Economic Development in Imperfect Economies

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Joe is one a small group of influential economists who brought theorizing about development processes to a new level. In trying to understand the reasons why low poor economies remain so, he was among the first to appreciate the importance of information and contracting issues. His seminal contributions on share-cropping, interlinkage and commodity price stabilization form the backbone of this understanding. Greenwald and Stiglitz (1986) took this to its logical conclusion and taught us that any theorems about the optimality of market economies were in jeopardy.

But how did this really change the face of development thinking? By the late 1990s the Washington consensus had taken root. Its main elements were (are?)[2]:

- Sound fiscal and monetary policy.
- Openness
- Security of property rights
- Privatization

Given its political sensitivity, calls for redistribution under the consensus were limited – focusing on broad based taxes and public spending targeted towards the poor. The most controversial parts of the consensus were its emphasis on openness and privatization which lead many of its opponents to view it as the handmaiden of unfettered markets. It served as focal point for the anti-globalization movement. Moreover, it has lead to economists losing ground among development specialists and NGOs.

The empirical basis of this consensus is fairly weak – efforts to find support using cross-country comparisons has met with only limited success. However, some recent studies do provide encouragement on key aspects. For example, Acemoglu, Johnson and

[1] Background remarks prepared for the panel on Development and Transition at the conference in honor of Joe Stiglitz to be held at Columbia University, October 24-25, 2003.
[2] See, for example, Williamson (2000).

Robinson (2001) examine the relationship between income per capita and security of property rights in a cross-section of countries. Using their estimated coefficient, some back of the envelope calculations find that an increase in protection of property rights across the globe of half of one standard deviation would be sufficient to halve global poverty (see Besley and Burgess (2003, Table 4)). In similar vein, Hall and Jones (1999) construct a measure of social infrastructure which is the average of an index of the extent to which property rights and contracts are enforced and respected in a country and the degree of openness to international trade. This measure is intended to capture the institutions and government policies that determine the economic environment within which individuals accumulate skills, and firms accumulate capital and produce output. They find a strong association between social infrastructure and output per worker and argue that this is an important determinant of growth. Using their estimate, our own calculations show that an increase in social infrastructure of two standard deviations would be sufficient to reduce global poverty by half. The impact of changing either measure varies strongly across regions with poverty in sub-Saharan Africa being most resilient to institutional change (see Besley and Burgess (2003, Table 4)).

But the intellectual disconnect between the macro-regressions and the study of development processes runs deep. Even knowing that property rights or social infrastructure matters tells us nothing about the form that government intervention should take. What we need for this are models of how economies work and the kinds of imperfections that need to be confronted.

What Joe offered us in his accounts are stories where economies work imperfectly because of the incentives faced by particular groups of actors where informational asymmetries are key. The new development economics has been in large measure running with this paradigm and understanding the micro-processes that underpin economic development. The specific imperfections that are a constraint on economic development are increasingly appreciated in the small.

I will outline a few areas (personal favourites) where I think that we have made good progress in matching theory and evidence:

Human Capital

Literacy and other indicators of education remain woefully low across much of the developing world. But our best estimates confirm that each additional year of schooling is associated with a 6-10 percent increase in earnings. But the private return to education is of little policy relevance. Even it was, the question of how to improve levels of attainment remains key.

Choosing the appropriate mechanism for expanding education is now an important part of the agenda. New work in the area is paying much more attention to the market conditions under which education is provided and the incentives faced by different providers. This is critical to understanding *how* education expansion can be achieved.[3]

Policy thinking on the way to expand human capital typifies how economists now think about development. Institutions for delivery are a primary object of reform and there is a reliance on solid micro-evidence as a means for charting the way forward.

Credit

Cross-country literature on credit shows a strong correlation between "financial depth" and growth. We now have theoretical literature that emphasizes the link between agency problems, inequality and growth through the credit market (Banerjee and

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[3] See, for example, Glewwe, Kremer and Moulin (2002), and Hseih and Urquiola (2002).

Newman, 1993; Aghion and Bolton, 1997). This builds on the seminal work of Stiglitz and Weiss (1981).

But the mechanism for credit delivery is key. Joe was one of the first people to see the theoretical potential in peer monitoring solutions (Stiglitz (1989)). But we are still grappling with the question of whether this works in practice. It remains unclear whether micro-lenders like Grameen Bank achieve their success in repayment through peer monitoring, or through the promise of future interactions with the bank, or simply because the bank itself spends more time in monitoring.[4] This is an area ripe for investigation using randomized program evaluation.

Property Rights and Contracts

Contracts are written in the context of legal systems, many of which work imperfectly. There is increasing evidence that secure land rights, in particular, are an important vehicle for the poor that may promote both equity and efficiency.[5] The literature, however, also makes clear that the implementation of rights over land needs to be managed carefully, or it can have unintended negative consequences (for example, summary evictions of tenants).

We now have much more empirical validation of the importance of contracting in the development of firms. For example, Banerjee and Duflo (2000) emphasize the importance of reputations in enforcing contracts in the Indian software sector. In this journal, McMillan and Woodruff (2002) discuss how social and business networks can help with access to credit and investment at one stage of development in transition

[4] See Pitt and Khandekar (1998) and Morduch (1998).
[5] See, for example, Banerjee, Gertler and Ghatak (2002), Besley (1995), and Field (2002).

economies, but how legal enforcement of contracts becomes necessary for further development.

Regulation

The postwar model of economic development was built on a raft of regulation. Such regulation was often justified as the welfare improving actions of benevolent governments intent on fixing market failures. However, the reality of much regulation was much different. Many economists who were marginalized in their time (notably Peter Bauer) now see their insights accepted by the mainstream. More generally, development economics has now lost its innocence in studying the state.

Appropriately structured *de-regulation* is now being part of the anti-poverty agenda. Economic analysis is increasingly playing a role in identifying specific directions for de-regulation that help the poor. Increasing access to justice and improving the functioning of court systems is now a key frequently viewed as a key element of poverty reduction.

Responsiveness and Accountability of Government

Mainstream economics has typically taken a technocratic view of government. However, over the last decade or so political economy has moved to center stage in terms of identifying effective routes to poverty reduction. Many states in the developing world are democratic only in a formal sense. Even if they hold elections, the poor and disadvantaged are poorly represented and, in any case, are largely uninformed as regards the actions of their representatives. Recent research has begun to look at how governments can be made more responsive and accountable for their actions.

Models of government that emphasise contracting in the public sector and problems of incentives and information build on the insights from the information economics and game theory developed a generation earlier.

Three important aspects of this are: (i) the role of the media as a watchdog,[6] (ii) a greater role for decentralized delivery mechanisms and (iii) changing the structure of political representation.[7]

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[6] See, for example, Besley and Burgess (2002).

[7] See, for example, Chattopadhyay, and Duflo, (2001), and Pande (2003).

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