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Development policy: An introduction for students

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Development Policy

An Introduction for Students

Tony Addison*

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Abstract

This paper discusses development policy objectives, noting how these have changed over the years, with a more explicit focus on poverty reduction coming recently to the fore. It also examines the relationship between economic growth and poverty reduction. The paper then discusses how to achieve economic growth, starting with the caveat that growth must be environmentally sustainable, and moves on to the big question of the respective roles for the market mechanism and the state in allocating society's productive resources. The paper next discusses how economic reform has been implemented, and the political difficulties that arise. It concludes that getting development policy right has the potential to lift millions out of poverty.

Keywords: development, poverty, human development, inequity

JEL classification: O1, O2, P5

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1 Introduction¹

There are over one billion people living in extreme *poverty* today, defined as having less than US\$ 1 per day to survive on (see Table 1). The situation in Sub-Saharan Africa (SSA) is especially desperate; nearly half of the population is poor and poverty has increased over the last decade. Some 799 million people, or 17 per cent of the population in developing countries, are undernourished, and in Sub-Saharan Africa one-third of the population is undernourished, the largest of any developing region and a percentage that is rising (World Bank 2003: 6). Yet, set against this grim picture there has also been considerable progress, notably in East Asia where the percentage of people living in extreme poverty has been cut in half (from 30.5 per cent in 1990 to 15.6 per cent in 1999: see Table 1). Even in South Asia, which has the largest numbers of poor people of all the world's main regions (some 488 million), the percentage of people in poverty has fallen substantially over the last decade.

Looking at *economic growth* (the rate of growth in gross domestic product (GDP) often presented on a per capita basis), Sub-Saharan Africa has performed very badly for much of the period since 1980 (with the notable exceptions of Botswana and Mauritius) and many African countries today have a level of per capita GDP below that of 1980: GDP per capita is below the level of the 1960s in countries that have experienced civil war (for example, Angola, the Democratic Republic of the Congo, and Liberia). At the other extreme, the growth of some East Asian countries has been at rates which are historically unprecedented. Whereas it took the United Kingdom—the world's first industrial nation—54 years to develop from a low per-capita income economy to a middle-income economy, it took Hong Kong, Singapore and Taiwan only 10 years to achieve middle-income status (estimates from Parente and Prescott 2000). China is presently growing at over 9 per cent a year. Latin America achieved steady if unspectacular growth in the period up to the late 1970s but then went into deep recession as the debt crisis erupted in the 1980s (years which Latin Americans describe as the 'lost decade'). Latin America recovered in the 1990s, but the region has begun to falter again, with a spectacular economic collapse in Argentina which was the star reformer of the early-to-mid 1990s. Lastly, the Middle East and North African countries raised their standard of living using their oil wealth, but have largely failed to achieve

Table 1
Extreme poverty, 1990-2015

	People living on less than US\$ 1 a day (millions)			Share of people living on less than US\$ 1 a day (%)		
	1990	1999	2015	1990	1999	2015
			(forecast)			(forecast)
East Asia & Pacific	486	279	80	30.5	15.6	3.9
Excluding China	110	57	7	24.2	10.6	1.1
Europe and Central Asia	6	24	7	1.4	5.1	1.4
Latin America and Caribbean	48	57	47	11.0	11.1	7.5
Middle East and North Africa	5	6	8	2.1	2.2	2.1
South Asia	506	488	264	45.0	36.6	15.7
Sub-Saharan Africa	241	315	404	47.4	49.0	46.0
Total	1,292	1,169	809	29.6	23.2	13.3
Excluding China	917	945	735	28.5	25.0	15.7

Source: World Bank (2003: 5).

¹ This paper is forthcoming in Burnell and Randell (2004).

Table 2
Economic growth, 1980-2001 (average annual % growth)

	1980-90	1990-2001
Low income	4.5	3.4
Middle income	2.9	3.4
Lower middle income	4.0	3.7
Upper middle income	1.7	3.1
Low and middle income	3.2	3.4
East Asia and Pacific	7.5	7.5
Europe and Central Asia	2.1	-1.0
Latin America and the Caribbean	1.7	3.2
Middle East and North Africa	2.0	3.0
South Asia	5.6	5.5
Sub-Saharan Africa	1.6	2.6
High income	3.3	2.5
Europe EMU	2.4	2.0

Source: World Bank (2003: 188).

economic diversification and provide employment for their growing and young populations, while dictatorship and war have driven countries such as Iraq back down into the low-income country group.

In summary, the developing world today presents a very mixed picture: very fast growth and poverty reduction in much of Asia; slow or negative per capita GDP growth in SSA combined with rising poverty; high volatility in Latin America's economic performance; and widespread stagnation in North Africa and the Middle East, despite often abundant natural resources.

What role has development policy played in these different outcomes? What policies are most important for accelerating development? Is the development past a guide to the development future? What lessons can we transfer across countries? As Nobel Laureate Robert Lucas says: 'The consequences for human welfare involved in questions like these are simply staggering. Once one starts to think about them, it is hard to think about anything else' (Lucas 1988: 5).

This paper will show how the answers contained in ideas about development policy have changed over time. On some issues there is now a large measure of consensus on what needs to be done. But many issues remain deeply controversial, with starkly contrasting viewpoints.

Key points:

- Over one billion people live in extreme poverty, about one-sixth of the world's population.
- Poverty is falling in Asia, but remains high and increasing in SSA.
- Developing countries show very mixed economic performance, with success in much of Asia, but poor performance in SSA, and economic instability in Latin America.

2 Defining development policy objectives

Much of today's debate is centred on poverty reduction as the primary objective for development policy (as can be seen when you look at the websites of the international agencies given at the end of this paper). People differ as to how to define poverty: economists typically favour monetary measures, using data collected from household surveys of incomes and expenditures. If the household falls below a defined poverty line, then it is classified as poor. However, since not all countries have the data to define poverty in this way, the US\$ 1 per day measure that we encountered earlier is often used to calculate the global and regional aggregates.

Non-monetary measures of poverty are increasingly used as well—measures such as infant mortality, life expectancy, and literacy—and nearly everyone now accepts that poverty is a multi-dimensional phenomenon. This is evident in the Millennium Development Goals (MDGs) which were adopted by the world's leaders in the UN Millennium Declaration of September 2002, and these are now the guiding principles for the international development community (Box 1 sets out the MDGs in detail).

In the early days of development policy—the era of decolonization which ran from the late 1940s through to the 1960s—poverty reduction was often more implicit than explicit in development strategies. These tended to focus on raising GDP per capita (more loosely income per capita) by means of economic growth—it being assumed that poverty reduction would then follow, more or less, from growth. So early development thinkers gave a lot of emphasis to raising output, in particular to increasing overall labour productivity (output per person) by shifting labour from sectors in which its productivity is low to sectors in which it is high. This led to a concentration on industrialization which was seen as the dynamic sector while for many policymakers, smallholder ('peasant') agriculture appeared to be hopelessly backward and unproductive (it could therefore release large amounts of labour for industry). Crudely put, industrialization and urbanization became synonymous with development in the minds of many policymakers from the 1940s to the 1960s. This was reinforced by what appeared, at the time, to be the successful example of the Soviet Union which had achieved large-scale industrialization from the 1930s onwards. Aid donors were also very willing to fund large-scale infrastructure projects, especially when these benefited their own suppliers of capital equipment.

Income per capita is an *average* measure of a country's living standard, and there can be a wide *variation* around this mean. This variation—the inequality of income—exhibits substantial differences across countries. Figure 1 shows the *Gini index*, a commonly used measure of inequality in income or consumption (the higher the value of the index the greater the level of inequality). Brazil and the southern African economies of Botswana, Namibia, and South Africa have the highest levels of inequality in the world, for example. These cross-country differences in income inequality reflect differences in the distribution of wealth (land, other property, and financial wealth) and *human capital* (defined as peoples' skills and capabilities, which are partly a product of their education, and which make them more productive). These differences in turn reflect country-specific histories of colonization, war, and policy decisions. South Africa's extreme inequality in income and wealth is a legacy of apartheid, for instance.

Box 1
The Millennium Development Goals

Goal 1 Eradicate extreme poverty and hunger

Target 1 Halve, between 1990 and 2015, the proportion of people whose income is less than US\$ 1 a day

Target 2 Halve, between 1990 and 2015, the proportion of people who suffer from hunger

Goal 2 Achieve universal primary education

Target 3 Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling

Goal 3 Promote gender equality and empower women

Target 4 Eliminate gender disparity in primary and secondary education, preferably by 2005 and in all levels of education no later than 2015

Goal 4 Reduce child mortality

Target 5 Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate

Goal 5 Improve maternal health

Target 6 Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio

Goal 6 Combat HIV/AIDS, malaria and other diseases

Target 7 Have halted by 2015 and begun to reverse the spread of HIV/AIDS

Target 8 Have halted by 2015 and begun to reverse the incidence of malaria and other major diseases

Goal 7 Ensure environmental sustainability

Target 9 Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources

Target 10 Halve by 2015 the proportion of people without sustainable access to safe drinking water

Target 11 Have achieved by 2020 a significant improvement in the lives of at least 100 million slum dwellers

Goal 8 Develop a global partnership for development

Target 12 Develop further an open, rule-based, predictable, non-discriminatory trading and financial system (includes a commitment to good governance, development, and poverty reduction, both nationally and internationally)

Target 13 Address the special needs of the least developed countries (includes tariffs- and quota- free access for exports, enhanced program of debt relief for and cancellation of official bilateral debt, and more generous official development assistance for countries committed to poverty reduction)

Target 14 Address the special needs of land-locked countries and small-island developing states (through the Program of Action for the Sustainable Development of Small Island Developing States and 22nd General Assembly Provisions)

Target 15 Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term

Target 16 In cooperation with developing countries, develop and implement strategies for decent and productive work for youth

Target 17 In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries.

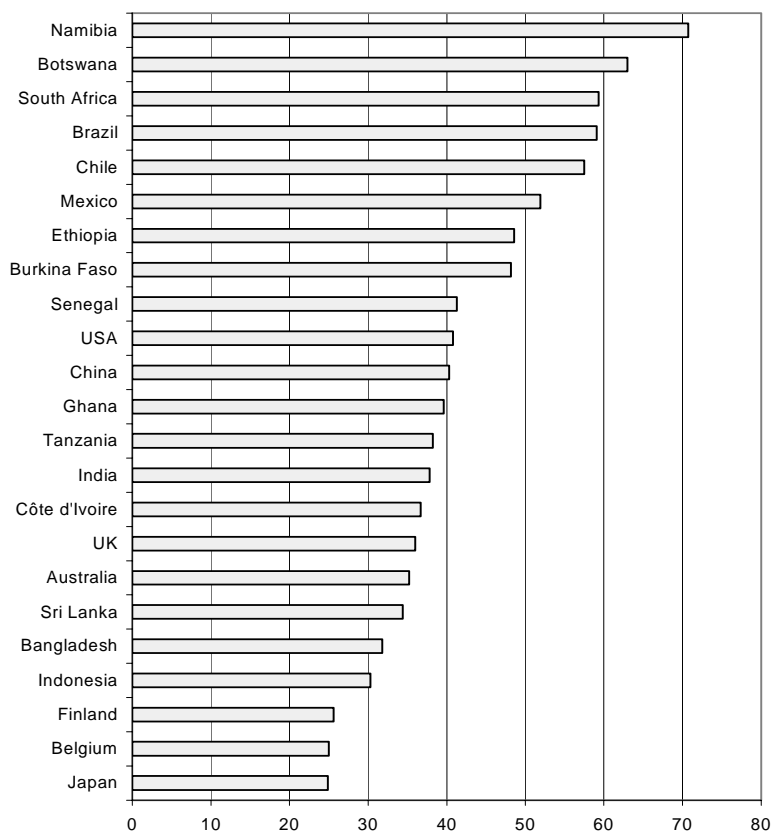
Target 18 In cooperation with the private sector, make available the benefits of new technologies, especially information and communication technologies

Source: UNDP (2003).

Quite apart from the ethical dimension and the possibility that high inequality can be socially destabilizing, many people are concerned about high inequality because when a society starts from a situation of high inequality (as in Brazil and South Africa) then economic growth has a smaller benefit in reducing absolute poverty than when society starts from a position of lower inequality. It is simply the case that the rich will gain more from any percentage point of GDP growth than the poor when the rich command substantial income and wealth to start with. When there are a lot of job-seekers, as is the case in many developing countries, it will take a great deal of sustained growth in output before the labour market tightens and people start to see a significant rise in their wages. So looking at it another way, high-inequality societies need to grow a lot faster to achieve the same amount of annual poverty reduction as low-inequality societies.

Figuring out how much economic growth is needed to halve the proportion of the world's people in poverty between 1990 and 2015 (Millennium Development Goal 1) is very important. This has led to an often heated debate about how much growth reduces poverty (for a variety of perspectives, see Shorrocks and van der Hoeven 2004). If we assume unchanged income inequality then, for the developing world as a whole, UNDP reckons that the poverty rate declines by 2 per cent for each 1 per cent increase in average per capita income (UNDP 2003: 67). On this score Africa presents the most depressing picture. In 2002, only five of Africa's 53 countries achieved the 7 per cent annual growth estimated necessary to meet the MDG for reducing extreme poverty,

Figure 1
Gini index for selected countries



Source: World Bank (2003: 64-7).

with average growth being 3.2 per cent for SSA (UNECA 2003). Forty-three countries achieved positive growth but below 7 per cent, and five saw a decline in GDP. The picture is especially bleak in the conflict-affected countries such as the Democratic Republic of the Congo, Liberia, and the Sudan (see Box 2). And the spread of HIV/AIDS is also dramatically affecting MDG indicators, and undermining economies, especially in southern Africa which has a high incidence of the disease.

The assumption that as growth proceeds, income (and wealth) inequality remains unchanged is of course a simplification. In practice, as economic growth proceeds, some of the poor will begin to accumulate some capital to invest in their livelihoods, buying more land, and using their own money to pay for their children's education—who will then obtain more remunerative occupations than their parents. But this will be a very tough challenge and they will be vulnerable to any setback; some will never get started at all, or will fall deeper into poverty, perhaps because of ill health.

So, countries need to protect and build the assets of the poor, particularly their human capital as well as the natural capital such as the soils, forests, and fisheries on which their livelihoods depend. Subsidizing primary education, basic health care, water and sanitation will not only raise the *human development* of poor people (measured by such indicators as life expectancy, infant mortality, and literacy) but will also raise their productivity. This will help them diversify their livelihoods in both self-employment (for example, from dependence on subsistence agriculture and into cash crops and micro-enterprises) and wage-employment (the poor will earn more as skilled workers than as unskilled workers). Asset *redistribution* may also be necessary to build the assets of the poor, and discussion of this issue often centres on the most fundamental asset of all for the rural poor, namely land, and the transfer of land from rich to poor. Asset redistribution is much more challenging politically, and large-scale redistributions tend to be associated with political revolutions. In these ways, economic growth will start to become more pro-poor, and each percentage point of growth will deliver more poverty reduction: a greater number of people will start to earn more than a dollar a day.

This awareness of what holds poor people back came to the fore in the 1970s, in part because of disillusion with the outcomes of the first development decades; the high hopes of decolonization proved to be largely illusory in Africa, and Latin America

Box 2
The development effects of conflict

The period 1990-2000 saw 19 major armed-conflicts in Africa, ranging from civil wars to the 1998-2000 war between Eritrea and Ethiopia. Peace has been elusive, and the term 'post-conflict' is often a sad misnomer.

Achieving peace has received much attention, but we should also take a closer look at the nature of post-conflict recovery. The end of war saves *lives*—including those of the poor who are often its main victims—but it may not deliver much if any improvement in *livelihoods*. War destroys the human and physical capital of the poor and it undermines the bonds of family and kinship that are central to the livelihoods of Africa's communities. These effects, together with the destruction of essential services and infrastructure, may so weaken the poor that they are unable to share in national recovery. Moreover, those who control the post-war state may be unable (or unwilling) to ensure that reconstruction benefits the majority. A narrow elite, sometimes including former warlords, may instead reap most of the gain; recovery's benefits will then be narrow rather than *broad based* in their distribution.

seemed to be mired in poverty despite otherwise achieving some economic growth. This led to a radicalization of the development debate with *dependency theory* much in vogue. In addition, by the 1970s there was much more evidence from academic research on the determinants of poverty and how poverty responds to economic and social change. This led to a reconsideration of the earlier view that smallholder agriculture was undynamic, and a new emphasis on the talents of poor people as farmers and micro-entrepreneurs. Development professionals began to see new ways of helping the poor to build their existing livelihoods. The World Bank, under its then President, Robert McNamara, began to move away from an emphasis on lending to physical infrastructure (the main business of the World Bank since its foundation and up to the 1970s) and towards poverty reduction, particularly through agricultural development—the principal livelihood of the world's poor. The UN agencies also sponsored considerable research into poverty and the 1970s saw the creation of new strategies of 'redistribution with growth' and 'basic needs', both of which put poor people at the centre of policy attention.

Note that a direct focus on poverty reduction has a sharper political dimension than a focus on growth in the development strategy. For a start, the poor may be poor because they have very little, if any, political voice. For instance in Sub-Saharan Africa, the rural poor have had generally very little influence over the political process, despite their numbers. This is seen in the way that development strategies have often ignored them or, perversely, taxed them—a point emphasized in the work of the political scientist Robert Bates (1981). Politicians need to expend very little political capital when they talk about economic growth being 'like a tide that raises all boats'. But when it comes to spending public money, basic pro-poor services—especially those that serve the rural poor—are often at the bottom of the list, after services that meet the needs of more vocal, and more effectively organized, non-poor groups (especially in urban political centres). A general bias against the rural areas and in favour of the urban areas (*urban bias*) was evident in much of post-independence Africa. Vocal and wealthy interests may effectively control the legislatures that determine the pattern of public spending and taxation (Central America is an example). And when economic crisis strikes, governments have too often let the burden of adjustment fall on the meagre services that are of benefit to the poor.

But we should not be too pessimistic. That some governments do more for poor people than others is evident from comparisons across countries that have similar levels of per capita income but substantial differences in poverty (see the data in UNDP 2003: 68). We see considerable variation in the poverty rate at each level of per capita income, with at least part of the variation due to differences in governments' political commitment to poverty reduction. And within countries, different regions often spend very different amounts on pro-poor services, reflecting the operation of local political factors: for instance in India, the state of Kerala has substantially superior human development indicators than many other Indian states (Sen 1999).

Unfortunately, the discussion of poverty strategies often amounts to producing 'wish lists'—long lists of everything that needs to be done for the poor, without much consideration of the cost. But how to finance the poverty reduction strategy is of critical importance, either through mobilizing more public money—requiring often difficult political decisions about taxation—or more external resources, including foreign aid. This in turn leads to often difficult decisions for the recipient government over how to deal with foreign aid donors and the conditionality they apply to their aid, as well as political difficulties for donors in dealing with governments that may not use aid effectively for poverty reduction. This issue has come to a head with the Poverty Reduction Strategy Papers (PRSPs) that aid donors now insist governments prepare; many of these strategies

are inadequately linked to the fiscal policies of governments (or are too ambitious for the resources that are available) and will therefore be under-funded. External capital flows, including foreign aid, can do much to assist poor countries. But countries themselves need to do more to mobilize additional domestic revenues to finance increased public spending on pro-poor development. This requires effective state organizations to mobilize the revenue and spend it wisely, but it also requires economic growth to raise the economy's tax base (for sales taxes, income taxes, and capital gains taxes, etc.) to provide, over time, higher levels of revenue to spend on raising poor people out of poverty.

But how do we actually achieve economic growth? That is the next important question for us to consider.

Key points:

- Poverty reduction has become a more explicit objective of development policy, and economic growth is now seen as more of a means to an end, rather than a final objective in itself.
- The effectiveness of economic growth in achieving poverty reduction lies in understanding how poor people make their livelihoods and whether they share in economic growth, and how the revenues generated by growth are used.
- Effective governance is necessary to achieve development objectives, particularly in providing pro-poor services and infrastructure.

3 Achieving economic growth

Economic growth can occur in many ways; population growth adds to the stock of workers and, provided that they are productive, to output; labour productivity rises through the accumulation of capital equipment together with technical progress. The implications of growth for poverty reduction depend in part on how growth occurs; whether it involves expanding the output and income that the poor derive from self-employment or their opportunities for wage-employment, for example. But before turning to the key issue of the respective role of states and markets in achieving growth, it is worth noting that the nature of growth also determines whether its environmental impact is benign or destructive. Agricultural output growth may result from a careful husbanding of 'natural capital' on which livelihoods depend, or these renewable resources may be depleted to levels that threaten their very existence. There is a big question of how to achieve economic growth in an environmentally sustainable way. Early development strategies largely ignored this dimension, and consequently inflicted often catastrophic environmental damage—some of which is irreversible, for example the reduction in biodiversity.

4 Markets and states

Most people agree that states have an important role to play in protecting property rights, providing law and order, and defending their citizens against external aggression. States can thereby reduce the *transactions costs* of market exchange (defined as the costs of doing business, including the costs arising when one party to a contract reneges on the agreement). But the demands that these tasks place on states should not be underestimated.

However, beyond a core set of *public goods* (goods and services such as defence, which will be under-provided by a market system) disagreement starts to open up about (a) the amount of physical infrastructure (roads, water and sewage systems, etc.) and social-sector provision (education, health care, etc.) the state should provide, together with the scale of its subsidy to users of these services and (b) how far the state should intervene in the market mechanism (the operation of supply and demand).

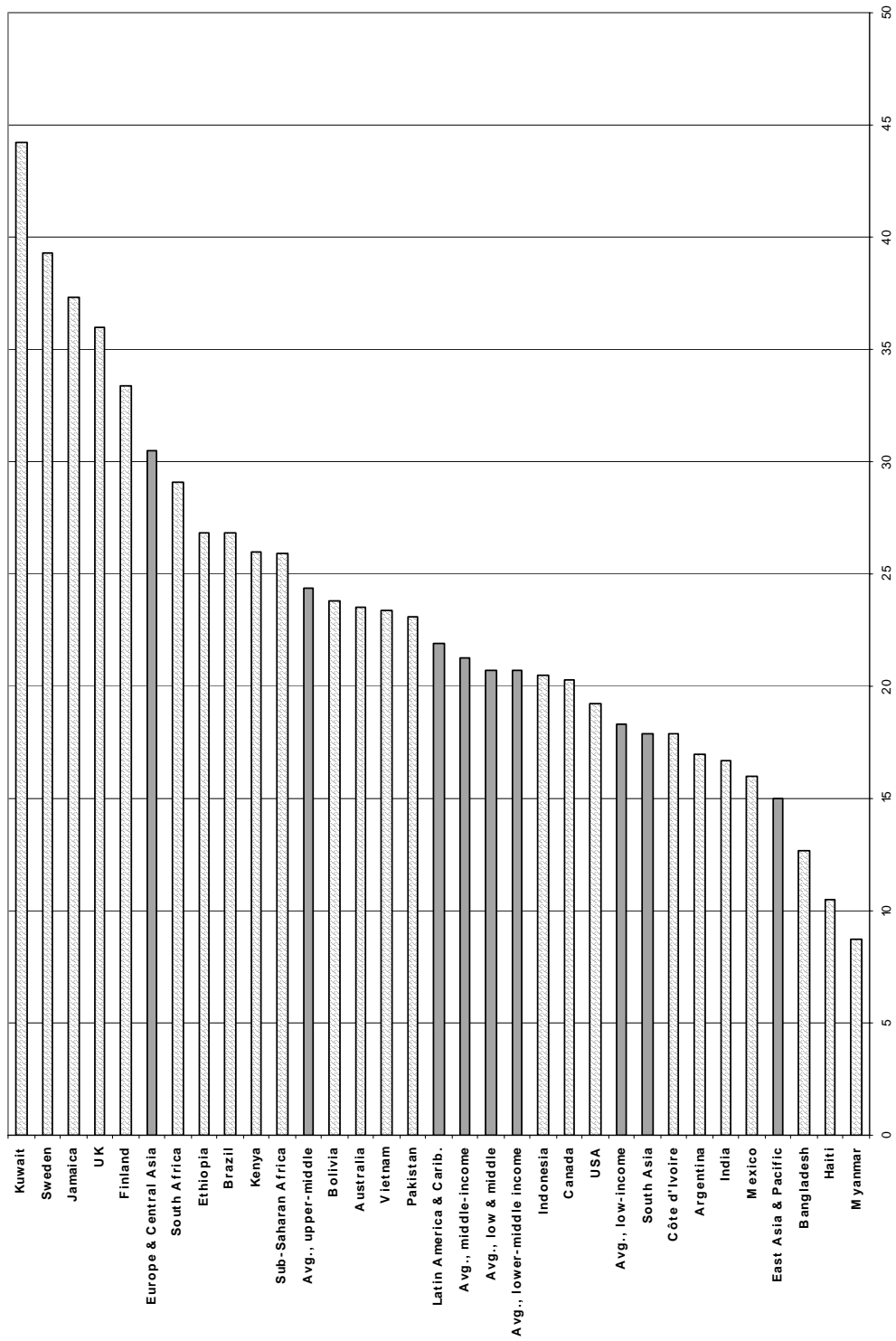
With regard to infrastructure and social-sector provision in the context of poverty reduction, there is wide agreement on the need for investment in education and basic health care, but there are differences over the scale of subsidy that the state should provide. The latter is also governed by the resources that the state can command through taxation, user-fees, domestic borrowing, foreign borrowing, and foreign aid (both grant aid and concessional borrowing). The range of provision can vary from partially-subsidizing basic services only, through to finely targeted pro-poor transfers, up to more generous subsidies at higher levels of service, and finally welfare states on the European model (including state pensions and unemployment insurance, etc.). Unless the state enjoys generous revenues (from abundant natural resources such as oil, for example), or generous external capital flows, its level of public spending will be low, and it will face hard choices in making the most effective use of the money that is available.

Again, the tasks involved in providing even basic levels of provision (and the resources required) should not be underestimated. Most of the world's poor people do not get the bare minimum package of primary education, health services, clean water and sanitation services, nor even the most basic infrastructure of roads, telecommunications and so on that they need.

For all these reasons, countries vary widely in their level of public spending as a share of GDP (Figure 2). This is one dimension along which analysts measure the involvement of government in the economy. But it is not the only dimension: the second dimension is the extent of the state's intervention in markets through controls on prices, quantities traded, and the number and nature of participants (including the state itself as a supplier of goods and services). Much of the debate on development strategy can be reduced to differences in views about how far market mechanisms (the operation of supply and demand) yield socially-desirable outcomes and therefore the virtue or otherwise of state action (where the definition of 'socially desirable' is also contested).

For instance, nearly everyone is agreed on the need for poverty reduction; their disagreement centres on how well market mechanisms yield poverty reduction (or indeed whether markets sometimes work against poor people). On the other hand, some people favour state action to reduce income inequality in addition to reducing poverty (that is, to reduce the spread of incomes right across society, not just reducing the number people living on less than US\$ 1 per day) while others are vehemently opposed to such egalitarian ideas, citing individual freedom, including the right to accumulate wealth (this is reflected in the traditional political debates of social democracy versus conservatism). Similar disagreement will be found on the ability of market mechanisms to yield economic growth, and whether a higher (or lower) growth rate will result from state intervention in the market mechanism (and how different types of intervention increase or decrease the prospects for growth). Similarly there is much debate on how far 'market-led' or 'state-led' development is compatible with, and supportive of, democratization and domestic political stability as well as national security and national sovereignty.

Figure 2
Total public expenditure as per cent of GDP for country groups and selected countries, 2000



Note: Total public expenditure on central government activities, as defined in World Bank (2003: 226-9).

People who are optimistic about the market's ability to produce their preferred set of socially-desirable outcomes will favour a minimal state: one that provides protection for property rights together with public goods that the market either does not supply or under-supplies (defence is one example, transport infrastructure is another). In contrast, people who are pessimistic about the market mechanism's ability to deliver any or all of their chosen set of socially-desirable outcomes will favour a more active state, but their conceptualization of what the state should do can show a very wide range. At one extreme is central planning (practiced by the former Soviet Union) where society's productive factors are allocated according to a plan without reference to market prices, and where state ownership of enterprises and property prevails. At the other end of the scale of the active state, there is the 'European model' where continental European states provide very high levels of public goods, regulate the market in the public interest, but otherwise encourage a very vigorous private sector.

Clearly, views about the desirability of state action are not only driven by attitudes towards markets but also by views on the effectiveness of states in correcting 'undesirable' market outcomes. Views on state effectiveness have swung like a pendulum over the last 50 years. As countries came to independence, they optimistically built national planning apparatuses and put considerable energy into devising national plans; the Soviet Union's example was very influential (most obviously in China, Cuba and Vietnam) as was the extent of state planning that the capitalist economies put in place in the Second World War and which many retained in the post-war years. By the late 1970s this confidence in the state's abilities was starting to erode, as growth slowed down, and often turned negative, due to a combination of policy failure—including the drain on the public purse of loss-making state-owned enterprises (SOEs)—together with the severe external shocks arising from the first (1974) and second (1979) oil price hikes, and the associated world recessions.

The intellectual pendulum swung back (albeit with considerable resistance) towards the market mechanism in the 1980s, a movement reinforced by the IMF and the World Bank and the conditionality they applied to their lending. This accelerated with the collapse of communism, and the start of the transition to market economies in Eastern Europe and the Soviet Union. By the early 1990s it was possible to write of a *Washington Consensus*—a term originally coined by John Williamson—and referring to the widespread view among policymakers, particularly in the IMF, the World Bank and the US Treasury but also in many Latin American governments, that a more liberal economic model, was the way to go. The key elements of the Washington Consensus are: fiscal discipline, reorientation of public expenditures, tax reform, financial liberalization, competitive exchange rates, trade liberalization, openness to foreign direct investment (FDI), privatization, deregulation, and secure property rights (see Williamson 2004).

These global changes influenced the climate of national debate within developing countries; in India, for example, the early 1990s saw a significant liberalization of the economy, as earlier ideas of planning and state-ownership came under intense domestic criticism. However, in the latter 1990s a reaction against market liberalization and privatization set in, and the intellectual pendulum began to swing back towards the state, owing to sharp increases in inequality, rising concern over liberalization's social effects, and the mismanagement of privatization. This was bound up in the intense debate about globalization (see Nayyar 2002). Economists increasingly recognized the importance of institutions in making the market mechanism work well for development and poverty reduction. Institutions are defined as formal and informal rules and

practices which affect human behaviour and interaction, especially in markets ('rules of the game') and which are often, but not always, embodied in organizations (for example, courts of law). The World Bank stepped back from its emphasis on the market alone and started to give increasing attention to institutional development.

Key points:

- The economic role of the state is one of the central issues dividing opinion on development strategy.
- Views on the role of the state have changed over the years, and the early emphasis on state-led development has been increasingly challenged by a market-liberal view, leading to widespread economic liberalization.
- Despite the roll-back of the state in many countries, the state still has many roles to play including the provision of public goods and the regulation of markets in the public interest.

5 Trade policy as an instrument for development

For market liberals, developing countries that follow their *comparative advantage* will reap higher living standards from trading as much as possible with the developed countries (where comparative advantage is defined, roughly, as the goods and services that a country is best able to produce relative to other countries). Their foreign exchange earnings will be used to finance imports of products in which they have a comparative *disadvantage*, namely those which are intensive in the use of capital equipment in their manufacture (where the developed countries will have the competitive edge, by virtue of their greater endowments of capital). Thus the developed countries will gain as well from trading as much as possible with the developing countries. In sum, the market-liberal story of trade is one of mutual gains from trade for both the developing and the developed worlds. This is a very powerful story, and one that has been refined by economists over the last 200 years, challenging the old *mercantilist view of trade* (which stated that one country's gain from trade is another's loss).

For market liberals comparative advantage is also the foundation of their view of how trade contributes to economic growth, through *outward-orientated* development (a development strategy that looks to the global market as a driving force for economic growth, through the creation of a favourable policy environment for exporters). In this view of the world, the growth in developing countries' labour-intensive exports will eventually bid up the price of labour (thereby contributing to poverty reduction). Capital-for-labour substitution will start to occur, and the composition of the country's exports will begin to move away from those intensive in unskilled labour and towards the skills that are necessary to run more capital-intensive production processes. In the meantime, the supply of skills should have increased with income: unskilled workers who saw their wages rise will have invested in educating their children and local and foreign investors will provide on-the-job training. But there is obviously a big role for government in subsidizing education and training to create the skills that an export economy needs as it moves out of the low-wage, unskilled labour stage. And the state has to protect the property rights of investors, ensure macroeconomic stability, and provide public goods, particularly transport infrastructure. So even in market-liberal accounts of economic performance, the state has a very important role to play.

Countries that have successfully pursued this type of development strategy, Mauritius for instance, have possessed an active state with a clear sense of priorities.

Nevertheless, in the early era of development (from the 1940s to the 1970s), many policymakers saw the domestic market as the main motor for growth; in other words, inward-orientated development was favoured over outward-orientated development. They resorted to large-scale market intervention, in particular introducing protection for their domestic producers by restricting imports of competing foreign goods (these quantitative restrictions are referred to as import quotas) and by raising the domestic price of foreign imports through the addition of tariffs at the point of importation. The effect of this was to increase the profitability of producing for the domestic market, in particular to engage in import-substituting industrialization. The infant-industry argument became very common: domestic producers should be protected from competition until they become efficient enough to compete against foreign goods. Achieving this competitiveness as quickly as possible is important because in the meantime purchasers of the protected goods will pay higher prices (and if the protected sector produces an important consumer good, this will inevitably raise the cost of living, including that for the poor). In some cases protection can actually work against industrialization; for example if protection is applied to the steel industry then domestic manufacturers (of vehicles, for example) will have to buy steel at a cost above the world price. Similarly industrial protection can work against agricultural development; for example protecting domestic manufacturers of agricultural inputs will reduce the profitability of farming.

Once in place, import protection tends to take on its own momentum. This is for two reasons. First, governments derive revenue from tariffs which are much easier to collect than indirect (sales) taxes or income taxes; a customs office is much easier to run than tax offices to collect sales taxes or income taxes (and politically much less trouble than income taxes or taxes on capital assets such as land). Consequently, many governments become very dependent on tariff revenues, and finance ministers find it easy to resort to hiking tariffs to resolve their budgetary problems.

Second, producers in industries protected by tariffs and quotas earn more than in a free market. It will pay producers to lobby for protection, either through the political system by supporting political parties that favour protection or through straight corruption (in both cases sharing some of their profits with state actors, who may themselves form partnerships with private-sector actors to profit from controls). In addition, when imports are subject to quotas, the restriction on the quantity to be imported raises the domestic price of the import, creating what economists' call an *economic rent* for those merchants fortunate enough to have the import license. They too have an incentive to press for import quotas that benefit their businesses, and to lobby vigorously for the valuable license.

Import protection may be introduced for the best of reasons; policymakers believe that the market, if left to itself, will not do enough to accelerate growth and that some closure of the economy to international trade is necessary. But critics of import protection argue that protection, once in place, starts to generate powerful forces that overwhelm national development priorities; eventually trade policy is driven by personal gain and not development priorities—with ever higher levels of protection undermining economic growth (thereby raising poverty). This view of the political economy of the *rent-seeking* society was most forcefully put by the economist Anne

Krueger, and it became highly influential in the World Bank's perspective from the early 1980s onwards.

The effects on policymaking, and therefore on economic performance, of lobbying and rent-seeking vary widely. They appear to have been worst in Sub-Saharan Africa where the smallness of domestic markets, combined with extensive use of import quotas, led to very high domestic prices for import-substituting domestic manufactures. Sub-Saharan Africa's infant industries achieved little learning by doing, and manufacturing has not achieved the expected growth. In India, there was much criticism of the so-called 'license raj'—leading to economic liberalization in the early 1990s—but India's growth performance was respectable, if undramatic, prior to liberalization. Those arguing for import protection as a positive force for development point to South Korea where the planning mechanism effectively contained rent-seeking and where export subsidies offset the disincentive to export production inherent in import protection. South Korea's large companies (the *chaebol*) benefited from protection of their home market which partly cross-subsidized their successful expansion into foreign markets. In this regard, South Korea's strategy, while being outward-orientated in nature, is markedly different from the pure market-liberal model.

Key points:

- Getting trade policy right is crucial for economic development, and the merits of using import protection and other trade policy interventions are hotly debated.
- Import protection can stimulate investment in infant industries, but it can also reduce growth by distorting economic incentives and encouraging rent-seeking.
- The failure of many countries to achieve growth through import protection has led to a new emphasis on outward-orientated development, but this too requires a well-designed strategy, particularly in creating new skills to sell in the global market-place.

6 Capital flows and economic reform

The previous section discussed how views about the respective roles of the market and the state in driving the development process have changed over the years. A major catalyst for economic policy change was the shocks experienced by the world economy in the 1970s and 1980s. Changes in the level and composition of capital flows (foreign aid, commercial bank lending, foreign direct investment, etc.) to developing countries have also been influential in inducing policy reform.

In the 1970s the non-oil producing developing countries ran into serious macroeconomic trouble with the first (1974) and second (1979) oil price shocks when the OPEC cartel quadrupled the world price of oil. It was during this time that the IMF became very important in providing balance-of-payments support to developing countries. Moreover, many middle-income countries, especially in Latin America, borrowed heavily from the international banking system. Many of the oil exporters used the revenue boom unwisely, spending profligately. They also borrowed heavily using their oil revenues as collateral; examples include Nigeria, Mexico, and Venezuela. They too ran into serious macroeconomic difficulties when the world oil price fell during the 1980s. The 1980s were therefore marked by a series of crises: the Latin American debt

crisis which ran throughout the decade as borrowers and lenders attempted to reschedule (and eventually write-off) debts, and in the poorer countries (Sub-Saharan Africa in particular) which became ever more dependent on aid inflows.

However, the East Asian economies of Malaysia, Singapore, South Korea, and Taiwan escaped largely unscathed and indeed maintained high growth during the 1980s and into the 1990s, until the Asian financial crisis of 1997-98. By the early 1980s South Korea was as highly indebted as some of the Latin American countries; however, it had built a powerful export economy which was able to generate the foreign exchange necessary to maintain debt service. This brought home an important lesson: countries neglect export markets at their peril. Chinese policymakers quickly learnt this lesson and China has, over the last twenty years, an increasingly large share of global manufacturing exports. Some analysts believe this could now pose a problem for smaller developing countries also seeking to grow by means of increasing their share of world markets for relatively low-cost manufactured goods.

7 Structural adjustment

With so many of its client countries in deep distress, the World Bank was compelled to move beyond its traditional project lending and in the 1980s it started to provide balance-of-payments support through structural adjustment loans (SALs). To get economies back on their feet, SALs carried policy conditionality typically including: currency devaluation (to stimulate the supply of exports); the conversion of import quotas into import tariffs to reduce rent-seeking (and then tariff reduction in order to place more competitive pressure on inefficient infant industries); the removal (liberalization) of market controls in agriculture (to provide more incentives for farmers); and the reform of public expenditures and taxation (to shift more spending towards development priorities and to mobilize more public revenues to finance spending). IMF lending also carried policy conditionality, the most important being a target for reducing the fiscal deficit and, relatedly, the growth in the money supply. The intention of IMF conditionality was to eliminate high inflation (and the associated loss of export competitiveness) which results from large fiscal deficits that are financed by monetary expansion, and to reduce the 'crowding out' of private investment which occurs when governments borrow heavily in domestic financial markets.

Although World Bank and IMF adjustment lending was intended to deal with the immediate macroeconomic crises, it was also seen as a way of introducing greater efficiency into the economy which, according to the Washington Consensus, required a reduced role for the state in the productive sectors (hence the start of privatization in the 1980s) as well as reduced controls (liberalization) on the private sector. As we discussed earlier, this has major implications for the way in which the domestic economy interacts with the world economy, since state controls on trade (through tariffs, and import quotas) are one of the main means by which governments drive development strategy. This would make development more outward-orientated in nature.

Irrespective of the merits (or not) of reform, most countries had little alternative but to sign up to the conditionality, since private capital flows slowed dramatically with the onset of the debt crisis in the 1980s, and official development flows became one of the few sources of external finance. This was especially true for the low-income countries: bilateral aid donors increasingly endorsed the World Bank and IMF viewpoint, and

linked their own aid programmes to acceptance of economic reform. At the same time, the volume of official flows stagnated and then fell after the end of the Cold War in the early 1990s, and official flows are presently about US\$ 55 billion per annum (OECD 2003).

Yet market liberalization has had very mixed results. Take the market for food staples for example. It is crucial for this market to work well because it affects so many people: farmers who produce a surplus to sell, farmers who produce too little themselves and must buy food, rural wage-labourers, and urban households. Therefore any change in the price and availability of food has major effects depending on whether you are a buyer or a seller. If the state withdraws, partially or wholly, from buying, storing, transporting, and selling food, then it has to be replaced by private entrepreneurs willing to undertake these tasks and bear the risks. But there is more profit to be made in supplying food to major urban centres than in marketing in remote and poor rural areas (Yotopoulos 1999).

Similarly, market liberalization in the manufacturing sector has mixed effects. The rapid removal of import protection led to factory closures and the loss of jobs in many reforming countries. While new jobs may eventually be created in export sectors—which, as we have seen, economic reform favours—it takes time to implement the necessary investment. In consequence, unemployment can rise sharply, at least in the ‘short term’.

It is not therefore surprising that many people oppose market liberalization. Moreover, reform’s effects are never clear cut. Many people will oppose reform (*ex ante*) fearing a loss, even if this is not the case (*ex post*). Conversely, some people may gain a lot (for example those producing exports) but the gains may take time to become apparent. And it may be the case that most people gain from a particular reform, but each individual’s gain is small, whereas a minority may lose, but their individual loss is very much larger. The incentive for the losers to organize to oppose the reform is therefore greater than the incentive of the winners to support the reform. Reform implementation may therefore stall even if, in aggregate, it benefits the majority. This is a good example of what Mancur Olson (2001) calls a *collective action* problem (defined as the difficulties that arise in organizing a group of people to achieve a common objective).

Although it is highly controversial, market liberalization is straightforward in its implementation because the state simply withdraws, partially or wholly, from the market. But to be successfully implemented, some reforms require state capacity to be strengthened. This is especially true of revenue and public expenditure reforms. The state’s capacity to mobilize tax and customs revenues and then to spend these resources effectively on pro-poor services and development infrastructure requires a capable and well-motivated government administration, at both central and local levels (the latter being especially important to improving local education and health for example). However, the quality of civil services, together with their motivation, was in steep decline before reform began in many countries, especially in Africa where inflation eroded the real wages in the public sector. Governments were therefore attempting to implement demanding changes with very limited institutional and human resources. At the same time they faced vocal opponents of public expenditure and taxation reforms. Reform breakdown and policy reversal have therefore been common; Zambia for example went through a series of donor-supported adjustment programmes that largely failed to achieve progress.

The *social impact of economic reform* (the impact on poverty and human development as well as on social cohesion more generally) has generated considerable controversy since the early years of adjustment lending. The picture is complicated because reforms have both positive and negative implications for the poor. These vary across countries depending on economic structures (agrarian-based economies versus the semi-industrialized) and thus the means by which the poor participate in the market economy (as smallholders or wage-employees for example). The initial concentration of assets (particularly land) and incomes also determines much of the distribution of the benefits if reform is successful in raising growth. The urban poor, as well as food-deficit rural households, are often hit hard by devaluation since reform raises the prices of imported food staples. This is especially the case when the authorities have failed to correct overvaluation for a long period, leading to a sudden and large devaluation when action cannot be forestalled any longer, as in the adjustment episodes of many West African countries. There is also a fierce debate on whether economic reform contributed to the breakdown of states and societies in such countries as Sierra Leone and Somalia.

So-called 'second generation' reforms (privatization and financial reform, in particular) have been taking place since the 1990s in countries such as Ghana, Uganda, and Tanzania that began their first generation reforms (devaluation and trade liberalization) in the 1980s. Implementation of second generation reforms has often been problematic. For instance privatization has been non-transparent in many cases, thereby transferring valuable assets to the politically connected. Financial reform has been an especially troublesome task, and the IMF's enthusiasm for early financial liberalization has now been tempered. Asia's financial crisis, and Africa's bank failures, both highlight the need to build capacity for prudential supervision and regulation in central banks before major liberalization of financial controls. Tax reform and the construction of better systems of public expenditure management (both essential to more investment in development infrastructure and pro-poor services) has stalled in many cases. Both financial reform and fiscal reform illustrate the importance of building effective state capacities to regulate the (financial) market in the public interest, and to achieve improvements in the public goods that are necessary to a well-functioning market economy as well as poverty reduction.

Key points:

- Many countries are engaging in economic reform, driven by the failure of past development strategies, policy conditionality attached to development aid, and the need to attract private capital.
- Market liberalization is much easier to achieve than reforming the state, so that state institutions become more effective in achieving development.
- Reform may be opposed because it has large social costs, or because the losers from reform often have more incentive, and find it easier to organize themselves politically, than winners from reform.

8 Conclusions

At the start of this paper we said that there are issues on which there is a large amount of consensus, and issues on which deep controversy remains. That development policy must have an explicit focus on poverty reduction is one of the main areas of consensus in the development community. In contrast to the period up to the 1970s, when it was thought that economic growth would automatically deliver poverty reduction, it is now recognized that while growth can achieve some poverty reduction, pro-poor policies are necessary to maximize growth's benefits for the poor. Moreover, it is widely agreed that poverty reduction does not just entail higher incomes, but also improving human development indicators. In other words, poverty is a multi-dimensional concept. This implies improving the delivery of pro-poor services, particularly in basic health care, safe water and sanitation, and primary education, with a particular emphasis on delivery to rural areas (which contain high levels of poverty) and to women. Relatedly, it is widely agreed that the formation of human capital through better health and education is not only good for poverty reduction, but also contributes to economic growth, especially as countries attempt to move beyond exporting primary products to selling skill-intensive manufactures and services.

Compared to the 1940s and 1950s, when the first development strategies were set out, there is a greater recognition within the development community of the role of the market in driving development, although this shift is somewhat grudging and reflects more the failure of state-led development in many (but certainly not all) countries rather than a large-scale conversion to market liberalism. Accompanying this has been a move away from the heavy import protection seen in the early development years—a shift accentuated by the World Trade Organisation—and a greater awareness of the possibilities offered by export production. Yet, many of the poorer countries find it difficult to achieve export success, specifically outside of their traditional primary products, and have become some of the most vocal critics of rich country protectionism, especially in agriculture. There is much less support for the idea that the state should directly run manufacturing enterprises or farms, and a greater recognition of the private sector's strengths. However, there is much less consensus on whether utilities—power, water, transport infrastructure—should be in private or public ownership, although the fiscal crises of developing countries have nonetheless driven many governments to privatize their state utilities. Finally, countries are now keener to attract private capital flows, in part because of the decline in official flows, however private flows remain concentrated on a relatively narrow range of countries (China in particular).

Getting development policy right has the potential to lift millions of people out of poverty and misery. But making the right policy choices is not just a technical matter. It requires careful political judgement about how to promote economic and social change in ways that stand the most chance of success.

Annex 1—Guide to further reading

Addison, T. (2003). 'Economics', in P. Burnell (ed.), *Democratization through the Looking Glass: Comparative Perspectives on Democratization* (Manchester: Manchester University Press). Looks at how democracy affects economic performance, and contrasts democracy to autocracy in its development effects.

Amsden, A. H. (2001). *The Rise of the 'Rest': Challenges to the West from Late-Industrializing Economies* (Oxford: Oxford University Press). A comprehensive discussion of the East Asian success, and the role of the state in guiding the growth process.

Chang, H.-J. (2002). *Kicking Away the Ladder: Development Strategy in Historical Perspective* (London: Anthem Press). Contrasts the historical experiences of today's developed countries, and challenges the conventional wisdom on how development institutions are created.

Kanbur, R. (2001). 'Economic Policy, Distribution and Poverty: The Nature of Disagreements', *World Development*, 29 (6): 1083-94. A clear and balanced view of the poverty debate today, and why people differ on the effects of economic growth on poverty. Makes very useful comparisons between the differing viewpoints on poverty of the World Bank and NGOs.

Kirkpatrick, C., R. Clarke, and C. Polidano (eds) (2002). *Handbook on Development Policy and Management* (Cheltenham: Edward Elgar). Provides summaries of the main economic and political issues in development policy, including further discussion of many of the topics of this paper.

Rodrik, D. (2003). *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton, NJ: Princeton University Press). A good place to start on the causes of the different development outcomes of countries, and the role of development strategy in determining success.

Wade, R. (1990). *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, NJ: Princeton University Press). (reprinted in 2003 with a new introduction by the author). An authoritative assessment of how East Asia achieved its economic success, and a book that challenges the market-liberal view of East Asia, and emphasizes the role of the state.

Annex 2—Websites

www.developmentgateway.org

An independent site that introduces the latest development research, with frequent updates of new research papers and breaking news in development.

www.eldis.org

Easy-to-use site, with downloadable research papers, reports, and many links to other sites. It has a very useful section on how to use the Web for development research, and the issues facing Web users in developing countries with slow band width.

www.ideaswebsite.org

The website of the International Development Economics Associates, a network of heterodox economists, critical of the conventional wisdom on economic development.

www.imf.org

The IMF posts reports on its member countries, and agreements with governments (such as ‘Letters of Intent’) which spell out in detail economic reforms. The IMF’s annual reports on the state of the world economy are also widely read.

www.odi.org.uk

The website of the Overseas Development Institute, an independent think-tank on development issues. The ODI *Briefing Papers* provide authoritative insight into the latest development issues.

www.undp.org

The website of the United Nations Development Programme (UNDP) which is leading the UN’s work on the Millennium Development Goals. The UNDP’s annual *Human Development Report* can also be viewed at this site.

www.unrisd.org

The website of the United Nations Research Institute for Social Development (UNRISD). UNRISD focuses on the social dimensions of development, as well as development’s political aspects.

www.wider.unu.edu

The website of the United Nations University-World Institute for Development Economics Research (UNU-WIDER). WIDER’s Discussion Paper and Research Paper series offers a wide range of viewpoints on economic development issues, particularly in the areas of measuring poverty and the development effects of violent conflict.

www.worldbank.org

The website of the World Bank offers an enormous range of country material, particularly on poverty reduction, as well as many of the statistics (such as the *World Development Indicators*) used by the development community.

Annex 3—Definitions of terminology used

Economic growth: The rate of growth in a country's national output or national income, usually measured by its gross domestic product (GDP) or gross national product (GNP) and often presented on a per capita basis.

Economic rents: Economic rents are incomes derived from the possession of a valuable licence or permit, particularly for the importation of foreign goods.

Gini index: A commonly used measure of inequality (measured in either household income or consumption). The higher the level of the Gini Index, the higher the level of inequality.

Human capital: People's skills and capabilities, which are partly a product of their education; higher amounts of human capital make them more productive.

Human development: The well-being of people in UNDP's Human Development Index comprises longevity, knowledge, and a decent standard of living, but broader conceptions of human development can also include participation in the political process.

Institutions: Often defined by economists as formal and informal rules and practices which affect human behaviour and interaction, especially in markets ('rules of the game') and which are often, but not always, embodied in organizations (for example, courts of law).

Outward orientated development: A development strategy that looks to the global market as a driving force for economic growth, through the creation of a favourable policy environment for exporters.

Poverty: Poverty can be defined in various ways, but a commonly accepted empirical measure is that a person is poor if they have to live on less than US\$ 1 per day.

Public goods: These are goods and services which will not be provided by the market, or which will be provided in amounts less than is socially-desirable because private-sector supply is not profitable enough.

Mercantilist view of trade: A view of international trade that sees gains from trade to a country as arising from losses to the countries it trades with.

Millennium Development Goals: A set of goals to be achieved by 2015 which were adopted by the world's leaders in the UN Millennium Declaration of September 2002.

Rent-seeking: The use of society's resources to engage in lobbying for valuable licences and permits that give rise to income in the form of economic rents.

Social impact of economic reform: The impact of economic policy changes on poverty and human development as well as social cohesion more generally.

Transactions costs: The costs of doing business in a market economy, including the costs of finding market information (on prices for instance) as well as the costs arising when parties to a contract do not keep to their agreement.

Urban bias: A bias in policy and public spending against the rural areas and in favour of the urban areas which tend to be more politically influential.

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