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## Development through globalization?

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## Development through Globalization?

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### Abstract

This paper seeks to analyze the prospects for development in a changed international context, where globalization has diminished the policy space so essential for countries that are latecomers to development. The main theme is that, to use the available policy space for development, it is necessary to redesign strategies by introducing correctives and to rethink development by incorporating different perspectives, if development is to bring about an improvement in the well-being of people. In redesigning strategies, some obvious correctives emerge from an understanding of theory and a study of experience that recognizes not only the diversity but also the complexity of development. In rethinking development, it is imperative to recognize the importance of initial conditions, the significance of institutions, the relevance of politics in economics and the critical role of good governance. Even if difficult, there is also a clear need to create more policy space for national development, by reshaping the rules of the game in the world economy and contemplating some governance of globalization.

Keywords: globalization, development, policy space, initial conditions, institutions, markets, state, democracy, governance

JEL classification: F02, F20, F40, O10, O19, O20

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## **Introduction**

Globalization, which gathered momentum during the last quarter of the twentieth century, has created unparalleled opportunities and posed unprecedented challenges for development. Yet, the virtual ideology of our times has transformed globalization from a descriptive word into a prescriptive word. But the reality that has unfolded so far belies the expectations of the ideologues. The exclusion of countries and of people from globalization, which is partly attributable to the logic of markets, is a fact of life. Even so, there is a strong belief and an influential view that globalization is the road to development during the first quarter of the twenty-first century.<sup>1</sup> In a volume that seeks to think ahead about the future of development economics, development through globalization is an appropriate theme. It is even more appropriate, perhaps, with a question mark at the end.

The object of this essay is to reflect on development in prospect, not retrospect, situated in the wider international context of globalization. In doing so, it shall, of course, address the question posed in the title. The main object, however, is to focus on the correctives that would have to be introduced and the rethinking that would have to be done, given the reality of globalization, if development is to bring about an improvement in the living conditions of people, ordinary people.

The structure of the paper is as follows. Section 1 outlines the rationale of globalization as a mantra for development, to juxtapose it with conflicting perceptions and complex realities. Section 2 examines the constraints on, and the choices for, for latecomers to development at the present juncture, given the asymmetrical consequences of globalization so far. Section 3 explains the essential meaning and sets out the objectives of development to suggest that we need to rethink the focus. Section 4 considers some important correctives, learning not only from the past but also from the present, for strategies of development. Section 5 argues that some rethinking is essential, from different perspectives, to understand and to foster the process of development, particularly because thinking about development, in terms of both theory and policy, has become narrower with the passage of time. Section 6 explores how the rules of the game for the world economy need to be reshaped to create more space for the pursuit of national development objectives. Section 7 concludes.

### **1 Globalization as a mantra for development**

Recent years have witnessed the formulation of an intellectual rationale for globalization that is almost prescriptive. It is perceived as a means of ensuring not only

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<sup>1</sup> See, for example, Sachs and Warner (1995), who were among the first exponents of this view. This prescriptive view of globalization is also set out, at some length, by Bhagwati (2004); Wolf (2004).

efficiency and equity but also growth and development in the world economy. The analytical foundations of this world view are provided by the neo-liberal model. Orthodox neoclassical economics suggests that intervention in markets is inefficient. Neo-liberal political economy argues that governments are incapable of intervening efficiently. The essence of the neo-liberal model, then, can be stated as follows. First, the government should be rolled back wherever possible so that it approximates to the ideal of a minimalist state. Second, the market is not only a substitute for the state but also the preferred alternative because it performs better. Third, resource allocation and resource utilization must be based on market prices which should conform as closely as possible to international prices. Fourth, national political objectives, domestic economic concerns or even national boundaries should not act as constraints. In this world, domestic economic concerns mesh with, or are subsumed in, the maximization of international economic welfare and national political objectives melt away in the bargain.

The ideologues believe that globalization led to rapid industrialization and economic convergence in the world economy during the late nineteenth century. In their view, the promise of the emerging global capitalist system was wasted for more than half a century, to begin with by three decades of conflict and autarchy that followed the First World War and subsequently, for another three decades, by the socialist path and a statist worldview. The conclusion drawn is that globalization, now as much as then, promises economic prosperity for countries that join the system and economic deprivation for countries that do not.<sup>2</sup> It needs to be stressed that this prescriptive view of globalization is contested and controversial.<sup>3</sup> Yet, for those who have this strong belief, globalization is the road to development in the first quarter of the twenty-first century.<sup>4</sup>

Interestingly enough, the development experience of the world economy in the last quarter of the twentieth century is invoked as supporting evidence, not only by advocates but also by critics of this prescription. In caricature form, these conflicting perceptions are almost polar opposites of each other. The pro-globalization advocates argue that it led to faster growth, that it reduced poverty, and that it brought about a decrease in inequality. The anti-globalization critics argue that it led to slower but more volatile growth, that it increased poverty in most parts of the world and that there was an increase in inequality. Of course, such a broad-brush picture of conflicting

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<sup>2</sup> See, in particular, Sachs and Warner (1995). For a very different, contrasting, historical perspective on globalization and development, see Nayyar (2006).

<sup>3</sup> In an interesting critique, Samuelson (2004) questions the analytical basis and the theoretical foundations of this prescriptive view. For a critical perspective on the implications of globalization for development, see Stiglitz (2002); Nayyar (2003a); Kaplinsky (2005). See also Soros (1998); Baker et al. (1998).

<sup>4</sup> Sachs and Warner (1995); Bhagwati (2004); Wolf (2004).

perceptions abstracts from the nuances and the qualifications. But it highlights the impasse in a debate that borders on a dialogue of the deaf.

Yet, there is a little dispute about some important dimensions of reality. In conventional terms, the world has made enormous economic progress during the second half of the twentieth century. Over the past fifty years, world GDP multiplied almost twelve-fold while per capita income more than trebled. The growth has been impressive even in the developing world, particularly when compared with underdevelopment and stagnation in the colonial era during the first half of the twentieth century. But such aggregates conceal more than they reveal. In fact, development has been uneven within and between countries. The pattern of development has been such that it has led to an increase in the economic distance between the industrialized world and much of the developing world. It has also led to an increase in the economic distance between the newly industrializing countries at one end and the least developed countries at the other. At the same time, economic disparities between regions and between people within countries have registered a significant increase.

Uneven development is not without consequences for people. Poverty, inequality and deprivation persist. And there is poverty everywhere. One-eighth of the people in industrial societies are affected by, or live in, poverty. Almost one-third of the people in the developing world live in poverty and experience absolute deprivation in so far as they cannot meet their basic human needs. As many as 830 million people suffer from malnutrition, while 1.2 billion people do not have access to clean water, and 2.7 billion people do not have adequate sanitation facilities. More than 250 million children who should be in school are not. Nearly 300 million women are not expected to survive to the age of 40. And 850 million adults remain illiterate. Most of them are in developing countries. But, in a functional sense, the number of illiterate people in industrial societies at 100 million is also large.<sup>5</sup>

In other words, many parts of the world and a significant proportion of its people are largely excluded from development. This may be attributable to the logic of markets which give to those who have and take away from those who have not, as the process of cumulative causation leads to market-driven virtuous or vicious circles. This may be the outcome of patterns of development where economic growth is uneven between regions and the distribution of its benefits is unequal between people, so that the outcome is growing affluence for some combined with persistent poverty for many. This may be the consequence of strategies of development as a similar economic performance in the aggregate could lead to egalitarian development in one situation and growth which bypasses the majority of the people in another situation.

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<sup>5</sup> The evidence cited in this paragraph is obtained from UNDP, *Human Development Report* (various issues), and World Commission on the Social Dimension of Globalization (2004).

## 2 Consequences, constraints, and choices

In retrospect, it is apparent that globalization has been associated with simultaneous, yet asymmetrical, consequences for countries and for people. There is an inclusion for some and an exclusion, or marginalization, for many. There is affluence for some and poverty for many. There are some winners and many losers. Joan Robinson once said, ‘There is only one thing that is worse than being exploited by capitalists. And that is not being exploited by capitalists.’ Much the same can be said about markets and globalization which may not ensure prosperity for everyone but may, in fact, exclude a significant proportion of people.

It would seem that globalization has created two worlds that co-exist in space even if they are far apart in wellbeing. For some, in a world more interconnected than ever before, globalization has opened door to many benefits. Open economies and open societies are conducive to innovation, entrepreneurship and wealth creation. Better communications, it is said, have enhanced awareness of rights and identities, just as they have enabled social movements to mobilize opinion. For many, the fundamental problems of poverty, unemployment and inequality persist. Of course, these problems existed even earlier. But globalization may have accentuated exclusion and deprivation, for it has dislocated traditional livelihoods and local communities. It also threatens environmental sustainability and cultural diversity. Better communications, it is said, have enhanced awareness of widening disparities. Everybody sees the world through the optic of their lives. Therefore, perceptions about globalization depend on who you are, what you do, and where you live. Some focus on the benefits and the opportunities. Others focus on the costs and the dangers. Both are right in terms of what they see. But both are wrong in terms of what they do not see.

On balance, it is clear that there is exclusion of countries and of people.<sup>6</sup> Too many people in poor countries, particularly in rural areas or in the informal sector, are marginalized if not excluded. Too few share in the benefits. Too many have no voice in its design or influence on its course. There is a growing polarization between the winners and the losers. The gap between rich and poor countries, between rich and poor in the world’s population and between rich and poor people within countries, has widened. These mounting imbalances in the world are ethically unacceptable and politically unsustainable.<sup>7</sup>

But that is not all. Globalization has diminished the policy space so essential for countries that are latecomers to development. Indeed, the space for, and autonomy to formulate policies in the pursuit of national development objectives is significantly reduced. This is so for two reasons: unfair rules of the game in the world economy and

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<sup>6</sup> For a detailed discussion, as also evidence, see Nayyar (2003a; 2006).

<sup>7</sup> This proposition is set out, as also explained, in the Report of the World Commission on the Social Dimension of Globalization (2004).

consequences of integration into international financial markets. In a world of unequal partners, it is not surprising that the rules of the game are asymmetrical in terms of construct and inequitable in terms of outcome. The strong have the power to make the rules and the authority to implement the rules. In contrast, the weak can neither set nor invoke the rules. The problem, however, takes different forms.<sup>8</sup>

First, there are different rules in different spheres. The rules of the game for the international trading system, being progressively set in the WTO, provide the most obvious example. There are striking asymmetries. National boundaries should not matter for trade flows and capital flows but should be clearly demarcated for technology flows and labour flows. It follows that developing countries would provide access to their markets without a corresponding access to technology and would accept capital mobility without a corresponding provision for labour mobility. This implies more openness in some spheres but less openness in other spheres. The contrast between the free movement of capital and the unfree movement of labour across national boundaries lies at the heart of the inequality in the rules of the game.

Second, there are rules for some but not for others. In the WTO, for instance, major trading countries resort to a unilateral exercise of power, ignoring the rules, because small countries do not have the economic strength even if they have the legal right to retaliate. The conditions imposed by the IMF and the World Bank, however, provide the more familiar example. There are no rules for surplus countries, or even deficit countries, in the industrialized world, which do not borrow from the multilateral financial institutions. But the IMF and the World Bank set rules for borrowers in the developing world and in the transition economies. The conditionality is meant in principle to ensure repayment, but in practice it imposes conditions to serve the interests of international banks which lend to the same countries. The Bretton Woods institutions, then, act as watchdogs for moneylenders in international capital markets. This has been so for some time. But there is more to it now. IMF programmes of stabilization and World Bank programmes of structural adjustment seek to harmonize policies and institutions across countries, which is in consonance with the needs of globalization.

Third, the agenda for new rules is partisan, but the unsaid is just as important as the said. The attempt to create a multilateral agreement on investment in the WTO, which seeks free access and national treatment for foreign investors, with provisions to enforce commitments and obligations to foreign investors, provides the most obvious example. Surely, these rights of foreign investors must be matched by some obligations. Thus, a discipline on restrictive business practices of transnational corporations, the importance of conformity with anti-trust laws in home countries, or a level playing field for domestic firms in host countries, should also be in the picture. The process of globalization is already reducing the autonomy of developing countries in the

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<sup>8</sup> For a more complete discussion on rules of the game, see Nayyar (2002a; 2003a).



formulation of economic policies in their pursuit of development. These unfair rules also encroach on the policy space so essential for national development.

The existing (and prospective) rules of the WTO regime allow few exceptions and provide little flexibility to countries that are latecomers to industrialization. In comparison, there was more room for manoeuvre in the erstwhile GATT, *inter alia*, because of special and differential treatment for developing countries. The new regime is much stricter in terms of the law and the implementation. The rules on trade in the new regime make the selective protection or strategic promotion of domestic firms vis-à-vis foreign competition much more difficult. The tight system for the protection of intellectual property rights could pre-empt or stifle the development of domestic technological capabilities. The possible multilateral agreement on investment, should it materialize, would almost certainly reduce the possibilities of strategic bargaining with transnational firms. Similarly, commitments on structural reform, an integral part of stabilization and adjustment programmes with the IMF and the World Bank, inevitably prescribe industrial deregulation, privatization, trade liberalization and financial deregulation. In sum, the new regime appears rule-based but the rules are not uniform. And it is not clear how or why this is better than discretion. For, taken together, such rules and conditions are bound to curb the use of industrial policy, technology policy, trade policy and financial policy as strategic forms of intervention to foster industrialization.<sup>9</sup>

At the same time, the consequences of integration into international capital markets also reduce degrees of freedom. Exchange rates can no longer be used as a strategic device to provide an entry into world markets for manufactured goods, just as the interest rates can no longer be used as a strategic instrument for guiding the allocation of scarce investible resources in a market economy. What is more, countries that are integrated into the international financial system are constrained in using an autonomous management of demand to maintain levels of output and employment. Expansionary fiscal and monetary policies—large government deficits to stimulate aggregate demand or low interest rates to encourage domestic investment—can no longer be used because of an overwhelming fear that such measures could lead to speculative capital flight and a run on the national currency.<sup>10</sup>

In sum, the existing global rules encroach upon essential policy space. And the problem is compounded by the rapid, sometimes premature, integration into international financial markets. Therefore, latecomers to industrialization would find it difficult to emulate the East Asian success stories. Indeed, the industrialized countries had much

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<sup>9</sup> It must be recognized that such state intervention was crucial for development in the success stories among late industrializers during the second half of the twentieth century. For a convincing exposition of this view, see Amsden (1989); Wade (1990); Chang (1996).

<sup>10</sup> For an analysis of this issue, see Nayyar (2002b).

more freedom and space in policy formulation at comparable stages of their industrialization.<sup>11</sup> There is an obvious question that arises. What are the options or choices in this situation for countries that are latecomers to development? First, it is essential to use the available policy space for national development, given the international context. Second, it is important to create more policy space by reshaping the rules of the game in the world economy. In the national context, therefore, it is necessary to redesign strategies by introducing correctives, and to rethink development by incorporating different perspectives, that would make for egalitarian economic development and a more broad-based social development. In the international context, even if difficult, it is necessary to reshape the rules of the game and contemplate some governance of globalization.

### **3 Conception of development**

Before considering these possibilities, it is both necessary and desirable to reflect on the essential meaning of development. For this purpose, a short digression is worthwhile. The reason is that the agenda on development in terms of both theory and policy has, unfortunately, narrowed with the passage of time. So has its meaning and the object of its focus. Hence, there is a need to reflect on the meaning and rethink the focus. There is a vast literature on economic development which is rich in terms of range and depth. Yet, there is not enough clarity about the meaning of development. There are many different views. And perspectives have changed over time.

In the early 1950s, conventional thinking identified development with growth in GDP or GDP per capita. The earlier literature emphasized economic growth and capital accumulation at a macro level. The contemporary literature emphasizes economic efficiency and productivity increases at a macro level. Industrialization has always been seen as an essential attribute of development. The emphasis has simply shifted from the pace of industrialization to the efficiency of industrialization. The underlying presumption is that economic growth and economic efficiency are not only necessary but also sufficient for bringing about an improvement in the living conditions of people. From time to time, dissenting voices question conventional wisdom to suggest other indicators of development but these were largely ignored by mainstream economics. And, even fifty years later, economic growth or increases in per capita remain the most important measure of development.

The early 1970s witnessed the emergence of a literature that suggested other indicators of development such as a reduction in poverty, inequality and unemployment which would capture changes in the quality of life.<sup>12</sup> This thinking moved further. Development, it was argued, must bring about an improvement in the living conditions

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<sup>11</sup> See Bairoch (1993); Chang (2002a); Maddison (1995).

<sup>12</sup> See, for example, Baster (1972); Seers (1972); Morris (1979).

of people. It should, therefore, ensure the provision of basic human needs for all—not just food and clothing but also shelter, healthcare, and education.<sup>13</sup> It was stressed that this simple but powerful proposition is often forgotten in the conventional concerns of economics. Such thinking culminated in writings on, and an index of, human development.<sup>14</sup>

In the late 1990s, Amartya Sen provided the broadest possible conception of development as freedom: a process of expanding real freedoms that people enjoy for their economic wellbeing, social opportunities and political rights.<sup>15</sup> Such freedoms are not just constitutive as the primary ends of development. Such freedoms are also instrumental as the principal means of attaining development. What is more, there are strong interconnections that link different freedoms with one another. Political freedoms help promote economic security. Social opportunities facilitate economic participation. Economic wellbeing supports social facilities and reinforces political rights. In this manner, freedoms of different kinds strengthen one another. The purpose of development, after all, is to create a milieu that enables people, ordinary people, to lead a good life. Development must, therefore, provide all men and women the rights, the opportunities and the capabilities they need to exercise their own choices for a decent life.

The significance of this abstraction about or conceptualization of development is not lost on everyone. But it is the tangible or the measurable that remains dominant in terms of wide use and popular understanding. Per capita income is only an arithmetic mean. Social indicators are also statistical averages. And neither captures the wellbeing of the poor. Even the human development index is not quite an exception. The quantifiable is obviously important. But it should not shape our thinking about development. In fact, it does. Consequently, the focus is misplaced. It needs to be corrected. And the correction has several dimensions. It is essential to make a distinction between means and ends. Economic growth and economic efficiency, or for that matter industrialization, are means. It is development which is an end. Much of the focus in the literature on development is on economies. But aggregates often conceal more than they reveal. Thus, it is important to shift the focus from countries to people. However, people are not just beneficiaries. It is only if people are centre-stage in the process of development, as the main actors, that development can empower people to participate in the decisions that shape their lives. The significance of this proposition is highlighted by the medieval distinction between agents and patients, which is invoked by Sen. He argues that the freedom-centred understanding of economics and of the process of development is very

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<sup>13</sup> See Streeten (1981); Stewart (1985).

<sup>14</sup> There is an extensive literature on the subject. For a discussion on the conceptual foundations, see Sen (1989) and Haq (1995). For an analysis of issues related to methodology and measurement, see Anand and Sen (1994).

<sup>15</sup> See Sen (1999).

much an agent-oriented view. This is because individuals with adequate social opportunities can effectively shape their own destiny and help each other. They must not be seen primarily as patients, or passive recipients, of the benefits of cunning development programmes.<sup>16</sup>

#### **4 Redesigning strategies: introducing correctives**

The introduction of correctives in the design of strategies for development is easier said than done. Even so, some essential correctives emerge from an understanding of theory and a study of experience that recognizes not only the diversity but also the complexity of development. In this reflection, it is necessary to recognize the limitations of orthodox economic theory and policy prescriptions even if these represent influential thinking about development at the present juncture. It is just as necessary to learn lessons from the history of development experience embedded in both successes and failures without neglecting specificities in time and space.

The first limitation of orthodoxy is its unquestioned faith in the market mechanism. It fails to recognize that there is no magic in the market. Indeed, market failures are not quite an exception but are closer to being the rule. The strong belief in the market mechanism is based on the proposition that market forces, or the invisible hand, achieve a competitive equilibrium. The fundamental theorems of welfare economics establish that this is an efficient state and a desirable state.<sup>17</sup> In spite of analytical elegance of these theorems, such faith is not quite warranted. The scepticism extends much beyond the critics. Consider, for example, the following quotations from three distinguished economic theorists: Frank Hahn, Amartya Sen and Joseph Stiglitz.

It showed that it is logically possible to describe a world where greedy and rational people responding only to price signals take actions which are mutually compatible. The theory does not describe the invisible hand in motion but displays it with its task accomplished...The importance of this intellectual achievement is that it provides a benchmark...Now one of the mysteries which future historians of thought will surely wish to unravel is how it came about that the Arrow-Debreu model came to be taken descriptively; that is as sufficient in itself for the study and control of actual economies. (Hahn 1984: 308).

The intellectual climate has changed quite dramatically over the last few decades, and the tables are now turned. The virtues of the market mechanism are now standardly assumed to be so pervasive that qualifications seem unimportant ... The need for critical scrutiny of

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<sup>16</sup> For a lucid analysis, see Sen (1999).

<sup>17</sup> For a detailed examination of the fundamental theorems of welfare economics, see Arrow (1950).

standard preconceptions and politico-economic attitudes has never been stronger. Today's prejudices (in favour of the pure market mechanism) need to be investigated and, I would argue, partly rejected. (Sen 1999: 111-12).

... the reason the invisible hand is invisible is partly because it's simply not there.<sup>18</sup>

There are, in fact, many reasons why these results, which highlight the virtues of the market, may not hold.<sup>19</sup> First, there may be externalities in production or consumption which would lead to market failure. The original solution to this problem was appropriate taxes and subsidies to be introduced by the government. But this went out of fashion with the Coase Theorem, which returned the market to its pedestal.<sup>20</sup> Second, in such a world, markets may not deliver efficient and desirable outcomes if transaction costs are too high or if there is no government that can assign and protect property rights. Third, markets may not function, as textbooks would have us believe, in situations where an enforcement of contracts is difficult or not possible. And this is a common occurrence in developing countries which are significantly different from industrial societies in this sphere. Fourth, markets may cease to function as expected if there is an uncertainty about quality. In other words, doing business in markets is difficult where goods or services are of poor quality and where quality cannot be discerned by consumers before purchase.<sup>21</sup> Fifth, it would seem that the market mechanism needs support to function as it is meant to. The need for such support spans a wide range from taxes-cum-subsidies in the presence of externalities, and laws to enforce contracts or property rights, to certification and regulation in a world of asymmetric information. Even with such support, markets are prone to corrupt practices whenever agents engaged by institutions to enforce regulations or laws are more interested in their own welfare rather than in achieving the goals set for them by institutions established to regulate markets.<sup>22</sup>

The second limitation of orthodoxy is the belief that getting-prices-right is enough. Such thinking makes an elementary, but commonplace, error in the design of policies. It confuses *comparison* (of equilibrium positions) with *change* (from one equilibrium position to another). In the real world, economic policy must be concerned not merely with comparison but with how to direct the process of change. Thus, for example, even

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<sup>18</sup> Joseph Stiglitz during interview on WBAI Radio, 15 August 2002, New York.

<sup>19</sup> For a succinct discussion on why these results may not hold, see Mukherji (2005).

<sup>20</sup> See Coase (1960). It is worth noting that Richard Coase was awarded the Nobel Prize in Economics, for this contribution, in 1991.

<sup>21</sup> This proposition was developed by Akerlof (1970) in a seminal contribution.

<sup>22</sup> See, for instance, Banerjee (1997).

if a reduction in protection can, in principle, lead to a more cost-efficient economy the transition path is by no means clear. And the process of change should not be confused with the ultimate destination of an economy that is competitive in the world market.<sup>23</sup>

The third limitation of orthodoxy is the presumption that policy regimes which are necessary are also sufficient.<sup>24</sup> The management of incentives motivated by the object of minimizing costs and maximizing efficiency at a micro level is based on a set of policies that is intended to increase competition between firms in the market place. Domestic competition is sought to be provided through deregulation in investment decisions, in the financial sector and in labour markets. Foreign competition is sought to be provided through openness in trade, investment and technology flows. It must, however, be recognized that there is nothing automatic about competition. Policy regimes can allow things to happen but cannot cause things to happen. The creation of competitive markets that enforce efficiency may, in fact, require strategic intervention through industrial policy, trade policy and financial policy, just as it may require the creation of institutions.

The fourth limitation of orthodoxy is its stress on government failures and its neglect of market failures. However, both market failure and government failure are facts of life. For neither markets nor governments are, or can ever be, perfect. Indeed, markets are invariably imperfect and governments are without exception fallible. The juxtaposition of government failure and market failure in an either-or mode, as if there was a choice to be made, is misleading. It is important to introduce correctives against both market failure and government failure. In such a perspective, the state and the market are complements rather than substitutes. What is more, the relationship between the state and the market cannot be defined once-and-for-all in any dogmatic manner but must change over time in an adaptive manner as circumstances change.<sup>25</sup> In this context, it is important to remember that markets are good servants but bad masters. What is more, efficient markets need effective states.

Development experience during the second half of the twentieth century also suggests important correctives for redesigning strategies. There are some important lessons that can be learnt from mistakes and failures of the past.<sup>26</sup> The first lesson to emerge from experience is that competition in the market is desirable. Such competition is essential between domestic firms, between domestic firms and foreign firms, as also between the public sector and the private sector. Industrial deregulation that removes barriers to entry for new firms and limits on the growth in the existing firms leads to competition

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<sup>23</sup> Bhaduri and Nayyar (1996); Nayyar (1997).

<sup>24</sup> See Nayyar (1997); Stiglitz (1998).

<sup>25</sup> For an analysis of the relationship between the state and the market, from this perspective, see Bhaduri and Nayyar (1996).

<sup>26</sup> The discussion on lessons in the following paragraphs draws upon Nayyar (2004).

between domestic firms. Trade liberalization which reduces restrictions or tariffs on imports leads to competition between domestic and foreign firms. The dismantling of public sector monopolies leads to competition between the public sector and the private sector. It is such competition between firms, in price and in quality, that creates efficiency among producers and provides a choice for consumers.

The second lesson to emerge from experience is that prudent macro management of the economy is both necessary and desirable. Soft options, such as borrowing by the government only postpone the day of reckoning. Borrowing to support consumption almost always leads to a fiscal crisis. The problem may be compounded by a reliance on external resources to finance development. And if such borrowing is used to support consumption, a debt crisis is almost inevitable. Even so, it is necessary to recognize the fallacies of deficit fetishism. It must be stressed that the size of the fiscal deficit or the amount of borrowings are symptoms and not the disease. The real issue is the use to which the government borrowing is put in relation to the cost of borrowing by the government. Thus, government borrowing is always sustainable if it is used to finance investment and if the rate of return on such investment is greater than the interest rate payable.

The third lesson to emerge from experience is that excessive and inappropriate state intervention is counter-productive. It is, of course, important to learn from mistakes but it is just as important to avoid over-correction in learning from mistakes, because there are dangers implicit in over-reaction. Clearly, there are things that markets can and should do. However, there are some things that only governments can do. If governments do these badly, it is not possible to dispense with governments or replace them with markets. Governments must be made to perform better. It is, therefore, necessary to reformulate the questions about the economic role of the state.<sup>27</sup> The real question is no longer about the size of the state (how big?) or the degree of state intervention (how much?). The question is now about the nature of state intervention (what sort?) and the quality of the performance of the state (how good?).

The fourth lesson to emerge from experience, in the more recent past, is that the speed and the sequence of change matter. For one, the speed of change must be calibrated so that it can be absorbed by the economy. For another, the sequence of change must be planned with reference to an order of priorities. The significance of speed and sequence emerges clearly in the sphere of trade policy reform and even more clearly from the experience with capital account liberalization. In both, whether speed or sequence, deregulation and openness must be compatible with initial conditions and must be consistent with each other.

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<sup>27</sup> For a discussion on the economic role of the state, see Stiglitz (1989); Killick (1990). See also Lall (1990); Shapiro and Taylor (1990).

Clearly, it is important to learn from failures. Recognition of where things went wrong translates easily into correctives. But it is just as important to learn from successes. And there are two important lessons that emerge from development experience in countries that are success stories. First, there are specificities in time and space which must be recognized and cannot be ignored. Obviously, one-size does not fit all. Second, latecomers to industrialization during the twentieth century, to begin with in Europe, and subsequently in Asia, that succeeded adopted strategies of development which not only varied across countries over time but also differed significantly from orthodox policy prescriptions now in fashion.<sup>28</sup>

Last but not least, there are some forgotten essentials that should form an integral part of any attempt at redesigning strategies of development. First, it is not quite recognized that economic growth is necessary but not sufficient to bring about a reduction in poverty. It cannot suffice to say that the outcomes of economic policies should be moderated by social policies. The dichotomy between economic and social policies is inadequate just as the dichotomy between economic and social development is inappropriate. In fact, no such distinction is made in industrialized countries. And the experience of industrialized world suggests that there is a clear need for an integration, rather than separation, of economic and social policies. Thus, it is important to create institutional mechanisms that mediate between economic growth and social development.

Second, it is often forgotten that the wellbeing of humankind is the essence of development. Thus, distributional outcomes are important. So are employment and livelihoods. Structural reforms associated with economic liberalization have important implications for employment creation and income opportunities. For one, in so far as such reforms increase the average productivity of labour, through the use of capital-intensive or labour-saving technologies, or through a restructuring of firms, which increases efficiency, it reduces the contribution of any given rate of economic growth to employment growth. For another, in so far as trade liberalization enforces closures rather than efficiency at a micro level, or switches demand away from home-produced goods to foreign goods at a macro level, it has an adverse effect on output, hence employment, which is magnified through the multiplier effect. This has important consequences in the medium term. There is a contraction of employment in some sectors without a compensatory expansion of employment in other sectors. And, as employment elasticities of output decline, employment creation slows down. It need hardly be stressed that employment creation is the only sustainable means of reducing poverty. Moreover, employment is also essential for the wellbeing and dignity of people.

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<sup>28</sup> See Amsden (1989); Lall (1990); Wade (1990); Chang (2002a).



## **5 Rethinking development: different perspectives**

The discourse on theory and policy in development has become narrower with the passing of time. Some rethinking on development is essential. It must incorporate different perspectives. A systematic, let alone complete, analysis of such alternatives would mean too much of a digression. Even so, it is necessary to stress the following as an integral part of any rethinking on development: the importance of initial conditions, the significance of institutions, the relevance of politics in economics and the critical role of good governance.

It is obvious that initial conditions are important determinants of development. It should also be recognized that initial conditions can and should be changed to foster development. This is an unambiguous lesson that emerges from economic history.<sup>29</sup> In countries that are latecomers to industrialization, state intervention creates conditions for the development of industrial capitalism through the spread of education in society, the creation of a physical infrastructure and the introduction of institutional change. This role has always been recognized. The building of managerial capabilities in individuals and technological capabilities in firms is also an important, even if less recognized, dimension of initial conditions, for such capabilities determine technical efficiency in the short run and competitiveness in the long run. This has been recognized for some time. The present juncture, however, is characterized by a widespread disillusionment with the economic role of the state and a strong belief in the magic of the market. Hence, orthodoxy neglects the importance of initial conditions. There is an irony in this situation. In the context of globalization, such a role for the state is more necessary than ever before. Indeed, creating the initial conditions is essential for maximizing the benefits and minimizing the costs of integration with the world economy.

The debate on development is, in large part, about policies. The time has come to move beyond policies to institutions. The recent recognition of the importance of institutions, even if late, is welcome.<sup>30</sup> Yet, the understanding of institutions in the profession of economics is, to say the least, limited. Economists have treated institutions as a black box in much the same way as they treated technology for some time. What is more, orthodox economics has sought to harmonize the role as also the form of institutions across the world irrespective of space and time. This is a serious mistake, since one-size does not fit all. There are specificities in space. Institutions are local and cannot be transplanted out of context. There are specificities in time. Institutions need time to evolve and cannot be created by a magic wand. The blueprints for economic liberalization over the past 25 years have simply not recognized this reality.

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<sup>29</sup> For a fascinating historical analysis of the development experience of latecomers to industrialization, see Amsden (2001); Chang (2002a).

<sup>30</sup> See for example, North (1990); Chang (2002b).

The meaning of institutions is not always clear. At one level, institutions refer to the rules of the game. These rules can be formal, as in constitutions, laws or statutes. These rules can also be informal, as in norms, conventions or practices. At another level, institutions refer to organizations or entities that are not players. The role of the state is crucial in almost every dimension of institutions. In an economy, the state seeks to govern the market through rules or laws. It does so by setting rules of the game for players in the market. In particular, it creates frameworks for regulating markets. But it also creates institutions, whether organizations or entities, to monitor the functioning of markets. The development of such institutions, which cannot always develop on their own, may need some pro-active for the state, as catalyst if not leader. Of course, there are institutions that may develop through markets, as in standards or for safety, but these depend on social norms.

In a market economy, social norms are perhaps as important as laws or organizations in the world of institutions.<sup>31</sup> Clearly, there is a world beyond ‘methodological individualism’ which reduces all social and economic interaction simply to the self-interest of the individual. This proposition is nicely illustrated by Adam Smith’s intellectual journey from the *Theory of Moral Sentiments* to the *Wealth of Nations*. The notion of society came to be embedded in a wider range of human moral sentiments. This was Smith’s composite notion of ‘sympathy’. Such sympathy was not just altruism. It was a complex range of co-existing, often conflicting, human motives that culminated in social norms such as trust in exchange, respect for contracts or reciprocity in behaviour. Some of these may also have been the outcome of longer term enlightened self-interest. In this world, exchange and production in markets is sustained by underlying, unwritten, social norms. Indeed, without such social norms, no market economy can function. Unfortunately, social norms, so essential for institutions, are no longer part of conventional academic discourse, which exaggerates the efficiency of an abstract market mechanism based on an invented auctioneer and neglects the role of the state in preserving or reinforcing these norms.

The literature does not make any clear distinction between forms and functions of institutions. There is, also, little understanding of processes of change in existing institutions or in evolution of new institutions. Much remains to be done so as to improve understanding of institutions and of institutional change in the process of development, which could be the difference between success and failure at development. Such understanding needs not only theory but also history. However, the theory must be non-ideological just as the history must be non-selective.

In every society, economy and polity are closely intertwined. It is the interaction of economics and politics which shapes outcome for people. Therefore, it is essential to

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<sup>31</sup> For a lucid discussion on the importance of social norms in market economies, with particular reference to Adam Smith, see Bhaduri (2002).

explore the interplay between economics and politics in the process of development.<sup>32</sup> There is, then, need for a political economy that extends beyond econometric analysis at a micro level, even if it is the fashion of our times. This is easier said than done. But a beginning could be made by exploring the relationship between markets and democracy, democracy and development, and development and empowerment.

The essence of the tension between the economics of markets and politics of democracy must be recognized. In a market economy, people vote with their money in the market place. But a political democracy works on the basis of one-person-one-vote. The distribution of votes, unlike the distribution of incomes or assets, is equal. One adult has one vote in politics even though a rich man has more votes than a poor man, in terms of purchasing power, in the market. This tension may be compounded by a related asymmetry between economy and polity. The people who are excluded by the economics of markets are included by the politics of democracy. The rich dominate a market economy in terms of purchasing power. But the poor have a strong voice in a political democracy in terms of votes. Hence, exclusion and inclusion are asymmetrical in economics and politics. In reconciling the market economy and political democracy, successive generations of economic thinkers and political philosophers have stressed the role of the state in this process of mediation. The reason is important even if it is not obvious. Governments are accountable to their people whereas markets are not. In a democracy, however, governments are elected by the people. But even where they are not, the state needs legitimation from the people most of whom are not rich or are poor.<sup>33</sup>

The relationship between democracy and development is also complex. But it is important to reject the view that latecomers to development cannot afford the luxury of democracy. Indeed, thinking ahead, it is clear that democracy is going to be conducive to the process of development. The reason is straightforward. The essential attributes of democracy, transparency and accountability, provide the means for combining sensible economics with feasible politics.<sup>34</sup> The economic priorities of the people will be reflected more and more in the political agenda of parties if there is a transparency in the system. The agenda of political parties will be reflected more and more in the reality of economic development if there is accountability in the system. Once this two-way process gathers momentum, transparency and accountability will create a commitment to long-term objectives of development in the context of a political democracy where governments are bound to change through elections over time.

The problem is that democracy, while conducive and necessary, is not sufficient to actually produce development. We know that from experience. Development may or

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<sup>32</sup> This is stressed by North (2001) in a short essay on understanding development.

<sup>33</sup> The discussion in this paragraph draws upon Nayyar (2003b).

<sup>34</sup> For a more detailed discussion, see Bhaduri and Nayyar (1996).

may not be provided from above by benevolent governments. It must be claimed from below by people as citizens from governments that are accountable. The empowerment of people, then, is an integral part of any process of change that leads to development. A political democracy, even if it is slow, provides a sure path for two reasons. It increases political consciousness among voters to judge political parties for their performance. At the same time, it increases participation in the political process when it leads to mobilization on some issues. This highlights the significance of Sen's conception of development as freedom. Expanding freedoms for people at large constitute development. But the same expanding freedoms, which empower people, are instruments that drive the process of change in development.

Governance is critical in the process of development. The real issue is not about more or less government. It is about the quality of government performance. This has two dimensions. The first dimension is more obvious. It is about redefining the economic role of the state in a changed national and international context. In the earlier stages of development, the primary role is to create initial conditions. In the later stages of development, the role is neither that of a promoter nor that of a catalyst. It is somewhat different and spans a range: functional intervention to correct for market failure, institutional intervention to govern the market, or the strategic intervention to guide the market.<sup>35</sup> In this era of markets and globalization, surprisingly enough, the role of the state is more critical than ever before and extends beyond correcting for market failures or regulating domestic markets. It is about creating the initial conditions to capture the benefits from globalization, about managing the process of integration into the world economy in terms of pace and sequence, about providing social protection and safeguarding the vulnerable in the process of change and about ensuring that economic growth creates employment and livelihoods for people.<sup>36</sup> In sum, governments need to regulate and complement markets so as to make them people-friendly. Thus, the role of the state in the process of development will continue to be made for some time to come, even as the scope of the market increases through liberalization in the wider context of globalization.

The second dimension, good governance, is less obvious. It is, however, more concrete and less abstract. Governance is largely about rules and institutions that regulate the public realm in civil society. A democratic system seeks to provide for equal participation of the rich and the poor, or the strong and the weak, individuals as citizens in political processes. And good governance is a process characterized by communication and consultation, through which disputes are resolved, consensus is built and performance is reviewed on a continuous basis. The basis for good governance is a democratic political system that ensures representative and honest governments responsive to the needs of people. This involves more than simply free and fair

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<sup>35</sup> Nayyar (1997); see also Bhaduri and Nayyar (1996).

<sup>36</sup> See World Commission on the Social Dimension of Globalization (2004).

elections. It implies a respect for economic, social and political rights of citizens. The rule of law is a foundation. An equitable legal framework, applied consistently to everyone, defends people from the abuse of power by state and non-state actors. It empowers people to assert their rights. The need for good governance extends to economic, social and political institutions required for the functioning of market economy and political democracy. A vibrant civil society, empowered by freedom of association and expression which can voice diversity in views, is just as important for good governance in so far as it provides checks and balances when governments do not act as they should. In sum, good governance, where governments are accountable to citizens and people are centre-stage in the process of development, is essential for creating capabilities, providing opportunities and ensuring rights for ordinary people. Governance capabilities matter. Indeed, the quality of governance is an important determinant of success or failure at development.<sup>37</sup> The moral of the story is not less government but good governance.

## **6 International context: governing globalization**

It is clear that, during the first quarter of the twenty-first century, development outcomes would be shaped, at least in part, by the international context. It is also clear that unfair rules of the game in the contemporary world economy would encroach on policy space so essential for development. This situation needs to be corrected. The correctives should endeavour to make existing rules less unfair, introduce new rules where necessary and recognize that even fair rules may not suffice. But this endeavour cannot succeed without more democratic structures of governance in the world economy. In this process, interestingly enough, the role of nation states would be critical. In reshaping unfair rules, it need hardly be said that the nature of the solution depends upon the nature of the problem. Where there are different rules in different spheres, it is necessary to make the rules symmetrical across spheres. Where there are rules for some but not for others, it is necessary to ensure that the rules are uniformly applicable to all. Where the agenda for new rules is partisan, it is imperative to redress the balance in the agenda.<sup>38</sup>

There is a clear need for greater symmetry in the rules of multilateral trading system embodied in the WTO. If developing countries provide access to their markets, it should be matched with some corresponding access to technology. If there is almost complete freedom for capital mobility, the draconian restrictions on labour mobility should at least be reduced. The enforcement of rules is also asymmetrical. In the Bretton Woods

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<sup>37</sup> A striking illustration of this proposition is provided by the wide diversity in economic performance across states in India, despite common policies, similar institutions and the economic union. There are even more striking examples that emerge from a comparison of economic performance across countries in the developing world.

<sup>38</sup> The following discussion on the rules of the game in the world economy draws upon earlier work of the author (Nayyar 2002a; 2003a).

institutions, enforcement is possible through conditionality. Such conditionality, however, is applicable only to developing countries or transition economies that borrow from the IMF or the World Bank. In the WTO, enforcement is possible through retaliation. But most developing countries do not have the economic strength, even if they have the legal right, to retaliate. The reality, then, is that the countries that are poor or weak conform to the rules, whereas countries that are rich or strong can flout the rules. And the hegemonic powers, often, simply ignore the rules. The enforcement of rules for the rich and the powerful is, therefore, essential. In addition, the agenda for the new rules needs careful scrutiny for it is shaped by the interests of industrialized countries while the needs of development are largely neglected. For instance, if the proposed multilateral agreement on investment is so concerned about the rights of transnational corporations, some attention should also be paid to their possible obligations. In any case, such an agreement should not be lodged in the WTO. The issue of labour standards, of course, is simply not in the domain of the WTO.

But that is not all. There are some spheres where there are no rules, such as international financial markets or cross-border movements of people, which are not even on the agenda. The time has come to introduce some rules that govern speculative financial flows constituted mostly by short-term capital movements, sensitive to exchange rates and interest rates, in search of capital gains. It is also perhaps necessary to think about a new international financial architecture in which a World Financial Authority would manage systemic risk associated with international financial liberalization, co-ordinate national action against market-failure or abuse, and act as a regulator in international financial markets.<sup>39</sup> Similarly, it is worth contemplating a multilateral framework for consular practices and immigration laws that would govern cross-border movements of people, akin to multilateral frameworks that exist, or are sought to be created, for the governance of national laws, or rules, about the movement of goods, services, technology, investment and information across national boundaries.<sup>40</sup> The essential object should be to create a transparent and non-discriminatory system, based on rules rather than discretion, for people who wish to move, temporarily or permanently, across borders.

Rules that are fair are necessary but not sufficient. For a game is not simply about rules. It is also about players. And if one of the teams or one of the players does not have adequate training or preparation, it will simply be crushed by the other. In other words, the rules must be such that newcomers or latecomers to the game, for example developing countries, are provided with the time and the space to learn so that they can become competitive players rather than push-over opponents. In this context, it is

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<sup>39</sup> For a discussion on the rationale for, and contours of, such a World Financial Authority, see Eatwell and Taylor (2000).

<sup>40</sup> For a discussion on the rationale for such a multilateral framework to govern cross-border movements of people, see Nayyar (2002c). The World Commission on the Social Dimension of Globalization (2004) makes a similar proposal.

important to stress that, for countries at vastly different levels of development, there should be some flexibility, instead of complete rigidity, in the application of uniform rules. Indeed, uniform rules for unequal partners can only produce unequal outcomes. Thus, we should be concerned with the desirability of the outcomes and not with the procedural uniformity of rules. It is, in principle, possible to formulate general rules where application is a function of country-specific or time-specific circumstances, without resorting to exceptions. It implies a set of multilateral rules in which every country has the same rights but the obligations are a function of its level or stage of development. In other words, rights and obligations should not be strictly symmetrical across countries. And there is a clear need for positive discrimination or affirmative action in favour of countries that are latecomers to development.

The reshaping of rules is easier said than done. Much would depend upon structures of governance. The existing arrangements for global governance are characterized by a large democratic deficit.<sup>41</sup> In terms of representation, the existing system is less than democratic. For one thing, representation is unequal, in part because of unequal weights in representation in institutions such as the IMF and the World Bank, and in part because of exclusion from representation in arrangements such as the P5 or the G7 or even the OECD. For another, representation is incomplete in so far as it is confined mostly to governments, with little that could be described as participation by civil society or corporate entities, let alone people or citizens. In terms of decision making, the existing system is even less democratic. Where some countries have more votes than others and yet other countries have no votes, the system is obviously undemocratic. Even the principle of one-country-one-vote, however, does not ensure a democratic mode. Much also depends on how decisions are made. The right of veto in the Security Council of the UN is explicitly undemocratic. But decision making by consensus, as in the WTO, can also be undemocratic if there is bilateral arm twisting or a consensus is hammered out among a small sub-set of powerful players, while most countries are silent spectators that are in the end a part of the apparent consensus.

It is difficult to imagine more democratic structures of governance in a world of such disparities, economic and political, between countries. But democracy is not simply about majority rule. It is as much about the protection of rights of minorities. The essential corrective, then, is to create institutional mechanisms that give poor countries and poor people a voice in the process of global governance. Even if they cannot shape decisions, they have a right to be heard. In addition, wherever existing rules constrain autonomy or choices in the pursuit of development, there is a need for the equivalent of an escape clause. Such a provision to opt out of obligations embedded in international rules, without having to forsake rights, could provide countries that are latecomers to development with the requisite degrees of freedom in their national pursuit of

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<sup>41</sup> The democratic deficit is analyzed, at some length, in Nayyar (2002a).

development objectives. It is important to recognize that, in democratic situations, *exit* has as much significance as *voice*.

In the international context, where the distribution of economic and political power is so unequal, the nation state is, perhaps, the only institutional medium through which poor countries or poor people can attempt to influence or shape rules and institutions in a world of unequal partners. This is because only nation states have the authority to set international rules. Groups of countries with mutual interests are more likely to be heard than single countries by themselves. There will always be some conflict of interest but there will always be areas where it is possible to find common cause and accept trade-offs. In principle, it is possible to contemplate co-operation among nation states to create rules and norms for the market that transcend national boundaries, just as the nation state created rules and norms for the market within national boundaries. In practice, however, a recognition of the benefits of such co-operation might not be motivation enough. Co-operation among nation states is far more likely to materialize, much like stable coalitions, if and when the costs of non-co-operation cross the threshold of tolerance. In either case, the nation state is the most important player in the game. Therefore, it is not possible to imagine good governance in the world without nation states, just as it is not possible to have good governance in countries without governments.

## **7 Conclusion**

In considering the prospects for development during the first quarter of the twenty-first century, it is time to reflect on a new agenda for development. In this reflection, the concern for efficiency must be balanced with a concern for equity, just as the concern for economic growth must be balanced with a concern for social progress. It is also time to evolve a new consensus on development, in which the focus is on people rather than economies. Such a consensus must be built on a sense of proportion which does not re-open old ideological battles in terms of either-or choices, and on a depth of understanding which recognizes the complexity and the diversity of development. This thinking should not be limited to the sphere of economics. It must extend to the realm of politics. For substantive democracy, which creates a political accountability of governments to the people, must be an integral part of the new agenda for, and the new consensus on development. In such a world, ensuring decent living conditions for people, ordinary people, would naturally emerge as a fundamental objective. Development must, therefore, provide all men and women the rights, the opportunities and the capabilities to expand their freedoms and exercise their own choices for their wellbeing. In this process, people would be participants rather than beneficiaries. The distinction between ends and means would remain critical. And, in the pursuit of development, the importance of public action cannot be stressed enough. It must be an integral part of development strategies, which should not be forgotten in the enthusiasm for markets and globalization.



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