intellectual straitjacketing. In other words, I emphatically am not advocating a mode of operation with very specific tasks handed down by A.I.D. or by the Project coordinator; but I do believe that in any future effort of this kind more energy be expended early on to try to achieve some consensus--given the substantive human resources, country experiences etc. available--as to what the "ideal" mosaic should look like--and then be prepared to deviate from it. The various recent NBER and World Bank comparative

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projects, mostly at a macro level, represent a case in point. Substantial efforts were made there to achieve some narrowing of the specific themes to be pursued as well as the methodologies to be deployed in a comparative (hopefully typologically rich) context. If one succeeds in this-- if only partially--the sum is bound to add up to considerably more than its parts. I am not, of course, suggesting that none of this was tried here--or indeed that these other larger projects really succeeded in some signal fashion; but I do believe that future opportunities to better understand some of the key issues of analysis and policy formulation involved here probably reside in trying a more concentrated multi-dimensional (and possibly even multi-disciplinary) approach.

ANNEX 3

Notes on the Political Economy of Policy Reform-- Paper Presented by Stephan Haggard

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NOTES ON THE POLITICAL ECONOMY OF POLICY REFORM

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The movement toward political liberalization that gained strength during the 1980s raises basic questions about the linkages between democracy and economic growth. In pondering AID's research and operational priorities, it is worthwhile to distinguish between two sets of analytic and policy issues. One set of concerns is how to promote political development and the consolidation of democracy. The second set of questions centers on how politics, particularly in those countries transiting to democratic rule, will affect the economic adjustment process.

The focus of this paper is primarily on the second set of questions, but I begin with some observations on the promotion of democracy since the issue has gained increasing attention. The concept of "broad-based growth" implies a concern with political development, the idea of "political conditionality" has been advanced in some circles, and even the World Bank (1989) is taking an interest in the effects of "governance" on economic performance.

There are direct and indirect means through which policy might seek to advance democracy; both run certain risks. Direct programs aimed at democratic consolidation run the risk of taxing the expertise of bilateral and multilateral aid agencies and can be accused of political interference.

The indirect approach to democracy, on the other hand, focuses primarily on advancing economic growth and equity on the assumption that they constitute the necessary preconditions for democratic development. This assumption needs to be qualified, but on the whole, it is probably justified. However, this constitutes an argument in favor of focusing operational efforts primarily on economic, rather than political, development.

In the second section, I provide a review of the current state of the art on the politics of economic policy. This work suggests some important hypotheses, rules of thumb, and possible lines of research, but it has still not addressed the critical issues of tactics and program design that are central to any practical reform effort.

In the third section, I suggest how support or opposition to reform programs might be affected by the design of reform programs, including issues such as the timing, sequencing and speed of reform, and the extent of compensation for losers. Unfortunately, there is no clear consensus on these issues, and prescriptions have been built around diametrically opposed political economy assumptions. This suggests an important research priority: an analysis of the tactics of reform efforts.

These tactical considerations cannot be divorced from the political milieu, however, including the organization of key interest groups and the nature of decision-making institutions; these are addressed briefly in the fourth section. The policy relevance of the political economy literature is uncertain in this area. On the one hand, the basic configuration of interests must be treated as a parameter. On the other hand, it is possible to think of institutional reforms that might improve the likelihood of reform. This constitutes a second possible research focus: strengthening decision-making institutions.

In concluding, I raise several methodological questions and make suggestions about research priorities. If there is serious interest in political economy research, certain types of projects should be avoided. These include broad country studies, analyses focused primarily on showing the economic wisdom of certain policies, and broad functional topics such as "democracy and economic reform." Greater gains could be had by focusing on one or two policy areas in which AID has ongoing operational expertise. A cross-national research effort could be designed that would collate and codify information and experience AID has already accumulated in its mission staff.

I. Promoting Democratic Development

The goal of promoting democratization and the consolidation of democratic institutions may be approached either directly or indirectly. If approached directly, a variety of actions are possible that go far beyond economic development assistance, including high diplomatic involvement of various sorts or simply the expansion of aid in order to buttress the short-term political position of a favored leader; this approach was used in the Philippines after 1986. Aid might be used in a more targeted way, however, to support the strengthening of the institutions that are central to democratic governance: a free press; the legislature; the courts; business, labor, and peasant organizations; "think tanks"; and political parties.

It goes beyond the scope of this paper to consider the range of possible actions that might be entailed in such an effort, but one particular possibility deserves mention because it concerns economic policy directly.
The analytic capacity of institutions with reference to economic questions is often quite weak in the developing world, particularly in the lower-income countries. For example, legislators and their staff often lack the ability to gather and process information and to assess the implications of different policy alternatives. In many developing countries, there are few independent organizations, such as think tanks, that are capable of offering economic policy analysis. Press coverage of economic questions is routinely weak if not misleading. Policy initiatives might be designed to focus on strengthening the capacity of these institutions directly.

There are at least three arguments against the direct approach. First, the bilateral and multilateral aid organizations do not currently have a comparative advantage in this area, and such initiatives would detract from its core mission of promoting economic development. At the margin, this need not be a damaging objection. One of the most important tasks in the area of institutional development is education and training, and AID could play an important role both directly and as an intermediary. For example, it could sponsor leaves for journalists to study economics, bring legislative aids to study the operation of Congress (assuming that this is a good model!), or provide training for officials in unions, peasant and farmers' associations, or other interest groups.

A second objection, or more accurately a caveat, is that such institution-building exercises do not necessarily yield clear, measurable benefits. They must be viewed as a long-term investment.

A third and more serious objection is political. In authoritarian settings, efforts to promote democracy and democratic institutions will quite naturally be opposed by existing elites, though such a considered risk may be worthwhile; Kenya provides a current example. Once political liberalization is underway or a regime change has occurred, overt and official U.S. support for domestic interest groups and institutions could still lead to charges of political interference and have the counterproductive effect of delegitimating those we seek to help. This would be particularly the case with political parties, but would also hold for involvement with interest groups and the press.

Technical assistance to these organizations might best be promoted through the corresponding non-governmental organizations in the U.S.: political parties, unions, and so forth. Were such an approach to be developed, it would probably best be focused on government institutions themselves--the bureaucracy, legislature and the judiciary--thus reducing the possibility that such assistance would be seen to imply partisan judgments.

The indirect approach to promoting democracy is based on the premise that the worst enemy of democratic development is poor economic performance and inequality. The most effective way of supporting democracy is therefore to assist countries in achieving higher <u>levels</u> of economic growth and/or a more egalitarian <u>pattern</u> of growth. Economic growth is presumably good for democratic consolidation because it increases the scope for political compromise among contending groups and enhances the legitimacy of new democratic institutions. More "broad-based," or egalitarian, development increases the income of socially weak groups, increases the likelihood that they would become politically engaged, and thus builds new bases of support for democratic rule.

These claims are not as self-evident as they might first appear, and have been attacked for their naive assumption that all good things go together (Packenham 1973); I have reviewed them in greater detail elsewhere in a study for AID on the relationship between democracy and economic growth (Haggard 1990b). As Mancur Olson (1963) argued in a well-known article, economic growth may itself be a destabilizing force. Economic development entails a disruption of traditional social structure, a reallocation of income and wealth among groups, and a widening of income disparities, at least in the short-run. The rise of fundamentalism in the Middle East is frequently cited as an example of the tensions that exist between modernization and democracy, as well as the ambiguities that arise across cultures in the very meaning of the term. The Iranian revolution followed a decade of extremely rapid growth. In Algeria, recent elections resulted in a very strong showing by an Islamic fundamentalist party that could easily be seen as anti-democratic in Western terms.

As will be argued in more detail below, the structural adjustment policies advocated by the World Bank and the IMF may also lead to political problems. It is often assumed that these reforms benefit relatively disfavored groups, such as the urban informal sector and agricultural producers. Yet the distributional consequences of these programs are still not well-understood, and it is at least plausible that some relatively poor groups will suffer at least in the short-run. To cite three examples, low-income households that are net purchasers of food will be hurt be raising producer prices, workers in import-substituting manufacturing face displacement by import liberalization, and recipients of government transfers will suffer from fiscal austerities.

Assessments of the political implications of poor economic performance have also undergone a change over the course of the last ten years. There are cases of democratic governments that were overthrown in the 1980s as a result of economic difficulties, including Turkey, Nigeria and Ghana. Yet it is also the case that the crisis of the 1980s contributed to the emergence of democratic rule in a number of countries. In at least four Latin American countries--Argentina, Brazil, Bolivia, and Uruguay--sharp economic downturns intensified democratic oppositions to incumbent military governments and lead reasonably quickly to their withdrawal from power. Poor economic performance in 1984 and 1985, in part a result of government stabilization efforts, was an important background condition in the democratic transition from Marcos to Aquino in the Philippines as well. Moreover, virtually all of the new democracies installed in the 1980s are still functioning despite historically poor economic performance.

This suggests that democracy may be more resilient in the face of low growth than is commonly believed. Why might this be so? Sharp economic shocks or changes in relative prices are likely to lead to widespread demands for public assistance; the clearest examples of this are the riots that have been associated with the elimination of food subsidies in a number of countries: Egypt, Morocco, the Dominican Republic, Venezuela (Bienen and Gersovitz 1985). Long periods of slow growth, by contrast, do not necessarily produce political responses. Citizens and firms lower expectations and make individual, "non-political" adjustments, such as sending more family members into the work force, entering into informal sector activities, and reducing consumption. Even if demands for relief are politicized, they are just as likely to be directed at the government in power as they are at the system as a whole. This may be particularly true in new democracies, in which the democratic system enjoys a cushion of political legitimacy on which it can draw.

This view is overly sanguine about the resilience of liberal constitutional institutions, however, and misspecifies the nature of the economic threat to the consolidation of democracy. It is possible to sketch a stylized process of political decay that while stopping short of formal regime change, would nonetheless drain constitutional institutions of their democratic content. Such a cycle would begin with developments already evident in a number of developing countries experiencing severe economic distress: an increase in political cynicism and apathy, a decline in effective political participation, and an inability for the political system to generate representative ruling coalitions. In a next stage, crime, civil violence, and organized revolutionary or anti-revolutionary ("death squad") activity could contribute to a gradual erosion of the substance of democratic rule through intermittent repression of opposition groups, "emergency" measures, and a decline in the integrity of legal guarantees, such as habeas corpus.

At a third stage--still short of a formal transition to authoritarian rule or constitutional change--electoral institutions could be rendered a facade. Elected officials would be subject to the veto power of military elites, would come under pressure from military elites, as happened in 1990 in Pakistan, or become little more than fronts for them. This was the case with the highly repressive "Uruguayan model" from 1973 to 1985, and is arguably true in El Salvador and Guatemala.

Finally, we can by no means rule out the possibility that sustained poor performance could lead to open reversals of democratic rule. A general erosion of faith in the capacity of democratic government to manage the economy could increase the popular appeal of authoritarian "solutions" to the crisis. The erosion of support for democratic institutions would lead to the election of leaders or parties with plebiscitarian or openly authoritarian ambitions, or reduce the perceived costs to the military of intervening. Economic crisis might reverse democratization in a more indirect route. Sustained poor performance, or a sudden deterioration in the economy, could lead to an increase in crime, strikes, riots, and civil violence. Rapid social changes, such as downward mobility for members of the middle and working classes, could increase the appeal of political movements on the extreme left and right, including revolutionary ones. The deterioration of social order and increasing social polarization are classic justifications for military intervention.

It should be noted, though, that the importance of economic growth for the consolidation of democratic rule might very well constitute an additional argument against what I have called the direct approach. Given AID's competence, the political problems associated with "interfering" in domestic politics, and the daunting economic problems many developing countries face, a strong argument can be made for focusing on traditional development goals. This raises the question of the political conditions under which reform is most likely and the best means for achieving political support for economic reform measures; this is the subject of the following sections.

II. The Political Economy Literature: The State of the Art

The political economy literature is growing at a rapid rate. A full review is beyond the scope of this paper (on macroeconomic policy, see Alesina 1989; on trade policy, D. Nelson 1988; Baldwin 1990; on the political science literature, Haggard and Kaufman 1989a). It is possible to outline briefly some of the major approaches and hypotheses that have been explored to date, underlining those that are of direct relevance for the analysis of policy reform. There are, however, strong limits on the relevance of the existing literature; I review these before turning to features of the reform process that deserve greater attention.

A. Regime Type. A longstanding debate in the political science literature concerns the relative capabilities of democratic and authoritarian regimes in launching economic reforms. This literature has focused primarily on the stabilization of inflation, but in some cases has been extended to other policy reforms as well (Skidmore 1977; Diaz-Alejandro 1983; Kaufman 1979, 1985; Haggard 1986; Haggard and Kaufman 1989a, 1989b, 1990; Bienen and Gersovitz 1985; Remmer 1978, 1986, 1990; Sheahan 1980; Siddell 1987; Weede 1983). The argument is that authoritarian governments are able to impose the short-term costs and to resolve the collective action problems that are inherent in economic reform efforts.

The empirical evidence for a relationship between regime type, macroeconomic policy and inflation is inconclusive. In a number of middle-income countries, high inflations associated with democratic stalemate were subsequently reduced by incoming authoritarian governments that imposed costs on previously mobilized labor and middle-class groups. In many of these cases, the governments also formulated wide-ranging structural reforms that would probably have been impossible under democratic auspices. Among the cases that fit this general pattern are Argentina (1966 and 1976), Bolivia (1971), Brazil (1964), Chile (1973), Uruguay (1973), Turkey (1971 and 1980), and Korea (1973 and 1980). It has also been pointed out that the economically successful outward-oriented strategies of the East Asian newly industrializing countries were carried out under authoritarian auspices (Haggard 1990).

Yet there are also cases of authoritarian regimes pursuing unsustainable development strategies, including many low-income African countries and some of the very same middle-income governments that initiated draconian stabilization programs earlier in their tenure; Argentina and Brazil both fall in this second category. Similarly, one can point to a number of democratic governments that managed to undertake relatively successful adjustment efforts, including Sri Lanka in the late 1970s and Costa Rica and Jamaica in the 1980s. Cross-national studies by Remmer (1978, 1986, 1990) find either no correlation between regime type and macroeconomic policy and performance, or find that democracies have better performance.

In general, the debate has moved beyond the simple distinction between authoritarian and democratic regimes to more qualified judgments and distinctions within each category (Nelson 1989, 1990). For example, Haggard and Kaufman (1989a, 1990) have argued that while there may be no overall relationship between regime type and successful stabilization, authoritarian regimes may be more likely to stabilize when inflation and social conflict are high. Nonetheless, this debate is a salutary reminder of the particular complexities that are posed by democratic reformism

B. Regime Change and Transitions. A modification of the regime argument is to look at the nature of the transition to democratic rule itself (Haggard and Kaufman 1989b; Remmer 1990). Three stylized sequences are possible. In Korea, Chile, Turkey, and Uruguay, the military began the structural adjustment process prior to undertaking political reform, and then initiated the transition to democracy "from above"; economic reform preceded political reform These cases of controlled political liberalization appear to have resulted in greater continuity in policy between governments, particularly where the policy reforms had a chance to yield positive results. Reforms resulted in benefits to new groups, which then became supporters of the new line. Examples include export-oriented manufacturing interests in Turkey and the East Asian newly-industrializing countries, and export-oriented agriculture in Chile.

A second pattern is to attempt political and economic liberalization simultaneously. This is the pattern in Mexico, Nigeria, and arguably in the Soviet Union. While there is inadequate experience to make a definitive judgement, it appears that this pattern is unstable. On the one hand, the short-term costs of reform provide a rallying issue for the opposition in its effort to speed the pace of political liberalization; this is particularly clear in the Soviet Union. On the other hand, since the regime maintains substantial political power and independence, it may be tempted to rely on authoritarian "solutions" to the economic reform process.

A third path is where political reform comes prior to economic reform efforts. In these cases, including Poland, Argentina, and Brazil, authoritarian regimes failed to pursue any coherent economic policy prior to their exit, leaving substantial economic difficulties to their democratic successors. These regimes usually collapsed in the face of substantial opposition "from below," though often with support from dissidents within the armed forces or previous ruling parties themselves.

In these cases, the initiation of new democratic governments will be conducive to stabilization and structural adjustment when: a. incoming governments and economic teams seek to capitalize on an economic reform platform; b. democratic forces are united; and c. the opposition is weak or divided. Where the incoming democratic coalition is divided on economic or political questions or faces continuing opposition from authoritarian political forces, governments are more likely to delay reform and use economic instruments for short-term political purposes; this was arguably the case in the first year of Corazon Aquino's rule in the Philippines.

C. Electoral Cycles. Once democratic rule is established, we can expect governments to face more routine political constraints. Perhaps the most extensive literature on the political economy of macroeconomic policy has been devoted to the question of electoral cycles. Electoral cycle models captured the attention of economists, were criticized theoretically for the assumption of myopic voters and empirically for their weak results, but have periodically been revived (for reviews see Alt and Chrystal 1983, ch. 5; Alesina 1988, Nordhaus 1990; Rogoff 1990). This literature suggests the hypothesis that stabilization and other structural reforms will be delayed prior to elections, and are more likely to be undertaken during the "honeymoon" period immediately following them.

The one effort to test such claims empirically for the developing countries, using a sample of Latin American countries, did find some electoral effects on expenditures and deficits (Ames 1987), but there is also contrary evidence (Haggard, Kaufman, Shariff and Webb 1990). Contrary to the prediction of strategic behavior, Nelson (1990b) finds that candidates can gain broad electoral support for dramatic reform programs. The Ozal government in Turkey is frequently cited as an example of a political leader running on a wide-ranging economic reform program and winning. Nonetheless, the general point is plausible: any reform effort must be cognizant of the question of electoral timing.

D. Government Strength and Stability. An alternative hypothesis is that electoral cycles matter less in the conduct of macroeconomic policy than the strength or stability of the government. Drawing on a cross-national study of thirteen countries and eighteen governments, Nelson (1990a) argues that democratic governments that have strong majorities and that face weak and divided oppositions are more likely to launch and sustain reform initiatives than those with more narrow majorities or facing a unified opposition. Sachs and Roubini (1989) argue for the advanced industrial states that coalition governments and those facing opposition majorities in the legislature (a possibility in presidential systems) pursue more expansionist macroeconomic policy.

There is also a growing theoretical and empirical literature that links political instability, measured by such indices as strikes, riots, or coups d'etat, with instability in the conduct of macroeconomic policy and economic performance (Stewart and Venieris 1985; Alesina and Tabellini 1988; Roubini and Sachs 1989; Cukierman, Edwards and Tabellini 1989; Roubini 1990). The results from these studies appear to be strong, but their relevance for policy is unclear.

E. Partisanship, Constituencies, and Interest Groups. A review of the preceding hypotheses reveals that they all focus on how the time horizons of politicians are affected by political constraints. It is assumed that the benefits of reform are likely to unfold relatively slowly, but that politicians operate under short-term constraints. Regime type, the nature of the transition, elections, and the stability of government are all factors that might incline politicians to longer or shorter time horizons, thus making them more or less amenable to reform efforts.

The major contending view is to focus on the distributional consequences of policies, conflicts of interest among different groups, and the constituent bases of the government in power. This tradition of political economy was first explored in the context of macroeconomic policy by Douglas Hibbs (1977) for the advanced industrial states, and developed further by Alberto Alesina (1987). These models begin with a stylized two-party system in which the two parties have different preferences over taxation, spending, inflation and trade policy. These preferences are, in turn, based on different constituent interests, usually labor (left) vs. capital (right), though the analysis might be extended to sectoral interests such as import-substituting and non-tradable goods vs. exportables.

While the electoral cycle model expects governments of all parities to behave in basically the same way, the partisan model predicts differences in policy behavior based on constituent appeals and ideology. "Left" parties will promote a structure of expenditures that reflects their constituent base, place greater emphasis on social services and transfers, and will be more likely to tax capital, and will pursue more expansionary macroeconomic policies as a way of redistributing income.

The left-right spectrum in the developing countries is not as uniform as it is in the advanced industrial states, but related arguments have been made concerning "populist" governments, such as the Allende government in Chile and more recently the Garcia government in Peru (Dornbusch and Edwards 1989; Sachs 1989; Haggard and Kaufman 1990b). This work suggests the hypothesis that populist governments will go through predictable cycles of policy, in which ambitious programs of redistribution, real wage gains to urban workers, and government spending, prove unsustainable in the face of the inability to tax, declining private sector confidence, dwindling reserves, and increasing political polarization . "Right" governments, by contrast, might be expected to emphasize the traditional functions of government to a greater degree, including military, infrastructure, and support for economic services, while limiting taxation. Where inflation is high, "right" parties are more likely to emphasize the goal of stabilization early in their tenure.

Such partisan models might also be developed for trade and pricing policy, but the more common approach is to focus on the sector or interest group level. There has been an extensive theoretical literature on rent-seeking that can also be extended to "revenue-seeking" or "transfer-seeking" and is thus relevant for fiscal and price policy as well (Krueger 1974; Buchanan, Tollison, and Tullock 1980; Colander 1984; Bates 1981). This approach is well-known and need not be reiterated here at length. It is based on the simple idea of a political exchange relationship between politicians and interest groups, in which the politician exchanges policies for various forms of support, whether electoral or financial.

F. Limitations on Existing Work. As can be seen from this brief review, many hypotheses are potentially relevant to the study of policy reform. Nonetheless, there are also important limitations to existing lines of research. First, as Grindle (1989) has pointed out most eloquently, much of the theoretical literature in neo-classical political economy has focused on explaining the political sources of state intervention, distortion, and resistance to reform. This is particularly true of the rent-seeking literature on trade and pricing policy. There is an extensive literature on the economics of stabilization and structural adjustment, but there is still relatively little comparative research on the political economy of policy reform (see however Grindle and Thomas 1990; Nelson 1990).

Second, most theoretical work has emphasized macro-political constraints, such as the role of interest groups and electoral pressures. This has two drawbacks. First, it can be overly deterministic. Within a set of given political constraints, there may still be some leeway for action through the adoption of appropriate tactics. Second, there has been little attention given to the role of institutional arrangements and the internal bureaucratic politics of reform. In many cases, key political battles occur within the bureaucracy itself; if reform is to be understood, these processes must be explored.

Finally, much of this literature remains focused on the macro-political level; the broad play of political institutions and interest groups and major policy initiatives such as stabilization and trade liberalization. These factors are clearly important for understanding major policy initiatives, but in practical and operational terms, problems are often more local: making a cooperative work, undertaking a local public works project, reforming a particular public enterprise. House Speaker Tip O'Neil once remarked that "all politics is local politics," and this is true in the development area as well. I return to this problem in the conclusion.

III. The Tactics of Reform

These weaknesses suggest an approach that raises questions by focusing on a stylized reform sequence. For countries with macroeconomic disequilibria and various policy-induced distortions, the first puzzle to be explored is the way decision-makers calculate the political risks in launching or delaying reform; this is the question of the timing of policy initiation. The much more important and complicated question, however, concerns the implementation of reform. Success at implementation will hinge on various components of program design, the organization of interest groups, and institutional characteristics of the government itself. These areas constitute the most important ones for research.

A. Initiating Reform. It could be argued that economic conditions determine the policy agenda. For example, exchange rate adjustments and stabilization programs are usually initiated in response to short-term balance of payments crises or increases in inflation. In fact, this is an economic (or an economist's) fallacy; economic conditions are not in themselves a good predictor of the timing of reform efforts. What constitutes a "crisis" varies substantially from country to country. Some governments take pre-emptive action, while other governments delay adjustment in the face of "obvious" problems and "unsustainable" policies.

The strands of literature reviewed above that deal with the time horizons of politicians suggest some fairly obvious conclusions about the initiation of reform efforts. Yet as obvious as these propositions may appear, their implications are frequently overlooked by both bilateral and multilateral aid donors seeking to design or support reform programs.

Economic circumstances being equal, policy-makers are likely to delay reform, launch more piecemeal reform efforts, and have lower credibility with private agents when they face immediate political challenges. These challenges are more likely during the transition to democracy, before elections, when the opposition to reform is strong in either the bureaucratic or legislative decision-making arena, or when the government faces challenges or threats from interest groups or collective protest around other issues (Nelson 1984a, 1984b; Bienen and Gersowitz 1985; Sidell 1987). Clearly, these are not conditions during which reform efforts are likely to be adopted.

Conversely, if politicians are temporarily freed from short-run political constraints or challenges, they are more likely to take initiatives in anticipation of capturing the political benefits of reform, which are likely to unfold gradually. The initiation of reform is therefore more likely from new governments, from governments with new, unified, and coherent economic teams, and from governments with strong legislative majorities.
Any of these conditions constitute "targets of opportunity" during which reform efforts should be pressed vigorously.

<u>B. Implementing Reform</u>. Once initiatives are launched, the second phase begins: <u>implementation</u>. The implementation of policy reform must be seen as a process of coalition-building (Waterbury 1989) through which political leaders and bureaucratic agencies gain political support through the establishment of linkages with beneficiaries of the new policy course, while managing the costs that reform inevitably impose on losers. Beneficiaries serve as a critical political counterweight to those experiencing losses in the short run. Support and opposition will depend in part on the organization of interest groups; I discuss this below. But the interests of groups are not fixed, and the design of the program will itself influence patterns of opposition and support.

Despite the paucity of empirical work on these issues, contending approaches to the adjustment process usually have implicit assumptions about the political economy of reform. Debate has crystallized around two main issues: the relationship between the speed and comprehensiveness of the reform effort and its "credibility"; and the utility of compensation in contributing to the sustainability of reform. In both areas, there are directly conflicting hypotheses. One possible research focus would be to draw on AID experience with particular policy reforms to test these contending views.

<u>C. The Pace and "Size" of Reform</u>. There has been a trend in recent thinking within the development policy community toward the position that policy reforms are likely to be more successful when they are, a. swift and large rather than gradual and b. extensive rather than piecemeal in scope. There are several reasons why this might be the case.

One hypothesis is that the political success of an adjustment effort depends on whether the reform yields results quickly in terms of inflation reduction, aggregate growth or by contributing to income gains for particular groups, such as exporters, that can provide the government support. Such quick results are most likely to be achieved through comprehensive action. Easterly and Wetzel (1989) show that major reductions in large distortions, such as an overvalued exchange rate, result in greater total efficiency gains than small ones. Moreover, since successful adjustment raises the growth of long-run per capita consumption, the winners from the reform process should be able to subsidize any short-term costs incurred by the losers, a topic taken up in more detail below. These arguments are all variants of the claim that the economically optimal policy is also likely to be politically optimal.

A second line of argument for swift and comprehensive action has to do with signalling commitment and building credibility (Rodrik 1989). There are a number of sources of credibility problems, including inconsistency between policies, such as fiscal policy and the exchange rate, and the time-inconsistency of optimal policies. An additional source of credibility problems is incomplete information on the part of the private sector about a government's true policy intentions or "identity." Assume that a new government comes to power and announces its commitment to policy reform. In the past, however, this political party has been unable or unwilling to undertake such reforms. Economic agents will thus doubt that the reforms will be sustained, and will engage in behavior, such as price-setting and foreign borrowing, which will serve to undermine the reform process. This suggests a second hypothesis why swift and comprehensive action is politically superior. Governments can build a reputation for reform and offset the lack of credibility stemming from previous political commitments by undertaking "radical" actions which signal its true intentions.

A final set of arguments for comprehensive reform stems from the observation that rent-seeking behavior is a consequence as much as a cause of government intervention (Krueger 1974). "Large" reforms, and particularly those that involve substantial institutional changes, will themselves reduce the opportunities for opposition groups to organize and will thus commit future governments to the reform. For example, by achieving fiscal cuts through the elimination of state-owned enterprises, agencies or programs, the government reduces the possibility that such spending will recur by weakening the groups directly tied to those programs, including those inside the bureaucracy itself. Similarly, by lowering tariffs to uniformly low rates and eliminating agencies which dispense licenses, the government reduces opportunities for exceptionalism and rent-seeking.

With the possible exception of the reduction of very high and persistent inflation, where swift and comprehensive action is necessary, each of these arguments can be reversed to make a case for a more gradualist approach. First, while the aggregate gains from large adjustments may be larger, the distributional consequences may be more severe and the adjustment process more disruptive. Second, it is assumed that comprehensive reforms, particularly those involving institutional change, will reduce the avenues for rent-seeking and policy reversal. Yet in a democratic political setting, this overlooks the potential for institutional innovation to circumvent the new rules. For example, a dramatic lowering of tariffs may be matched by other forms of compensation that have equal, if not more distortionary, consequences.

Finally, the argument for comprehensive action assumes that the adjustment model is correct, and that economic results will in fact be forthcoming. This may not be the case. For example, in many African countries, the supply response from initiating price reforms is slow due to the decapitalization of agriculture and lack of investment in infrastructure. If such a response is not forthcoming and there are no "winners" from the adjustment process, the reform effort can be delegitimated; this is the source of "adjustment fatigue." Comprehensive programs promise high returns both economically and politically, but they also run higher political risks if they fail. Gradualism may therefore be politically more palatable due to lower adjustment costs which imply a lower level of political opposition, and a lower likelihood of costly policy reversals.

The same argument may be made with reference to the building of credibility. This can be seen by outlining what might be called the credibility paradox. Assume that a comprehensive program is undertaken in the first period, in part to build reputation, but it fails either for political reasons or because of an exogenous shock. In the next period, the credibility problem of the government is compounded. Establishing credibility in the second round requires even more drastic action than before. But such announcements are likely to be less, not more credible with the private sector. Credibility may therefore be higher when the policy path is more gradual.

D. Compensation. A second set of debates concerns the importance of compensatory measures, and focuses less on the aggregate economic results of reform as the distribution of economic benefits among groups. A well-known UNICEF study, Adjustment with a Human Face (Cornia, Jolly, and Stewart 1986), argued that targeted compensation for low-income groups might help offset political resistance which stems from an unequal distribution of gains. Similar arguments might be made for the role of partial wage indexing or other forms of social policy during stabilization episodes or devaluations; for adjustment assistance for workers and firms during a trade liberalization or price adjustment; or for a variety of compensatory schemes such as those pursued in Ghana and Bolivia to cushion the effects of adjustment programs.

The concept of "compensation" should not be limited to various transfers, however; it can be expanded to include tradeoffs among different types of reforms, both in the current period and intertemporally through the sequencing of the reform process. For example, it may be politically optimal to undertake fiscal adjustments by raising revenues rather than cutting expenditures if the latter generates greater opposition. Similarly, the transition to a more export-oriented economy may be better achieved by subsidizing exporters and maintaining some domestic protection in order to compensate for the costs and uncertainties of operating in international markets, while postponing the process of liberalizing the domestic market (Sachs 1987; Rodrik 1989; Haggard 1990). These compensatory actions may have some costs, but they can forestall more serious opposition that might undermine the program altogether.

Skepticism might also be expressed concerning the necessity of compensation, however. There might be some humanitarian justification for cushioning the effects of adjustment on the poorest groups, but the adjustment process itself is frequently welfare-enhancing for the poor and in any case, the poorest are not likely to be politically powerful and thus not likely to be the beneficiaries of compensatory programs. Compensation is more likely to mean subsidizing groups other than the poorest and most needy, and has the effect of establishing new rent-seeking relationships. These are at best costly. At worst, "compensation" may undermine other adjustment objectives. For example, wage indexation or compensatory wage increases can offset the gains in competitiveness from a nominal devaluation.

To date, there is very little evidence on these claims concerning the politics of program design. Empirical evidence from stabilizations (World Bank 1990) appears to provide some support for the view that gradualism has high costs, particularly where inflation is high and persistent, but the record of shock treatments, both orthodox and heterodox, is also mixed. The evidence in the trade area is also ambiguous. A World Bank project on trade liberalization (World Bank 1988) underlines the importance of decisive action, but empirical studies of the transition to export-led growth in the East Asian NICs (Sachs 1987; Haggard 1990a), other World Bank work on trade policy reform (Levy 1990), and theoretical work on trade reform (Rodrik 1990) all suggest that compensation, broadly defined, plays an important role. With the exception of Nelson's (1990b) work on poverty reduction measures and several studies of the lifting of subsidies (Bienen and Gersovitz 1985), there is little research on how compensation, or failure to compensate, affects political opposition and support for the program.

IV. Interests and Institutions in the Reform Process

A. The Organization of Interests. The foregoing discussion has treated the problem of coalition-building from the perspective of the economic impact of the reform on different groups. Political support and opposition were seen to result primarily from differences in the nature of the program itself. It is difficult, however, to predict the political success of programs based on their distributional consequences alone without reference to the organization of groups and their relationship to the political system. On the one hand, even if the aggregate benefits are relatively widespread, politicians may not be able to capture political gains from the reform because institutional and organizational arrangements weaken or diffuse support from beneficiaries and strengthen anti-reform forces. Conversely, institutional arrangements that limit the opportunities for the opposition to mobilize can provide the political space for new coalitions to form, even if initial beneficiaries are relatively few.

It is difficult to isolate the range of institutional arrangements and interest groups that may be relevant in this regard. Much will depend on the nature of the reform under discussion. In some national settings, regional and ethnic conflicts are more salient than class or sectoral ones. Some relevant "interest groups" are not organized; the most important are lower urban strata that are prone to spontaneous collective protest in the face of changes in relative prices of goods and services. Nonetheless, it is clear that two, broad groups of interests are like to pose the most crucial challenges for stabilization and structural adjustment programs: organized labor, including government workers; and the private sector.

Labor is frequently subject to direct control under authoritarian regimes, and thus political liberalization can be expected to lead to more extensive and active union organization and greater labor militancy. Since organized urban labor is usually a net beneficiary of government spending and is often concentrated in the non-tradable and import-substituting sectors in middle-income countries, labor will potentially be an important actor in understanding the politics of fiscal policy, trade liberalization and exchange rate adjustment. Efforts to raise food prices and lift subsidies are also likely to strike at urban workers.

The second important group in middle-income countries is the organized private sector, particularly in manufacturing, but also in commerce. The private sector will play an important role in stabilization to the extent that they are beneficiaries of government expenditures and the source of tax revenues. With reference to trade reform, long-standing patterns of import-substitution and concentration of activity in the non-tradable goods sector might be expected to generate opposition to liberalization and devaluation.

Whether labor is effective in resisting reform is a function of its sectoral location and organization. Devaluation and trade liberalization should be more contentious and subject to reversal where labor is: (a) highly organized, particularly in the non-traded and import-substituting sectors, as in Argentina; (b) has other coalition partners that are opposed to adjustment, for example, among portions of the private sector, as has been the case in Brazil until recently; or (c) is concentrated in strategic sectors which are of critical importance for the economy as a whole, such as the copper sector in Zambia, the tin miners in Bolivia, or the coal miners in Poland. A high concentration of workers in the state-owned enterprise sector will complicate stabilization measures, since efforts to control wages or lay off workers are immediately politicized. Conversely, adjustment is facilitated where labor markets are flexible, allowing labor to move quickly from the protected and non-tradable sectors to the export sector, where workers are weakly organized, and where they are not located in highly concentrated or "strategic" sectors.

For adjustment to be sustained, reform measures must garner support not only from key interest groups, but also within the broader party system. The position of labor in the party system is important in this regard. The key question is whether labor has incentives and organizations through which cooperative agreements can be reached, or whether its political position is more likely to lead it to reject compromise. A growing literature on the advanced industrial states suggests that the inclusion of labor into the decision-making process may prove a more viable strategy. Corporatist arrangements (Katzenstein 1985), close ties with the governing party (Cameron 1984; Lange and Garrett 1985; Hicks 1988), or ties with cross-class parties (Haggard and Kaufman 1990) can integrate labor into decision-making structures that provide the basis for compromise, social pacts, and enhanced policy credibility. The closest approximation to corporatist arrangements in the developing world is in Mexico, though a number of two-party systems, including Venezuela, Colombia, and Costa Rica also have institutionalized relations with labor. By contrast, where labor has weak links with the government, but strong links with class-based leftist or populist parties, it can contribute to policy instability and resistance to reform (Haggard and Kaufman 1990).

These hypotheses about factor mobility, interest group organization, and the links to political parties can be elaborated for other groups that might oppose adjustment, including import-substituting manufacturers, yet the basic questions are the same. First, do groups have market-based adjustment options in the face of policy reforms, or are they likely to respond to changed incentives through political action? Second, how effectively organized are major groups of winners and losers? Third, do they occupy strategic positions that give them power over economic policy? Finally, does their relationship with the government and party system provide channels for the negotiation of compromises?

B. Institutions and the Policy Process. The work of political scientists and economists differ sharply on the role of institutions in the policy process. Most economic models have primitive institutional assumptions: referenda, policy-by-lobbying (the rent-seeking literature), two-party systems with policy determined by electoral majority, etc. These assumptions increase theoretical tractability, but reduce realism. Political scientists, on the other hand, have devoted much more attention to how institutional arrangements structure the incentives to organization and even the range of decisions. While there are studies of fiscal and trade policy-making institutions in the advanced industrial states, such analysis has rarely been extended to the developing countries. The relevant institutions vary by policy area, but two arenas are of particular importance in newly emergent democracies: the legislature and the economic bureaucracy.

Political scientists have long noted that legislative structures can create perverse incentives for both macroeconomic management (Shepsle and Weingast 1984) and trade policy (D. Nelson 1988). For an individual legislator, increasing expenditure is a good while increasing taxation is a bad; each legislator is, in effect, seeking net transfers to his or her district. Similar problems also arise in trade policy, where legislators are likely to be voices for protection for constituents. This produces clear collective action dilemmas and perverse incentives. For example, legislators will always prefer projects that are larger than their optimal scale, or which involve returns to numerous districts regardless of the efficiency of fragmented production. Similarly, legislators may favor free trade "in principle," but fight for particularistic measures which, if generalized, would lead to high levels of overall protection.

These effects will not necessarily hold, however; much depends on various institutional mechanisms of control. Reform will clearly be facilitated in systems capable of generating stable majority governments, but other institutional factors will be of importance as well. There is greater likelihood of executive influence where legislative votes are controlled by the party bureaucracy rather than the legislative leaders, where legislative committees are weak, and where legislative districts are relatively large, forcing the aggregation of more diverse interests. Reform will be more difficult in settings of coalition or minority governments, where legislators have autonomy and party discipline is weak, where committees are powerful and internal legislative politics therefore fragmented, and where legislative districts are small, forcing responsiveness to particularistic interests.

The relationship between the executive and the legislature will clearly have a decisive effect on policy outcomes in new democracies. How much autonomy does the chief executive have over economic policy? A growing literature on Latin America, for example, has noted how stalemates between presidents and legislatures create policy problems (Linz, Lijphart, Valenzuela and Godoy Arcaya 1990). One mechanism for resolving these legislative dilemmas is by delegating authority back to the executive and to politically insulated bureaucratic fora, while maintaining oversight. In the area of macroeconomic policy, these include budgeting offices or more independent central banks that limit the supply of financing (Wooley 1984). In the area of trade policy, similar institutions have developed in the advanced industrial states that have the function of filtering demands from interest groups (D. Nelson 1988).

The area of institutional design is an important one for policy purposes, since there is some room for institutional innovation. Reform is more likely to be sustained where decision-making has been institutionalized in relatively centralized and insulated bureaucracies and agencies, including the central bank, rather than in settings in which bureaucracies have overlapping jurisdictions or are subject to interest group pressures or executive interference.

One important factor in this regard is the extent to which the finance ministry is separate from the planning ministry, and the extent to which the finance ministry has power over the spending requests from the ministries (Lacey 1989). For example, the budgetary process in Korea is tightly controlled by the Economic Planning Board, where as in many developing countries the central government ministries have only minimal control over state-owned enterprises. A second important factor is the extent to which the central bank has some independence from the demands of the chief executive or decentralized agencies. To the extent that such independence is institutionalized, the central bank can act as a crucial counterweight to pressures for fiscal expansion emanating from other parts of the political system.

It is important to recognize that in a democratic setting the bureaucracy is exposed to increased political pressures. It is well known that certain ministries are likely to represent constituent interests (agriculture, industry, transportation, etc.), and can become the locus for rent- and revenue seeking. In this case, the bureaucracy itself becomes the terrain where policy battles are fought. Just as political elites must build broader coalitions of support within the political system as a whole, so those bureaucratic agencies that are leading the reform effort must also construct networks of support; countervailing groups with an interest in sustaining policy reforms.

V. Conclusion: Methodological Caveats and Concrete Suggestions for Research

Just as there are diverse theoretical movements within political economy, so there are a variety of different methodological routes that have been taken as well. Three distinct trends are visible. The first is the attempt to develop formal (ie., mathematical) models of political-economic processes. These efforts grew initially out of the application of microeconomics to political processes, particularly in the study of voting and public choice mechanisms. They blossomed in a variety of directions in the 1980s, in part because of the tremendous renaissance in game theory as a tool for understanding the strategic interactions that are so typical of political life. Among the contributions in this area are increasingly sophisticated models of trade (Nelson 1988) and macroeconomic policy (Alesina 1989).

The second general strand of research is cross-national quantitative analysis. This work may be motivated by the effort to test formal models, or it may be more inductive and eclectic in its design, for example, pursuing correlations between political and economic variables. Among the research in this area are analyses of the effects of democracy, the ideological orientation of parties, or political instability on economic performance (for a review see Haggard, Kaufman, Sharif and Webb 1990).

By far the largest strand of literature is neither rigorously formal nor quantitative, but what might be called "qualitative comparative analysis." This work seeks to understand particular political economy problems through a combination of informal theorizing and comparative analysis of individual or multiple cases. Writing in this area is now vast. Some debates have been spawned by particular regional experiences. Examples include debates about the political economy of import-substitution and export-led growth, built particularly around the East Asia-Latin America comparison, about the political economy of market-oriented reform in socialist economies, and the causes of Africa's prolonged crisis. There is also a growing literature on the political economy of reform more generally, as well as analyses of particular policies and policy reform measures: macroeconomic policy and stabilization, trade and exchange rate policy, agricultural policy, and so forth. Finally, political developments have raised interesting new questions, the most important being the relationship between democratization and political liberalization on the one hand, and economic reform on the other.

I provide this rather sketchy outline of the methodological terrain to underline several important points that AID will have to confront in developing its research priorities in this area. First, it is important to be clear from the outset about the advantages and disadvantages of different research methodologies. The particular ordering of the research agenda that I have offered does not imply a hierarchy of merit; each of these approaches has its advantages and disadvantages. Formal modeling provides rigor, but is often weak and anecdotal on empirical testing. Quantitative analysis helps identify general trends, but at some cost to the integrity of individual case. Qualitative comparative analysis can degenerate into the details of the particular. This third type of work is likely to be of most relevance to AID, but it is important that it be guided by some clear policy purpose and that it be explicitly comparative in nature.

A second methodological observation is that the topic is vast, and therefore a premium must be put on concentrating research efforts on problems that are both tractable and of relevance to AID operations. In general, I think this means avoiding three types of research: country case studies; studies that point in the direction of things we already know; and overly-broad topics such as the relationship between democracy and economic growth.

Each of these dicta deserve further elaboration. Though there are certainly countries that are understudied, there is a growing body of studies that detail individual country experiences. There are many fewer studies that isolate a particular reform and study its political dynamics across countries. Examples that might be of relevance include experiences with removing price subsidies, reforming the civil service, or in establishing and running foreign exchange auctions.

Second, it is important to be aware of a particular style of "political economy" that is typical of a number of economists. This takes the form of extracting policy lessons from particular country experiences without really analyzing systematically the <u>politics</u> of policy choice. Those economic policy lessons on which there is broad consensus do not need to be reiterated through further proof. Few would disagree anymore that growth is more likely when countries pursue stable macroeconomic policies, when key prices--labor, inputs, capital, the exchange rate--are not badly distorted, and when there is a hospitable business climate. What we don't know is why these policies are pursued in one case and not in another. If political economy is to be taken seriously, it should be held distinct from prescriptive economics. Policy prescriptions based on sound economic theory are, of course, crucial to AID's mission, but those form the basis of a different component of the proposed project.

Finally, while there are interesting things to be said about broad relationships, such as those between social structure or democracy and economic performance, they are not necessarily going to be relevant to AID's mission. It is more important to break such broad issues down into questions that will have operational significance. Thus, rather than focusing on democracy and economic development, it might be more meaningful to ask about how an enhanced role for the legislature will affect the making of economic policy.

With these caveats in mind, it seems that three areas of research have the greatest potential. The first is on the tactics of the reform process. Taking reform efforts that have been attempted, it would be useful to see systematically how the timing, scope, and use of compensation has affected the success of reform efforts. A second area of research concerns decision-making institutions. It is a technocratic fallacy to believe that reorganizing lines on an organizational chart will necessarily lead to important policy changes; politicians and constituents are more clever than that. Nonetheless, institutional reform is an area that is of growing importance. It is increasingly clear that sustained economic reform is unlikely without attention to the creation of viable decision-making institutions, and knowledge of what works and what doesn't is in short supply. This still leaves open the substantive focus of research efforts, however, and this is arguably the most important question. Here, however, is precisely where AID should seek to tap its own experience to focus on those policy areas in which it is routinely engaged, whether price policy reform, trade liberalization, or the promotion of small businesses. One possible design for a project would be to choose one or two policy areas, to develop a set of loose, orienting propositions based on the literature, and to survey the experiences of missions in selected countries. This would not only provide valuable information for policymakers, but it would also codify within AID some of the organization's collective memory.

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ANNEX 4

Policies for Broad-Based Growth--
Paper Presented by Gary Fields

- 87

POLICIES FOR BROAD-BASED GROWTH

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I. The Meaning of Broad-Based Growth

A. What is broad-based growth?

The aim of economic development is to raise the standard of living of a country's people, especially its poor. Economic growth, especially when broadly-based, is a means to that end.

I define "underdevelopment" to be a state of severely constrained choices. When one is choosing from among an undesirable set of alternatives, the outcome will itself be undesirable. Standards of living will be low. If standards of living are to be enhanced, people must have a better set of alternatives from which to choose.

I define "economic development" as the process by which the constraints on choices are relaxed. Based on ample evidence from microeconomic studies (see, for instance, the Nobel Prize-winning research of T.W. Schultz, 1980), we may be confident that when poor people in the developing world have better options from which to choose, the choices they make will lead them to enjoy better outcomes, hence rising standards of living. Accordingly, the task of economic development is to enhance the alternatives from which to choose, i.e., the "choice set."

"Broad-based growth" means that the choice set is improved for all economic strata. We have good reason to expect that the upper and middle classes have many mechanisms at their disposal for benefiting from the growth process. These groups gain when economic growth takes place. The open question is whether the poor also are reached.

The case can be made that the poor deserve special attention from development analysts and policy-makers, because they (the poor) have (or may be presumed to have) the greatest needs and hence the highest marginal utility of income. This justifies the so-called "focus axiom," which suggests that we focus our attention on the poor (e.g., Sen, 1976).

One philosophical school of thought holds that the proper goal of a society is to maximize the well-being of the worst-off person. This criterion, called the "maximin principle," has been developed fully by John Rawls (1971). Maximin adherents would accept gains for others, especially the rich, only to the extent that such gains raise the well-being of the least well-off members of society.

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The development community supports the concentration of development efforts on the poor. AID is guided by the Foreign Assistance Act of 1975, which specifies that development assistance is to be used to "help the poor toward a better life." The World Bank has now come out strongly in favor of focusing economic development efforts on the reduction of poverty (World Development Report 1990). Some developing country governments (e.g., the government of India) have made anti-poverty efforts the centerpiece of their development plans.

For political economy reasons, societies do not actually maximize the well-being of their worst-off members. In practice, the programs which benefit the poor must offer substantial enough benefits to the non-poor so that they (the non-poor) will support these programs, both financially and politically. These political economy considerations imply that even if the policy-makers themselves wish to mount pro-poor programs, there will inevitably be a certain amount of benefit accruing to the non-poor.

In this connection, the late Arthur Okun (1975) suggested the metaphor of a leaky bucket. The bucket carries benefits directed toward target groups. Inevitably, there will be a certain amount of leakage, and others will thereby gain. Okun asked, how leaky must the leaky bucket be before it's not worth carrying the water?

The points raised by the maximin principle, the focus axiom, and the leaky bucket metaphor turn traditional development economics on its head. Rather than pursuing economic growth for its own sake and hoping that the benefits will be spread widely enough that the poor derive some gain, these alternative approaches favor directing development efforts toward the poor. In the absence of such directed efforts, it might be expected that the benefits of growth might be so narrowly-based that the have-nots may be excluded from the growth process or even, in some circumstances, impoverished by it.

In sum, I would conclude that "broad-based growth" means raising standards of living at all socioeconomic levels. As things are, the middle and upper strata probably do not need much help -- they will benefit if growth takes place. It is the least well-off in society who require special attention. Therefore, "broad-based growth" is best operationalized to mean that development efforts are targeted on raising the standards of living of the poor.

B. What distributional pattern is it reasonable to look for?

Development analysts customarily measure standards of living in terms of household consumption or income. Ideally, these measures would include the value of goods and services provided or subsidized by the public sector (e.g., government housing, food, health care, education), by employers (e.g., living accommodations for workers, on-the-job meals), and by others (e.g., NGOs). In practice, though, the information at our disposal is often limited to cash income or expenditures only.

Suppose that we have such information on income or consumption for two or more points in time during which economic growth has taken place. By what criterion might we gauge how broadly-based are the benefits of such growth?

One criterion is to see whether an economy has registered gains in real incomes or consumption for all groups. If this takes place, we would observe higher real incomes in all income quantiles (e.g., deciles or quintiles) and lower absolute poverty as measured by the poverty headcount ratio, the Sen index, or the P-alpha class.

The criterion of absolute gains for each group, and hence falling absolute poverty, is a weak one. One reason for this is that although groups as a whole gain, there may be losses for certain individuals or households within those groups. Another reason that this is a weak criterion is that if we find that there have been some gains for all groups, this does not tell us whether particular target groups have benefited a lot or a little.

The criterion for broad-based growth might be made more stringent by looking to see whether standards of living have been raised for all individuals or households. This, however, is probably too stringent a criterion: it is hard to imagine an economy in which there are only winners. Someone invariably loses. At issue are the numbers and characteristics of those in each category. Looking on balance at winners and losers is more fruitful.

One way of doing this is to see whether an economy has achieved equiproportionate gains for all groups (in proportion to their original economic positions). A stricter criterion is to ascertain whether those with greatest need received disproportionate gains. By the first of these criteria, growth would be judged to be broad-based if inequality were constant (because then each group would have benefited proportionately). By the second criterion, we would require that inequality fall (because only then will the poor have benefited more than proportionately).

Two workable criteria may be used to help determine if growth has been broad-based. The first is to determine if real incomes have risen and absolute poverty fallen. The second is to determine whether income inequality has increased, decreased, or remained unchanged.

Let us now examine the empirical evidence using these criteria.

II. Countries' Experiences with Poverty and Inequality

This section examines how poverty and inequality have changed in various developing countries' experiences. One would think that these subjects are central to assessing the extent of economic development and that statistical offices of development agencies would regularly publish such information. Alas, such data are not regularly published anywhere: there is no place we can turn and find data on changes in poverty and inequality over time. The development agencies' irresponsibility in neglecting to collect and disseminate such information is quite extraordinary.

In the absence of such a data base, I compiled my own. Countries are included in my data base if they meet the following criteria:

(i) The data on income or expenditure must be derived from an actual household survey or census.

(ii) The surveys must be comparable over time.

(iii) The surveys must be national in coverage.

(iv) The data must be presented in enough categories so that reasonable calculations of poverty and inequality can be made.

The data themselves are presented in Fields (1989b). An updated and expanded collection of data for Latin American countries appears in Fields (1990).

The findings on changes in poverty and inequality over time have been published in Fields (1989a) and will appear in expanded form in Fields (forthcoming). The results are summarized here.

A. How has poverty changed over time?

To be in "poverty" means to experience a low living standard. "Absolute poverty" means that the living standard is absolutely low, given the standards of the particular society in which one lives. In practice, a person or household falling below a specified income/expenditure amount is said to be "poor".

Poverty lines are set very differently in different countries. In India, the poverty line was set in a scientific way. The caloric and nutrient values of various foods consumed by the poor were measured. The cost of an adequate diet was then figured. To this was added the cost of shelter, clothing, and other basic necessities of life. Separate poverty lines were set for urban and rural India, reflecting differences in the cost of the basic market basket of goods. Each year, these poverty lines are increased in proportion to changes in consumer prices. Thus, the poverty line changes in nominal terms but is constant in real terms.

In Brazil, there is no poverty line. However, Brazilian income distributions are regularly published as multiples of the minimum wage (and the largest number of recipients are in the category "less than one minimum wage"). Althought the Brazilian minimum wage is a convenient reference point, it has no scientific basis. It is determined by the Brazilian Congress in light of political considerations. (The U.S. minimum wage is determined in the same way.) So in the absence of a scientifically-determined poverty line for Brazil, the most practical thing to do is to define poverty relative to a reference year's minimum wage, adjusting that figure upward for inflation so that the poverty line used is constant in real terms.

Having defined a poverty line and determined whether a given individual or household is or is not poor, the next step is to determine how much poverty there is. The simplest poverty measure is the percentage of recipient units below the poverty threshold. This is called the "poverty headcount ratio." It would also be desirable to measure two other aspects of economic deprivation: the extent to which the incomes of the poor fall below the poverty line (termed the "average income shortfall") and the extent of income inequality among the poor (as measured, say, by the Gini coefficient). Sen's poverty index and the P_a class include all three of these aspects. However, the available tabulations for developing countries do not report these measures or the additional data needed to calculate them, so we are forced to rely on the poverty headcount ratio alone.

When we look at the data on changes in incomes over time, we find that nearly always, aggregate economic growth has raised real incomes of individuals and households and thereby lowered absolute poverty. The probability that poverty falls is a function of the economic growth rate: the higher the economic growth rate, the more likely poverty is to have fallen.

We find too that in most instances where poverty has risen, aggregate economic growth has been very small or even negative. This was true, for instance, of India in the 1960s and of Jamaica in the 1970's. It is also true of many Latin American countries in the 1980's. There, because of severe economic crises, which in some cases are still ongoing, poverty rates were no lower at the end of the 1980s than they were at the beginning. Indeed, in terms of absolute poverty, the 1980s were a lost decade for Latin America. The same is thought to be true of many African countries as well, but because these countries lack household surveys for the beginning of the decade, this conjecture cannot be confirmed rigoroously.

Generally, when poverty increased, it was the absence of economic growth. But, in the outstanding exception, poverty rose despite a growth of real GDP of more than five percent a year. The most straightforward explanation -- crony capitalism -- may well be the right one.

The implication of these findings is that more twoth can be expected to help all income groups including the poor. The poor have benefited absolutely

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when growth has taken place, even when that growth was based on a very unequal initial distribution of income. Of course, some kinds of economic growth would undoubtedly be more beneficial for the poor than than others. When it is possible to stimulate such kinds of broad-based growth, this should indeed be done.

Some claim that in the absence of fundamental change, the poor will be rendered poorer by economic growth, and for this reason it is better not to grow at all. This claim is not supported by the bulk of the evidence. In countries such as Brazil and Mexico, growth on the existing economic base has been better for the poor than no growth. Whenever possible, the first-best kinds of broad-based growth policies should be sought. But when political realities render the first-best unattainable, the second-best will probably still be to grow.

B. How has inequality changed over time?

Another criterion for determining whether growth is broad-based or not is the change in relative income inequality. Studying "inequality" means that we are comparing one group's income change relative to another's or to the average in an economy as a whole. When the comparison is made on the basis of income ratios (rather than income differences), the comparison is one of "relative inequality." Most often, income is the basis for such comparisons, though sometimes expenditures are used instead.

Ever since Simon Kuznets' pathbreaking work on economic growth and income inequality in 1955, relative income inequality measures have been the basis for comparisons. The most commonly-used relative inequality measures are the income shares of particular quantile groups and Gini coefficients.

Kuznets himself and many others who followed used cross-sectional data to derive empirical inferences about the supposed relationship between inequality and economic growth. It was well-understood that this was not the ideal methodology -- looking over time within individual countries' development experiences would clearly have been better -- but with the data then available, this could not be done. One investigator whose empirical work was extremely influential, Montek Ahluwalia, was quite explicit about this:

> The use of cross country data for the analysis of what are essentially dynamic processes raises a number of familiar problems. Ideally, such proceses should be examined in an explicitly historical context for particular countries. Unfortunately, time series data on the distribution of income, over any substantial period, are simply not available for most developing countries. For the present, therefore, empirical investigation in this field must perforce draw heavily on cross country experience. (Ahluwalia, 1976, p. 307)

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Kuznets suggested, and a long series of cross-section studies seemed to confirm, that inequality tends to increase in the early stages of economic growth and to decrease in the later stages; see Fields (1980, pp. 59-77) for a review of this literature. But intertemporal studies of individual countries revealed no pronounced tendency one way or the other; see Ahluwalia, Carter, and Chenery (1979, pp. 466-468), Fields (1980, pp. 77-98), and the references therein.

In Fields (1989a, forthcoming), I have summed up the available evidence on changes in inequality over time, using the Gini coefficient as the inequality measure. As with the choice of the poverty headcount ratio to measure poverty, the choice of the Gini coefficient is on purely practical grounds: many countries publish Gini coefficients but not other inequality measures.

Taking the criteria discussed in Section I.B, we might ask: How broad-based is economic growth? Are the gains for the poor sufficiently large that the Gini coefficient falls? Do the poor benefit equiproportionately from economic growth, thus keeping the Gini coefficient unchanged? Or do the poor benefit less than the non-poor, so that the Gini coefficient increases?

The evidence is decisively indecisive: although inequality changes with economic growth, there is <u>no</u> pattern to the observed changes. I tested four hypotheses, with the following results:

> Hypothesis 1: Inequality tends to fall with economic growth.
> Result: This is not true, but the opposite hypothesis is not correct either. I find that inequality increases in half the countries' growth experiences and decreases in the other half.
>
> Hypothesis 2: Inequality tends to increase in the early stages of economic development and to decrease in the latter stages.
> Result: This hypothesis also is refuted. Inequality rises as often in the lower-income developing countries as it does in the higher-income developing countries.
>
> Hypothesis 3: Inequality is more likely to increase in fast-growing developing economies than in slow-growing ones.
> Result: Again, the evidence fails to confirm the hypothesis. Instead, we find that the rates are the same: inequality rises with the same frequency in the fast-growing developing economies as in the slow-growing ones.
>
> Hypothesis 4: A more unequal initial distribution of income leads to a faster subsequent rate of economic growth.

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Result: False again. The initial inequality in the distribution of income has nothing to do with the subsequent rate of economic growth.

These results establish that there is no empirical tendency whatsoever in the inequality-development relationship. If inequality does not tend to increase before it decreases, to fall with economic growth (or to rise either), or to change systematically with the rate of economic growth, it must be that it is not the rate of economic growth but rather the type of economic growth that determines the extent to which the poor share in the growth process.

Furthermore, even when inequality has changed, the changes have nearly always been small in magnitude. The observed changes are so small that countries maintain their original rankings. Thus, Brazil remains a high inequality country, Costa Rica a middle inequality country, and Taiwan a low inequality country, notwithstanding changes in inequality within each.

A more suitable generalization on how inequality changes with economic growth is this: In the absence of fundamental change in a country, relative income inequality tends to change very little. Each group shares in economic growth about in proportion to its original income position. In Brazil, this means that the poorest 20% will get about 2 1/2% of the benefits of growth and the richest 10% about 46%.

This has the following policy implication: If the poor are to receive a larger share of the benefits of growth, major reforms are needed. Absent these, the poor will share in economic growth, but only proportionately. Income disparities on the order of forty to one between the richest 10% and poorest 20% will be perpetuated.

Broader-based growth is possible. Reforms which increase the shares of the poor need not slow the rate of growth in the aggregate, but they will mean slower growth for the non-poor. This is as far as economics can take us. Politics is the determining factor.

C. Further research needs

There is more to be learned about how poverty and inequality have changed in various countries' growth experiences. Surveys are being conducted in more and more countries. These additional countries' experiences need to be incorporated into our data base. In addition, newer data are becoming available for many countries which already are included. It is a matter of someone sitting down and processing the latest available information.

We cannot make informed judgments about the policies affecting broad-based growth until we have the maximum possible data on how broadly-based growth has been.

III. What Types of Growth Have Been Most Broadly-Based?

For economic growth to have broad-based effects, there must be mechanisms for transmitting gains throughout the economy and especially to the poor. The single most important asset of the poor is their labor. It follows that economic growth can reach the poor if it increases the demand for their labor, increases the demand for the products of their labor, or provides complementary inputs with which to make the poor's labor more productive.

The most outstanding examples of broad-based economic improvements are the Newly-Industrializing Economies (NIE's) of East Asia (Hong Kong, Korea, Singapore, and Taiwan). In this section, I shall emphasize their experiences and the lessons I feel can be learned from them, drawing on the writings of many writers (e.g., Krueger, 1981; Krause, 1985; Bradford, 1986; Scitovsky, 1986; Ranis, 1989; Amsden, 1990).

In a short paper such as this, space does not permit analysis of more than a few of the major factors determining how conducive various types of growth have been to broad-based economic participation. The first points discussed in this section relate to labor returns directly. These include the labor-intensity of growth and the distribution of productive assets, especially land and education. The section continues to discuss two aspects of the economic environment which have proved central to determining how broadly-based economic growth is: the interrelation between government regulation and private enterprise and countries' trade and industrialization strategies.

A. Labor-intensity of growth

Because developing economies are labor-abundant and because labor is the chief asset of the poor, it stands to reason that economic growth of a labor-intensive character would not only be efficient relative to capital-intensive development but it would also benefit the poor more than would capital-intensive growth. Yet, there are those who argue that the pursuit of labor-intensive growth leads to a dialectical contradiction: that the very act of stimulating labor demand raises wages and/or generates labor shortages, choking off the very growth it was designed to stimulate.

The strongest counter-argument is the experience of the East Asian NIE's. In Hong Kong and Singapore, Korea and Taiwan, as firms expanded output, they also expanded their demand for labor. Labor-intensive growth first succeeded in leading to full-employment in previously labor-abundant economies. When an additional supply of labor was no longer forthcoming at prevailing wage rates, firms that wished to expand output and employment further were forced to raise wages in order to attract sufficient labor. They

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could have decided not to pay the higher wages, not to increase employment, and hence not grow, and indeed some firms made exactly this choice, textile producers being perhaps the best-known example. But so many other firms were willing to pay the higher costs that real labor earnings increased year after year in industry upon industry. Wages throughout these economies rose apace with economic growth as a whole. Unemployment rates of just one or two percent prevailed for decades.

The tightening of labor markets has another advantage: prejudicial behavior becomes increasingly costly for employers. In the Far East, an important group of beneficiaries from tight labor markets was women, whose job opportunities expanded greatly. Women have yet to attain economic and social equality with men in that part of the world, but the gap is narrowing.

Once their labor surpluses dried up, economies in the Far East successfully changed to a more capital-intensive type of economic development. One research question is how these changes were effectuated.

Another question is how best to create more and better jobs. Real wages have plummeted in many countries and yet employment has increased little. This suggests that developing countries may have little scope for increasing employment through wage-cutting. It may be that a better way is to increase production and hence shift the derived demand for labor. I return to this theme in subsection D below.

B. The distribution of productive assets: education

The last subsection concentrated on the quantity of labor demanded in the labor market. Equally important is the quality of the labor process, i.e., what skills the worker brings to the labor market and what inputs he or she has to work with. This subsection deals with the education, the next with land.

Education makes people more productive. Notwithstanding arguments about credentialism, screening, low quality, and inappropriate curricula, there can be no doubt that genuine human capital formation takes place in schools in developing countries.

Due to scarcity of resources, education in the developing world is neither universal nor free. Typically, the education ministry has a certain agreed-upon budget, to be divided between various levels and qualities of educational inputs. More of one type of education necessarily means less of another.

How should education dollars best be spent? The efficient allocation of resources would be the one that yields the highest social benefit per dollar spent. Typically, the social cost of a year of higher education is many times that of a year of primary education. Cost ratios of twenty, thirty, or forty to one are not uncommon. One college graduate is probably not twenty, thirty, or forty times as valuable to the society as one primary school graduate. So on efficiency grounds, resources would best be allocated to primary education. The egalitarian allocation of resources would be the one with the most equal possible outcome. Spending the marginal educational dollars on twenty, thirty, or forty children who would otherwise be unschooled rather than on one person who already has a relatively high level of schooling would be preferable on equity grounds.

This illustrates that in allocating resources to education, there may be no tradeoff between efficiency and equity: spending the marginal educational dollars on primary education rather than higher education may add more to the productive capacity of workers in the economy and spread the benefits of economic growth more widely.

More research is needed on the empirical effects of educational expansion. We need to know more about how labor markets adjust when more workers are educated. What kinds of jobs do the graduates get? How much more productive are they in those jobs with education than they or others might have been without the education? What happens to the less-educated persons who are displaced by the better-educated? What kinds of jobs do they get? After taking account of the possible reallocation of the labor force among jobs and the changes in productivity in each, how much is output enhanced when the labor force is better-educated?

C. The distribution of productive assets: land

Above, in discussing the alloction of educational resources, I suggested that there may be no tradeoff between equity and efficiency. The same may be true of land. After labor, land is the next most important asset of people in developing countries. In the early post World War II period, both Korea and Taiwan had major land reforms. Singapore and Hong Kong, being city states, faced no significant inequality of land ownership. Thus, in all four of the East Asian NIE's, the post-war economic development was based on an egalitarian foundation.

An initially egalitarian distribution of land and other assets has three principal advantages. One is the direct effect of the assets in generating incomes, hence spreading the benefits of growth to those at the bottom of the economic scale. Second, ample research shows that small farms have higher yields per acre. Thus, on efficiency grounds, the presumption is that a more equal distribution of land would raise total agricultural productivity. The third advantage is political. Landed oligarchies can be extraordinarily powerful, often channeling public decisions toward their own personal gain rather than toward the larger social interest. It may well be because of the land reforms that the influence of landed oligarchies was much more limited in Korea and Taiwan than it was (and is) in the Philippines or Brazil.

Land reform is a valuable ingredient in helping achieve broad-based growth. Such reforms should be sought and supported when possible. But when it is not possible to equalize the distribution of productive assets, growth may still be beneficial.

D. Government regulation and private enterprise

There are two kinds of governments: those that mean well and those that don't. There are also two kinds of private enterprises: those that behave decently and those that will do whatever it takes to maximize the returns from their activities.

Well-meaning governments often regulate their economies in the hopes of effecting better outcomes. At times, these regulations offer genuine protection against abuses that would otherwise occur. The question is how to strike the right balance between the legitimate interests of workers to earn fair wages and work in decent conditions, consumers to receive fair value for price paid, and businesses to earn profits.

To illustrate how such a balance might be struck, let us consider the regulation of labor markets. Most developing countries have abundant labor relative to other factors of production. When economic growth has not been labor-intensive, it has often been because of efforts to legislate higher returns to labor. Among the mechanisms for doing this are minimum wages, encouragement of unions' wage bargaining efforts, public sector employment creation at above-market wages, and ambitious labor codes.

These efforts, though well-intentioned, ignore the fact that higher wages for workers mean higher labor costs for employers, thus creating an incentive for firms to economize on the use of labor by not employing as many people. Some firms respond by substituting capital in place of labor. Others cut back on their output levels, using less of both capital and labor to produce less output. Others use less of one country's labor by moving offshore and hiring workers elsewhere.

Premature wage increases have predictable side-effects. I think it is no accident that the forces leading to premature wage increases have been largely absent from the East Asian economies, which not only have achieved rapid economic growth but also rapidly-rising real earnings. The labor market policies conducive to broad-based improvements in labor market rewards are those that pull the poor along when the economy grows, not those that push wages and working conditions up in the hope that the rest of the economy will somehow absorb these increases.

I am not arguing for a completely unregulated labor market. Far from it. Essential freedoms must be guaranteed and decent treatment assured. Labor markets must be regulated to prevent abusive practices. No person should have to endure such abuses as slavery, indentured servitude, restrictions on freedom of association or on collective bargaining, the unknowing exposure of workers to unsafe or unhealthy working conditions, or the employment of children for long work hours simply because they are cheaper to hire than adults, and no country should knowingly permit such abuses.

As a working rule, I would suggest asking a very simple question: Is a particular way of doing things a socially-acceptable procedure for undertaking economic activity? If the answer is no, as it is for slavery, for example, then that procedure is properly outlawed. But when the procedure is not inherently objectionable, the creative energies of the various participants may best be harnessed in a well-functioning market.

Research is needed to determine when regulations have impeded desirable private enterprise adjustments and, equally importantly, when regulations have prevented private enterprise from engaging in socially undesirable actions. Regulations in labor markets would be a good place to start.

E. Trade and industrialization strategies

I have become convinced by empirical evidence that outward-oriented trade and industrialization strategies are better than inward-looking strategies, not only for raising the rate of aggregate economic growth but also for achieving more broad-based economic growth. The most spectacular economic growth successes of the post-World War II period have been in East Asia: Japan, Hong Kong, Singapore, Korea, and Taiwan. These economies have low to moderate levels of inequality by international standards. They have all maintained essentially full employment and rapidly rising real wages. Poverty has fallen rapidly. And all achieved their successes through export-led growth.

The value of being able to sell profitably in foreign markets can hardly be questioned. Exporting is good for the export firms, for their suppliers, and for their workers. To be able to sell profitably in world markets means that the home-produced good is comparable in quality and price to the best foreign products (otherwise foreign buyers would buy elsewhere), and this means that domestic consumers also benefit. Using additional labor to produce for export brings about heightened competition in these countries' labor markets, thus spreading the benefits to workers in all parts of the economy, including nonexportables and agriculture.

In the previous paragraph, I listed some of the benefits of exporting profitably. The word "profitable" is the key. I am mystified as to why some countries insist on exporting unprofitably. (Yes, I know that flying the national flag on a jumbo jet is a source of national pride, but isn't there a better way for man not to live by bread alone?) Sociocultural factors aside, the only economically defensible reason to export unprofitably is as an investment in profitable activities for the future. Such investments might be warranted, at least temporarily, in order to learn by doing, to set up a marketing network, or to establish a reputation for quality.

As has now become clear, the East Asian NIE's did not follow identical trade and industrialization strategies. What the East Asian economies did share, though, was a belief that they could achieve broad-based growth by producing for the world market. Judging by the record, they were quite right.

One reason the East Asian NIE's succeeded is that they chose their trade and industrialization policies with careful attention to comparative advantage. Of equal if not greater importance is that those countries adapted their policies when comparative advantage shifted. We need to know more about policy response to changing comparative advantage than we now do.

IV. Policy-Relevant Basic Development Research

I conclude by listing topics which merit high priority for understanding development processes and formulating appropriate development policies, yet may be lost amidst calls for research on other, more directly-applied topics:

1. Determinants of constraints on choices - Basic economics courses teach that individuals make maximizing choices subject to constraints. While we have learned a great deal about the choices individuals make given the constraints they face, we know a great deal less about how the constraints are determined. The "choice set" is the set of opportunities from which choices are made. Choice sets are determined by macroeconomic conditions, public policies and strategies, markets, institutions, and the summation of individual behavior. But how precisely do these factors interact? More work is needed at the level of the market and intermarket analysis -- what some now call the "meso" level.

2. Coping strategies - Over time, choice sets change. Individuals and households cope with these changes and reoptimize. How does behavior change with economic growth and decline? Are the adjustments symmetric, or do individuals and markets respond differently on the downswing than they had on the upswing? When macroeconomic conditions change or when policy reforms are undertaken, which institutional arrangements facilitate smooth adjustments? We need to know much more than we do about coping strategies and their determinants.

3. Labor market functioning - Labor market studies too often consist of descriptive information on rates of unemployment, employment patterns, labor supply, and earnings functions. We know too little about how labor markets

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actually function. How integrated or segmented are various countries' labor markets? What determines the amount of employment in each major sector or segment? What determines earnings levels and earnings changes in various parts of a country's labor market? How do education and labor markets interact? We need more behavioral studies of developing countries' labor markets -- in the best sense of the term, to "get the story right."

4. Informal sector - Uncharacteristically of our profession, we talk a lot about the informal sector without having defined clearly what we mean by it. This term means many things to many people. A clear definition is needed. If the "informal sector" consists of more than one tier, as I think it does, we need to look at each tier separately and ask: Why are people in each part of the informal sector? What are the determinants of incomes in each? How might income opportunities be improved in each? Considering the costs as well as benefits, is the solution to be found within the informal sector or outside of it?

5. Dynamics of growth - After a long hiatus, economists are once again building formal theoretical models of economic growth. These models analyze various "engines of growth" including technological change, human capital formation, quality upgrading, new product development, cost reductions, research and development, and international trade. Including these factors in formal models is a most welcome development. However, as with earlier formal growth models, the new models are emphasizing equilibrium growth paths, whereas the evolution of economies when they are out of equilibrium is of much more interest to development economists and policy makers. We need to adapt these new models to the study of non-steady state growth dynamics. We also need empirical case studies, including both successful instances of market penetration (e.g., textiles, electronics) and non-successes. The insights from these case studies should then be used to guide further theoretical modeling efforts.

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ANNEX 5

Broad-Based Growth: Concepts and Processes--
Paper Presented by Henry Bruton

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BROAD-BASED GROWTH
CONCEPTS AND PROCESSES

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Introduction

The purpose of this paper is to discuss several aspects of the notion of broad based growth and to identify and examine a variety of hypotheses as to its origins and the mechanism by which it continues. The paper is intended to review the literature and to suggest arguments and models and hypotheses that seem to be especially fruitful and worthy of further discussion. The objective is not to build a new model and explore it in detail. Data are referred to as we go along, but there is no formal testing or gathering of new data.

The paper has six parts. The first summarizes and then discusses in some detail what I have called the stylized facts of broad based growth, which may also be called indigenous development. The second section discusses in more detail the role of productivity growth, the principal building block of broad based growth. Special attention is given to the social capacity of countries to find and utilize increasingly productive production and distribution techniques and procedures. In this same section I discuss briefly a specific approach that has some merit of its own and that illustrates a variety of the issues that are inherent in the broad based growth notion. In the third section I comment on what contemporary "orthodoxy" tells us about broad based growth and how it -- orthodoxy -- differs from the arguments of the first two sections. In the fourth section I am concerned briefly with the role of government and institutions, and in the fifth with the role of foreign aid. These sections are brief and are intended to illustrate ideas and hypotheses, rather than develop general propositions.

Throughout I note areas of ignorance and incomplete understanding. These areas are obviously ones where more, much more research is called for. It seemed useful to summarize these in the last section.

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Those countries that presently have a very high GDP per capita are, with a few exceptions, rich because over the past 100 to 250 years their GDP has grown at fairly modest rates in a stable, more or less uninterrupted fashion.[1] There have been some starts and stops, downturns and depressions of course, but, in general, the West is rich because it has grown slowly, but regularly, year after year after year. This suggests that

[1]The oil rich countries are the exceptions, but these countries, Saudi Arabia, United Arab Emirates, Kuwait, etc. are not developed countries. They are countries that happen to have an extremely valuable mineral.

growth of output and per capita output was and is built in to these economies. The growth occurred as a consequence of the routine functioning of the economic and social system. Growth is, in this sense, indigenous. The modern less-developed country has not been able to establish the kind of routine functioning that results in output increasing in a regular fashion over extended periods of time. Even where growth has occurred in an impressive way in certain low income countries, it seems to be derivative, seems to be imported, not really indigenous. In general then, we may say that the basic task of development is to so modify the economic and social and political system in such a way that the growth of social welfare (or as we shall say later, of well-being) occurs as a consequence of the routine operation of the economy.

The principal characteristics of such long term, sustained growth may be summarized in the following way. I call them the "stylized facts" of sustained, indigenous growth of welfare. I list them briefly here and then discuss each in more detail.

1. The rate of growth of the productivity of both capital and labor is positive in almost all activities of the economy. Indeed in an economy that is generally growing, if factor productivity in a given activity is very low or negative, that activity will (and should) disappear.[2] So that over a substantial period of time, one should observe no continuing activity that experiences productivity growth that is well below the average.

2. All growing economies have investment rates that are generally ten percent or higher.

3. The labor market works well in two senses: Wage rates do not rise, or do not rise much, in the face of unemployed or underemployed labor, and labor moves fairly readily into sectors where its productivity is rising and out of sectors where it is falling.

4. There is a fairly constant appearance and growth of new, non-traditional exports. This seems a more important consideration in recent years than in the beginnings of growth a century and more ago.

5. The macro conditions are such that the economy does not have to stop or slow down to "correct" a balance of payments or inflation or some other macro problem. It is not a stop and go economy. The way the macro economy functions allows the economy to be pressed hard against its constraints without producing inflation or balance of payments problems.

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[2]Certain activities - the making of music, drama, teaching, painting - are still with us despite the fact that productivity does not (cannot) increase. Thus it took about 100 people an hour to play Beethoven's Fifth Symphony 150 years ago, and it still takes the same number of people the same amount of time to play this music. They survive simply, because people are willing to support them, despite their high costs.

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6. There is a government that can resolve the public choice problems as well as maintain order and harmony, and do its share of the development effort.

7. The growth of output and per capita output that takes place respects, is consistent with, the values, traditions, institutions, culture, etc. of the community. To so respect is necessary in order that well-being, not just measured goods and services, does in fact increase.

8. The growth is indigenous, it is not imported, not borrowed, not created by foreigners.

A brief comment of each of these will help to clarify their meaning and to show why they are essential components of sustained growth. I consider them in the order listed.

1. In recent years there has been a great deal of discussion of the "sources of growth." In this literature the most common approach is to distinguish between the contributions of increased inputs -- usually defined as capital and labor--and the increased productivity of the inputs to the growth of output. This is usually done by assuming a production function that enables one to measure the increased output due to the inputs, and then that growth that is not accounted for by the increased inputs is attributed to enhanced productivity of capital and labor. This latter measure is referred to as total factor productivity growth or TFPG. One of the important findings to emerge from this literature is that productivity growth is an important source of the growth of output. In many instances it accounts for a larger share of output growth than does the growth of inputs.

In general the data lend support to the hypothesis that TFPG is larger and accounts for a larger share of the growth of output in the West (including Japan) than in the developing countries. The evidence is not conclusive. A more clear-cut finding is that both TFPG and TFPG as a percentage of the growth of output vary widely from country to country and, within a country, from one time interval to another. This latter statement applies both to GDP and to the individual sectors that make up GDP. The data also make clear that those developing countries that are generally looked upon as successful -- Korea and Taiwan in particular--have rates of growth of productivity and shares of productivity growth of output growth that are much higher than the average for the less-developed countries in general and that compare with those in the Western countries. On the other hand, those countries generally looked upon as not doing very well have low, and in some cases negative, rates of growth of the productivity of their capital and labor. The attached tables (taken directly from Chenery, et al., 1986, p. 21-23) show all this reasonably clearly.

This evidence is surely one of the basic facts of development: productivity must rise regularly if an economy is to continue to grow. The other generalization that it is necessary to include is this: our understanding of how productivity does in fact rise is extremely primitive. Some observers would go further and say that we know virtually nothing about how to create an economy where productivity growth takes place as a regular feature of the operation of the economy. I discuss in later sections some hypotheses about why productivity grows. The fact of the substantial variance in all the productivity growth series is evidence that there is a lot to explain.[3]

2. In the growth models and theorizing of the 1950s and 1960s capital formation played the role of the prime mover and major source of growth. Many policies were designed and implemented that reflected this assumed role of capital formation. It was noted that the most immediate difference between the economies of the rich and the poor was that the amount of capital (physical and human) per worker in the former countries was vastly greater than in the latter. Therefore, the way to overcome underdevelopment was to achieve a very high rate of investment.[4] Saving and investment rates were the key policy variables, and many policies were designed specifically to encourage investment. Many of those policies, it may be noted, are now looked upon as sources of damaging distortions.

This strategic role of capital formation must, in light of recent research, be qualified to a significant degree. Capital formation's role remains important, but it does not now seem to be the principal Primum Mobile, the principal source of moving the system. Rather, capital formation is a means of implementing certain policies and of creating certain kinds of commodities.

That capital formation cannot be a continuing source of growth can be seen by noting that without productivity growth, rates of return on investment would surely fall in almost all countries. Our evidence is not complete, but we can say with great confidence that if the rate of growth of capital exceeds that of labor so that the capital/labor ratio rises over long periods of time, then the productivity of capital will fall and so will its rate of return unless productivity changes. Put differently, the capital/output ratio will rise, and thereby drive down the rate of return. (If the capital/output ratio rises, while the share of output accruing to capital remains constant, then the rate of return falls.) The rising ICOR will also drive up the cost of investment. In this event, the only way that capital formation will continue is for the government to carry it out directly or to subsidize it in some way or other. Something like this seems

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[3]It is important to appreciate that the measures of productivity growth, especially TFPG, are open to many questions and many doubts. The fact that the results all tell about the same story however supports the view that the ideas stated in the text are valid. For further discussion of these issues, see Chenery, et al. (1986), Ahluwalia (1985), and Kim and Park (1985). There are, of course, many other books and articles on the subject.

[4]A famous statement of Arthur Lewis (1955, p. 225) reflects this point of view: "The central problem in the theory of economic growth is to understand the process by which a community is converted from being a 5 percent to a 12 percent saver - with all the changes in attitudes, in institutions and in techniques which accompany this conversion." The world read the first part of this sentence, but, in general, ignored the part after the dash.

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to have happened in India in the 1960s and 1970s. In this period TFPG in India was often negative, while labor productivity growth continued positive. The latter was positive because the capital labor ratio rose steadily and capital productivity declined. Rates of return must have fallen and thereby made some sort of continuing subsidy to investment necessary if investment were to continue. (See Ahluwalia, 1985, for further elaboration.)

All this is, however, not to argue that investment is not important, and indeed the data show a significant relationship between investment rates and growth of GDP. We must also add that our understanding of private investment and of saving rates in developing countries is very limited.

3. The way the labor market functions is especially relevant in an economy where there is widespread underemployment and possibly considerable open unemployment for the achievement and maintenance of high levels of employment and for getting the largest output possible from available resources. The evidence is quite convincing that rising real wage rates dampen the rate of growth of the demand for labor and lead to a capital intensity that is incompatible with factor supplies. Of equal importance, is the fact that a labor market that does not perform well -- does not meet the two conditions stated earlier -- adds to the problems associated with the alleviation of poverty. Employment is necessary to profit from on the job learning, a major source (we argue later) of increased productivity. We will argue later also that jobs and on the job learning for all members of the labor force is an essential condition for the sustained growth of well-being. For this to happen the labor markets need to work very much along the lines defined by the two conditions: no wage increases in the presence of unemployment or underemployment and a considerable mobility of labor toward activities where productivity is rising. Taiwan and Korea and other success stories (Malaysia, for example) have been characterized by this kind of labor market.

One further point may be made explicit here. Rising productivity with wage rates constant will increase the demand for labor, unless there is a problem on the demand for the product side. If the productivity of labor rises while wage rates are constant (because there is unemployment) then evidently it is profitable to hire more labor, to hire more labor until the added employment pushes the productivity of labor back down to the unchanged wage rate. If there is a demand for the product problem because of the small size of the domestic market, the best answer is to export. This is another reason why it is advantageous to be entering new export markets at all times.

So it is important how labor markets work and it is important to appreciate that we are not very clear on how they do in fact work in the developing countries. The evidence is convincing that labor does respond to wage and incentives with considerable speed. Therefore much depends on the wage setting mechanisms in the various countries, and on this less is known. We also need to understand more clearly than now how the labor market arrangements contribute to productivity growth, to the evolution of new technologies, etc. and other matters that move the economy.

4. The growth of non-traditional exports is an end, a means, and a piece of evidence. It is evidence that the economy is becoming increasingly flexible and increasingly capable of creating and exploiting new opportunities. It is evidence of what Charles Kindleberger has taught to identify as the "transformation capacity" of the economy. This notion refers to the capacity of the economy to move resources into new activities quickly and with little reduction in the productivity of resources. With very low transformation capacity, heavy dependence on foreign trade is especially risky. In such a case a fall in demand for its major export will impose great costs on the economy because it takes so long to find new activities of similar or near similar levels of productivity. One may say that until transformation capacity is great, some form of protection may be appropriate. More generally, one may say that exploiting comparative advantage implies that a country is able to shift resources very quickly and easily into and out of activities.

The growth of non-traditional exports is a means of increasing productivity. Again the process is not completely clear, but the empirical evidence is quite impressive. Exporting, primarily of new products, does seem to be a source of increasing productivity. The main hypothesis supporting this evidence is that producers learn and import knowledge in the process of exporting and trying to satisfy foreign buyers.

It is important to make explicit that the argument is <u>not</u> that the country must export in order to import the physical capital deemed necessary for development. This is the argument of the 1950s and 1960s, and is now, I am suggesting, misleading and incomplete.

5. The macro conditions for the long term sustained growth are such that the economy does not have to be stopped or slowed to "correct" any general macro policy, the most common of which are inflation and a balance of payments problem. There are several reasons to put the argument in these terms rather than in the more specific terms of balance of payments equilibrium and price level stability. Most obviously, price level stability and balance of payments equilibrium are not themselves ends or objectives. One must argue that they are necessary conditions for development. The main conclusion one gets from an examination of the evidence, however, is that these conditions are not themselves sufficient conditions for development. In particular, putting too much attention on preventing inflation and balance of payments difficulties as such will divert attention from the basic objective, increasing the productivity of domestic resources. At the same time it is appropriate to emphasize that a stop/go kind of situation does have negative effects on productivity growth. Long periods of more or less uninterrupted growth at high levels of employment seem to be positively related to productivity growth. The basic macro objective, therefore, is to try to ensure that this is in fact the case.

The other macro condition is a bit different. For several reasons it is advantageous to be able to push the economy hard, i.e. to create a macro environment where the economy is pressing hard against general supply constraints. This condition has major advantages for both the employment objectives and for the productivity growth objective. To achieve this situation, it must be possible to push the economy hard, but not to generate too much inflation or balance of payments collapse. Thus the macro objective is to create the kind of environment that allows this. Again one must report that the macro economics for developing countries (or any other kind of country) is not in very good shape. A suggestion is made later for one particular approach to the problem.

6. The public choice task is of course difficult in all countries, even in those ruled firmly by a small group of people. There are two layers of problems. The first refers to the basic issue of choice itself at the individual level. Traditional economic theory begins with the assumption that all actors know their preference maps for all levels of income and all prices. This is a dubious assumption at best, but it is especially inappropriate in a developing country. In a country in which per capita income has long been stagnant and opportunities to experience new products, new services, new ideas have essentially been non-existent, choice making capacity is very limited. Almost everyone must learn what they want, learn what their preferences are, and, in the best of worlds, search for those preferences that contribute most effectively to well-being. The question of choice, I regard, as a major unresolved issue in development economics. To put the question a bit differently: What is the real objective of development?

The other layer of the public choice issue is that of adding up individual choice in some way or other to get a decision on matters that affect the general social and cultural milieu in which members of society live. We know that there can be no formal "right" solution to this issue, and that any decision is to some extent and in some way arbitrary. This is true in a fully democratic society as well as in a dictatorship. The government or society must decide about a whole range of exceedingly complex issues, and do so in a way that does not lead to general chaos. The issues involved range from rather narrow matters (taxes, import policy, etc.) to enormously complex matters that go the very sources of meaning and value and life styles, on family life, the role of women in the economy, extent of urbanization, ethnicity, language, etc. etc. In many countries where the economy is performing reasonably well, we have observed unrest, even upheaval. The main reason for this, I suggest, is that a public choice mechanism that everyone is willing to accept is not in place. Such a mechanism must be learned, and learning it is part of development.

7. That the economic system functions in a larger social milieu is recognized by everyone. At the same time, we often seem to ignore this interdependence between the performance of the economy and the impact of that performance on the rest of the society. To do this in any country is dangerous, but it is especially dangerous in the context of development where, as just noted, deeply established social characteristics are frequently being challenged and undermined by the way the economy is changing. This argument rests on the notion that there is no such thing as economic welfare or, as I prefer, well-being, rather well-being is well-being. There are economic sources of well-being, but there are many other sources as well. Thus if the quantity of goods and services increases, but that increase results in (e.g.) traditional family and other social arrangements being undermined, then well-being may in fact fall. Thus, sustainable increases in output and in well-being require that such increases be consistent with the accepted practices of the community. "Consistent with" does not mean that the general

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social environment cannot or should not change. Rather it means that the changes must be acceptable, must occur at a rate that is compatible with what is recognized as acceptable. So we are back to public choice again. Iran seems to be a good example of a development effort that foundered badly on this very point. Perhaps China in its effort to liberalize its economy also found itself trying to do that which it was not ready to do. So, that, no matter how much one would have liked for the liberalization effort to succeed, there was actually little chance that it could.

The stylized facts that I have listed and elaborated upon are those of indigenous development. Indigenous development may be contrasted with development viewed as "displacement." Most of development economics has, in fact, concerned itself with displacement. The most established of all development models, the dual economy, surplus labor model originated by Arthur Lewis and elaborated upon by John Fei and Gustav Ranis and others, is essentially a displacement model. In this model there is, at the outset, a very small modern sector and large traditional sector. Development is completed when the modern sector encompasses the entire economy. Development in this context means the displacement of existing activities, identified as traditional, by imported ones. The latter are deemed so unambiguously superior to the former that no explicit justification is usually recognized as needed. It is assumed, implicitly in most cases, that the traditionalism is really a vacuum into which modern Western activities can move virtually unimpeded. Such a displacement process is greatly facilitated by imports and by domestic activities that replace imports, and import capacity became the key to the success of the effort.[5]

The basic assumption of this paper is that the ideas and arguments developed above define an approach to development that is not displacement, but is concerned with generating change in the traditional sector itself. The basic question of development is, in fact, how to get the traditional sector to begin to move. This approach I have called indigenous development. The argument is that a country must find its own way, rather than simply trying to imitate the West. It is also what seems to me to be the meaning of Broad Based Development, development from within the country, development that builds from the traditions and history and social arrangements that are its own. This kind of thinking about development does not mean isolation and autarchy, it does mean that the developing country must find ways to learn from the West without being dominated by the West and without trying simply to imitate the West. It also means that the frequently used notion of "catching up" is not a helpful concept, but indeed tends to lead one's thinking down the wrong route.

The following sections try to examine these ideas in more detail and with more attention to policy.

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[5]The contrast between indigenous development and displacement is becoming increasingly common in economics. It has for a long period been made in the anthropological and sociological literature. Further elaboration of the notion may be found in Bruton (1985) and in the literature cited there.

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The first basic question is how to transform the developing economy into one in which productivity growth is occurring regularly and without significant interruption over a wide range of activities. Recent empirical evidence suggests the following observations, but we must always keep in mind that the evidence is far from being conclusive.

a. Productivity levels between the West (including Japan) and the less developed countries are not converging. They are among the Western countries. It would seem, therefore, that there is no mechanism generally at work that brings about a convergence of productivity levels of the less developed countries with those in the West.[6]

b. There appears little relationship between investment in physical capital and productivity growth. Note that the data refer to investment in physical capital, and do not include education and research outlays. In the language often used, there appears little evidence that productivity growth is embodied in new physical capital. There is, as noted above, some relationship between physical capital formation and growth of GDP.[7]

c. Saving and investment rates within a country are closely related. This result means that the international flow of capital is apparently less than the frequently referred to world capital markets would lead one to expect. (Some data suggest that the relationship between domestic saving and domestic investment is closer now than in the late 19th century, when, presumably, capital markets were less complete and worked less well.) It is, therefore, inappropriate to depend on such movements as a reliable instrument of development. This finding (open to a number of questions) is closely related to the failure of productivity levels to converge. If the productivity of capital in the less-developed world approached that in the West, then, given the relative amounts of capital in the two areas, <u>all</u> investment should take place in the developing world. It does not. Put a bit differently, since everyone agrees that the developing countries have much less capital per unit of labor, average and marginal products of capital should be many times higher.[8] Surely under these circumstances private investment would rush

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[6]Data gathered by William Baumol (1986) first called explicit attention to this point. Others have added to it more recently. See especially Abramovitz (1988).

[7]Nicholas Stern (1989) has a good brief discussion on this and some references to available data.

[8]Joseph Stiglitz, p. 142, in Chenery and Srinivasan (1988) has an example that shows that the marginal product of capital would be 10,000 times higher in the capital poor country. The assumptions are extreme, but they illustrate the point in the text.

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into these countries in very large amounts. All this means that, for the most part, the developing countries must do their own investing.[9]

d. There is no real evidence of the effectiveness of R & D institutions in raising productivity. In general, I think, that conventional wisdom is that they have had very little effect, except in particular instances. The evolution of the higher yielding varieties of seeds is perhaps the most widely noted example of exceptional success, but there are others as well. The relationship between formal schooling and productivity growth is also ambiguous. Many observers now argue that higher education is yielding relatively small returns and that too much investment in university education has, in fact, taken place, and that further investment in this kind of activity will add little to productivity.

e. Finally, one should mention the role of foreign investment as a possible source of the productivity growth. The evidence on this possible source is also very slight. It is evident, of course, that the productivity of both capital and labor in multinational enterprises in the developing countries is generally higher than it is in domestic firms. There are major measurement problems, but this seems to be a safe generalization. The real issue, however, is the extent to which the presence of the foreign firms contribute to raising the productivity of the domestic firms and of domestic resources in general. There are some isolated examples of this occurring, but no general, systematic evidence to support the view that it is commonly the case nor to provide clues as to how it can be brought about.[10]

So then how to proceed to set in motion a process that will result in the more or less regular growth of productivity?

The fact that productivity levels between the West and the developing countries are not converging, while they are among the Western countries is especially important. To the extent that technical and administrative knowledge is a public good (as assumed by much of economic theory) <u>and</u> is the basic determinant of the level of resource productivity <u>and</u> that access to this knowledge is more or less the same for all countries, a catching up should always be in process. It is not for the less-developed countries, while it is for countries of the West. The argument for why there should be a catching up follows from the assumption, generally acceptable, that it is easier and cheaper for firms to acquire and apply existing technical knowledge than it is for the lead country to develop the new knowledge. Thus catching up with the leader should always be underway. There are many reasons why a particular country might not be able to catch

[9]The foreign debt problem in many countries illustrate this argument further. Of course there are many reasons for the debt problem, but one important one is that the productivity of the loans was very low.

[10]Richard Caves (1982) and Raymond Vernon (1977) have useful general discussions of this issue. There are also more recent sources. See for example Casson and Pearce (1987).

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up, but the generality of non-catching up suggests that there may be a more pervasive, more fundamental explanation.

Moses Abramovitz (1988) and many other (e.g. Easterlin, 1981) noted that the countries where convergence is most clear cut are all, save Japan, Western European countries or countries that were settle largely by Europeans. The growth of GDP and of productivity that has been observed in these countries has been consistent with, has emerged as part of, the social and institutional structure of Europe. The frequently employed term "modern economic growth," suggested first by Kuznets, refers essentially to a process or phenomenon that is part of this larger social evolution of European civilization. Abramovitz goes on to argue that the catching up process in its pure form can refer only to technological backwardness. There are, however, other aspects of the society that may help to account for the low productivity and the inability to exploit the more productive technology that in some sense exists, and prevents the catching up. Abramovitz then refers to the "social capability" of the lagging nations. The exact content of this latter term is not clear, but the notion seems quite helpful. The main idea of the notion is, I think, that the members of the community genuinely believe that it is possible, by their own efforts to improve their well-being. Given that this notion exists, efforts will be made to search and learn how to bring about such improvements. (See Bruton in Chenery and Srinivasan, 1989, for further elaboration.)

How then to do this? Evidently such a thing has to be learned. If we look back at the discussion of the basic characteristics of indigenous or Broad Based Growth, it would seem that the main underlying theme there is that there must be considerable learning, largely learning by doing, by experiencing, by searching. Albert Hirschman (1958) and others have argued that one of the strategic characteristics of an economy that has long been stagnant and where mass poverty has long prevailed is the prevalence of the view that improved well-being is simply not possible. Then, the argument continues, a change that leads to the widespread belief that things can be better constitutes a major source of dynamism, a great inducement to search and to learn. This, it seems to me, is the fundamental reasons, the fundamental rationale for indigenous growth--the population must see that it is possible for them, by their own efforts, to grow, rather than simply to rely on what the West will hand them or allow them to have. This is what induces the search and learning and efforts to improve that can in fact create indigenous growth.

One of the ideas that I want to suggest as a means of creating a sort of social capacity includes that of protection. It is now common to condemn protection -- and especially import substitution -- but it seems evident that those countries that have done well in recent decades have also engaged in some form of protection and indeed continue to do so.[11] Protection gives a country more learning time, more time to react

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[11]Numerous publications of the World Bank make this argument in great detail. See, for example, the World Development Report of 1987 for an extended discussion.

It is also useful to note that those countries that developed in the 18th and 19th centuries enjoyed considerable natural protection.

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and choose, than would be the case without any protection. The notion of learning time is helpful, and has been discussed in a number of contexts.[12] It must be recognized that protection has created many problems for many developing countries. The great question then is how to gain the advantages of protection without being so penalized by it that the economy cannot respond. Two characteristics seem especially important: the protection must somehow encourage exporting, and secondly, must induce efforts to find ways to increase output and productivity, in contrast to enjoying the luxury of a protected monopoly.

A Specific Approach

The ideas developed above may be given more concreteness by a brief discussion of a specific approach to protection that creates some of the incentives and helps to create the learning time and learning environment that is deemed necessary. The purpose of this discussion is to help make clear the nature and content of indigenous development (and, I believe, Broad Based Growth). It is not to urge this particular approach as such, although I do think the approach has considerable merit.

The approach centers around what has become identified as "exchange rate protection."[13] The basic idea is that an undervalued exchange provides essentially non-distorting protection by making imports costly,[14] facilitates exporting, and makes it profitable to search for ways to increase productivity. An undervalued exchange rate that makes exporting very profitable and makes imports costly combined with little or no foreign investment, creates opportunities for profit that should, in most instances, elicit major efforts to exploit. The absence of any (or much) foreign investment, means that the community is on its own to find ways to take advantage of the opportunities. The undervaluation will mean, in many cases, that new non-traditional exports can be found, and, as argued above, this can be an important method of importing new technical knowledge, new knowledge that is directly relevant to the productive process or to new processes that are understood by members of the community. The greater variety of output also is an advantage in creating more opportunities for learning and for experimenting, a process that contributes to the emergence of increasing transformation capacity.

The exchange rate protection can also make a contribution to the task of learning to choose. Too much openness makes such learning very difficult as economic agents -- consumers and producers -- find themselves involved with products and services about

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[12]On learning time one should read historians, who seem to like the idea better than do economists. Hartwell (1977) and Wrigley (1988) are helpful, as are many others.

[13]The notion was originally developed by W.M. Corden (1985, Chapter 7). See also Sebastian Edwards (1988, 1989) and Bruton (1989).

[14]The undervalued exchange rate does discriminate in favor of tradables, but this does not seem to be a major source of distortion.

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which they know virtually nothing. Choice of consumer goods or of technologies in such a case puts demands on the individual that can rarely be met with much understanding and insight. There is, of course, a great deal of evidence of importing the "wrong" technologies, and evidence is accumulating that suggests that the people in the developing world often choose consumption goods that are based largely on imitation of the West. The result is disappointment, even when measured incomes are rising, and so the well-being that rising incomes would allow may not be realized, (Hirschman 1982).

The undervalued exchange rate protection can create another major advantage. Since undervaluation makes exporting very profitable, a balance of payments problem is unlikely to emerge even if the economy is pushed very hard. Thus it becomes possible to follow a more expansionist policy that keeps demand for labor strong. With a strongly undervalued exchange rate then there is a great and evident inducement to search for ways to increase productivity and thereby increase the demand for labor -- if the labor market works well.[15]

The existence of an undervalued exchange rate results in an accumulation of foreign exchange, almost by definition. Exports must exceed imports. To achieve this, domestic absorption must be below domestic output, i.e. private saving plus taxes must exceed domestic investment plus government spending. In most instances this means that the government must have a significant budget surplus, not the most frequently observed event in the developing world. The most convincing argument that this requirement does not mean that the whole idea is completely unrealistic is that its achievement is conceptually simple. If basically all the government does is to maintain the surplus through its taxes and spending policies, the achievement should not be beyond possibility. It is certainly not a more demanding assignment than many other duties that have been assumed possible for a government.

The other condition necessary for the undervalued exchange rate to work is that the West must be ready and willing to import everything that the developing countries can export competitively -- given the favored exchange rate. This issue is discussed in the last section of the paper when I examine the role of foreign aid.

The empirical evidence to support the argument for the undervalued exchange rate is, of course, open to all kinds of question and doubt. The nearest example of a clear cut case of a country pursuing such a policy is Taiwan. Taiwan has accumulated foreign exchange almost without interruption for many years, and has accumulated enormous amounts of foreign exchange reserves, (Li, 1988). While there are many factors that account for Taiwan's great success, there is a lot of evidence to support the view that this unambiguous undervaluation had many of the effects outlined above as following from such undervaluation. There is no doubt at all that the exchange rate

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[15]There is the important question of whether it is possible, even with active searching, to find new products and processes. I have argued in Bruton (1987) that there is considerable underutilized knowledge in many less developed countries. See Also Robert Chambers (1983).

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policy followed in Taiwan provided a great deal of protection, and that the domestic economy responded well to this protection.

There are other countries where the evidence supports the view that the exchange rate probably was undervalued for a time and the economy responded well. Colombia in the 1970s and Brazil at various times, maybe Korea and Japan, also in certain years, but it requires very careful analysis to nail down the case in a convincing way. The best general evidence is to be found in the work of Sebastian Edwards. Edwards is not concerned with the argument as presented here, but he does offer some evidence that supports this argument. In his Exchange Rate Misalignment in Developing Countries, data (p. 44/45) show a strong negative relationship between extent of misalignment and rate of growth of GDP. On the other hand the greater the undervaluation, the higher the rate of growth of GDP. Evidently, much more work is called for, and a good research effort would be to try to examine the relation between growth of productivity and the extent of undervaluation. The basic hypothesis is that high marginal costs (due to the undervaluation) in the presence of very favorable profit (domestic and export) opportunities will induce the search and learning that produces increased productivity. A corollary hypothesis is this: R and D activities are likely to be more productive when they occur in response to specific requests, specific questions. So that a situation in which supply is pressing hard against a constraint encourages the identification of specific bottlenecks that R and D may help to break. A final hypothesis that merits great attention may be stated in the following way: There is a significantly positive relationship between non-traditional exports and productivity growth, and the undervaluation encourages non-traditional exports.

One further point is of direct interest. Why should a country where the vast majority of the population is heartbreakingly poor have an export surplus? The answer is that the export surplus is an investment, an investment, whose return is in the form of increased learning, learning to increase productivity, learning to enhance the transformation capacity, learning to make good choices, learning to hold one's own in the world. If the argument holds, it is an investment with a very high rate of return. The rate of return is in the form of generating an economy in which the routine operation produces rising well-being.

III

The general approach just outlined has not been worked into a formal theory of development, nor is it widely recognized as a specific approach to development. There is, however, much in the literature that supports such an approach and many bits and pieces of evidence that bear on it. In the context of indigenous (or Broad Based Growth) it is even more convincing. One should not fail to emphasize, however, that the evidence in its favor is far from complete, and open to many questions. The strategy defined by exchange rate protection is even less widely recognized, and has been discussed very little in the literature. In light of these possible doubts and questions, it is appropriate to examine somewhat more briefly what might be identified as a more

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orthodox, and certainly more frequently defined, approach to development. Much of the studies of the World Bank, the IMF, and many academicians push this view.

After the theory of development built on the assumption that capital formation was the sole significant source of growth began to fade, attention turned to a more conventional approach (the neo-classical resurgence) in which allocation and efficiency (in contrast to productivity growth) and so, relative prices, received prime attention. The first questions about the capital model arose as it became increasingly clear that the neglect of relative prices was creating distortions that penalized the economy even as investment took place. In many instances the misleading prices were created by policies that were based on their presumed effects on investment. Thus low (often negative) interest rates, overvalued exchange rates combined with high tariffs and quotas on consumer goods, highly subsidized technical education, etc., all came into being largely in response to the argument that they would induce high rates of investment which in turn was the source of growth. As evidence accumulated that this was not working in the anticipated fashion, many economists turned attention to the importance of preventing the distortions by relying much more heavily on the market and trying to ensure that prices did in fact reflect relative scarcities. Thus the idea that to "get prices right" was an essential condition for development emerged. It is useful to note that this idea appeared largely in consequence of the observed difficulties that were appearing in those countries that had distorted so severely in an effort to get the rate of investment up. Along with "right prices" the necessary conditions included balance of payments equilibrium and price level stability. Consumer subsidies were often blamed for the absence of either or both of these conditions.

The sources of growth in this argument are investment in physical capital, in education, and in R and D. A great deal of attention was (and is), therefore, given to ways of calculating the rates of return on various investment projects and various categories of investment. Great confidence is placed on the accuracy of these estimates. Also great attention has been given to what the correct prices really are. Correct prices and price level stability it was argued, would facilitate the evaluation of investment proposals. As it became evident that a major characteristic of Taiwan and Korea was remarkable rates of growth of exports, exporting was added as an essential condition, and "outward looking" in contrast to import substitution or "inward looking" development strategy was strongly emphasized. The identification of why exports are important is not very clear in these arguments except in terms of keeping the balance of payments strong.[16]

The argument, for the most part, encourages private foreign investment. Such investment will add to the overall investment in an important way, will help create employment, and add to the technological capacity of the country. Finally, the argument places heavy emphasis on reliance on the market mechanism to solve essentially all

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[16]The argument that productivity growth is linked to exports is, as already noted, an important argument. For solid empirical evidence see the paper by Nishimizu and Robinson in Chenery et al. (1986).

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economic and social problems. There is to be no planning, no public ownership of firms, minimum public employment, and more or less free trade. Privatizing of public enterprises became a frequently advocated policy.

While there are a number of similarities between the approach just summarized, and that identified earlier as an indigenous approach, there are fundamental differences. The more orthodox approach clearly looks upon development as displacement, as creating in the less-developed countries replicas of the West. No attention is given to institutions, values, culture, religion, etc. as themselves major sources of well-being. Attention is focussed entirely on GDP. Unsatisfactory growth rates are blamed in this approach on "wrong" policies. It gives little or no attention to the more basic characteristics that define modern underdevelopment -- incomplete markets, inexperienced governments, colonial heritage, institutions designed to make poverty bearable, but that impede growth, pervasive views that change is either impossible or harmful, etc. It assumes that the economies are already flexible enough that they can respond quickly to all market signals. In a very fundamental way it assumes that no learning is necessary, or at least it is not the key notion around which to build. Finally it surely implies a much too simple view of the role of government. It is not sufficiently informative to say simply that complete reliance should be placed on the market or that there is government failure as much as market failure. The division of labor between the private and public sector is one of the very fundamental things that has to be learned on the job. I undertake a few comments on this large issue later.

One of the basic points of what I have called the more orthodox approach has to do with the openness of the economy. The rationale of the advantages of openness are, as noted above, not very well spelled out in the literature.[17] Countries which have achieved high rates of growth of exports seem to have done well and countries where exports have faltered have, in most instances, done less well or very poorly. The emphasis on indigenous growth (and thereby on Broad Based Growth) points up three important qualifications to this argument.

The first refers to the international context in which the export booming economies have prospered. In the period from 1950-1975 world trade grew decidedly faster than world output, and in general much faster, absolutely and relative to output, than it has grown at any previous time for which data are readily available. That fact plus the much less impressive developments in the 1980s suggests that the quarter century, 1950-75, is something of an exception. It is exceptional in large part because, as several people have argued,[18] it was a catching up period after the long interval from

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[17]The finest discussion of this new orthodoxy is I.M.D. Little (1982). Little, in effect, denies that there is any such thing as development economics. There is just micro economics. See also the paper by Jagdish Bhagwati in Carbo, et al. (1987).

[18]Angus Maddison has discussed this point in several places and has accumulated data that supports the argument. See especially Maddison (1987 and 1989), and Streeten (1982).

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the outbreak of World War I to the end of the 1940s during which world trade was severely penalized by all the upheavals that took place over those years. One may argue then that the difficulties of the 1980s show some signs of a return to lower growth rates of both trade and output. In this event it will be much more difficult for developing countries to repeat (or continue) what Korea and Taiwan (and Japan) have done in recent decades. In particular, it will be decidedly difficult for all developing countries to achieve exceptionally high growth rates of exports. There are many reasons to believe that this hypothesis is nearly enough valid to warrant very careful attention.[19]

The second point is to call attention again to the role of transformation capacity in international trade. There is some discussion in the literature about a dynamic theory of trade or a dynamic comparative costs theory. Such theories that exist are not very satisfactory. It would seem that the most useful notion of a dynamic theory of international trade refers to transformation capacity. A high degree of transformation capacity means that a country can, as noted above, shift quickly and easily from one activity to another as world demand and technology change. If a country cannot do that, then international trade carries a high risk. When one reads that the health of e.g. Ghana depends on the world price of cocoa, that must mean that Ghana has very low transformation capacity. Many, surely most, developing countries are in this category. Thus one of the principal aims of policy is to create the transformation capacity that enables a country to participate in world trade without undue risk. This argument is a bit different from the diversification argument. Diversification will probably keep the country from profiting fully from world trade. Rather the ultimate objective is to create an economy that can profit from trade without being unduly penalized with the inevitable shifts in world demand and supply conditions. Too much openness can prevent this kind of transformation from emerging. The kind of protection provided by the undervalued exchange rate (and possibly other instruments) is intended to create this transformation capacity. The questions of how much and what kind of openness in a developing country are important questions on which our understanding remains very primitive. Modern orthodoxy seems to assume that there is no problem in this regard.[20]

The third issue to emphasize that distinguishes the indigenous approach from what we have identified as orthodoxy refers to the importance of recognizing the role of basic community characteristics. We have noted this above in some detail, and need only to add one or two points here. The basic notion of course is that many of the institutions and traditions of the developing countries are themselves important sources of well-being, and their destruction in the name of more GDP can result in a net reduction in well-being. This fact, and it surely is a fact, means that great weight must be placed on the capacity of the country and of the members of the community to make accurate choices as to what it is that will in fact enhance well-being. This issue is

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[19]Trade should always grow somewhat faster than output if the relative cost of transportation falls.

[20]This argument is a kind of structural argument. The new orthodoxy denies that structuralism of any sort has any validity. See Little 1982.

perhaps the most clear cut example of where imitation and displacement can lead to great problems, rather than solving them. The societies of Japan and Korea are very well-organized and strongly established, and so could withstand exposure to the West without simply succumbing. Most of the societies of developing countries are not in this situation, and need time and opportunity to reflect on what it is that they really want from development. This point also means that foreign investment and foreign aid need to be thought through very carefully before doors are open wide.

IV

The role of the government may be commented on briefly. While everyone recognizes that in any country a government has important roles to play, the new orthodoxy places an important emphasis on the enhancement of the role of the market. As already noted, this emphasis in many cases makes a great deal of sense. It is also important to appreciate that, while market failure is a reason for the government to take a direct role in the economy, it is also necessary to appreciate that there can be significant government failure as well. Just because there is market failure does not mean that the government can correct those failures. So one of the questions that must be addressed is what should the division of labor be between the government and the private sector. The answer depends very much on country circumstances -- including history, culture, social organization, life styles, etc. -- and is sure to vary from one country to another and within a country over time.

The indigenous (Broad Based Growth) accepts this complexity. It recognizes in particular that it takes a strong government to maintain a hands off posture, because all governments are subject to a great deal of pressure and lobbying. Thus just because a government is weak and inexperienced does not mean that it should or can avoid taking an active role in the economy. One must then be prepared to examine a country situation and determine as specifically as possible what activities can be done by each. Such a position does not deny that, in most instances, the private sector is likely to be more efficient and more directly concerned with finding ways to increase productivity.[21]

It is useful to mention consumer subsidies in particular because they have been so frequently criticized by the new orthodoxy. Such subsidies have prevailed in many countries, but perhaps those in Sri Lanka have attracted most attention. The evidence suggests two things about the Sri Lankan rice (and other) subsidies that are relevant to the present analysis. In the first place, in the Sri Lanka of the 1950s and 1960s it is fairly clear that no government could have gained power -- or remained in power -- had it not gone along with the subsidy arrangements. Voting in Sri Lanka in these decades was quite honest and virtually the whole electorate voted, and there is little doubt that

[21]A good general, and somewhat philosophical, discussion of the role of the State in economic matters is a new book by Phyllis Deane (1989). A useful collection of papers on the subject is Helm (1989). See especially the articles by Sen, Dasgupta, Grey, and Skidelsky.

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the people wanted subsidies. The second point is that there is also little doubt that the subsidy system in these years kept many people from being hungry and malnourished. The difficulties arose because the government violated the requirement that overall macro stability be maintained. It seems fairly clear in the case of Sri Lanka that growth of GDP was of secondary importance relative to maintaining a traditional lifestyle that included everyone having enough rice. Similar arguments apply to many other countries, but, one must always note, consumer subsidies have also been abused.

Much of the analysis of the problems that governments face has been attributed to rent seeking activity, and, it is often implied, that this activity would not be present in an economy where the market has full range and that it (rent seeking) is necessarily harmful.[22] There are many examples where such is the case, and there are many examples where it is not the case. In particular, it is important to argue that a loyal, honest, committed bureaucracy cannot be created over night. Such must emerge, must evolve. How to be a good bureaucrat must be learned. More fundamentally, the idea of a good bureaucracy must be learned. When tasks well beyond the capacity and experience of a government are given it, problems will surely arise. The question is how to bring into being such a bureaucracy. One major part of the answer is to allow the government to work with problems that are within its understanding and experience, and that do not create major issues that are so different from its experience that it is helpless on how to proceed.

One other point may be mentioned in the present context, that having to do with institutions. Since the theory of institutions is essentially non-existent, an illustration is the best way to make the argument. In Robert Bates (1989) analysis of Kenya's agricultural sector, the government intervened significantly because there was no market or only very incomplete ones. It was deemed cheaper and more efficient to monitor and control inputs into production than to try to establish a market that revealed information about quality and other matters of the outputs. These non-market mechanisms were institutions of one kind or another, and once established took on a life of their own. With a life of their own they not only influenced the policy makers, but are relevant in determining the environment within which the economy operates. Robert Bates (1989, p. 150) concludes his analysis of the Kenya story by saying,

> The new development economics stresses the significance of markets. To secure economic objectives, it holds, the allocation of resources is best left to market forces. And yet we have repeatedly been compelled to draw a basic lesson from the Kenyan experience: that <u>nonmarket</u> institutions are organized to promote <u>economic</u> objectives. A major source of Kenya's agrarian prosperity, we have found, has been the structure of its agrarian institutions. Bureaucracies and organizations do not necessarily stand in opposition to

[22] A formal review of rent seeking is Brooks and Heijdra (1989).

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markets. Rather they are often put in place in an effort to underpin and to unleash market forces.

Bates and others have forced us to consider the role that institutions, including government institutions, play in determining how an economy can perform, and can be influenced. If we are to understand indigenous growth we must understand institutions, including government, because few things are more indigenous than institutions.[23]

V

I would like now to conclude with a very brief discussion of some ideas for foreign aid that seem to follow from the general approach discussed above as indigenous development.[24] The purpose here, in large part, is to illustrate the basic ideas of indigenous and Broad Based Growth developed in the previous sections rather than to push any particular policy. At the same time I do think that the specific proposals merit a great deal of attention.

Indigenous development is essentially a process of learning, so the idea is to use aid to help to create an environment in which searching and learning take place. When an economy is pressed hard the most likely problem is that the balance of payments will deteriorate. To prevent this problem, I have suggested that the local currency should be undervalued. I noted above that the undervaluation of domestic currency creates widespread opportunities for import replacement and new exports without completely eliminating foreign competition. The new opportunities will also be "near" existing techniques, and therefore conducive to learning as well as to increasing employment and output. Protection in this manner does not distort to any significant degree, nor would it result in the creation of large scale white elephants, and helps to create transformation capacity. I also argued above that transformation capacity is a necessary condition to profit from foreign trade.

What can the United States or any foreign country do to help this process along? There are several possibilities that may be noted, to discuss them helps to make clearer the general arguments.

a. The donor must be willing to import any and everything that the developing country can export at competitive prices, given its exchange rate. Where such imports harm activities in the United States, aid funds may be used to facilitate or

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[23]The role of institutions in development is an important topic on which research is beginning to accelerate. In addition to the Bates book, see Van Arkadie (1989) and World Development, September 1989. This issue of World Development is concerned with the role of institutions in development. The contributions by D.C. North and by V. W. Ruttan are especially useful.

[24]The discussion in this section draws heavily on Bruton (forthcoming).

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ease their shift into new activities. The exact way that this can be done is not completely clear, but the general point is: use foreign aid funds to remove obstacles to importing into the United States.[25] This is different from giving imports from less developed countries preferences. There would be no such preferences. The only advantage the developing country would have would be the undervalued domestic currency that would make exporting unusually profitable.

b. The added incentive to export provided by the undervalued exchange rate should create inducements in the developing country to search for ways to enter export markets. The economic agents in the developing country have an incentive to seek out information, data, plans of present and potential importers. Aid may be used to cover costs that an importer may have in working with an exporter from the developing country. The initiative however -- and this is crucial -- must come from the exporter.

c. Investment in new activities, even more than in familiar ones, is an uncertain activity. Aid may be used to provide some form of insurance against failure. The insurance must not be provided free, but could be provided at a subsidized price. There would be an educational and publicizing task, but this should be left to the agency providing the insurance.

d. It has been argued that there is underutilized knowledge available in the less developed country, that is knowledge that could be found by economic agents on their own who engaged in search. This will at some point lead to a blank wall where some more formal, organized help is necessary. Aid may be a means by which such walls are removed or circumvented. This does not mean large scale support for elaborate research institutions, most -- but not all by any means -- of which have not proved effective. What is wanted are organizations that can respond to specific questions identified by economic agents seeking to produce more with given resources. This, for the most part, calls for small operations staffed by people with great practical experience in the activities of the economy, and knowledge of the society, its organizations and institutions, and history (Bruton, 1987).

Jon Sigurdson (1986) makes a similar point with respect to Japan. He writes (pp. 71-72) "...the production plants in Japan do not rely on a specific technology but a system under which production is gradually improved in response to requests by users and in cooperation with machinery makers." Aid used to support these indigenous research activities could make significant contributions to the growth of productivity.

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[25]It is recognized that retraining and similar labor programs for declining industries have not been successful. It does not seem to be beyond human capacity to make them so. Lawrence and Litan (1986) discuss a variety of dislocations that can arise as a consequence of free trade, and offer several practical suggestions on how they (the dislocations) might be dealt with.

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Aid that helps resolve a problem which people have recognized and are willing to confront is always more acceptable than is aid aimed at more general, more distant targets.

e. Aid in the form of technical assistance has a mixed history. There are many examples of individuals who have made extraordinary contributions, but there is also evidence of considerable failure. Foreign technical assistance is most likely to be effective when it arises from a genuine request from a developing country, and when the latter shares significantly in the costs. Such aid should be ended forthwith when it becomes evident that the country is either not committed to its use or not able to use it.

f. Aid may be exceptionally helpful on small scale, very labor intensive infrastructure projects. In rural areas, in particular, there are opportunities to organize labor -- underemployed generally or seasonably idle -- to construct roads, bridges, water control devices, etc. Aid funds can be used simply to pay wages to the workers on such projects. This is essentially a means of providing the liquidity to a government to finance the activities. Such use of aid has the further advantage of providing income to some of the very poorest groups in the country, and involve some learning. These projects will be small, but could be numerous. If they get too big, the organizational problems become unmanageably severe.

g. Aid to facilitate the implementation of policies that are aimed directly at employment creation and productivity growth among low income people can pay off handsomely. Three examples will help illustrate this point.

i. In Egypt the Ministry of Agriculture has detailed data on most farms. The Egyptian government also sets the price for a number of farm products. A policy that rewarded increased yields with higher prices would surely induce search for ways to get yields up year after year. With such a policy the government may need to do very little else to bring about a more dynamic agriculture.

ii. A similar kind of policy may be designed for employment in manufacturing. Tax rate adjustment or a direct subsidy might reward a firm that increased the labor intensity of its operations from year to year. For example a formula such as $W_0 (E_1 - E_0)/\triangle VA$ measures the increase in the share of the increment of value added ($\triangle VA$) due to the increase in employment ($E_1 - E_0$) with no change in wage rates (W_0). Evidently the higher this ratio the greater the employment effects and the greater the reward. Note also that increased productivity with no change in wage rates means that unit labor costs are reduced and this will provide an incentive to hire more labor.

iii. In many developing countries, it is advantageous to keep food prices low in urban areas. This is frequently done in a way that penalizes agriculture, either by taxes or price controls on agricultural products. In certain situations aid may be used to subsidize the food prices in urban areas at the same time that farmers receive high prices for their output. A policy of "buy high, sell low," made

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possible by aid will permit strong incentives for agricultural development and still keep urban prices low.

There are other examples that could be noted but these three make the general point clear. Aid that is used to reward increased yields and increased employment and increased productivity not only helps the low income groups directly, but also contributes to the creation of a tradition of search and learning and trial and error in the community.

h. Where a country runs into an unexpected difficulty for which it cannot be held responsible while pursuing a range of policies that conform to those discussed above, a lump sum loan (possibly a grant) may be made immediately with no limitations on its use and without exhortation or arm twisting.

Evidently there are many more issues which one would have to confront if the approach reviewed above were to be taken seriously. The basic point can be stated simply: the developing countries must themselves create a demand for aid, and the donor countries stand prepared to meet that demand. It is to be noted that there are important examples of foreign aid that has some of the effects outlined here.

There are two general points that follow from these examples. The first is that the indigenous development idea pays little heed to catching-up, and also plays down the notion of international competitiveness. The basic idea of undervaluation is that it provides the protection and the incentives that lead to searching and learning and more effective transformation capacity, the capacity to seize and to create opportunities. It therefore decreases dependence on foreign trade, or, more accurately perhaps, it recognizes that foreign trade is extremely risky until transformation capacity is extensive. It is a means of creating independence and self reliance and increased productivity. It is a means of creating a base, a foundation from which change may proceed in a reasonably untraumatic fashion. This can lead to international competitiveness at "correct" exchange rates at some point for an economy that has allowed the reflective choices of the community to be found and realized.

The second point refers to the possibility that implicitly in this approach we are asking the developing countries to "reinvent the wheel." To some extent this is correct simply because it is the way to learn. Albert Hirschman (1987, p. 24) writes that,

> [H]umans have to reinvent a great many things -- from learning how to walk to the proper use of language -- and this intensive practice in reinvention and re-creation is surely a necessary, although not sufficient, condition for the subsequent generation of genuine creativity. The problem in industrial research and development is not how to minimize reinvention but how to achieve the best possible balance between reinvention and taking advantage of the existing stock of knowledge for the purpose of accelerating both industrialization and creativity.

This Hirschman statement and many of the preceding arguments remind us that development is necessarily a slow process. Get rich quick schemes do not work. The emphasis on searching and learning, on productivity growth, on endogeny and institutions also helps make clear that genuine social and economic change that produces a continuing increase in social welfare is a slow, long term process. Therefore aid is a long term matter, and it is essential to establish it on a solid institutional basis.

VI

Throughout the preceding pages, I have noted where our understanding is incomplete, where our ignorance is especially rampant. There are many such places, and it is helpful to conclude by summarizing the principal areas where more research seems both useful and feasible.

1. Perhaps the key question is why does the productivity of factors increase in specific sectors and in the economy as a whole? There are many hypotheses and an increasing amount of data, but we still have a long way to go in order to say that if policies X Y and Z are pursued, productivity growth will occur. In particular we need to know more about the relationship between exports and productivity growth and the exchange rate and productivity growth. We need to know more about the specific content of "social capacity." I think that all these can best be studied on a country basis, although some cross country work is possible on productivity growth and exports and the exchange rate.

2. Empirical studies of private investment and private saving are needed. Some studies have appeared recently, but we need more, especially of private investment.

3. We need detailed, empirical studies of labor markets in developing countries. How are wage rates determined? Why do they seem to rise even in the face of underemployment? How does the labor market affect productivity growth?

4. Macro economics is of course in bad shape nowadays. But we need to understand more clearly what kind of macro models are most useful in understanding how hard we can push an economy without generating inflations of various kinds or balance of payments problems. The work of Lance Taylor (Chenery and Srinivasan, 1988 and elsewhere) is especially helpful in this area.

5. Private foreign investment is both necessary and dangerous. It is also full of political and emotional issues. Accumulated (and objective) case studies of specific foreign private investment projects could be very helpful.

6. Institutions have begun to attract attention and study. They are important in all countries, but especially so in developing ones. A vast field is here waiting to be explored.

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7. The role of government is complex. Most observers now believe government has not performed very well in many countries, and so greater reliance on the market is in order. This is surely acceptable, but it is only the first step. The government can do many things well and effectively. Studies on the division of labor between the public and private sector could be enlightening. This issue is also fraught with ideology and emotion.

8. Finally, the broad question of how open should an economy be needs study. Outward-looking has many supporters, but it is a vague, empty term unless it is given specific country context. Korea, Japan, Taiwan all had and have many forms of protection, yet are also in the world economy. This is the great issue: to be able to learn from the world without being inundated and defeated by the world, without losing the national identity and culture and traditions on which well being so heavily depends. Part of this problem is that of how to choose, how to decide at both the individual and community level.

There are other possibilities, but this is enough to keep us busy for a while. It is all very exciting.

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ANNEX 6

List of Conference Attendees

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RESEARCH PRIORITIES FOR REFORMS SUPPORTING

BROAD-BASED ECONOMIC GROWTH

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