Gerald M. Meier
Stanford University

DEVELOPMENT ECONOMICS: PAST AND FUTURE*

UDK/UDC 330
Izvorni znanstveni rad
Primljeno/Received: 15. listopada/October 1997.

This article appraises the progress in the evolution of ideas that has been accomplished by the first two generations of development economists and focuses on the unsettled questions and unfinished tasks for the next generation. The intention is not to present yet another survey of the literature, but rather to offer a subjective summary appraisal of the past and future of the subject.

1. THE FIRST GENERATION

After World War II, the subject of development was thrust upon economists as newly independent governments in emerging countries sought strategies for the acceleration of their development. Political independence could be obtained by legislation, but for economic independence the new governments sought advice from economists. As a discipline, however, the subject of development economics had to be newly established.

At its outset in the 1950s, development economists were more confident than now, and their general propositions and general principles were bold. Development economists started with grand models of development strategy and with a correlative role for extensive government involvement in programming or planning.

Their models were visionary -- looking to the requirements for accelerated development. The objective was an increase in per capita real income. Because population (the denominator) was increasing, the emphasis had to be on a rapid rate of growth in GDP (the numerator). As the necessary requirement, capital accumulation was the central focus of the models. Although originally formulated for conditions of full growth in an advanced economy, the Harrod - Domar approach was applied to estimate

---

**This article is based on a lecture presented to the Faculty of Tourism and Foreign Trade, Dubrovnik, October 15,1997. My appreciation is extended to the Faculty and to the audience for their comments.*

the capital requirements of less developed countries. (The Harrod-Domar formulation for the necessary growth rate of the capital stock was s/v, where s is the saving rate and v the capital-output ratio.) Growth accounting also emphasized the contribution of capital. The simple Solow (1957) decomposition of growth into factor contributions and a residual was based on a differentiation of a production function, Y=F(K,L,T), where Y is output, K capital, L labor, and T time. Production function analysis was subsequently refined, and the size of the residual reduced by first taking account of technical advance and then recognizing the residual to be a composite of the effects of many different forces: improvement in the quality of labor, reallocation of resources from low-productivity to higher productivity uses, exploitation of economies of scale, and improved ways of combining resources to produce goods and services. (Harberger,1983, pp. 864-66)

Capital accumulation was also featured in other early models of development strategy: Rostow's "stages of growth", Nurkse's "balanced growth", Rosenstein-Rodan's external economies and "big push", Lewis' unlimited supply of labor and dual sector model, the Prebisch-Myrdal-Singer hypotheses about the terms of terms of trade and import substitution, Leibenstein's "critical minimum effort" thesis, and Chenery's "two gap model".

The models and hypotheses of the 1950s had policy implications that called for strong state action. To many of the early development economists, a less developed economy was characterized by pervasive market failures: To correct or avoid market failure, they advocated central coordination of the allocation of resources. The newly expanding subject of welfare economics also provided considerable rationale for government to correct market failures. Moreover, the structuralist school criticized the market price system by emphasizing rigidities, lags, shortages and surpluses, low elasticities of supply and demand, structural inflation, and export pessimism.

Believing that a less developed country did not have a reliable market price system, that the supply of entrepreneurship was limited, and that large structural changes - not merely marginal adjustments - were needed, the first generation of development advisers turned to the state as the major agent of change. Government was to promote capital accumulation, utilize reserves of surplus labor, undertake policies of deliberate industrialization, relax the foreign exchange constraint through import substitution, and coordinate the allocation of resources through programming and planning.

A growing number of visiting missions and foreign advisers cooperated with local planning agencies and industrial development corporations in producing analyses and policy recommendations underlying national development plans. Modern techniques of economic analysis - especially input-output analysis, dynamic programming, and simulation of

growth models - were to provide tests for the consistency, balance, and feasibility of plans.

The advocacy of inward-looking policies derived from a belief that export earnings were inelastic. This gave support to the two-gap model in which extra savings cannot be converted into imports of capital goods and is therefore frustrated, structural inflation in which the marginal propensity to import exceeds the marginal propensity to export, and balanced growth.[1]

At the same time as pessimistic conclusions were reached about the LDC's capacity to export primary products and to pursue export-led development, optimistic conclusions were expressed on the capacity to accelerate development through the extension of the public sector and wide-ranging governmental policies. The combination of external pessimism and internal optimism dominated the thinking of the first generation.

With these macro-strategies it was believed that government could accomplish a structural transformation in the developing economy. Government would give reality to the slogans of the first generation by breaking the "vicious circle of poverty" via a "big push" and "balanced growth" that would establish complementarity in demand, achieve a "critical minimum effort", break out of the "low level equilibrium trap," and fulfill the conditions of the "take-off".

Both the models and the policy advocacy of the first generation were subsequently criticized. The models lacked sufficient empirical content. Moreover, as Krugman observes, the development theorists in the 1950s were "at first unable, and later unwilling, to codify [their insights] in clear, internally consistent models. At the same time the expected standard of rigor in economic thinking was steadily rising. The result was that development economics as a distinctive field was crowded out of the mainstream of economics. Indeed, the ideas of 'high development theory' (of the 1950s) came to seem not so much wrong as incomprehensible."[2]

For the offering of policy advice, "grand theories" came to be viewed as less useful than highly specific applications. Micro studies - rather than the broader visionary models of the earlier period - could provide more direct policy implications for specific policies such as a change in tariffs or agricultural subsidies.[3]

---

1 W. Arthur Lewis, "Development Economics in the 1950s," In Gerald M. Meier and Dudlez Seers (eds.), Pioneers in Development, (New York: Oxford University Press, 1984), p. 127.

2 Paul Krugman, "Towards a Counter-Counterrevolution in Development Theory" Proceeding of the World Bank Annual Conference on Development Economics, supplement to World Bank Review (1992), p.29.

3 Kenneth Arrow, "General Economic Theory and the Emergence of Theories of Economic Development", in The Balance between Industry and Agriculture in Economic Development, vol. 1, (London, Macmillan, 1988).

Moreover, in the late 1950s and early 1960s, the initial concentration on physical capital accumulation was giving way to the concept of investment in human capital and its importance for development. It was increasingly recognized that development depended on productive human agents who through their acquisition of knowledge, better health and nutrition, and increase in skills could raise total factor productivity.

With its emphasis on knowledge, the new endogenous growth theory of the 1980s and 1990s constituted a marked change in the analysis of aggregate production functions. (Romer 1986, 1989, 1990 and Lucas (1988). Instead of the early Solow version of diminishing returns to capital and labor separately and constant returns to both inputs jointly, and technological progress as a residual, the new growth theory examines production functions that show increasing returns because of specialization and investment in "knowledge" capital. Technological progress and human capital formation are endogenized within general equilibrium models of growth. New knowledge is generated by investment in the research sector, and the technological progress residual is accounted for by endogenous human capital formation. With knowledge being treated as a public good, spillover benefits to other firms may then allow aggregate investment in knowledge to exhibit increasing returns to scale. This in turn allows investment in knowledge capital to persist indefinitely and to sustain long-run growth in per capita income. Learning by doing (Arrow 1962) and learning by watching (King and Robson 1989) are also knowledge-producing activities.

For developing countries, the implication of the new growth theory is to place more emphasis on human capital (including learning)--even more than on physical capital, and to emphasize the benefit from the exchange of ideas that comes with an open economy integrated into the world economy. The new growth theory also has relevance for the question of convergence - that is, whether poor countries grow faster than rich countries.[4]

Criticisms of the early models were reinforced by experiencing the adverse effects of government interventions. Economists became increasingly disenchanted with development programming or planning. Despite the optimism of the earlier generation and the deliberate efforts of governments to accelerate development, it became only too painfully evident in many countries that mass poverty persisted, more people were unemployed or underemployed, the numbers in "absolute poverty" increased, and the distribution of income and assets became more unequal.

4 For an instructive empirical study, see Robert J. Barro, "Economic Growth in a Cross-Section of Countries," Quarterly Journal of Economics, May 1991, pp. 407-43.

To explain these disappointments, many blamed the policy-induced distortions and the non-market failures associated with the implementation of public policies. Particular criticisms were levied at the neglect of agriculture, the inefficiency of state owned enterprises, the adverse effects of import substitution industrialization, and balance of payments deficits.

By the late 1960s and early 1970s, deficiencies in industrial programming and comprehensive planning became acute. Former supporters of development planning could lament the "Crisis in Planning".[5] Critics could now point to the causes of government failure: deficiencies in the plans, inadequate information and resources, unanticipated dislocations to domestic economic activity, institutional weaknesses, and failings on the part of the administrative civil service.[6]

If the rationale of government interventions had been to remedy market failure, the perverse result was only too often government failure. This was increasingly evident in the adverse effects of price distortions - distortions that were especially prevalent in wage rates, interest rates, and the foreign exchange rate. The policy challenge now became: "get prices right." As Timmer [1973] expressed it, "getting prices right' is not the end of economic development. But "getting prices wrong" frequently is.[7] The logic of choice was again reasserting itself in economic analysis. And the second generation of development economists were now to support a "resurgence of neoclassical economics".[8]

2. THE SECOND GENERATION

If the first generation of development economists were visionary and dedicated to grand theories and general strategies, the second generation was almost moralistic and dedicated to a somber realism grounded on fundamental principles of neoclassical economics. As Harberger said to governments of developing countries, "Economics is good for you - and by Economics, he meant neoclassical analysis as the basis for policymaking.[9]

---

5 P. Streeten and M. Lipton, The Crisis of Indian Planning (London: Oxford University Press, 1969); M. Faber and D. Seers (eds.), The Crisis in Planning (London: Chatto & Windus, 1972).

6 Tony Killick, "The Possibilities of Development Planning," Oxford Economics Papers (July 1976), p. 164. See also S. Chakravarty, "Development Planning: A reappraisal," Cambridge Journal of Economics (March 1991).

7 C. Peter Timmer, "Choice of Technique in Rice Milling in Java," Bulletin of Indonesian Economic Studies (July 1973).

8 Ian M. D. Little, Economic Development, (New York; Basic Books, 1982), chs. 9-10.

9 Harberger, arnold C., 1993. "Secrets of Succes: A Handful of Heroes," American Economic Review Papers and Proceedings May 1993: 343-350.

Governments were admonished not only to remove price distortions but also to "get all policies right". Markets, prices and incentives were to be of central concern in policymaking. Claiming that the usual postulates of rationality and the principles of maximization or minimization have genera applicability, some emphasized the universality of neoclassical economics and dismissed the claim of the first generation that development economics is a special sub discipline in its own right. Krueger, for example, maintained that:

"Once it is recognized that individuals respond to incentives, and that 'market failure' is the result of inappropriate incentives rather than of non responsiveness, the separateness of development economics as a field largely disappears. Instead, it becomes an applied field, in which the tools and insights of labor economics, agricultural economics, international economics, public finance and other fields are addressed to the special questions and policy issues that arise in the context of development".[10]

In accord with neoclassical economic theory, the second generation moved from highly aggregative models to disaggregated micro studies where the units of analysis were the firm and household. Numerous studies criticized price distortions, high effective rates of protection, and rent seeking. Not differences in initial conditions but differences in policies were now to explain the disparate performances of developing countries. A country was not poor because of the vicious circle of poverty, but because of poor policies. Not adverse external conditions, but inappropriate domestic policies explained why some countries were not taking advantage of their external economic opportunities. The East Asian newly industrializing economies were viewed as the success stories of development.

The correct policies were to move from inward-looking strategies to the liberalization of the foreign trade regime and export promotion, to submit to stabilization programs, to privatize state-owned enterprises, and to follow the dictates of the market-price system. Through its guidance to the correct policies, neoclassical economics was believed to be the safeguard against policy-induced distortions and non-market failures.

More emphasis was placed on applied research that was country-specific, or sectoral-specific, or project-specific. Studies concluded that more important than the level of capital accumulation is how capital is allocated. Despite high rates of saving, as in India, growth could be slow. High rates of saving were seen to be neither necessary nor sufficient for success. In view of the importance of the allocation of capital, the techniques of shadow pricing that lay behind project appraisal were also refined.

---

10 Anne O. Krueger, "Aid in the Development Process," World Bank Research Observer (January 1986): 62-63

Being able to consider two or three decades of development experiences, the second generation recognized the increasing heterogeneity of the LDCs and gave more attention to an explanation of differential rates of country performance. Cross country econometric studies of the determinants of economic growth have multiplied. A comparative approach has also been adopted in an attempt to understand why certain policies were effective in a country, while others were not, and why the same type of policy was effective in one country, but not in another.

The inquiry into the causes of differential development performance led to more attention to the politics of policy making. Elements of a "new political economy" - a neoclassical theory of politics - were formulated. The analytical concepts and principles for interpreting why governments do what they do are analogous to those of neoclassical economic analysis. Postulates of rationality, the concept of self interest or self-goal choice, and the techniques of marginal analysis and equilibrium outcomes have been applied to political markets and political objective functions. Whereas the first generation followed the usual approach of normative economic analysis that assumed that the government is composed of Platonic guardians and that the state acts benevolently in seeking the public interest, proponents of the "new political economy" now focus on other types of states--the Leviathan state, bureaucratic state, or factional state. Whereas government to the first generation was an exogenous force, the new political economy now attempts to endogenize the decisions of politicians, bureaucrats, and administrators. It attempts to open windows in the black box of the "state" by using various strands of thought: public choice, collective choice, transaction costs, property rights, rent seeking, and directly unproductive profit-seeking activities.

A major modification of neoclassical analysis occurred in the 1980s and 1990s when "new market failures" were analyzed. Risk and information imperfections in the economy became highly relevant for development analysis. The recognition of informational limitations, incomplete markets, transaction costs, and absence of future markets extended the range of market failures beyond the earlier attention to public goods and externalities that required only selective government intervention. Correction of the new market failures provided a basis for a potential role for more pervasive government intervention. The major emphasis, however, was still given to government failures rather than market failures, and concern with policy reform dominated in the 1990s.

The recognition of risk and information imperfections did, however, improve analysis of two sectors that had been relatively neglected by the first generation -- namely, agriculture and finance.

Countering the first generation's emphasis on industrialization, the second generation emphasized policies that would promote the important role that agriculture must play in the process of structural transformation. The effects of government intervention in agricultural pricing became a major concern. Numerous studies presented evidence that agricultural-

pricing policies had an adverse effect on the gap between urban and rural income, the incentive to produce food and export crops, the ability of governments to establish food reserves, and employment opportunities in farming, processing, and rural industries. The theory of rural organization was also advanced through the use of information, risk, and contract analyses.[11] The microeconomics of the rural sector examined the organization of labor, land, and credit markets - and also their interlinkage. The decision making of members of rural households was also studied from the perspective of the maximization behavior of a "household-firm."[12]

Financial institutions and markets had also been neglected by the first generation. A too facile approach had been taken in the spirit of Joan Robinson's comment that "where enterprise leads, finance follows." Based on experience with financial bottlenecks and financial repression, the second generation was concerned with the design of financial systems that would allow the banking system and money and capital markets to perform their proper functions in financial intermediation between savers and investors, and in efficient investment allocation. "New market failures" also gave due weight to transaction costs, adverse selection, and moral hazard in an analysis of capital market imperfections and the requirements for more effective financial policies.[13]

The second generation's recognition of new market failures has also renewed interest in the first generation's models that were concerned with issues of investment allocation and coordination activities. So, to have elements of the new growth theory (knowledge, externalities, dynamic increasing returns), new institutions economics (information, contract, response to missing markets); and new international economics (imperfect competition, strategic trade theory). This new or extended neoclassical analysis provides a basis for increasing returns and coordination of externalities resulting from capital accumulation. As such, there is a return to the first generation's emphasis on the importance of increasing returns and pecuniary external economies arising from the effects of market size. As Krugman now concludes, "intellectual credibility" can be restored to a useful set of core ideas from the early analysis of the 1950s. "What was

11 Stiglitz, "The New Development Economics," World Development 14, no.2 (1986): 258-61; Hans P. Binswanger and Mark R. Rosenzweig, Contractual Arrangements, Employment and Wages in Rural Labor Markets, Agricultural Development Council, 1981.; A. Braverman and J. L. Gausch, "Rural Credit Markets and Institutions in Developing Countries," World Development, 14, no. 10/11 (1986),; 1253-62.

12 Inderjit Singh, Lyn Squire, and John Strauss, "A Survey of Agricultural Household Models," World Bank Economics Review, vol. 1, no. 1, september 1986: 149-54.

13 Joseph E. Stiglitz, "Financial Markets and Development," Oxford Review of Economics Policy" 4 (4), 55-68.

ironic was that a competitive neoclassical orthodoxy settled in on the development front just as the orthodoxy was breaking up in other fields. We can now see that whatever bad policies may have been implemented in the name of high development theory, the theory itself makes quite a lot of sense. Indeed, in some ways it was a remarkable anticipation of ideas that would come to analytical fruition thirty years later in the field, for example, of international trade and economic growth".[14]

Although a more meaningful case can now be made for a big push or "balanced growth", the experience with government failure has remained dominant in weighing against government intervention. The common consensus in the 1990s is for the promotion of policy reform. The state is believed to be overextended. A market price system is needed to get prices right. And now to get policies right, there is a need for stabilization, liberalization, deregulation, and privatization. Supporting these policies are the IMF's requirements of conditionality and the World Bank's structural adjustment lending.

Finally, to "get prices right" and to "get policies right', there is increasing recognition of the need to "get institutions right". But the model of the competitive ideal world is essentially institutionless and provides little guidance on the establishment of efficient markets. Similarly, as North observes (1997), we now know a good deal about what makes for successful development, but we still know very little about how to get there especially how to establish the institutional and organization structure that will support the desired rate and composition of economic change.

Although, at the end of the 20th century, the second generation of development economists leaves the subject in a far more advanced state than it was at mid-century, there is clearly much unfinished business and many unsettled questions to be considered by the next generation of development analysts.

3. THE NEXT GENERATION

It would be presumptuous and unrealistic to dictate a future research agenda, but we may suggest some central topics that are likely to be of future concern.

The starting point must still be the meaning of "economic development." The earlier generations meant growth plus change leading to an increase in per capita real income (or in a purchasing power parity index per capita income). Sen has expanded the meaning of development in terms of "entitlements" and "human capabilities." So too has the UNDP's

14 Paul Krugman, "Towards a Counter-Counterrevolution in Development Theory," World Bank Economics Review Supplement (1992), p.29.

"Human Development Index" included other objectives besides per capita income. The conception of "development" may acquire even wider meaning in the future, including for the purpose of better governance such objectives as civil liberties, popular participation, and democracy. Although specific strategies will be necessary to achieve the non-monetary objectives, growth and change will continue to be central to any explanation of the determinants of development.

Advancement in determining the sources of growth has been notable. Given the importance of total factor productivity, however, future research will have to increase our understanding of the "unexplained residual factor" in aggregate production functions. As Stern observes, "we seem to have too many theories claiming 'property rights' in the unexplained 'residual', and have no reassurance that any of them separately or together, really capture what is going on. Just as worrying is that they omit many issues which are probably crucial to growth in the medium run, including economic organization and the social and physical infrastructure" (Stern,1989). Beyond disaggregating the residual into recognizable elements, attention will have to be given to how these elements are to yield to policies. Many policies that economists have considered bear on the supply of inputs, but in the future it will be a more difficult challenge to devise and implement policies to promote the income-raising forces constituting the residual.

The persistence of poverty - even with creditable rates of growth is particularly disconcerting. The World Bank estimates that approximately 1.3 billion people in the developing world will be consuming less than $1 a day (at 1985 prices) by the year 2000.[15] If poverty is to be reduced, future analysis will have to give more attention to how the pattern of growth determines who are the beneficiaries of growth. Patterns of growth will have to be designed that avoid urban bias, displacement of unskilled labor, alteration of relative prices to the disadvantage of the poor, gender gaps, deterioration of child welfare, and the erosion of traditional entitlements that have served as safety nets. Moreover, insofar as experience indicates that economic growth does not always lead to widespread improvement in standards of health and education, policies that differ from those for simply increasing income will have to be devised to improve the health and educational attainment of the poor.[16]

A central problem of development will remain surplus labor. The need to create jobs will be especially pressing, given that the world's labor force will increase by 40% over the next two decades, and 95% of the increase will be in the LDCs where less than 15% of the world's capital

15 World Bank, Implementing the World Bank's Strategy to Reduce Poverty (1993), p.7.

16 Squire, Lyn, 1993. "Fighting Poverty," AEA Papers and Proceedings (May 1993), p.379.

investment will occur.[17] To reduce poverty by increasing productivity and earnings, government will have to devise appropriate policies in four crucial sectors of the economy: the rural sector, urban informal sector, export sector, and the social sector.

To understand the heterogeneous experience of developing countries, it will be necessary to appreciate the role of institutions more fully. It is common to say that institutions matter. And to overcome dualism and establish a robust market price system, it is now common to say "get institutions right." But what is the meaning of "right"? And how are the right institutions to be established? These are important questions for the next generation's research agenda.

Some preliminary insights have been offered by North (1997) and Williamson (1994). North emphasizes that the incentive structure of society - which is fundamental for the process of change - is a function of the institutional structure of that society. Institutions provide the rules of the game: formal rules (constitutions, law, regulations) and informal constraints (norms, conventions and internally devised codes of conduct).

Similarly, Williamson interprets the new institutional economics from the perspective of the institutional environment - i.e., the macroanalytics of political and legal rules of the game - and the microanalytic, perspective of the firm and market modes of contract and organization. Based on the objective of economizing transaction costs, the latter establish institutions of governance of contract, investment, and private ordering. There are alternative modes of organization: markets, hybrids, hierarchies, public bureaus. Each mode establishes different incentives and controls that lead to different degrees of cooperation and/or competition, credible investment conditions, and credible contracting.

The future concern with institutions may also revise and extend the dual sector model of earlier generations. Long ago Myint (1985) suggested that dualism is pre-eminently a phenomenon of an underdeveloped organizational framework, characterized by an incomplete development, not only of the market network but also of the administrative and fiscal system of the government. Contrary to the second generation's reliance on neoclassical analysis of a two-sector model, the concept of "organizational dualism" moves the policy implications away from "getting prices right" to an examination of what is the development of appropriate institutions.

Further, North's contention that cultural beliefs are a basic determinant of institutional structure should also move the explanation of the process of change into a multidisciplinary endeavor. Not economics, but psychology, sociology, political science, anthropology, law and history must provide the answers to what are the origins of cultural beliefs and how

17 Lawrence Summers, "Research Challenges for Development Economists," Finance & Development, September 1991, p. 5.

they lead to institutional change over time. Only a beginning has been made in this area.

Analysis of the foregoing issues -- and others such as those involving gender or the environment - would all benefit from multidisciplinary attention. It is important to correct the economists' assumptions about institutions and motivations that have been generally derived from only western societies. The social infrastructure that underlies the process of development will merit deeper analysis. So too will the contribution of socio-cultural development and political development to economic development.

From the heterogeneous experience with development policy-making, it will be vital to know what has caused the positive "turning points" in policy reform in various countries. What forces induce political innovations? Policy reform requires political enterpreneurship, but a theory of political enterepreneurship is yet to come. For this, we must look beyond economists to historians, social psychologists, and political scientists.

Simplified public choice theory is insufficient, especially for the governments of LDCs. The analysis of development policy will have to identify the functional relationships between economic and non-economic factors, and their quantitative significance, in order to determine how to operate on incentives, attitudes, organizational structure, social relations, or any of the many other factors that connect non-economic and economic change. Clearly, the future success of economic policies in achieving structural transformation will also depend on a better understanding of how to achieve social and political transformations.

Insofar as the elucidation of institutional change must go beyond the perfect competition and rational choice framework of neoclassical analysis, development theory will not be locationless, as it was in large part for the second generation, but will have to be more country-specific and time-specific.

Moreover, new problems of undertaking national development in the context of an integrated world economy will become more prevalent as globalization deepens. Even more than for the previous generations, open economy models will be the rule. And while previous policy issues revolved around trade policy, the next generation will have to devote more attention to determining the effects of international capital movements, migration, technology transfer, and dynamic changes in comparative advantage.

The previous provocations of dependency thinking and a New International Economic Order are over. But there will be more controversy over whether globalization benefits the poor countries and whether it creates benefits for poor people within countries. The next generation will have to sort out the positive and negative impulses resulting from globalization.

Insofar as markets, technology, and corporations are global in scope while the jurisdiction of the nation-state is only local, there will be a need

for new actions by the World Bank, IMF, and WTO. As the major constituents of the international public sector, they will have to devise new programs to ensure that the benefits of global integration are more equally shared, that competitive policymaking is avoided, and that problems of incomplete risk markets are mitigated as international integration becomes ever more complex.

If the future of development economics is to be dominated by any one theme it will be, as in the past, that of the respective roles of the state and the market. But there will be new perspectives on the role of the state. The issue will not be market failure or government failure, as viewed from the neoclassical perspective. Instead, future analysis will have to recognize the new market failures, undertake cost-benefit analysis of government policies, and determine how state action can support the institution and deepening of markets.

The future is likely to witness a reaction to the minimalist state that was advocated by the second generation. True, the state should not be overextended. And it is true that government cannot engage in the direct production of consumer and producer goods better than the private sector, and cannot induce innovations and change better than the private sector. But government will still have extensive functions in dealing with the new market failures (imperfect information, imperfect and incomplete markets, dynamic externalities, increasing returns), providing public goods, satisfying merit wants such as education and health, reducing poverty and improving income distribution, providing physical infrastructure and social infrastructure, and protecting the natural environment.

The objective will be to have government do what government does best. The challenge will be to obtain the benefits of government action at the least cost. And the complementary relationship of state and market will have to be emphasized in policymaking.

Although past generations have regarded government and the market as alternative resource allocation mechanisms, it will be more useful to treat government as an integral element of the economic system, functioning sometimes as a substitute for and at other times as complement to other institutional elements. This will require more extensive analysis of what Aoki has termed a "market-enhancing" view that examines the role of government policy in facilitating or complementing private sector coordination {Aoki, 1995}. "Government should be regarded as an endogenous player interacting with the economic system as a coherent cluster of institutions rather than a neutral, omnipotent agent exogenously attached to the economic system with the mission of resolving its coordination failures... In this view, government policy is not aimed directly at introducing a substitute mechanism for resolving market failures, but rather at increasing the capabilities of private sector institutions to do so." (Aoki, 1955, pp. 25-26)

Market-enhancing can take many forms: from indirect rule making that affects incentives to direct government interventions that structure

markets. As an example of indirect rule making, Aoki and others have applied the market enhancing criterion to the deepening of financial markets {Hellmann et al. 1996}. The government can support the banking system through deposit rate controls and restrictions on entry -- that is, the exercise of financial restraint - thereby avoiding excessive competition and creating rents. This would increase the franchise value to banks and induce banks to refrain from moral hazard and to provide more effective monitoring of loans and risks. The general principle is that government action can facilitate private sector coordination and provide necessary incentives to the private sector by creating "contingent rents'--returns in excess of the competitive market, provided certain conditions are fulfilled (as for patents or export subsidies based on targets.)

In the future, the theory and practice of development policymaking should give much more consideration to this type of interdependence between state and market in a variety of policy situations.

Although the next generation may focus on these policy issues, their efforts will be to little avail if governments do not heed their normative conclusions. Why do governments not listen to development economists? And how can their policy advice be better implemented? These questions will be a major preoccupation of the next generation.

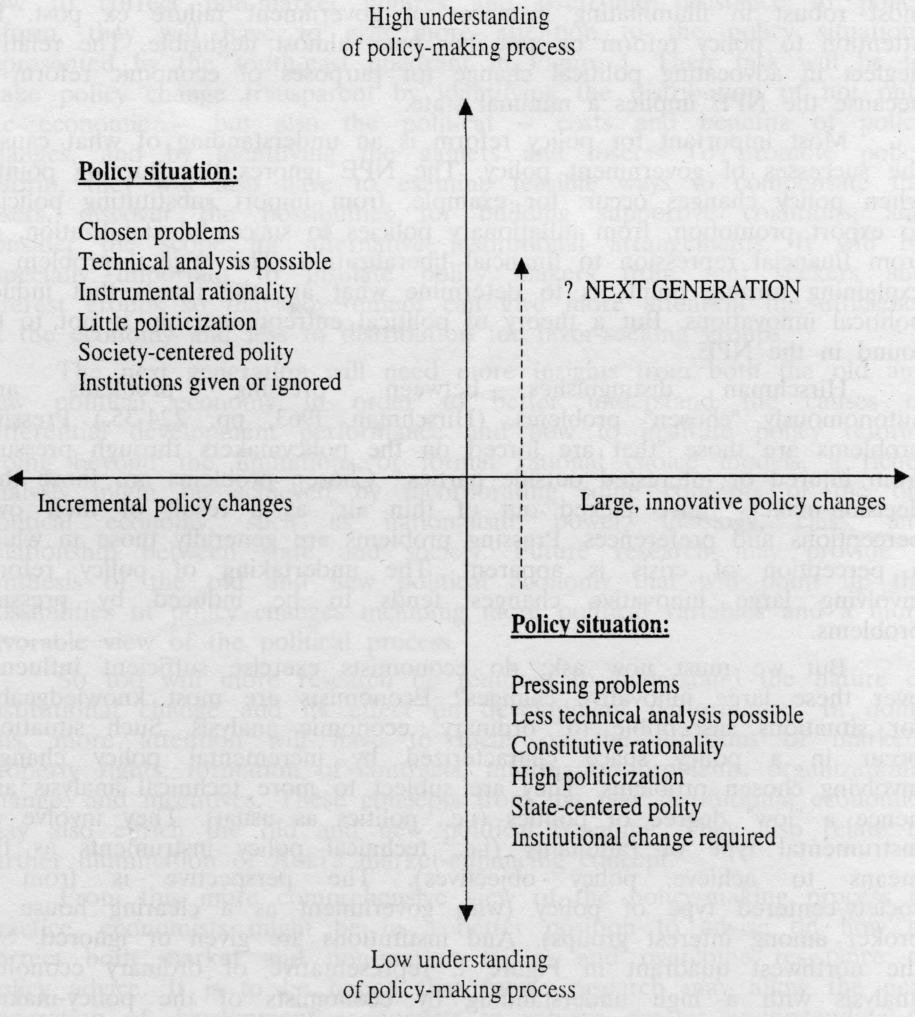
To answer them, the new (neoclassical) political economy (NPE) provides a beginning in helping economists to understand the policymaking process, endogenize government, and identify the conditions that may be conducive to policy reform. But the next generation will have to go beyond a neoclassical type of analysis of political preference functions, political resources, and political constraints as applied to political markets.

Whether a Leviathan, bureaucratic, or factional model of the state is used, the thrust of the NPE is that an underdeveloped economy has commonly given rise to an overextended state and to a negative or exploitative state. This implication appears in writings on price distortions (rent-seeking and directly unproductive profit-seeking activities), state-owned enterprises (patronage and bureaucracy), financial repression (politicized credit allocation and cheap credit to supporter), agricultural markets (pro-urban bias), inflation (populism), tariffs, and quotas (lobbying).

Although the NPE can provide insights into some instances of government failure, it is over-generalizing to maintain that all policy making can be explained in terms of rational choice self-interest models. Indeed, no single universal characterization of political behavior is possible. Instead of a unitary state, there is in reality an aggregation of preferences. Moreover, at times, altruism or some sense of the social good may be more operative than self-interest. Other social-psychological elements enter into decision making, especially when "bounded rationality" prevails.[18] Nor

18 Simon, H., 1957. "A Behavioral Model of Rational Choice," in Models of Man: Social and Rational, ed. H. A. Simon, (1957), pp. 241-60.

FIGURE 1 Development Analysis in Different Policy Situations



should insights from the old political economy be ignored: historical tradition, social structure, ideologies, and institutions can all influence policy decisions at the expense of rational choice models. And at times economic rationality can take precedence over political rationality.

Besides the positive analysis of the NPE, can the NPE also have predictive and normative value in promoting policy reform? The NPE is most robust in illuminating instances of government failure ex post. Its attention to policy reform ex ante has been almost negligible. The relative neglect in advocating political change for purposes of economic reform is because the NPE implies a minimal state.

Most important for policy reform is an understanding of what causes the successes of government policy. The NPE ignores the "turning points" when policy changes occur: for example, from import substituting policies to export promotion, from inflationary policies to successful stabilization, or from financial repression to financial liberalization. The general problem in explaining turning points is to determine what are the forces that induce political innovations. But a theory of political entrepreneurship is not to be found in the NPE.

Hirschman distinguishes between "pressing" problems and autonomously "chosen" problems. (Hirschman, 1963, pp. 224-35.) Pressing problems are those "that are forced on the policymakers through pressure from injured or interested outside parties." Chosen problems are those that decision-makers "have picked out of thin air" as a result of their own perceptions and preferences. Pressing problems are generally those in which a perception of crisis is apparent. The undertaking of policy reform involving large innovative changes tends to be induced by pressing problems.

But we must now ask: do economists exercise sufficient influence over these large innovative changes? Economists are most knowledgeable for situations susceptible to "ordinary" economic analysis. Such situations occur in a policy space characterized by incremental policy changes involving chosen problems. They are subject to more technical analysis and hence a "low" degree of politics (i.e., politics as usual). They involve an instrumental type of rationality (i.e., technical policy instruments as the means to achieve policy objectives). The perspective is from a society-centered type of policy (with government as a clearing house or broker among interest groups). And institutions are given or ignored. See the northwest quadrant in Figure l, representative of ordinary economic analysis with a high understanding by economists of the policy-making process.

In contrast, when economists have to deal with situations involving large, innovative policy changes, they are called upon to advise in a political economy context in which the economist has a lower understanding of the policy-making process. In this policy space (see the southeast quadrant in Figure 1), the problems are pressing problems. They are not amenable to as much technical analysis but instead are highly politicized.

The rationality involved is of a constitutive type -- that is, decisions have to be made about how decisions are to be made. A constitution is needed and an institutional context for decision-making has to be established. The policymaking process is more state-centered. And institutional structures need to change.

If the next generation is to become more influential in advising on how to correct non-market failures and overcome resistance to policy reform, they will have to give more attention to the policy situations represented by the south-east quadrant in Figure l. Their task will be to make policy change transparent by identifying the distribution of not only the economic -- but also the political -- costs and benefits of policy changes, and by identifying the gainers and losers. To promote policy reform, they will also have to examine feasible ways to compensate the losers, discover the possibilities for building supportive coalitions, and consider the scope for alternative institutional arrangements. It will be especially important to insulate policy makers from rent seekers and interest groups so that government can give more attention the efficiency of the economy and less to distribution for favor-seeking groups.

The next generation will need more insights from both the old and new political economy in order to better understand the causes of differential development performance and how to institute policy reform. Going beyond the limitations of formal rational choice models, a richer analysis might be achieved by incorporating some concepts of the old political economy, such as nationalism, power, ideology, class, and relationship between state and society. Future research may provide a synthesis of the old and new political economy that will point up the possibilities of policy changes including more political variables and a more favorable view of the political process.

So too will more research be required to understand the nature of institutional change and its effect on development performance. In doing this, more attention will have to focus on the functions of markets, property rights, formation of contracts, information problems, organizational change, and incentives. These concepts from the new institutional economics may also enrich the old and new political economy. They also relate to further illumination of Aoki's market-enhancing concept.

From this more comprehensive view of the policy-making process in practice, economists might be in a better position to advise on how to correct both market and non-market failure and overcome resistance to policy advice. It is to be hoped that future research may allow the next generation of development economists to achieve greater understanding of pressing problems that are less tractable to technical analysis, more politicized, involve issues of constitutive rationality, and require institutional change. As analysts of development policymaking, the next generation may then move from the southeast quadrant of Figure 1 to the northeast quadrant.

REFERENCES

Aoki, Masahiko, et al. 1995. "Beyond the East Asian Miracle : Introducing the Market-Enhancing View," Stanford University, Center for Economic Policy Research, Discussion Paper no. 442, October 1995.

Arrow, K.J.,1962, "The Economic Implications of Learning by Doing", Review of Economic Studies 29:155-173.

Currie, Lauchlin,1967. Obstacle to Development (1967), p. 31.

Harberger, Arnold C.,1993. "Secrets of Success: A Handful of Heroes", American Economic Review Papers and Proceedings May 1993: 343-350.

Harberger, Arnold C., 1983. "The Cost-Benefit Approach to Development Economics, World Development, vol.11. no.10.

Hellmann, Thomas, Kevin C. Murdock and Joseph Stiglitz.1996. "Financial Restraint: Towards a New Paradigm", World Bank EDI working paper.

Hirschman, Albert O., 1963, Journeys Toward Progress (New York: Twentieth Century Fund).

King, M.A. and M. Robson, 1989, "Endogenous Growth and the Role of History", Discussion paper no. 63 (Financial Markets Group, London School of Economics) October.

Lucas, R.E.,1988, "On the Mechanics of Economic Development", Journal of Monetary Economics 22: 3-42.

Myint, Hla.1985. "Organizational Dualism and Economic Development," Asian Development Review vol.3, no.1: 25-42.

North, Douglass C.,1997. "The Contribution of the New Institutional Economics to an Understanding of the Transition Problem", Wider Annual Lectures 1.

Romer, P.M.,1986, "Increasing Returns and Long-Run Growth", Journal of Political Economy 94:1002-1037.

Romer, P.M.,1989, "Capital Accumulation in the Theory of Long-Run Growth", in R.J. Barro, ed., Modern Business Cycle Theory, ch. 2 (Oxford, Basil Blackwell).

Romer, P.M.,1990, "Endogenous Technical Change", Journal of Political Economy 98: 71-102.

Squire, Lyn,1993. "Fighting Poverty," AEA Papers and Proceedings (May 1993): 377-89.

Stern, Nicholas,1989. "The Economics of Development: A Survey", Economic Journal 99: 597-685.

Williamson, Oliver E., 1994. "The Institutions and Governance of Economic Development and Reform", Proceedings of the World Bank Annual Conference on Development Economics:171-208.

W. Arthur Lewis, "Development Economics in the 1950s," in Gerald M. Meier and Dudley Seers (eds.), Pioneers in Development, (New York: Oxford University Press,1984), p.127.

Paul Krugman, "Towards a Counter-Counterrevolution in Development Theory", Proceedings of the World Bank Annual Conference on Development Economics, supplement to World Bank Review (1992), p.29.

Kenneth Arrow, "General Economic Theory and the Emergence of Theories of Economic Development," in The Balance between Industry and Agriculture in Economic Development, vol. l, (London, Macmillan,1988).

For an instructive empirical study see Robert J. Barro, "Economic Growth in a Cross-Section of Countries," Quarterly Journal of Economics, May 1991, pp. 407-43.

Streeten and M. Lipton, The Crisis of Indian Planning (London: Oxford University Press, l969); M. Faber and D. Seers (eds.), The Crisis in Planning (London: Chatto & indus,1972).

Tony Killick, "The Possibilities of Development Planning", Oxford Economic Papers (July 1976), p.164. See also S. Chakravarty, "Development Planning: A Reappraisal", Cambridge Journal of Economics (March 1991).

C. Peter Timmer, "Choice of Techniques in Rice Milling in Java," Bulletin of Indonesian Economic Studies (July 1973).

Alan M.D. Little, Economic Development, (New York; Basic Books, l982), chs, 9-10.

Harberger, Arnold C.,1993. "Secrets of Success: A Handful of Heroes," American Economic Review Papers and Proceedings May l993: 343-350.

Anne O: Krueger, "Aid in the Development Process", World Bank Research Observer (January 1986): 62-63.

Stiglitz, "The New Development Economics", World Development 14, no. 2 (l986): 258-61; Hans P. Binswanger and Mark R Rosenzweig, Contractual Arrangements Employment and Wages in Rural Labor Markets, Agricultural Development Counal,1981.;

A. Braverman and J.L. Gausch, "Rural Credit Markets and Institutions in Developing Countries", World Development;14, no.10/ll (1986),: l253-62.

Inderjit Singh, Lyn Squire, and John Strauss, "A Survey of Agricultural Household Models", World Bank Economic Review vol.1, no. l, September 1986:149-54.

Joseph E. Stiglitz, "Financial Markets and Development", Oxford Review of Economic Policy 4 (4), 55-68.

Paul Krugman, "Towards a Counter-Counterrevolution in Development Theory", World Bank Economic Review Supplement (1992), p.29.

World Bank, "Implementing the World Bank's Strategy to Reduce Poverty", (l993), p.7.

Squire, Lyn, 1993. "Fighting Poverty," AEA Papers and Proceedings (May 1993), p. 379.

Lawrence Summers, "Research Challenges for Development Economists", Finance & Development, September 1991, p. 5.

Simon, H.,1957. "A Behavioral Model of Rational Choice", in Models of Man: Social and Rational, ed. H. A. Simon, (1957), pp. 24l-60.

Gerald M. Meier
Stanford University

EKONOMIJA RAZVOJA: PROŠLOST I BUDUĆNOST

Sažetak

Ovaj rad procijenjuje napredak u evoluciji ideja postignutih u prve dvije generacije ekonomista razvoja i usredotočava se na nedovršena pitanja i zadataka budućih generacija. Cilj nije predstaviti još koji pregled postojeće literature, nego prikazati subjektivnu procijenbu prošlosti i budućnosti subjekta.