Introduction

The papers in this volume were presented at the sixth World Bank Annual Conference on Development Economics, held April 28-29, 1994, in Washington, D.C. The conference series seeks to expand the flow of ideas among development policy researchers and practitioners around the world and to open the Bank to the views of outside experts who can challenge or expand our knowledge of the theories and practice of development. Each year the topics selected for the conference represent either new areas of concern or areas we believe will benefit from a review of existing knowledge and identification of areas for further research.

The sixth conference addresses five themes: transition in socialist economies, new institutional economics, economic geography, international migration pressures, and labor markets under systemic change. The 1994 conference continues the tradition of holding a roundtable discussion related to the subject of the next World Development Report—in this case, employment and development.

In his opening remarks Lewis T. Preston, president of the World Bank, reflecting on the Bank’s nearly fifty years of experience, emphasizes that in many ways its real value added lies in ideas. He stresses the importance of knowledge and research at the World Bank and the value of advice and technical assistance based on the lessons learned from working in more than 140 countries. Preston notes that the challenge of transition also deals with the power of ideas and involves not just a change in economic systems but a change in thinking as well. He outlines what we know about reform and what we still need to learn, emphasizing such important areas as poverty, environmental degradation, and change in economic systems, where improved knowledge and good ideas are more important than ever.

Michael Bruno notes in his keynote address that the development agenda has changed significantly in the past twenty-five years. Drawing on the experiences of recent decades, Bruno sets out three necessary conditions for development: sustainable growth is necessary for a sustainable reduction in poverty, adjustment is necessary for the resumption of growth, and fiscal and monetary restraint is a nec-

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essary component of adjustment. However, these conditions may not be sufficient. Bruno discusses three areas in which experience has provided insights, but in which further work remains to be done. First, he points out that growth may not be sufficient for poverty reduction; investment in human capital, notably in basic education and health, is an essential complement. Second, he considers the links between macroeconomic stability and microeconomic reforms such as privatization and financial sector reform. Additional research is required to understand the appropriate sequence for reforms and new regulatory needs. Finally, Bruno considers institutions and the transferability of policies. Bruno concludes that the research agenda should aim at reducing the area of ignorance between what we know to be necessary and what we suspect to be sufficient, by deepening our knowledge of institutions and political factors and by drawing on the Bank's extensive operational knowledge.

Leszek Balcerowicz and Alan Gelb analyze three elements of transition to a market economy: macroeconomic stabilization; the liberalization of prices, markets, and entry; and institutional change. They point out that initial stabilization has been most successful when radical programs have been launched during an early period of "extraordinary politics" following a political breakthrough. A reversion to "normal politics" and business-as-usual complicates further stabilization by raising inflationary expectations, slowing reform, and reducing the propensity of state enterprises to adjust. Country experience suggests that there are no adverse medium-run tradeoffs between stabilization and either output or the speed of transition to a private economy. Failure to stabilize wastes valuable time and delays recovery. For countries that are grappling with stabilization in the absence of a major political breakthrough the authors recommend that, even without a formal program, they proceed with liberalization and institutional changes as rapidly as possible to strengthen the constituency for future stabilization.

Jeffrey Sachs describes the deep crisis facing Russia and argues that highly unstable political and economic conditions could trigger a collapse of that country's nascent democracy. He points out that the situation could unravel in a spiral of self-reinforcing destructive responses: criminality, regional separatism, tax evasion, and flight from the currency. To overcome these risks, the Russian government should embark on a rapid program of stabilization, backed by large-scale assistance. Reviewing the role of international assistance to Russia during the past three years, Sachs concludes that assistance has fallen far short—in speed, direction, and magnitude—of real need. The concerns he raises apply not only to Russia, but more generally to weak states in acute financial crisis. The current methods of delivering aid are typically too slow and too oblivious to the risks of a "contagion" of state collapse. Throughout the world weak, newly democratic states are grappling with an inheritance of high indebtedness and failing public institutions. These countries can overcome their bitter inheritance, but only if the world community responds with urgency and support. Sachs argues that a combination of restrictive monetary policy, an early pegging of the exchange rate, and large-scale international assistance offers Russia the most realistic chance of avoiding political catastrophe.
Andrei Shleifer argues that establishing property rights in developing countries and the transition economies of Eastern Europe amounts to solving two problems: inefficient structures of control rights over assets, and unenforceable contracts. The allocation of resources is inefficient in transition economies because politicians and bureaucrats have control over too much of the economy, thus discouraging investment by entrepreneurs. The most obvious way to get around excessive bureaucratic control is corruption, but this strategy is of limited usefulness as an efficiency-restoring mechanism given the general unenforceability of corruption contracts between politicians and entrepreneurs. Shleifer discusses three alternative approaches for establishing property rights: giving bureaucrats equity ownership, reforming the civil service, and eliminating bureaucratic control rights politically, through privatization. Equity ownership might not be politically feasible because equity contracts are not enforceable, while weakening the control of bureaucrats through civil service reform requires a very effective government or a very effective press, and so may be an option only in countries with advanced political institutions. Using the example of Russia, Shleifer shows how privatization, combined with equity incentives for insiders, transfers control rights from bureaucrats and stimulates political and economic pressures for the genuine protection of private property rights.

In another exploration of transition in socialist economies, Gary Jefferson and Thomas Rawski compare China’s gradual and partial implementation of reform with other approaches. The authors explore the mechanisms through which initial attempts at partial reform unleashed forces that, fifteen years later, have brought China’s economy to the brink of a market system. Their analysis highlights the participation of tens of thousand of enterprises and millions of administrators, managers, and workers whose decisions over the years of reform eventually built a constituency for market-directed change that was far stronger than any official announcement could have produced. This process, though very different from that in Western parliamentary democracies, has produced a durable reform constituency that easily rebuffed high-level efforts to roll back reform in the wake of the inflation scare and political repression of 1989. The authors conclude that China’s industrial economy, despite its divergences from textbook ideas, is looking increasingly like a market system.

Oliver Williamson explores the reasons why the ambitions of economic development practitioners are so often disappointed. He says that one answer is that development policymakers and reformers are congenital optimists. More to the point, though, is that good plans are regularly defeated by those who occupy strategic positions. Williamson suggests that these negative outcomes reflect the fact that institutions are important for carrying out the intentions of government, and yet they are a persistently neglected aspect of the planning process. The author suggests that useful work can be accomplished by the new institutional economics. He notes in this connection that the predilections of both optimistic planners and cynical implementers are features to which institutions should be expected to respond. Williamson takes a bottom-up, microanalytic approach that examines the efficacy of the de facto (as against the de jure) institutional environment with respect to credi-
ble commitments. According to Williamson, institutional economists are in effect cast in the role of archaeologists of economic development and reform: they uncover and decipher the lessons of the past that bear on shaping better programs for the future.

Also on the theme of institutional economics, Jon Elster examines the interaction between constitutions and economic performance. He distinguishes between two core provisions of modern constitutions: those that regulate the machinery of government and those that guarantee the basic rights of citizens. These components are so basic that they cannot be changed by the ordinary legislative process but require a more stringent amendment procedure. The author discusses two polar positions of economic performance. The first pertains to economic efficiency, and the second to well-being, or security. Because neither the pure efficiency-oriented view nor the pure security-oriented view is satisfactory, Elster discusses the impact of constitutional provisions on both efficiency and security. He concludes that constitutions matter for economic performance to the extent that they promote the values of stability, accountability, and credibility. While emphasizing the idea that constitutions can be useful by serving as precommitment devices, the author also underlines the dangers of rigidity and the need for flexibility.

Pursuing the topic of economic geography, Paul Krugman claims that very large urban centers are a conspicuous feature of many developing economies, yet development economists have neglected the subject of the size distribution of cities. He argues that some important insights into urban concentration, especially a tendency in some developing countries toward very large cities, can be derived from recent approaches to economic geography. Krugman compares three approaches: the well-established neoclassical urban systems theory, which emphasizes the tradeoff between agglomeration economies and the diseconomies of city size; the "new economic geography," which attempts to derive agglomeration effects from the interactions among market size, transportation costs, and increasing returns at the level of the firm; and a nihilistic view that cities emerge out of a random process in which there are roughly constant returns to city size. Krugman suggests that the desire to reduce the size of these large cities, or at least slow their relative growth, may be met indirectly by the kinds of economic policies currently in favor—liberal trade, less government intervention, and decentralization of power.

In another exploration of economic geography Ann Markusen argues that national governments are turning increasingly to sectoral and technological policies as strategies for economic growth and competitiveness. Such policies are often fashioned simultaneously as regional initiatives to decentralize economic activity from large metropolitan areas and to stimulate laggard regions. Using evidence from Brazil, the Republic of Korea, Japan, and the United States, Markusen concludes that industrial policy was essentially compatible with regional policy over the postwar period but has become less so in recent years as the emphasis shifted toward innovation-intensive export sectors. A key element in the shift has been a preference for locating in primate cities, undermining efforts at regional decentralization. As conflict between industrial and regional policies intensifies, governments appear to favor
industrial policy initiatives and to deemphasize centralized regional planning. The increasing devolution of economic development powers to local governments in all four countries is seen as an indicator of this trend. Markusen argues that the emphasis on high-technology industrial sectors will reinforce the advantages of regions with already high per capita incomes and relatively faster rates of regional growth, slowing progress toward eliminating differentials in regional growth and income.

On the topic of international migration Klaus Zimmermann notes that the heightened interest in European migration is a reflection of increased tensions about foreigners in countries of the European Union. For decades migration was seen as benefiting the host country by supplying needed labor. But in the 1970s immigration policies became more restrictive as social tensions and fear of recession mounted. Considering Europe’s long experience with immigration after World War II, Zimmermann suggests that this new concern has more to do with recent flows of asylum seekers and persistently high and increasing unemployment rates than with migration as such. New econometric evidence suggests that immigration after World War II was driven by business-cycle effects as well as by family migration patterns but that the processes changed after 1973, when many countries acted to halt the recruitment of workers. Zimmermann argues that neither the families of earlier waves of migrants nor ethnic networks in sending countries were affected by the economically motivated immigration policies. His analysis shows that ethnic and family migration networks can counteract policy measures to induce return migration.

Writing on frontier issues in international migration Oded Stark presents the results of an analysis that, although not conclusive, is sufficiently advanced to suggest a number of concrete testable implications. His analysis addresses three issues: return migration, migrants’ remittances, and migrants’ market performance. Stark asks why and which migrants return home, why and how much migrants remit, and what explains migrants’ market performance. Building on the assumption that information is imperfect, Stark traces return migration to the lagged ability of employers at destination to distinguish between skilled and unskilled workers, which results in the return of less-skilled workers. The motive for remittances is seen as self-interest: remittances protect the wages of high-skill workers from being eroded by the entry of low-skill workers into the same pool. To account for the fact that migrants often outperform native-born workers, Stark suggests that perceived group attributes rather than individual abilities and skills determine how migrants fare, absolutely and relative to the indigenous population.

Robert Flanagan addresses the employment problems in Eastern Europe and concludes that the transition to a market economy has led to a contraction in aggregate labor supply and the beginnings of a reallocation of labor from activities favored by central planners to those favored by consumers. Flanagan observes that the expansion of the private sector has reversed—if not eliminated—many of the labor market distortions established under central planning. Thus the first years of economic transition recorded increasing returns to human capital. But there is little evidence of a tight connection between growth of the private sector and development of more rational wage structures. Labor market programs in the region seem ill-suited for
facilitating restructuring. In particular, the emphasis on "passive" measures, such as unemployment compensation, may extend joblessness. Would a change to "active" labor market policies designed to improve the skills of job seekers reverse the decline in employment? Not likely at this point, the author observes. Training and related measures do not create vacancies; they help to fill them. Only when job vacancies and unemployment are more closely aligned would a reorientation away from passive measures and wage subsidies toward training programs for modern production seem desirable. Flanagan finds little evidence that labor unions and minimum wage legislation have inhibited the objectives of restructuring, but he argues that incomes policies appear to have retarded adjustments in wages and other aspects of labor restructuring in state enterprises.

The roundtable discussion on employment and development was designed to address some of the issues central to the forthcoming World Development Report 1995. The panel brought together four experts, each of them drawing attention to different aspects of the topic. Nancy Birdsall talked about growth, inequality, and the labor market. Paul Collier discussed African labor markets. Richard B. Freeman discussed global market issues. Christopher A. Pissarides compared the performance of European and U.S. labor markets and presented lessons for the developing world. The panelists' presentations were followed by a floor discussion chaired by Michael Bruno.

As in previous years, the planning and organization of the sixth conference was a joint effort. We would like to thank Shahid Yusuf, the acting administrator of the Research Advisory Staff, for his guidance on the conference. Particular thanks for their support are due to Gregory Ingram, Paulo Vieira Da Cunha, and Mark Baird. We would also like to thank other staff members, in particular the conference coordinators, Jean Gray Ponchamni, Mantejwinder Jandu, and Evelyn Alfaro, whose excellent organizational skills kept the conference on track. Finally, we thank the editorial staff, especially Meta de Coquereaumont, Paul Holtz, Patricia McNees, and Bruce Ross-Larson.