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Commentary: Kenneth Davidson
MOVING TOWARD GROWTH IN A MARKET ECONOMY: SMALL CAN BE BEAUTIFUL

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COMMENTARY

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MOVING TOWARD GROWTH IN A MARKET ECONOMY: SMALL CAN BE BEAUTIFUL, a commentary occasioned by the recent report of the international Commission on Growth and Development.

Abstract

This Commentary presents perspectives on The Growth Report: Strategies for Sustained Growth and Inclusive Development, a report of the international Commission on Growth and Development. It reports that sustained growth is possible for nascent market economies but makes explicit that its studies show that growth requires substantial time periods and active government involvement to develop market institutions and overcome cultural obstacles to establishing relationships that make durable markets possible. Thus it goes beyond much of recent development literature that either suggests that sources of growth are unknown or that sometimes focuses on a list of legal prerequisites to a functioning market (which I have characterized in previous Commentaries and articles as the "instant-mix recipe for markets"). This Commentary discusses the effectiveness of market approaches to development that are designed to create economic progress and leaves to my other writings comments on when and how competition enforcement agencies can enhance the development of market economies. This Commentary reviews why some economic development programs have not been successful, why -- when they are successful -- economic growth is not likely to be instantaneous, and why there is no universally applicable plan for sustainable development.

MOVING TOWARD GROWTH IN A MARKET ECONOMY: SMALL CAN BE BEAUTIFUL

Mike Spence, Nobel Laureate for Economics, Chairman of the Commission on Growth and Development, has charted a new approach to lessening world poverty and increasing global wealth and well being. The approach of *The Growth Report: Strategies for Sustained Growth and Inclusive Development* is based on an analysis of nations that appear to have escaped the traps of poverty that have prevented so many billions of people from participating in the wealth that developed countries have demonstrated is technologically possible. The report of the Commission brings the good news that progress against poverty is possible. This conclusion is supported by the history of the thirteen countries that the Commission studied. Each of these countries was indisputably poor fifty years ago. Each has experienced significant economic growth in its GNP over the past 25 years. Each has achieved an average annual growth rate in excess of seven percent in this time period. Each has and has had a very different political, economic, and cultural history. All are countries that have a market economy or are in transition towards a market economy. The lesson from the experience of these countries is that economic progress is possible for poor countries but it requires sustained effort that reflects the success and failure of public policy.

To be sure, some elements, such as the promotion of public education, health and physical infrastructure were present in all the countries. Also the *Report* insists that growth requires integration into the world economy to acquire technology, markets and other institutions. The *Report* lists five empirical findings that seem to constitute the parameters for the countries that were able to sustain economic growth:

1. *They fully exploited the world economy*
2. *They maintained macroeconomic stability*
3. *They mustered high rates of saving and investment*
4. *They let markets allocate resources*
5. *They had committed, credible, and capable governments*

The *Report* discusses varieties of strategies, and traps, as well as national and international constraints illustrated by the studies of both countries that have sustained economic growth, those whose growth has stalled and those who have failed to achieve growth. The *Report* is replete with common sense commentary based on the Commission's studies and the lifetime work of its distinguished Commissioners.

However, to overemphasize the particular suggestions in the *Report* is to ignore what seems to be its central conclusion -- the economic progress of each country seems to have been a result of learning-by-doing, rather than the implementation of a common plan. Some protected domestic businesses (for a time); some subsidized businesses (for a time); some gave incentives for direct foreign investment (for a time); but no government program directed the economy. Government decision making is portrayed throughout the *Report* as essential to this economic development; but, more often than not, the key role of government was to terminate programs that did not work and to delegate, empower or support those individuals and programs that did work. The recommendation of the Commission is that other developing countries learn from the successes and failures of these countries and try to find ideas for policies that are suitable for the time and circumstances of their development.

This approach, pioneered the Harvard Business School and followed by many others, trains businesses executives by examining the success and failure of real companies. The idea is not that they will face identical problems or be able to apply identical solutions but rather that they will develop a better understanding of the nature of the problems faced by businesses in similar or analogous circumstances. They gain this understanding from detailed case studies of businesses in a variety of circumstances. With this understanding, they may hope to develop solutions to the problems identified.

The central idea of the Commission seems to be that leaders of poor countries can adapt this case method to the decisions that they must make to develop their economies. Thus the crucial output of the Commission will eventually be the studies of economic development in the thirteen countries. They are not available at the time of this writing. To be fully useful, these studies must highlight not only the policy failures and the reasons for those failures and the human, cultural, environmental and climatic costs of the successes. There is reason to believe that these Commission reports will attempt such detail because in its general report and presentation at the Brookings Institution the Commission included climatic and environmental harm as part of its definition of sustainable development. This Commentary considers some of the history and prospects of this flexible circumstantial approach to developing nations that are using market economies.

The Millennium Development Goals, commitments at the G8 summit and the Live 8 Rock Concert, Jeffrey Sachs' book, The End of Poverty, the Millennium Development Corporation and various books on the globalization of the world's economy all suggest that we are on the cusp of a new era in which economic growth, competition and globalization will end poverty and promote peace and prosperity. The estimated three billion people who attended, watched or listened to the Live 8 rock concert supported an end to world poverty. The endorsement of the World Bank, the United Nations Secretary General, and the President of the United States have created expectations that in the next twenty years we will create a new era in which the world will be better and very different economically.

The Commission on Growth and Development's report should temper such expectations. Even after 25 years of sustained growth many of the countries it analyzed remain quite poor, both in average per capita income and in large geographical areas and population groups that remain untouched by development. China, India, Indonesia and others have grown continuously but the effects of that growth have been uneven.

To be sure, there have been long term doubters about the advent of a new era in which poverty will end. Most prominent among the recent doubters is William Easterly. He gave fair warning in the introduction to the paperback edition of his insightful and entertaining book on The Elusive Quest for Growth:

> [M]any readers have asked if my statement in the original prologue that "my employer . . . the World Bank . . . encourages gadflies like me to exercise intellectual freedom" was really accurate. Well almost. It should be modified slightly to read ". . . the World Bank encourages gadflies like me to find another job."

His more recent book, The White Man's Burden, is a good-humored polemic or diatribe that is targeted in his subtitle – Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good.

According to Easterly, the consensus that the populations of poor countries are poor because they lack money is wrong. He does not dispute their poverty. He and Jeffrey Sachs agree on the statistics.

> Almost three billion people live on less than two dollars a day. . . . Eight hundred and forty million don't have enough to eat. Ten million children die each year from easily preventable diseases. . . . . One billion people in the world lack access to clean water; two billion lack access to sanitation. One billion adults are illiterate.

However, Easterly rejects the consensus articulated by Sachs that the poor are caught in a poverty trap from which they could escape with just a modest investment of money. Easterly notes that $2.3 trillion have been spent on aid to poor countries over the past 50 years without any discernible sign that foreign aid has contributed to economic growth in any of these countries. He sees no reason to think that a new initiative by wealthy countries will have any better success than previous failed efforts. He thinks that poverty experts in Washington, Brussels or Tokyo believe, wrongly, that they know how to fix the economic problems of people in poor countries. This belief makes him furious: first because he believes it is demonstrably untrue and second because he finds the assumption that it is true is unbelievably condescending, given the repeated failure of foreign aid programs.

To be sure, Easterly does not advocate abandoning the poor; rather he advocates the abandonment of the planning approach to poverty reduction. He believes that poverty problems are local and that the solution to those problems must be based on knowledge of the local politics, the local geography and the local culture. The planting of high yield wheat or rice has been a boon to many, but it has created deserts for others who have terrains with different soils or weather patterns. But he concedes that there is suggestive evidence that "aid works on average in some sectors such as, health, education, water and sanitation." The world wide elimination of smallpox is a stunning success.

In contrast, Easterly believes, "You can't plan a market"! His list of failed foreign aid attempts to help create viable sustainable growth is long – from Russia to Argentina to almost every African, Asian and South American country that has followed the advice of foreign agencies. He points out that the great success stories come from countries that grew on their own. Countries like South Korea, China, Thailand, Singapore, Taiwan, India, Japan and Hong Kong all received either no foreign aid or less than 1 percent of their GDP in foreign aid between 1980 and 2002 yet had the highest growth rates in the world. Niger, Togo, Zambia, Madagascar, Liberia, Sierra Leone and Haiti received foreign aid amounting to between 9.41 percent and 19.98 percent of their GDP during the same period and all had negative growth rates. Moreover, unlike the rapidly growing Asian countries, there a significant number of "poor" African and South American countries that have and have had vast amounts of mineral wealth. These riches have not helped impoverished populations of Russia, Nigeria, Congo, or Venezuela.

Easterly would have us draw two lessons from these facts. First that easy money, whether it is from natural resources or foreign aid, is likely to breed corruption, not economic growth. The success of Botswana's diamond riches seems like an exception. Second, that foreign aid that attempts to stem corruption compounds the ineffectiveness of the aid because the process of obtaining grants becomes so slow and so complex that the information on which decisions are based becomes even less reliable. In place of a top down planning approach, Easterly advocates a bottom up search or exploratory approach.

This is not a new insight. It is the theme of a 1959 collection of stories about development assistance, entitled *The Ugly American*, written by William Lederer and Eugene Burdick. Although written almost fifty years ago, this semi-fictional account illustrates how central planning of aid or development or developing governments fail because they are not based on indigeneous practices of the society and do not take into account whether and why initiatives fail or succeed. The title story has been often misunderstood as an example of Americans aid blundering into poor countries, establishing a program that seems sensible but fails precisely because of insensitivity to local conditions.

In contrast, the character in the book is an American engineer, who is big and ugly, who is devoid of any development theory, but filled with experience in solving his own practical problems. He is asked to go to a Southeast Asian country and help design and administer the US aid program. Frustrated with the development bureaucracy, he and his wife abandon the capital city and take up residence in a small agricultural village to figure out how to improve the irrigation system for a hilly terrain.. He learns that much of the farmers' difficulties arise from their irrigation system which requires drawing water from a well and carrying by hand the water from the well to the field. The Ugly American understands that the time and effort to transport water could be avoided by the use of a pump. This would allow each farmer to cultivate more land and grow more crops. The problem was that the village lacked electrical power and could not afford to buy an internal combustion pump or the fuel to operate them.

The American notes that the village has one common source of mechanical power, bicycles. The bicycles, while old, are a vital part of the economy of the village. They are the normal means of transport from the village of the crops that they sell in the closest town and the means that villagers use to transport products sold in the town that they need but cannot produce themselves. With a little ingenuity, he designs an effective pump from junked automobile pistons which are plentiful and cheap. He then designs an irrigation system using some bamboo to transport the water that is powered by the pedals and chain of a bicycle. His design is improved upon by the local bicycle repairman whose talents were essential to keeping the villages' ancient stable of bikes in operating order. The bicycle was easily mounted to power the pump and could easily be dismounted to resume its transport functions.

One farmer agreed to try the irrigation system. Its success was obvious and other farmers expressed a desire to have similar systems. The American helped the original farmer and the bicycle repairman form a company to build and install the bicycle irrigation system in return for a portion of the increased crop production. As word spread of the success, the business expanded to other villages through a franchise system, whereby others came to the company to learn the system and paid for their training by a portion of their earnings when they made irrigation systems for farmers in their own villages.

This is the story or fable of a small improvement that, initially at least, helped only a few people. Its essential elements contain significance for the development of market economies. The irrigation system is developed from tools, techniques, and talents that are readily available in the local economy. The system is replicable and sustainable within the technological and social setting in which it is introduced. It is a system that is capable of improvement and that could provide a model for the introduction of other technological and organizational innovations. As a result, it meets Easterly's criteria of bottom up development.

The story of the pump is plausible and evocative but the formation of the business entity and the franchised spread of pump technology seem less credible. Those legal institutions were not generally available or understood in the geographic area at the time of the book was written.

The story is interesting primarily because it was written early in the history of international development assistance. The book was a popular success and not alone in its view of how development could be made more effective and less costly. E.F. Schumacher's 1973 book, *Small Is Beautiful*, from which the subtitle of this Commentary is borrowed, provided a more scholarly and general framework for understanding the success of the fictional ugly American. Schumacher asserted that the "real task [of economic development] may be formulated in four propositions[:]"

> *First,* that workplaces have to be created in the areas where the people are living now, and not primarily in metropolitan areas into which they tend to migrate.
>
> *Second,* that these workplaces must be, on average, cheap enough so that they can be created in large numbers without this calling for an unattainable level of capital formation and imports.
>
> *Third,* that the production methods employed must be relatively simple, so that the demands for high skills are minimized, not only in the production process itself but also in matters of organization, raw material supply, financing, marketing and so forth.
>
> *Fourth,* that production should be mainly from local materials and mainly for local use.

The success of this strategy, he wrote, depended on the development and use of what he termed "intermediate technology" of the sort that was created by the ugly American.

Schumacher, who spent most of his career as an economist for the British National Coal industry, viewed large organizations and complex products as often imposing unnecessary burdens on industrial societies. His conclusion that bigger-is-not-necessarily-better was illustrated over and over again in soviet countries and developing nations that used central planning and built huge steel factories, giant hydroelectric projects, and technologically sophisticated factories. The landscape of Africa, Asia and the former soviet bloc is littered with projects that were never finished, factories that never made products at all or products that could not be sold internally or internationally. Like Easterly, Schumacher believed in bottoms-up development.

Bottom-up is a market based concept. It maintains that if people are enabled to start entrepreneurial ventures they will find ways to build successful businesses. The most notable such ventures are the microlending projects in Bangladesh that have been copied elsewhere. A typical venture might be a loan to a woman who seeks to buy a sewing machine to earn her living. The woman has no collateral and brings to the lender, instead, a business plan that explains how she will be able to repay the loan and villagers who attest to her character. As the loan is repaid (at low interest rates) the lender is able to loan more money to more individuals. This format has been replicated in Bangladesh and other poor countries with repayment rates that are comparable to or better than those of larger financial institutions. The impact of these loans on individuals and their families has been great. The incidence of malnutrition among the children of these families has declined; the attendance of these children at school has increased. The use of birth control devices by the women has increased as has the usage of health facilities.

The success of such modest ventures by large numbers of individuals has potentially large societal implications. It is a model that demonstrates that there are personal opportunities for even the poorest of people. It is not only an empowering individual experience; it is also creates bonds of commerce and of trust between people within communities. Such bonds create the possibility of larger ventures and, perhaps, even of meaningful political participation in a way that hiring a person for a job in a factory or on a plantation does not. Microlending requires that an individual figure out how he or she can fulfill an economic need and what he or she must do to get paid for the work. That requires knowledge of local circumstances and personal abilities. In contrast, work in a factory or on a plantation is planned by others and could be done by forced labor instead of paid labor. It provides fewer building blocks for further development of a market or a society.

The notion of what works in local circumstances also applies to government programs. While writing his book, *The World's Banker*, Sebastian Mallaby followed James Wolfensohn, President of the World Bank, as he travelled in Africa. The problem Wolfensohn sought to understand was how to make sure that money intended to help uneducated poor and even starving Africans actually achieved its purpose. On his first trip to Africa, he found a success story in Mali that impressed him and provided a vision for his attempts to alter the operations of the World Bank. Linda McGinnis, the Bank's representative in Mali, argued that President Alpha Oumar Konare had changed the structure of power in that country so that control of funds from bank projects was held by the communities that were the intended beneficiaries of the projects. In other countries visited on this trip, bank funds were controlled by central ministries that used funds in ways that had little effect on economic development. Mallaby reports that Wolfensohn came back determined to decentralize the bureaucracy of the World Bank and to fund local projects. He wanted to give more funding authority to engaged bank representatives like Linda McGinnis, but require that the projects be formulated locally. The idea was that money would be allocated to locales rather than to ministries; however the locale had to submit a qualifying plan that had the approval of the parents of the students or the users of the water. Feedback and responsibility for one's own destiny were to be made the goals of such projects. Much like the microloans, these could form building blocks for other ventures. Wolfensohn's effort to transform the bank was at most a qualified success.

These notions of organic local growth exist in some tension with Thomas Friedman's *The World is Flat*. Friedman's thesis in that book was that technology has made the world into a single global market. Thanks to the internet and modern transportation, local markets have ceased to exist. Home Depot stores seem to sell only products made in China. India appears to provide more backroom IT services than anyone else. Americans buy grapes from Chile, cut flowers from Central America and oil from Venezuela, Nigeria, and the Middle East. And everyone buys American entertainment products, education, technology, treasury securities and other American financial securities. To be sure, this picture has changed substantially and will continue to change if the price of oil and the costs of transportation continue to rise.

If Friedman's picture were true, it would suggest that most products and services are and will be traded internationally. Accordingly, the small and slowly developing economies that adopt microlending or lawn mower sized cultivators would not survive. But, of course, billions of people are not part of the global market. The workplaces of beauticians, barbers, repair workers, sanitation workers, construction workers, health workers, fire persons, and police are inherently local. Though they may use products of the global system, their role is predominantly local. Even more absent from the world wide economic network are the billions of poor in developing countries. Those living on less than two dollars a day are not even significantly part of a money economy, much less a part of the global market.

Moreover, as the price of oil increases, the world will become less flat. There will be more incentive to make more products where they are consumed. Even if the price of carbon products were to continue falling, concerns about pollution and environmental damage would provide reasons to encourage more local production and more efficient methods of production and transportation that lessen the harm to the climate and to people. In this less flat world, rich countries will have to develop new ways of producing goods and services that reduce the harms, the wastes, and the costs of ways our economies currently operate.

Bill McKibbon's book *Deep Economy*, tries to outline ways in which wealthy nations might bridge some of the tension between the global market and bottoms-up solutions to poverty and climate issues. His solutions/proposals combine local farming successes that do not rely on commercial fertilizers, pesticides, genetically modified seeds, or huge tracts of land with internet solutions that provide information and experience on how to manage land and produce better food. The transformation of refuse to compost to soil and fertilizer is not a new idea, but is one that can be enhanced with modern technology. The internet makes it easier to find out what is known and to share experiences about what has been shown to be possible.

McKibbon notes that the kinds of life style changes he advocates –especially consumption of locally produced goods-- do not necessary involve sacrificing quality of life. For example, he notes the founder of Chez Panisse in San Francisco was appalled when she visited the dining rooms of Yale University where her son was enrolled. Yale accepted her offer to direct the operation of one of its kitchens and her condition that that kitchen prepare and serve only locally produced food. Her kitchen's products were so successful that students assigned to other dining rooms tried to eat at her dining area.

Although many of his examples come from Vermont, where he lives, McKibbon also describes how Cuba has become self sufficient in growing food by allowing individuals to grow crops in Havana's many vacant lots and sell their produce. The success of that venture is yet another illustration of how, when permitted, individuals can see and exploit opportunities that can benefit their society in ways that central planners cannot visualize.

McKibbon makes many points about waste, pollution, and misallocation of resources through subsidization and regulation in the developed world and is particularly critical of the consumer product orientation of American society. He cites cross cultural studies indicating that personal happiness appears to increase as countries GDP grows toward $10,000 a person, but that increases beyond that do not seem to increase personal satisfaction. (The US has a per capita income of nearly three times that amount.) For purposes of this Commentary, McKibbons' points suggest that developing countries need not aim to emulate the income levels or production methods of the industrial and post industrial world to improve the standard of living of their residents.

In contrast to *The Growth Report,* I have repeatedly cited authors in this Commentary who suggest that local growth also can be successful in developing market economies. This is not to suggest that international trade is bad or insular markets are good or that government is not required to develop large infrastructural projects. Together these provide important options. One need not subscribe to beliefs of 19th Century agrarian utopias or 1960's hippie communes to believe that there are benefits from developing locally productive resources in ways that encourage more stable and sustainable economies. The pollution problems of the rapidly growing, and already giant, economies of China and India demonstrate that they are straining world resource supplies, creating enormous environmental damage, and disrupting local and international economic relationships as they continue to grow at record rates. The limiting of transportation and industry during this summer's Olympic Games for the Beijing is only one small demonstration of the daily environmental cost that the pattern of growth has cost China. Economic successes can continue only if they develop policies that are environmentally and culturally sustainable.

The policy choices on how to continue growth are limited by more than resource, environmental and educational constraints. There are cultural and social factors that limit the speed and types of growth that a country may adopt. Institutional Economists have demonstrated the ways in which economic growth developed in Europe was based on rules of behavior that were internalized by the parties to transactions as a result of their understanding of realistic options. Avner Greif for example describes the social/political forces that supported the prosperous Hanseatic League. He, Douglass North, and their colleagues argue persuasively that durable rules of conduct emerge from existing understandings.

These cultural understandings tend to make economic development path dependent. A country that does not respect existing cultural understandings risks destroying the social cohesion that makes market economies possible. The prevalence of kleptocracies may be a result of well intentioned but failed attempts to impose reasonable rules because those rules were alien to the culture. When those new, seemingly efficient, modern rules fail, the result may create a culture in which power becomes the ruling factor and corruption replaces bureaucratic, democratic, and market processes.

McKibbon describes Kerela, a socialist province south of Bangalore, India's IT capital, that has not participated in the rapid economic growth of experienced in many parts of India. He notes, however, that the province has less poverty and higher life expectancy than more economically dynamic provinces. Socialism is, of course, not indigenous to India. But the particular brand that exists in Kerela seems to have been grafted onto the local culture because the party continues to prevail in provincial elections. Note, however, the same is true of Singapore where an authoritarian pro-market government has prevailed in democratic elections for more than fifty years.

The idea that government actions support of particular technologies, of industries, of universities, of the rule of law has now been incorporated into economic growth theory by Paul Romer and others. It can no longer be assumed that technology and the standard of living of industrial countries will automatically spread to poor countries. Economic and legal development theories do not identify what actions are most likely to be successful.

The problems of transforming market infrastructures are not merely problems of detail, because social and economic conditions vary so greatly. Neither is the problem of corruption, which is often endemic especially in resource rich countries, simply an issue of unprincipled leaders. Rather, the problems rest on the necessity of establishing the political will to implement development policies and the need for effective feedback systems that evaluate and alter development plans in response to their local success (or lack thereof) and their suitability to international circumstances. An economic market is successful to the extent that it incorporates adequate feedback systems about demand and supply of products, about the accuracy of claims about products and investment opportunities, and the ability of the government and persons in the society to incorporate that feedback into their future actions. To facilitate the development of sustainable feedback systems requires the engagement of larger portions of a society in a market economy with technology and institutions that are matched with the resources, education, and institutions of each developing country.

The Growth Report of the Commission reminds us that that the path to economic growth is not easy or quick, but it seems to be possible if leaders are sensitive to what works. It demonstrates that governmental actions and decisions can speed economic development through market mechanisms if the governments are sufficiently sensitive to which actions succeed and which do not. That general conclusion is welcome information, but it is only a launching vehicle for a new approach. Too often ambitious economic development plans have failed because they did not take into account the strengths and weaknesses of individual countries and communities. The Commission seeks to avoid this pitfall through its reports on individual countries. Together these reports on each country will provide a menu of strategies with various outcomes.

Even supplemented by the country development reports, the efforts of the Commission are unlikely to be sufficient to make a major change in international development strategies. To become effective, the work of the Commission needs to become part of a text for those involved in economic development. It would be especially helpful to establish educational programs for leaders and potential leaders of transitional economies and for international assistance donors. They need to study the lessons of success and failure that are contained in these reports and other histories of economic development. As noted at the outset of this Commentary, American business schools have long offered case history courses to assist corporate managers and have extended these programs to businesses and governments in developing countries. Michael Porter's *The Competitive Advantage of Nations* was a 1990 landmark set of country studies that made this kind of learning possible. It has been followed by others, including William Lewis'2004 *The Power of Productivity*. Now, those who teach and learn will have a new set of materials in the *Report's* country studies with which to explore positive options for economic development and the relief of world poverty. Used as analytic tools, these materials can provide frameworks for the decisions that need to be made to promote sustainable economic growth.

Ultimately, *The Growth Report* tells us that growth can be expected only as a result of long term effort that responds to both local and world conditions. Only governments that have persevered over years have succeeded in fostering markets that facilitated sustainable economic growth.