RECENT LESSONS OF DEVELOPMENT

Lawrence H. Summers
Vinod Thomas

Development is the most pressing challenge facing the human race. Despite the enormous opportunities created by the advances in technology, more than 1 billion people, one-fifth of the world’s population, live on less than US$1 a day, a standard of living that the United States and Europe attained two centuries ago.

In the past the development effort may have mattered primarily to the citizens of poor countries. But now demographic, political, and technological trends make development an urgent priority for rich countries as well. Ninety-five percent of the growth in the world’s labor force will take place in the developing world over the next quarter of a century. With the end of the cold war, economic and environmental issues will occupy the center of the diplomatic stage, and these issues will increasingly involve developing nations. As improvements in transportation and communication shrink the world, the rich and poor countries will inevitably impinge more and more on each other. International television’s impact on the less-advanced nations and the sharp increase in refugee flows worldwide are harbingers of things to come.

A remarkable transformation in prevailing views about how governments can best promote economic development has occurred in recent years. Where it was once thought that government needed to occupy an economy’s commanding heights by allocating credit, rationing foreign exchange, ensuring against dependence, and operating key industries, today it is widely accepted that government’s responsibility for directing the production and distribution of goods and services should be much reduced and the private sector’s role much enhanced. It is in those tasks for which markets prove inadequate or fail altogether—for example, investing in education, health, or physical infrastructure—that government has a central role.

For some time now, the advice of the Bretton Woods institutions (the World Bank and the International Monetary Fund) has reflected the view that eco-
omic progress is impeded by governments that seek to supplant, rather than support, markets. That view has recently been taken on board by policymakers in many parts of the world. Most publicized has been the collapse of communism in what was once the Soviet bloc. China, where one-fourth of the people in the developing world live, calls itself socialist, but the past decade has witnessed spectacular growth of the nonstate sector and very substantial price liberalization. India, where one-fifth of the population of the developing world lives, is now undertaking a program of structural adjustment and liberalization that is mild by Eastern European standards but would have been unthinkable even two years ago. Chile and Mexico have demonstrated to other Latin American nations the benefits that liberalization can bring. And change is coming, albeit slowly, in Africa, as agricultural marketing boards are dismantled and investment licensing schemes are scaled back.

For fifteen years, the World Bank's *World Development Reports* have been distilling the lessons of the record in various aspects of economic development. In a synthesis of what has been learned to date, the 1991 report (World Bank 1991) described the emerging consensus in favor of what was labeled the "market-friendly" strategy, one in which governments sustain rather than supersede markets. That report coincided with a growing literature on thinking about development (for example, Krugman 1993; Srinivasan 1991; Ranis and Schultz 1988) and on the lessons of growth and development (for example, *Journal of Economic Perspectives* 1990; Barro 1989; Stern 1989; Chenery and Srinivasan 1988; WIDER various years). This article summarizes what we consider to be the main policy conclusions from the development experience of the past thirty years and then considers a number of unresolved issues and challenges for the future.

The Development Record

In thinking about development strategy, it is a mistake to lose sight of the enormous progress that has been made and continues to be made in the developing world. Average incomes in developing countries have doubled over the past three decades—faster, that is, than in the United Kingdom during the Industrial Revolution, in the United States during its spurt to industrial maturity in the nineteenth century, or in Japan during its prewar growth spurt. Economic progress in some developing countries has been dramatic: Turkey doubled its average income in twenty years (1957–77), Brazil in eighteen years (1961–79), the Republic of Korea in eleven years (1966–77), and China in ten years (1977–87).

Tremendous social progress has also been achieved in the developing world. Infant mortality rates have been cut in half, total fertility rates have been lowered by 40 percent, and life expectancy has increased by nearly a decade, equivalent to twice the gain from eliminating both cancer and heart disease in the United States. A child born in Shanghai today has a smaller chance of dying...
in the first year of life, a longer life expectancy beyond one year, and a greater chance of learning to read than a child born in New York City. Social advance has been most striking in East Asia. It is estimated that the incidence of absolute poverty (that is, the percentage of the population that subsists below the poverty line) in that region has fallen dramatically in the past three decades, from a third of the population in 1970 to a tenth in 1990 (Johansen 1992).

Many people think of the 1980s as a “lost decade” for development. Indeed the economies of Latin America, the Middle East and North Africa, and Sub-Saharan Africa, where average incomes declined in real terms during the decade, did have a difficult time during the 1980s. But growth of income per capita weighted by population was slightly above the historic average during the decade. In other words, the income of the average person worldwide grew more in the 1980s than in the 1970s. This reflects the acceleration of growth in India and China, where more than 2 billion people live: average incomes in China expanded at roughly 8 percent a year in the 1980s, while those in India increased by more than 3 percent a year.

Of course, this relatively favorable record conceals enormous variations in growth rates and poverty reduction across countries. Per capita incomes in some economies have doubled twice over since 1960 and are well on the way to a third doubling. But thirty-six nations with a combined population of nearly 500 million people have seen low or declining average incomes over the past twenty-five years. Poverty remains a formidable problem, and substantial economic progress has yet to touch millions of people. Before turning to the more detailed implications of this record of divergence for national policy, three broad facts of experience are worth emphasizing.

First, peace is prerequisite to successful development. Most of the economically successful countries have been able to enjoy sociopolitical stability. By contrast, most of the thirty-six countries that have lost ground over the past twenty-five years were involved in a substantial military conflict (Sivard 1989). In Africa, where development performance has been most disappointing, 7 million lives have been lost in wars in the past thirty years.

Second, nations shape their own destinies. Poor domestic policies, more than an unfavorable external environment, are usually to blame for development failures. By any measure more foreign assistance goes to Africa, where performance has been poor, than to parts of Asia, where it has been better. Net capital inflows over the past quarter of a century to the most successful area of the developing world, East Asia, were less than one percent of the region’s gross domestic product (GDP). Moreover, East Asia has not had the benefit of natural resources to export. And countries such as the Korea and Indonesia, despite debt burdens similar to those of some of the highly indebted countries, have not experienced debt crises because they used the proceeds of borrowing to make investments yielding high returns. The recognition that countries make their own histories has begun to be reflected in models of economic
growth, which increasingly factor in aspects of a country’s policy environment that affect performance (Easterly and others 1991; Romer 1990; Lucas 1988).

Third, the proper blend of state and market in the economy is a decisive factor. A review of the record identifies some important characteristics of successful government intervention. Most of these follow from the general principle of supporting, rather than supplanting, markets and the related idea that, as Keynes (1926) put it, “the important thing for government is not to do the things which individuals are doing already and to do them a little better or a little worse; but to do those things which at present are not done at all”.

Market development itself requires government action. The socialist economies in transition, from Eastern Europe to East Asia, are finding out that the establishment of the rules of the game by the government is crucial to the success of market reforms. The need for government action goes further, its rationale resting on various notions of market failure.

Investment in human capital and physical infrastructure by the government are usually justified because of externalities or spillover effects in the consumption or production of both of these categories and the inadequate incentives for markets to take them into account. In the case of primary education, for example, there are consumption related spillovers. The benefits to literacy go well beyond the gains to the individuals becoming literate. In the case of physical infrastructure such as roads, there are production related externalities based on the need to make lumpy investments or to integrate the service in large networks. Negative spillovers, too, justify government intervention: environmental pollution and congestion are inadequately accounted for by the market.

The central issue, then, is one of the state and the market, but it is not a question of intervention versus laissez faire—a popular dichotomy but a false one. As discussed below, it is rather a question of the proper division of responsibilities between the two and of efficiency in their respective functions.

Learning from Experience

The relation between government and market can be seen under three broad headings: human and physical infrastructure, competitive climate for enterprise, and macroeconomic management. A fourth area, institutional development, cuts across all three. The areas, of course, are interrelated. A relatively undistorted and competitive domestic economy rewards the buildup of human capital more generously than one that is highly regulated and protected. At the same time, investments in education make the domestic economy more productive by speeding the adoption of new technology. To take another example, a stable macroeconomic framework allows the domestic price system to work effectively because it helps to avoid inflation. But microeconomic efficiency also makes it easier to keep inflation low: with fewer unviable enterprises, there
will be less need for subsidies that swell the public sector deficit. And, reforms in all these areas work better if a country's institutional framework, embracing both market and government institutions, is improved.

**Human and Physical Infrastructure**

Perhaps the most important investments governments need to make are in people. The economic returns from public and private investments in education and health are often extremely high (Psacharopoulos and Woodhall 1985; Easterlin 1981). Improving peoples' health and education strengthens the demand for smaller families, which, together with better provision of family planning services, helps to tackle the population problem in many parts of the world. Markets in developing countries often cannot be relied upon to provide people—especially the poor—with adequate education (particularly primary education), health care, nutrition, and family planning services. The returns to government development of various forms of physical infrastructure are also usually very high (Jimenez forthcoming). The incentives for the private sector to develop adequate infrastructure, such as rural roads, are often lacking.

A child born in Africa today is more likely to be malnourished than to go to school at all, and is more likely to die before the age of five than to go to secondary school. And yet because basic health care services are labor-intensive, they can be effectively produced in developing countries. By one recent calculation for Pakistan, providing 1,000 girls with one extra year of schooling would raise their market productivity by between 10 and 15 percent and would avert nearly seven hundred births and close to fifty infant deaths. (Summers 1992).

Many governments are investing far too little in human development (World Bank 1991; United Nations Development Programme 1990). In Brazil and Pakistan rapid economic growth alone was insufficient to improve social indicators substantially. In Chile and Jamaica, however, these indicators improved even in periods of slow growth. Among low-income countries, Guinea and Sri Lanka have the same per capita income, but average life expectancy is some two-thirds longer in Sri Lanka. Brazil and Uruguay have similar per capita incomes, but infant mortality is two-thirds lower in Uruguay.

Governments must also make necessary tangible investments in infrastructure. However appropriate the incentive framework, firms cannot function if the water runs brown, and nothing happens when a coin is put in the phone. Too often, as in the case of electricity and water supply, failed government efforts to provide or maintain infrastructure lead to very expensive attempts at private sector substitution. For example, in India power plants operate with a capacity utilization of less than 50 percent, yet firms are forced to install their own generators because the risk of interruptions is so great.

Ensuring that governments make the necessary investments in both tangible and intangible infrastructure is partially a matter of making sure they have
adequate resources. But in addition to increasing the quantity of human investment, governments must improve its quality. Too often, capital investments go forward without adequate provision for the recurrent expenditures they entail, which results in wasteful underutilization. Too often water is provided at little or no cost to industry and then is wasted, while clean water is unavailable where it is desperately needed to improve health. Targeting expenditures appropriately is crucial. Expenditures are frequently poorly targeted and involve a great deal of leakage.

The need to shift priorities in spending is wide-ranging. It will pay to reduce heavy subsidies for higher education and to spend much more on primary education, from which the returns are relatively higher. The case for a similar switch in spending on the margin, from expensive curative health care systems to primary systems, is also strong. In too many developing countries half the national health budget goes to a few hospitals that do open heart surgery in or near the nation's capital, whereas immunizations cannot be afforded in rural areas. The question of priorities goes beyond the area of human resources. In many countries there is scope for substantially reducing spending on the military in favor of increased spending on human and physical infrastructure.

**Competitive Climate for Enterprise**

Growth led by the private sector needs a permissive, rather than a prohibitive, environment. Almost no one disagrees that communism is the longest route from capitalism to capitalism. For all their faults, competitive markets are the most effective way yet found to get goods and services produced and distributed efficiently. External and domestic competition provides the incentives that unleash entrepreneurship and technological progress (Balassa 1977; Bhagwati 1978; Krueger 1978; Porter 1990).

Openness to trade, investment, and ideas encourages domestic producers to cut costs and improve productivity by introducing new technologies and to develop new and better products (Chenery, Robinson, and Syrquin 1986). A high level of protection for domestic industry, conversely, has held development back by decades in many places. The effect of import protection on firms in Chile and Turkey, for instance, and the effect of greater competition in export markets on firms in Brazil, Japan, and Korea confirm the decisive contribution to efficiency that the external economy can make.

Many developing countries are taking to heart the lessons from worldwide experience in trade liberalization. As a result of the various liberalization episodes of the 1970s and 1980s, the developing world is more open today than at any time in recent history. But the threat of increasing protectionism is ever present, not least from the industrial countries. In fact, as the developing countries liberalized, the industrial countries on average raised trade restric-
tions in the 1980s: development prospects can be substantially improved if all countries roll back trade barriers.

A permissive domestic environment is one where government seeks to reduce, rather than increase, the cost of doing business. That means doing away with licensing requirements for investment, avoiding debilitating restrictions that limit firms’ ability to downsize, and reducing tariffs and quotas on capital goods whose cost is found to affect growth performance significantly (De Long and Summers 1992). One study found that the price of traded capital goods was 50 percent higher in Africa than in other parts of the developing world (World Bank 1989). Creating a competitive climate for the private sector also entails avoiding government monopsonies or punitive regulations. The success of the Nigerian government's action in abolishing agricultural marketing boards and moving toward a realistic exchange rate illustrates what deregulation can accomplish. Cocoa output has risen 50 percent since 1986, both rubber and cotton production has more than quadrupled, and soybean production and processing of soybean products have increased even more. A permissive environment is also one where market forces are able to set prices without price controls or large subsidies. The former Soviet Union, where the price of oil at any realistic exchange rate has been less than $1 a barrel for many years, is an extreme example of distortions caused by subsidies, but large subsidies to energy and energy-using products are ubiquitous in developing countries.

Governments have a history of failure in attempting to manage directly the production of private goods and services. Around the world the record of public enterprise management is one of disaster. It may be true in theory that a properly managed public enterprise can often be as productive and efficient as a private one, but the reality is that politics usually intrudes and efficiency is sacrificed (Nellis 1986; Jones 1982). Public enterprise managers are rarely permitted to shed labor in order to produce at minimum cost. And procurement is often treated as a way of enriching contractor and procurement officers rather than producing efficiently.

Nigeria provides an example of what can go wrong when government tries to operate what should be private industry. Between 1973 and 1990 the Nigerian government invested $115 billion in its public sector, or about $1,000 for every citizen. This investment, depending on what exchange rate is used, represented as much as four years' worth of gross national product. Yet there is little growth to show for it. Public sector assets are operating at a capacity utilization rate of less than 40 percent. And a $3 billion steel complex sits empty, awaiting the $1 billion of investment necessary to complete it. Mexico, by contrast, provides an example of what privatization can accomplish. Large-scale privatization has attracted substantial foreign investment and has already considerably improved efficiency. Indeed, several countries have found that the expectation that enterprises will be privatized creates an impetus for increased efficiency.

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Macroeconomic Management

Sound macroeconomic policies with sustainable fiscal deficits and realistic exchange rates are a prerequisite to progress (Fischer 1986). Large government budget deficits absorb domestic saving and foreign funds that could otherwise be channeled to the private sector. Crowding out productive investments by farmers, entrepreneurs, and large businesses, government deficits place the financial system under great strain. Often they induce rapid inflation, which in turn exacerbates the deficit, creating a vicious cycle. Deficits also lead to overvalued exchange rates, which stifle exports, damage domestic producers, and create pressures for protectionism. Evidence is accumulating from country experience of widespread ill-effects of large fiscal deficits (Corden 1989; World Bank 1988; Tanzi and Blejer 1986, for example).

A distinguishing feature of the East Asian experience is that the public sector exercised discipline in its spending; such discipline is essential to ensure that rents from government interventions are kept to a minimum. Fiscal discipline was practiced in different ways. In Taiwan before 1987, a law limited the value of outstanding government bonds to no more than 40 percent of the central government's annual budget. Thailand limits its budget deficit to 20 percent of expenditures. In Indonesia the openness of the capital account has served as a check on irresponsible fiscal behavior that could precipitate currency speculation and crisis. Malaysia, however, ran a large deficit (a high of 19 percent of GDP in 1982) but cut it sharply (5 percent in 1990) when performance was threatened.

To be sure, fiscal and financial instability have sometimes been partly inflicted on governments by external events—or by internal shocks such as civil wars or natural disasters. But governments can choose how to respond to such pressures. In such countries as Côte d'Ivoire, Kenya, Mexico, and Nigeria, the response to a temporary economic upswing was an unsustainable increase in public spending. Countries such as Botswana, Chile, Colombia, Indonesia, Korea, Malaysia, Mauritius, and Thailand managed to keep their macroeconomic policies on course, and their broader economic performance has benefited accordingly.

If a persistent government budget deficit is the surest route to economic failure, an artificially overvalued exchange rate must be the runner-up. Underlying such overvaluation are expansionary fiscal and monetary policies, excessive borrowing, and inadequate trade and exchange rate policies. Overvaluation leads to the rationing of foreign exchange, which is invariably associated with its discretionary allocation and appropriation by government officials and their friends. Overvaluation also creates pressures for layer after layer of controls on imports, capital flows, and even travel. And it destroys emerging export industries, perhaps the most important foundation for growth that any developing country enjoys. The extent of exchange rate misalignment and its deleterious effects on performance are now well documented (see, for example, Edwards 1989; Williamson 1987).
Institutional Development

The better a country's institutional capabilities are, the more effective such actions will be. Similar policy reforms have produced different results across countries (Thomas and others 1991), and one of the explanations is the variation in the capacity of institutions to implement the reforms. Institutional development refers to market as well as to government institutions.

In many countries market development requires less government intervention. Market institutions are often stifled by a series of harmful interventions. Governments sometimes intervene in the market to address political instability and other political constraints. But, all too often, the resulting combination of pervasive distortions and predatory states leads to development disasters. Reversing this process is a crucial part of institutional development. It requires political will and a political commitment to market reform and market development.

But it is a myth that "government is the problem, not the solution." When governments do the things they should not do, they are stretched too thin to do the things they must do. Governments need to assist in the efficient development of markets. Only governments can provide the institutional framework for exchanges. This means rules governing property rights, and it means enforcement based on preestablished principles of contracts. The establishment of a well-functioning legal system and judiciary and of secure property rights is an essential complement to economic reforms.

Reform of the public sector is a priority in many countries. In addition to market liberalization and privatization, it includes reforming the civil service, rationalizing public expenditures, and reforming some state-owned enterprises. Related economic reforms include better delivery of public goods, supervision of banks, and legislation to encourage financial development. Adopting these reforms will increase the quality of governance and the capacity of the state to implement development policy and enable society to establish checks and balances.

What Are the Uncertainties?

Across a wide spectrum of opinion there is agreement on the basic principles we have just described. Governments have done too much of the things they cannot do well—regulating markets and producing ordinary goods—and too little of the things they must do well—maintaining macroeconomic stability and making necessary public investments. Governments, in ways that will differ from country to country, need to do less of certain things and to do them better. But the agreement on these points leaves a great deal unresolved. There are questions about implementation and concerns about external constraints of various kinds.
First, the East Asian success stories remain open to differing interpretations (Wade 1990; James, Naya, and Meier 1989). Government, at key stages in each of these countries' development, did seek to affect the allocation of resources across sectors through industrial, trade, and credit allocation policies. World Development Report 1991 noted some key conditions under which East Asian interventions were far more effective than similar actions in other parts of the world. Government interventions were disciplined by international competition. And they were flexible enough to be changed on the basis of the evidence about their effectiveness.

As the success of Japan, Korea, and Taiwan continues, the position taken by some economists that they succeeded despite government efforts at channeling market forces is increasingly implausible. But there is still room for disagreement, and so for research on two questions: how important in explaining East Asian growth is the contribution of sectoral interventions relative to the contribution of overall macroeconomic stability, outward orientation, and investments in capital and people, and what is unique about these countries that enabled interventionist policies to succeed there when they have been so unsuccessful in the rest of the world? Answering the latter question is essential if the East Asian experience is to provide guidance to other countries.

Second, what is the best sequence and pace of reform? If the role of government that we have just described is agreed to be appropriate, there remains the question of how policies should be reformed. On the sequencing question, experience suggests that it is wrong to think of reform as a series of obstacles, each of which must be surmounted. Policy changes typically occur simultaneously or nearly simultaneously on many fronts. But as a general proposition it appears that macroeconomic stabilization is essential to reform and needs to come early, and that it is usually best to delay financial liberalization until macroeconomic stability has been put in place and the viability of enterprises has been restored (Fischer and Gelb 1991). On the question of the pace of reform there is also room for disagreement. Where hyperinflation is rampant or looming, the case for urgent action is clear. But where the threat is not imminent, as in much of Africa, China, or India, the case for "big bang"-style reform is much weaker. Particularly where reform will involve large displacements of workers who will not be quickly reemployed, there are legitimate grounds for favoring gradual transitions. The difficulty, of course, is that gradual transitions are often favored by those whose first choice would be no transition at all.

Third, what is the relationship between political and economic reform? An earlier view that democracy was antithetical to development and that the strong-arm state with a strong leader at the helm was essential has now been discredited. A number of studies, some summarized in World Bank (1991), have found no systematic relationship between liberties and rates of economic growth and evidence of a positive relationship between liberties and social performance. These findings are reassuring to friends of both economic and political freedom, but doubts remain. Most of the major development success
stories—for example, Chile, China, Korea, or Singapore—had governments that were or are authoritarian in many respects. It is possible that democracy can foster growth by making it impossible for hopelessly incompetent and corrupt governments to remain in power, but one also has to wonder whether democracy can be inconsistent with outstanding performance. A related issue involves the sequencing of political and economic reform—the ordering of glasnost and perestroika. It is easier to identify examples of successful economic reform that preceded political reform than that immediately followed it.

Fourth, can adjustment to the “market-friendly” approach work in very low-income countries, especially in Africa? It is hard to answer this question in the absence of a clearly specified alternative strategy. One of the hard lessons of the adjustment efforts of the past decade is that adjustment and reform take time to yield results (World Bank 1989). Government credibility, once lost, is restored only very slowly. And would-be investors, whether foreign or domestic, can always delay investment, waiting to see how things turn out before deciding whether to invest. Most of the success stories—Japan and Germany after World War II and Chile, Korea, and Mexico more recently—took time, and things often got worse before they got better. The process appears even more protracted in very low-income countries. It is no accident that programs put in place with the cooperation of the Bretton Woods institutions involve a higher ratio of adjustment to austerity than would have been the case a few years ago.

Fifth, will the external global economic conditions make export-led growth possible on a large scale over the next twenty-five years? Export-led strategies have not invariably been the most effective. Looking at the record of the period between the two world wars and of the immediate postwar period, it is not difficult to understand the appeal of import substitution notions. Brazil, with relatively closed markets, was about the fastest-growing country in the world from 1965 to 1980. The liberal advice that most developing countries receive must be based on one of two premises. One is that it will be widely ignored, so the adding-up problem—that is, the problem that increased exports from all will deny benefits to individual countries—will not arise, and those few countries that increase their export capacity will benefit. The other is that many countries will be able to increase exports greatly without depressing their terms of trade, either because industrial markets for domestic products will grow without protectionist policies being imposed, or because trade among developing countries will become more important in the future than it has been in the past (World Bank 1992a). These premises are not self-evident as reform sweeps the developing world, industrial country growth slows, and the Uruguay Round flounders. Although it has been true in the past that the external climate has been a less important barrier to development than misguided domestic policies, this may change as domestic policies improve and protectionism in the industrial world mounts.
Sixth, will natural environmental constraints hold back development or force a new paradigm based on notions of sustainability? Environmental concerns are very important and have been too little reflected for too long in policymaking in both developing and industrial countries. To a large extent environmental problems are a consequence of policies that are misguided on narrow economic grounds—subsidies to energy, failure to give farmers title to their land and adequate credit, public ownership of major industries, inefficient charging for water, and so forth. And where they are not, the difficulty is to do the right cost-benefit analysis and implement the most cost-effective policies for sustainable development (World Bank 1992b). Of particular importance are steps to eradicate the severe forms of environmental degradation, such as poor sanitation and water and air pollution, that threaten human lives and well-being. The agenda for environmental reform is a large one. Accepting the challenge to accelerate development in an environmentally responsible manner will involve substantial shifts in policies and priorities and will require substantial investments. Failing to accept it will be far more costly.

Seventh, and finally, there is the ever present danger that some new problem will surface. The only real constant of experience is the unpredictability of the future.

Note

When this article was written, Lawrence H. Summers was the chief economist and vice president of Development Economics at the World Bank; he is now U.S. Treasury Undersecretary for International Affairs; Vinod Thomas is the chief economist in the East Asia and Pacific Region at the World Bank.

References

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