

The Bases of Development Policy

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Development economics seeks to isolate the elemental forces at work in developing countries that raise per capita income, initially *and* then continuously, by exploiting fully the inter-industry and inter-sectoral network of economies of scale, externalities, and complementarities; it also analyses the key factors that decide a fair distribution of the fruits of economic progress, and those which enhance human happiness more directly. The process of economic development is seen as complex, even mysterious; which must be tackled by conscious planning where coordination failures are threatening, and through the market mechanism if information problems are daunting. Yet a persistent theme in economic literature has been one of denial of the (marginal) utility of development economics. Essentially, most of these “arguments” against development economics are nothing more than a thinly disguised championing of the ideology of free-market capitalism and neo-classical economics as the ultimate truths about the economic universe [Heilbroner (1990)]. They are a frame of thought into which development economics would not fit “naturally”. As one would expect, these views about development economics have not gone unchallenged. But the main issue is far from settled. I, therefore, restate here the case for development economics to make sure that development policy is saved from the revages of an incompatible liberalist philosophy. I would concentrate on issues related to the acknowledged mainsprings of economic progress, and those related to the relationship between trade and growth and the interface of the government and the market. Finally, I would like to emphasise the need to acquire an overarching *ethical* vision in order to identify the *ends* of economic progress and to order the *means* to achieve them.

I

I first turn to discuss briefly an area where development economics enjoys a virtual monopoly—namely, in offering an adequate explanation of the nature of the development process and suggesting a viable strategy to achieve a high rate of economic development.

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Author's Note: This is an abridged version of the address given by the former President of the Pakistan Society of Development Economists.

(a) Dimensions of the Process of Development

Development economics identifies four distinct though related dimensions of the process of economic development.

- (i) It seeks to identify the “stylised facts” or the “regularities” of the development process over time and across countries. This analysis is concerned with such matters as physical capital accumulation, industrialisation, and a rising share of international trade; and its main focus is on forces that enlarge the size of the market by large doses of investment to raise the per capita income rapidly—through the Big Push, the Critical Minimum Effort, and the Great Spurt. Human Capital, defined as the accumulation of effort devoted to schooling and training, was added later to this exclusive list of stylised facts. The positive role of total factor productivity (TFP) features prominently in the pioneer-latecomer catching-up sequencing of the development process.
- (ii) A related factor of economic development is the secular change in the sectoral composition of production—which is known as “structural transformation”, and is indicated by the rising share of manufacturing, and by a corresponding decline in the share of agriculture, in total employment, and in the GNP. This can be referred to as the Fundamental Law of Economic Development.
- (iii) Another theme has been to see economic development as a wider phenomenon involving transformation of the structure of demand, trade, production, and employment, together with the accumulation of physical and human capital. Similarly-motivated are the investigations that deal with the effects of economic development on income distribution, unemployment, and poverty; and also those explorations which interpret economic development as one that keeps a dynamic balance between income, life expectancy, and literacy, so that it also fosters “human development”.
- (iv) Yet another important observation about the nature of the development process is based on the development experience of the hi-growth economies (especially those of East Asia). Generalising from the development experiences of 40 developing countries belonging to Asia, Africa, and Latin America, I showed in my last Address, to the 10th Annual General Meeting of our Society, that economic development is characterised by an essentially “orderly transformation” of the fast-developing countries to higher stages of economic development—that, in these countries, the growth of per capita income, macro-economic stability, and distributive justice tend to move together in a reinforcing fashion. Also, the human development indicators register the fastest improvement in such conditions. However, the transformation for slow-growing and medium-growing economies is not so orderly.

(b) Neo-classical Explanations of Economic Development

Of late, the “endogenous growth theory” has sought to extend the neo-classical model to identify the forces that *raise* per capita income indefinitely. In this conceptualisation, technological change is not exogenously given; and there are no diminishing returns to capital. Also, it recognises human capital to be as important as physical capital, especially because it is a key input in the research activity, which eventually leads to greater (private) R&D expenditure and generates new products and ideas that lead to (endogenous) technological progress.

However this theory, which is incorrectly seen by some as having replaced development economics, does no better than reinvent the wheel which then gets stuck in its trained incapacity to handle problems of economic development for the simple reason that it is antiseptically neo-classical: it makes extremely stringent assumptions about international production functions as it assumes a single sector, or that all sectors are symmetrical in nature. And due to such restrictions, it fails to highlight the growth-generating re-allocation of labour (and capital) among the sectors associated with the process of structural transformation.

Also, there are problems both with the cross-country studies of the growth phenomenon and with the empirical tests of the endogenous growth theory. Thus, its main prediction—namely, the developed and the developing countries need not converge because the former tend to grow faster than the latter—does not hold as a universal prescription. In the last forty years or so, a convergence has occurred between the per capita incomes of the fast-developing countries like Japan and South Korea, on the one hand, and the developed Western Europe and the U.S.A., on the other; and the same is going to happen in the case of Hong Kong and Singapore by the end of this century. For all these reasons, while the endogenous growth theory provides a valuable extension of the neo-classical theory, it fails to provide “a powerful organising framework for thinking about actual growth phenomenon” [Pack (1994)]—much less explain the wider phenomenon of economic development.

II

A large enough literature has mushroomed around two basic propositions: Trade liberalisation strategies are unambiguously superior to protectionist regimes (i) *because* they promote higher rates of export growth; (ii) and *because* higher exports are positively related to a higher growth rate of the GDP. But the evidence about the first proposition does not seem to be entirely free of ambiguity, either because of the authors’ inability to define clearly as to what exactly is meant by alternative policies and by trade reforms, or because the choice of the liberalisation index has been largely subjective, or even worse, because the superiority of trade-liberalisation has been simply asserted on ideological grounds rather than proved empirically.

As to the second proposition, we know that a significant correlation between exports and GDP growth does not decide the issue of causation: whether it is the faster GDP growth that causes greater exports or it is the other way round! Indeed, it can be shown that greater export orientation—when the effective exchange rate for exports (EER_x) is strictly greater than the effective exchange rate for imports (EER_m)—may *not* necessarily be growth-promoting and welfare-raising in the long run for the developing countries. However, these arguments do *not* deny that greater exports do lead to higher growth; it is rather that export orientation is not necessarily a sure-fire remedy under all circumstances. It depends partly on the stage of development reached by a specific developing country as well as on the world market condition.

But there can be little doubt that development *policy* has wilted under the force of the anti-protectionist attack. It has been asserted, for instance, that countries practising import substitution industrialisation (ISI) scored only low or moderate growth rates—dispirited as they were by the pessimistic Singer-Prebisch (1950) hypothesis about a secular deterioration in the prices of the primary goods which combined with low income and price elasticities of demand for such goods and the raw material-saving nature of technological change in developed countries. On the other hand, the HPAEs (High-performing Asian economies), allegedly guided by a free market *ideology*, practised an export-push strategy and reaped incomparably higher growth rates of per capita income. Whence follows the verdict that the free-trade prescription of neo-classical (and classical) economics should be trusted more than the protectionist proclivities of development economics in the design of development policy. But such generalisation is unwarranted, both factually and logically. It is factually wrong, because the HPAEs have continued to practise *efficient* import substitution industrialisation by “picking the winners”. It is also logically false because a concern about the fairness of the distribution of gains from trade and investment did not amount to denying the existence of the gains from trade; nor was it asserted, as pointed out by Singer (1984), that “the deteriorating barter terms of trade must of necessity impose a welfare loss on developing countries”. The reason why the HPAEs have done incomparably better than other developing countries is more basic: it was their capacity to see clearly and promptly the margin of advantage between import substitution and export expansion when the time came; and because they have shown an uncommon resilience in adjusting domestic policies to external shocks and in taking advantage of the possibilities of gains from foreign trade during periods of a strong external demand for exports.

UR Agreement and Development Economics

What would then be the most beneficial policy for the developing countries now? The deciding factor, in my view, is *not* a return to the free-trade ideal that neo-

classical economics has professed. Instead, a more relevant policy would be to adjust to the Uruguay Round (UR) Agreement, which, like the GATT, does *not* subscribe to a free trade policy, even though it promises to enhance market access for goods and services by reducing the explicit and implicit forms of protection. This Agreement has now been ratified by almost all developed and developing countries within the framework of the World Trade Organisation (WTO).

Among other things, the Agreement opens up a new perspective on the trade-and-growth debate.

Firstly, the issues relating to the unequal distribution of gains from trade *and* investment, highlighted since the beginning of the development economics literature, will assume an even *greater* importance in the post-UR world than in the period before. A preliminary estimate of the gains from greater trade due to the UR Agreement clearly shows that their distribution will be positive for both the developed and the developing countries, but it will also be *unequal*: of an estimated increase in world real income between \$ 212 billion to \$ 274 billion, the developed countries will receive about \$ 196 billion—and will be the merrier because they suffer much more from protection-induced “distortions” than the developing countries! If the likely (positive but even more unequal) gains from the TRIPS and TRIMS are added to this, some mechanism will have to be found to compensate the losers—directly by the gainers or indirectly by multilateral financial institutions like the World Bank, the IMF, etc.—even though there is a possibility that greater international investment may flow to the developing countries due to a strict adherence to the TRIPS accord.

Secondly, the choice between import substitution and export expansion will not be as open in the post-UR world trading order as in the decades of the 1950s and the 1960s—when to be an infant industry “was very heaven”. No longer that, the infant-industry protection, though still available under Article 18-c of the GATT, will be much more difficult to practise as tariff and non-tariff barriers are reduced sharply everywhere. But would the UR Agreement enable the developing countries to reap the promised growth rewards attributed to greater export expansion? Perhaps; but not certainly, because their access to developed countries’ markets is not likely to improve dramatically. This is because even as the non-tariff barriers on textiles and clothing are lowered by the developed countries under the terms of the UR Agreement, a greater use of anti-dumping laws, safeguards, and countervailing duties against developing countries’ exports is a bitter reality that the developing countries must learn to adjust to in the post-UR world trading order.

Thirdly, the fact that developing countries will be less able to invoke the “non-reciprocity” principle, enshrined in Article 18 of the GATT, as they “graduate” (actually or on paper) also means that the reciprocity principle will increasingly govern the post-UR world, *even though not always in a non-discriminatory fashion*—

because the Safeguard Clause (Article 19 of the GATT) has now been altered in ways that make discrimination between competing developing-country suppliers possible.

Fourthly, the outcome of such negotiations will be decided, as before, by the balance of international economic power, which is more likely to tilt against the developing countries because trade liberalisation has already been compulsorily undertaken by the developing countries under the structural adjustment programme of the World Bank and the IMF; and so, for this the developing countries are not likely to get credit in future negotiations with the developed countries.

Fifthly, each individual developing country's exports will have to face a fierce third-country competition as voluntary export quotas are relaxed, and they will also encounter significant import restrictions in the developed countries' markets till the Year 2002, when the non-tariff barriers on textiles and clothing will be completely phased out.

However, all this does not necessarily mean that developing countries must do worse in terms of exports and GDP growth in the post-UR era. In general, the success of the developing countries to export more will *not* come through by deceptively simple tricks like "setting the prices right"; it will rather depend on their ability to innovate (to some extent, by import-substituting "knowledge" rather than "goods") and to improve the quality of their exports. The post-UR world will probably be eventually beneficial to the developing countries, but the weak chain of causation between trade liberalisations, exports, and growth must be made stronger not by simply specialising more in the traditional (unskilled) labour-intensive industry, but by applying new scientific ideas to the production processes.

III

It has been asserted that development economics suffers fatally from an innate *etatisme* so that a demonstration of the superiority of the free markets amounts to disproving its logical validity. The issue is also of great practical relevance because such arguments have been used to justify the large-scale privatisation of public enterprises in developing countries. And yet, I shall argue that there is no warrant to privatise everything—including commonsense—in the vain search for efficient market solutions, because "it is *not* true that economic theory 'proves' that free markets are always the best" [Krugman (1992)].

The debate on this issue has been conducted at three distinct levels, each of which should be noted carefully for clear thinking.

First, there is the all-out advocacy of free and competitive markets, which are assumed to work with textbook accuracy in the *real* world.

Secondly, assuming that technological change is exogenous, and that investment is fully appropriable, it has been asserted that the government can do nothing to promote accumulation and growth.

Thirdly, it is argued that even though the market fails in the face of externalities, yet government intervention does not necessarily follow from this, because the governments also can and do fail—and this failure is generally more pervasive and costly than market failure.

Finally, it has been argued that market-based solutions should be sought even when the market is *not* issuing the right signals due to some malfunctioning in the capitalist system.

However, it should be easy to see that there is not much force in these arguments.

First, attaining to the textbook primordial state (of nature) may not be a rewarding experience because market success is guaranteed only *if* there are enough markets; *if* both the consumers and the producers behave competitively; and *if* equilibrium exists. A non-satisfaction of *any* of these conditions amounts to a withdrawal of the guarantee of market success. Thus, “a pure market system with its high degree of decentralisation runs the risk of bringing inequitable results and being inefficient because markets can never be complete, externalities exist, and public wants tend to be neglected” [Malinvaud (1989)].

Secondly, the many suggested remedies to find a market-based solution of externalities, though possible, may not be feasible. Also, *while government may be wasteful when patronising rent-seeking activities, the same is the case with modern managerial capitalism*. Indeed, it is not an uncommon sight when an “agent” in the free markets commits “fraud” (in a strictly technical sense) against the “principal”: real resources in this case are diverted to the “provision of unnecessary services”.

Thirdly, in cases where a public good characterised by non-exclusivity and indivisibility must be produced, where structural change involving a redistribution of private property rights must be made, or when in the initial stage of economic development large amounts of investable resources must be raised to initiate and diversify the development process, state intervention in these and similar other situations could be welfare-raising—to smooth out the rough edges produced by structural change.

It follows that the latter-day denial of the state not doing *any* good to the society, so that the less we have of it the better, is essentially wrong-headed because there is a large area of social life where state intervention is obligatory; it is also dangerous, because a state not doing development work is not the one that would help economic progress. The fact of the matter is that there is ample room for both the public sector and the private sector to coexist—within the mixed economy framework of a society like ours—and to seek remedies for such fundamental problems as slow growth, unemployment, poverty, illiteracy, inadequate supply of health services, etc.

IV

Development economics has long suffered from a deep-rooted tension. On the one hand, its principal concerns are essentially moral and ethical. These are to enhance people's well-being by a fair and equitable distribution of the fruits of economic progress and by minimising the incidence of poverty, famine, unemployment, etc. For instance, Singer's (1984) classic paper "concentrated on the issue of distributive justice or fairness or desirability in sharing out the gains from trade". In such conceptualisations of development economics, a rapid rise in per capita income assumes an instrumental value; it is the *means* to achieving economic progress. The *end* of economic development is sometimes identified, on moral grounds, as "human development", which seeks to put "people back at centre-stage" by achieving a higher level of literacy, health, and longevity of life. On the other hand, since its inception, development economics has pretended to be a rock of "positivity", leaving little room for "warm-hearted" value judgements about the "goodness" of a social order. It has often distinguished itself by an arid detachment from all the relevant ethical issues—in deference to Robbins's positivism (1932). Arthur Lewis's (1954) sang-froid was typical and is worth remembering: "We are not interested in the people in general, but only say in the 10 percent of them with the largest income..."

As a result of this "inner" split, development economics has remained ambivalent when making choices involving value judgements. Even the recent drift to market capitalism in development economics—which preaches a one-sided quick-march to efficient market solutions—is an example of such ambivalence. Another example of this drift is the structural adjustment programmes, which are implemented in a patently inequitable fashion, e.g., by raising the prices of food and other goods and services normally consumed by the poor. Yet another example is the manifest disregard of equity concerns in the design of tax reforms to maximise tax yields.

But for clear thinking, the tension that I have noted should be minimised. The ethically determined ends of economic development are essentially reference-points to position the (positivist) economic remedies efficiently. Thus, for instance, to fix the target rate of inflation, policy-makers must know the acceptable rate of unemployment in case there is a trade-off between these variables. Indeed, "the simple picture of the economist who provides value-free technical information to the decision-maker is at best a useful caricature" [Hausman and McPherson (1993)]. It follows that the relevance of development economics—indeed, also of neo-classical economics—would be greatly diminished if it were to eschew value judgements altogether. Thus, for instance, the feudal structures that dominate the economic landscape in most developing countries may be justified because in a certain view of moral rights these have "arrived" today by using correct legal procedures. Also, insofar as extreme poverty, hunger, and even famines have been shown to result

from the exercise of legally sanctioned rights rather than natural calamities [Sen (1981)], any attempt to remedy such obvious social injustices will be held, in this “liberal” view, as an infringement of individual freedom.

To summarise, normative judgement is required to issue adequate instructions to distribute the fruits of economic progress equitably, and also to be concerned about such problems as poverty, illiteracy, ill-health, and high rates of (open) unemployment—all issues which carry a clear altruistic ethical motivation and which do not admit of a somewhat vulgar market-clearing prescription. The argument that the market-given freedom economises on the use of scarce ethical resources is true to some extent; but the fact remains that altruism is *not* a scarce resource; rather, it increases (decreases) with a more (less) frequent use.

It would not be a correct perspective from which to view development economics as essentially positivist, hell-bent on finding efficient solutions even if unjust. Our discipline is *prescriptive* by temperament: it not only describes what the state of underdevelopment *is* but also prescribes, in a “consequentialist” vein, what *ought* to be done to modify this state by suitable policy action. When thinking about development issues, it should be neither irrational to act morally nor immoral to act rationally—especially because the inculcation of moral and ethical values is *growth-promoting*, and doing so reduces the cost of policing and contracting in society. By the same token, a greater ethicalism makes it easier to undertake a major restructuring of the unjust social and economic institutions, both national and international—to make them just and to make economic development both possible and meaningful for the “voiceless millions” who sullenly endure what they cannot change. The job of combining efficiency with justice and realism with compassion for the poor, the needy, and the downtrodden is difficult; but it can be done since, as Lawrence Klein (1985) puts it, “there is no reason to believe, either in logic or in experience, that [our economic system] must be inhumane and unjust in order to function successfully”.

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