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An Agenda for the New Development Economics

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Introduction

The seeming disappearance of development economics as a separate discipline some quarter century ago could not have come at a more inopportune time. Some of the criticisms made by mainstream economists of development economics as it was often practiced at the time are valid: for instance, it underestimated the role of markets and rationality. But their argument that developing countries are just like more developed countries, only lacking as much physical (and later, it was emphasized, human) capital and their assumption that competitive equilibrium theorem can be applied in a straightforward way is, if anything, even more misguided. In the last two decades, there has been a growing awareness of the limitations of the competitive paradigm, with its assumptions of perfect information, perfect competition, and complete markets, and with the correlate propositions that distribution and institutions do not matter. Much of the theoretical and empirical work in *developed* countries has focused, for instance, on agency theory (how information imperfections affect firm behavior and labor markets), the new industrial organization (how imperfections of competition affect corporate behavior), finance (viewed as centering on the *information* problems associated with allocating capital and monitoring its usage), and R & D. Yet, in this same period, the reigning paradigm in development economics was the Washington consensus, which ignored these considerations, despite the fact that they are even more important to developing countries.

Empirical work looking at a variety of characteristics of developing countries (including not just growth rates, but volatility of growth, wage and price flexibility, etc) shows that they are markedly different from the more advanced countries *and from each other*. A new development agenda thus must center around (i) identifying and explaining key characteristics of developing countries, and especially those that differentiate them from the more developed countries, and exploring the macro-economic implications, e.g. for growth and stability; (ii) describing the process of *change*, how institutions, including social and political institutions, and economic structures are altered in the process of development. This includes analyzing reform processes: how can those wishing to effect certain changes bring those changes about, and what are the impediments in doing so. It must do so in light of changes in the global economy (not just changes in the movements of trade in goods and services and flows of capital and labor), and then importance of services, including information and communication (the new economy) and the decreasing importance of heavy manufacturing; and changes in thinking about economics and development more broadly (including those cited above). In assessing development programs we need to look not only at impacts on GDP, but also on the environment, poverty, and democracy. We need to look not only at their short run impact but at their sustainability. Today we recognize that social and political contexts are intertwined with more conventional economic analysis: For instance, there are social control mechanisms that prevent the "tragedy of the commons" in many developing countries, and these mechanisms can be eroded by the process of industrialization, with adverse effects on living standards. The failure to pay due attention to these variables in Indonesia led to policies that created social and political turmoil, with long run adverse effects on Indonesia's economy.

Thus, in these new perspectives, development is seen as a transformation of society[1], not just an increase in physical and human capital. One of the challenges of development is the recognition that that transformation requires changes both in ways of thinking and in society's institutions. Such changes cannot be effected overnight, nor forced on countries (though under some circumstances, they have occurred with impressive rapidity). One of the challenges is that in the process of transformation, traditional institutions may be eviscerated, with adverse effects on the functioning of society[2], and the economy.

Thinking about development as a transformation of society naturally encourages one to look at a countries long-run comparative advantages, rather than its current comparative advantage. For example, policies which encourage mining may do little to promote development, defined in this way, and when appropriate account is taken of the environmental degradation and resource depletion, may not even contribute much to current *correctly measured* national output.

A related set of issues concerns macro-instability, both how to reduce its depth and frequency and how to respond to the downturns and crises that seem to occur with such frequency. It is now recognized that many of the Washington consensus policies that were foisted on developing countries, did little to increase economic growth, and may have contributed significantly to economic instability.[3] It is remarkable that virtually no attention was paid (even using the flawed methodology of cross country regressions) to analyze how policies might affect volatility, attenuating automatic stabilizers and accentuating accelerators. Moreover, the manner in which crises were addressed—with little attention paid, for instance, to the impacts on unemployment—exacerbated the weakening of "social capital," with, at least in some countries, adverse effects on long run growth potential. These issues should be among the focal points of the new development agenda.

[1] Stiglitz 1998c
[2] See, for instance (Stiglitz 1997**,** Serageldin 1998)
[3] Easterly, Islam and Stiglitz 1999d

A long-standing issue is what should be the role of government. Much of the neoliberal program compared an ideal market economy with the *average* or *worse* performing states, with the obvious conclusion that, even where there are market failures, there is limited role for government intervention. A more balanced approach attempts to identify the limitations of markets and governments; ask how each can be improved; recognize the gap between "average" and "best practice;" and observe that in some of the most successful economies, government and markets have been complementary. Recent research, for instance, has shown that market failures (e.g. associated with imperfect information, incomplete markets, and limited competition) are far more pervasive than was previously realized, and that there are numerous examples of well-performing public enterprises. At the same time, one has to recognize the numerous examples of failures in the public sector, and attempt to identify which are consequences of inherent limitations in collective action, and which are consequence of practices which could be altered.

Widespread corruption is increasingly recognized as an impediment to the effective working of the state in many countries; but it is also increasingly being recognized that the extent of corruption is endogenous, and affected by economic policies. Some policies (e.g. associated with particular privatization strategies) have encouraged corruption. Some tax structures are more corruption resistant than others. Earlier, we argued that development strategies need to be attentive to how they affect the overall transformation of society. Government (at every level) is a key player in any modern society, and therefore it is important to be attentive to how development strategies affect government.

Each of the arenas of economic activity can be looked at from these perspectives. In some areas, there has already been more progress than others (though not all the advances have been fully integrated into standard policy perspectives.) For instance, there has been significant progress in understanding the institutions of the rural sector[4] (though much remains to be done) and how they affect economic behavior and performance. There is a large literature concerned with the dissemination of knowledge (both concerning production and social knowledge). For more than a quarter century there has been an awareness of the social, political, and economic problems brought about by large migration from the rural to the urban sector. Governments focusing on these concerns (like that of Ethiopia) have asked, what is the experience of rural based industrialization? How can it be promoted? Traditionally, education has been viewed as a "way out, not a way up," in other words, a way out of their rural life, not a way to improve it. Governments are thus asking, how educational systems can be redesigned not only to encourage individuals to remain in the rural sector, but also to be more productive in that sector.

Another area in which these new perspectives appear is in financial and capital market liberalization. The standard neoliberal model, assuming perfect information, promoted such liberalization — but, of course, the key functions of financial and capital markets is the gathering and processing of information to ensure the efficient allocation of resources. There is by now

[4] See for instance Bardhan [1989], Bardhan and Singh [1987], and Braverman, Hoff, and Stiglitz [1993]

strong empirical evidence of the adverse effects of liberalization as it was commonly practiced, just as earlier there was evidence that excessive, or more accurately, misguided government control of financial markets often led to adverse effects. While the events of the last five years have brought home the importance of finance in the economy, and there is a growing recognition that the liberalization agenda pushed by the IMF were counterproductive, there is no well developed theory upon which policy makers wishing to have a nuanced, gradual transition can base their prescription.

To take a third area: the standard models (underlying the Washington consensus) assumed a fixed technology; yet the essence of development is an improvement in technology, a closing of the knowledge gap between developing and more developed countries. Only recently has the World Bank recognized this (e.g. in its 1998 World Development Report)[5] and the implications it has for development strategies (e.g. increased emphasis on technical education and research institutions). Industrial policies, though widely vilified under neo-liberal doctrines, have played an important role in the development of almost all of the successful countries.

The point should be clear: virtually every aspect of economics, from industrial organization to the economics of the rural sector, from tax policy to macro-economics, from trade policy to finance, can be re-examined from these perspectives. The approach to development economies that was often taken in the past was to ask, what changes in the standard model of an industrial economy need to be made in order to adapt it to the situation in developing economies. The standard model that was used was the competitive equilibrium model. Today, the limitations of that model are widely recognized; it provides an inadequate model of developed countries, and therefore a poor starting point for the construction of a model for developing economies. There is no single, overarching model to replace the competitive equilibrium model: the world is too complex. But there are a set of tools and perspectives (such as those that derive from models of imperfect information and incomplete markets) that can be used, and some simple macro-models have been constructed making use of these tools and perspectives.[6] Over the past twenty five years, knowledge has flowed two ways: developed country economies have learned much from developing country models. Agency theory (e.g. sharecropping), screening models, and efficiency wage theory were all developed first in the context of developing countries, though subsequently they have become standard parts of the economics of advanced industrialized economies. This is likely to continue in the future, and a research program for development should encourage it.

I want to conclude by adding a few remarks about *process* as well as substance, about how to promote the new development agenda, ensuring that it more effectively challenges the reigning neoliberal paradigm. The task is not easy: the competitive paradigm is taught in virtually every graduate program in the world. Many of the ingredients in the alternative paradigm are barely mentioned: Few graduate schools in their core courses spend any

[5] World Development Report 1998/1999: Knowledge for Development, Washington, DC, 1998.

[6] There are other important strands that should be emphasized. New models have, for instance, emphasized the importance of multiple equilibria. See, for instance, Hoff and Stiglitz [2000].

significant time on the problems of technological advance or knowledge transfer; and hardly any undergraduate texts devote a chapter to this subject. However, the time for challenging the current reigning paradigm may be ripe, as dissatisfaction with globalization grows, and the spotlight placed on it has highlighted many of its deficiencies.

The question is, how can we *institutionally* facilitate the replacement of the old paradigm with new perspectives? Further development of these perspectives, as outlined earlier in this note, is clearly essential. Without stronger intellectual foundations, one can point out the weaknesses in the neoliberal paradigm, but cannot offer an alternative that is not equally subject to criticism. Greater networking among like-minded economists will strengthen this intellectual foundation. Some networking of this kind is currently taking place, e.g. through projects sponsored by the Ford and MacArthur Foundations[7], but this has yet to reach far into the developing world. Beyond this, achieving more visibility within the leading educational institutions is critical. This requires two things: first, "capturing" graduate students at an early stage, before they have fully "bought into" the neoliberal paradigm. Summer institutes can provide students interested in alternative paradigms with opportunities to become better acquainted with perspectives that they might not normally encounter in their more conventional graduate programs, and help them develop a research program for their PhD. that will further elaborate on the new perspectives, while building a network of supportive intellectual relationships. For this to be effective, these institutes will have to recruit some of the world's leading development scholars. Granting dissertation fellowships and post doctoral support for young scholars working in these areas will also contribute to advancing this new development paradigm.

Secondly, achieving tenure in leading educational institutions requires publications. However, many journals are not as open to alternative perspectives as they should be. The creation of a high quality refereed journal (partly internet based) may help to rectify this problem.[8] Still another part of the strategy of replacing the neo-liberal agenda with an alternative requires more extensively "challenging" both the assumptions and conclusions of the standard paradigm, as well as the appropriateness and effectiveness of the policy doctrines. By exposing more explicitly the incidence of the policies (who benefits, who bears the risk), and by analyzing more explicitly the political economy (who makes the decisions, whose interests do they serve), the legitimacy and credibility of the policies will be undermined, and thereby the support for them.

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