Development Issues in a Changing World: New Lessons, Old Debates, Open Questions

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The 1960s look like the golden age of economic development. GDP in Latin America, East Asia, and the OECD countries was growing at about 5 percent a year. South Asia and Sub-Saharan Africa were trailing close behind. Predictions for the future were frankly optimistic and—interestingly—rosier for Africa and somewhat bleaker for East Asia. Growth would continue (if not accelerate) and poverty would be sharply reduced.

But the next twenty years were turbulent—with many setbacks. During the 1970s and 1980s the interregional growth gap widened dramatically. Roughly half the wider gap came from the unexpectedly fast growth in East Asia (including China). The other half came from the plummeting drop to negative growth rates in Latin America and particularly in Sub-Saharan Africa.

Growth has now resumed for the developing countries as a group. Will it last, and will it spread? Do past failures of prediction imply that we have learned no general lessons about the sustainability of the development process, its fundamental components, its distributional consequences? Do we understand when and why some countries—facing the same world environment—got into the wrong growth and poverty track and stayed there for a long time? What rises from the wreckage and the reform process as the correct blend of government and market? And what pieces of our acquired knowledge are generalizable, and what institution-specific or country-specific? In short, how have our old ideas about some of these questions been modified with experience? What robust lessons have we learned? In what areas are new ideas (or rigorous testing of existing ones) most needed? All these questions are important for shaping future development policy.

Modified Perceptions of Growth’s Fundamentals

Most striking about the comparative developments of the past twenty years is the diversity of regional experience in a common turbulent environment. The East

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Asian “miracle” countries emerged with an apparent long-run model of development, seeming to have done almost everything right. Against them, one can contrast other countries and ask what went wrong.

There is very broad agreement about their remarkable shared growth—with rapid growth and poverty reduction reinforcing each other. The most interesting and compelling part of the story (it featured less in the development literature of twenty years ago) is the role of basic education in enhancing the quality of labor—complemented on the demand side by a pattern of export-led growth that made productive use of labor, the poor’s most important asset. The emphasis on the health and education of mothers reduced fertility rates and increased the time they spent at home on the education of the next generation of children. Supplementing this was an increased slice of basic education spending in an expanding resource pie.

The effect was substantial. Based on a cross-country regression estimate, if Korea had Pakistan’s low school enrollment rate in 1960, its GDP per capita in 1985 would have been 40 percent lower than what it actually attained. The role of educating mothers can also be decomposed. Between 1965 and 1985 Korean mothers’ enhanced primary education and the resulting drop in their fertility rates doubled their estimated gap with Kenyan mothers in the time (weighted by education) they devoted to their children. Similarly, Korea’s lower birth rate kept a more or less stable number of children eligible for basic education over the period—in Kenya the number eligible almost doubled. Combining the effect of a larger percentage of GDP spent on basic education and the much faster growth rate gives a startling result: in 1985 Korea’s public expenditure per child was twenty-seven times Kenya’s, up from being only three times as high in 1970. This stronger performance on education plus a high savings rate (cause or effect?) provided the bulk of the supply-side capital and labor accumulation for Asia’s “miracle.” Exports, meanwhile, delivered the demand side—along with the discipline of market prices.

Technological spillovers, contrary to what is sometimes claimed, do not appear to explain much of the rapid East Asian growth. Measured total factor productivity for many of the East Asian countries does not account for more than 20 to 30 percent of GDP growth. And the part of this residual attributable to technological progress could be much smaller.

Consider instead that the East Asians responded to the thick and thunder of the 1970s and 1980s with better macroeconomic policies. The departures from rapid growth were shorter and the margins of underused capacity were smaller. Better macroeconomic policy may thus account for a big part of the observed difference between East Asia and the rest of the world in the growth of total factor productivity.

Amid Diversity—Salvaging Necessary Conditions

Among the factors that may account for varying country performance over the past two decades, domestic responses to external shocks may be most important. The protracted crises and their different resolutions have highlighted growth as a path-depen-
dent process. The shocks and the different responses were not predicted. But the unfolding of the crises vindicated the importance of macroeconomic fundamentals and highlighted the importance of market-oriented microeconomic reforms—salvaging some major common policy lessons amid the diversity of country experience.

It is useful, and conventional, to distinguish two elements of the adjustment package to rescue an economy from a crisis and move it to relative price stability and the resumption of growth. One is stabilization, necessary to correct the underlying macroeconomic imbalance. The other is structural reform centering on the supply side, necessary to change incentives and restructure the distorted microeconomy. This usually encompasses a series of market-oriented reforms, such as trade liberalization, public sector reform, and financial sector reform. These also fundamentally redefine the role of government.

Three nested necessary conditions link growth with poverty reduction and with the two elements of adjustment:

- Fiscal and monetary restraint is necessary for adjustment.
- Implementing an adjustment package is necessary for resumption of sustainable per capita growth.
- Attaining sustainable average growth in per capita income is necessary for sustainable reductions in poverty.

All three, in addition to basic education, are necessary—but by no means sufficient—for more rapid growth, and narrowing the gap between necessity and sufficiency remains a major research task. But even the three conditions have been—and sometimes still are—subjects of heated dispute, especially the links between growth and poverty reduction.

**Links between Growth and Poverty Reduction**

The controversy on the “tradeoff” between growth and equity endures, though its intensity and form have varied. In the golden age of growth at the end of the 1960s and in the early 1970s, the debate was over “redistribution with growth.” Policy actions, often misguided, led to an undifferentiated increase in public social spending that largely bypassed the poor. Higher spending enlarged public sector deficits and deepened macroeconomic imbalances when worldwide shocks impinged on country performance.

In the adjustment to new external shocks (such as the debt crisis), the attack has centered on the social consequences of adjustment. One form of the attack implies that poverty can be reduced only by direct targeted policies. The rhetoric comes close to denying any link between growth and sustainable poverty alleviation. By implication, it belittles the view that adjustment is in turn a fundamental step toward renewed long-term growth after a crisis.

It is hard to see how a given (or diminishing) pie can be redistributed in favor of the poor and yet make them absolutely better off in income or wealth. The evidence on this is clear, and here again recent research has helped clarify and solidify our understanding. The incidence of poverty, defined as the proportion of the pop-
ulation living below the poverty line, falls rapidly with growth in consumption. Across several countries, the elasticity is about -2: that is, each percentage point of growth in mean per capita consumption is associated with a reduction in the incidence of poverty of 2 percentage points (Ravallion forthcoming).

East Asia’s shared growth shows that growth and poverty alleviation can go together, though estimates differ about the strength of the two-way causal link between them. Experience elsewhere in Asia and more recently in Latin America shows that poverty measures are strongly correlated with the ups and downs of growth. But this evidence is silent on two crucial aspects. It does not argue that growth is sufficient for poverty alleviation. Nor does it support the view that pro-poor government policies, other than those that enhance growth, are not important for poverty reduction. On the contrary, patterns of growth can clearly be shown to be more or less poverty-enhancing, depending on initial conditions.

World Development Report 1990 has already stressed the importance of primary education and basic health care both for the benefits they confer and for their role in promoting labor-intensive growth. Moreover, the experience in Latin America and elsewhere shows that growth can falter and become increasingly inequitable when policy is biased against the rural sector through mistaken pricing and protection policies, overvalued exchange rates, or the neglect of rural infrastructure.

Adjustment need not hurt the rural poor even when it reduces short-term aggregate output. The result depends on the economy’s openness: in more open economies the adjustment costs are significantly lower. The result also depends on the choice of public expenditure cuts and on the efficiency of public spending in improving the terms of trade for the rural sector (as producers versus consumers). Costa Rica and Indonesia show adjustment with reduced social costs. Argentina, the Philippines, and Venezuela show the opposite. Venezuela’s recent policy reversals attest to the dangers of a reform program whose fruits are not widely shared, as do recent events in Mexico. More widespread household survey data—particularly panel data—should provide further evidence on this important issue, especially for the most controversial and least-researched region of Sub-Saharan Africa. Note that none of this refutes the basic premise that sustainable per capita growth is a necessary, though by no means sufficient, condition for sustainable poverty reduction.

A new consensus on the roles of the private and public sectors is influencing the design of policies aimed at poverty alleviation. With a more neutral structure of microeconomic incentives, price stability and growth work in favor of the poor on two important counts. First, the poor benefit from increased demand for labor and thus from greater private consumption. Second, with incomes growing, governments are more capable of financing (and arguably more willing to do so) public action that is pro-poor.

One key question, requiring much more study, is how to make public action on poverty more cost-effective, especially in the provision of infrastructure and social services. Unresolved is the issue of programs targeted to groups (such as women, families with many children, or poverty-stricken regions) compared with universal provision of social services. This issue raises difficult questions of political economy and is fraught
with problems in implementation. There is also difficulty in evaluating the effectiveness of proposed policies. Much is known about poverty, about how to measure it, and about its relationship to growth and macroeconomic policies—much less is known about developing effective policies and institutions for optimal poverty reduction.

**Macroeconomic Fundamentals and Microeconomic Reforms**

Macroeconomic fundamentals and the reform of microeconomic incentives work together in adjustment and in the resumption of growth after a prolonged crisis—and the past twenty-five years vindicate some old and by now well-honed ideas.

High inflation in Latin America (as well as in Israel and Eastern Europe) has dealt a mortal blow to the bubble theory of inflation—that nonmonetary and nonfiscal means could be used for stabilization. Orthodox fiscal and monetary components have become a necessary and generally accepted part of any stabilization package. But there are some important new modifications. Since the mid-1980s there has been an added twist for countries that have had prolonged inflationary inertia—the multiple anchor approach. This calls for a wage and exchange rate freeze (with or without price controls) to accompany the orthodox parts of a stabilization package, making it heterodox. First successfully used in Israel in 1985, it was followed by Mexico in 1988 and later applied in several Eastern European countries. Another relatively new emphasis calls for bolstering the independence of central banks, a stabilization tool with a structural reform element.

The other important legacy of recent reform experience has to do with the microeconomy of market incentives and the redefinition of the role of government and the private sector. Here again are old elements and new. The advantage of trade-determined market discipline for reasons of efficiency and distribution (political economy) was well established more than twenty-five years ago. It proved effective for the Asian newly industrializing countries, for isolated Latin American countries (Colombia), and for Israel.

The crises of the past two decades produced additional hard evidence on the resilience of an outward orientation in the face of external shocks. And the very recent brand of reform experiments in Latin America (Argentina, Chile, Mexico) and Eastern Europe (the former Czechoslovakia, Poland) incorporates an even more extreme form of quick-fix import liberalization. Indeed, in these later approaches the pace of liberalization is clearly more heavily influenced by political economy than by economic arguments alone.

Government divestiture is providing new lessons about its two main aspects: the divestiture of production (mainly through privatizing state-owned enterprises) and the demonopolization of finance. A new paradigm is emerging from the pervasive mismanagement of public enterprises and political patronage in both industrial and industrializing countries, culminating in the extreme in the collapse of the centrally controlled economies. Private ownership of the means of production—except in a diminishing share of infrastructure investment, natural monopolies, and so on—is the new ideal.
Changes in ownership do matter in the long run. And in the transition economies privatization is the only way to move from central state control to a market economy with a private sector. But hard budget constraints and market disciplines are critical even in the short run. These forces can work—or fail—under either government ownership or private ownership.

In the intermediate stage of commercializing state-owned enterprises, the credible imposition of market discipline even before the transfer of ownership, as in China and Poland, creates the incentives for productivity and profit through better management. In Poland managers (and workers) may change their behavior either because they have a stake in future profits under an impending privatization program or because they are signaling their value as managers in a future market for their services.

But a mere formal change of ownership does nothing to change incentives when the budget faucet stays open. Consider an authoritarian ruler distributing ownership of enterprises to cronies or close family associates (the Philippines under Marcos). Or consider quasi privatization in Russia, where ownership passes into the hands of managers and workers—yet the enterprise may for a time continue to milk the state budget. There are also many examples of private enterprises that are mismanaged under soft budget constraints. Redrawing the boundary between the public and the private sector as part of structural reform may thus start with the clear demarcation of future ownership of enterprise debt even before proceeding on the asset side.

With time, more will be learned from the varying restructuring experiences in Eastern and Central Europe. For example, to resolve bad debts, the most advanced restructuring economies in transition have opted for different channels. The Czech Republic expects private owners to take responsibility. Poland relied on the banking system. And Hungary is relying on liquidation and bankruptcy procedures.

On the importance of financial reform and the restructuring of banks, lessons are coming from both Latin America and Eastern Europe. Governments with large deficits tend to sequester private savings through monopolies of the financial system. But even with more prudent fiscal behavior, the philosophy of central control over investment and lending invariably segments credit markets. Privileged sectors obtain credit at low—and often negative—real interest rates, while the much smaller free market segment is exposed to usurious rates. In times of high inflation the allocative distortions usually mount, and the microeconomic counterpart of public sector reform becomes a necessary complement of the adjustment package.

Two issues require more research. First, what is the correct sequence of reforms in the financial and production sectors? Experience in Latin America and Africa suggests that financial reform fails when public enterprises are not restructured at the same time (as they continue to be a drag on the bad loan portfolio of the banks). But commercial banks may help induce changes in the corporate governance of nonfinancial enterprises in the immediate postprivatization stage of a transition economy. For that matter, what is the relevant model for banks? Should they be allowed to hold equity, as in the continental or Japanese models? When and where is one or the other argument dominant?

What are the appropriate regulatory mechanisms for newly liberalized economies? (Again, what is the best sequence?) The fact that greater microeconomic
market liberalization has to go hand in hand with tougher supervision at the govern-
ment level, especially for the financial sector, is a paradoxical lesson that not just
the newly reforming countries are learning (see the recent major financial supervi-
sion failures in the Japan, the United Kingdom, and the United States).

Can microeconomic adjustment precede macroeconomic stabilization? The stan-
ard answer used to be that macroeconomic stabilization has to come first. From the
perspective of the 1990s the answer may be somewhat less straightforward. It still
seems correct to say that without macroeconomic stabilization no sustainable growth
is possible because price instability usually yields large distortions in relative prices.
Even Brazil, where growth continued for a long time despite high inflation, seems to
have fallen into the familiar low-growth pattern in the past ten years. Yet Brazil man-
aged to privatize amid high inflation. Argentina failed in its stabilization attempts and
managed to get its act together only after a substantial tax reform, suggesting that
microeconomic restructuring had to precede macroeconomic stabilization. The most
recent case in which stabilization has not—or could not have—been achieved before
substantial microeconomic change is Russia, which has gone through mass privatiza-
tion amid high inflation. For the subsequent restructuring stage, however, greater
price stability becomes crucial. The upshot: some years and more country experience
will have to accumulate before we can rewrite the macroeconomic-microeconomic
adjustment sequencing paradigm.

Second, what are the necessary and sufficient conditions for adjustment that leads
to sustainable growth? Put differently, what is the minimum package of reforms? We
seem to understand the issues, but we know little about how to handle them for pol-
icy design. Even when macroeconomic fundamentals are in place, and structural
reforms are under way, sustainable growth takes a long time to resume.

We know that stabilization from high inflation may yield fairly immediate output
dividends—but that investment is very slow to resume. The resumption of profit-mot-
vated, real long-horizon private investment (as against portfolio investment or specu-
lation) depends on how investors evaluate the future of an economy that is emerging
from a crisis and that has a bad track record. The irreversibility of reforms—both eco-
omic and political—plays the dominant role in forming investor’s speculations.

Governments can help to some extent by providing complementary infrastructure,
covering start-up costs, and alleviating the worst social hardships. But the most im-
portant—and hardest—service for a government to deliver is the irreversibility of a new
policy environment and the credibility of the reform effort. A supposed positive-sum
game (with society in the aggregate standing to gain) is not enough. Government
resolve and the widespread shared ownership of a reform effort are the great impon-
derables. Experience is accumulating from the successes and failures in more and more
countries, yet evaluation for policy purposes escapes precise assessment.17

Institutions and the Transferability of Policies

Institutions matter, and they may vary substantially, as recent cross-country expe-
rience demonstrates. So, similar policy advice (as for the introduction of regula-
tory agencies and rules) can result in different policy outcomes in different institutional settings.

Progress in economic theory does not always conform to progress in policy practice. Practitioners and policymakers reared in the cultural and political traditions of a particular country know the importance of institutions in shaping what is feasible (that is, both the enhancing and constraining factors) for recommended policies. The problem arises with attempts to replicate policy lessons in another setting, naturally tempting for the emissaries of a multilateral institution. Not all policy applications are institution-sensitive, but many are.\textsuperscript{18}

Is there a general institutional theory that could be empirically applied or used as a tool kit for predictive modeling? Not yet. But this does not mean that the study of institutions and organizations should not be taken seriously. At a minimum, the economics agenda should involve a careful and systematic comparative study of markets and the institutional constraining factors in different countries. The normative implication of this agenda would then—in the absence of generally distilled theories—bring cumulative international experience to bear when advice is given for the application of a policy in a country.

Consider three very different recent lines of inquiry. Much progress has been made in recent years in understanding the relationship of central bank independence and price stability.\textsuperscript{19} One interesting finding is the difference between legal independence (based on an index derived from formal statutes, that is, the written “rules”) and actual independence (measured by, say, the rate of turnover of central bank governors).\textsuperscript{20} Legal independence is a good predictor of price stability for industrial countries but a very poor one for developing countries. Actual independence turns out to be a much better predictor for developing countries. This is consistent with the intuition that the enforceability of legal rules (including their social and political acceptance) is what matters.\textsuperscript{21}

Another example is a recent World Bank comparative study of regulatory agencies in the telecommunications industry, from which some general lessons can be drawn about the applicability of different regulatory institutions depending on the commitment mechanisms and the complexity of regulations in different country settings (Levy and Spiller 1995).

Third is a study comparing the efficiency of the civil service, in terms of the different rates of mobility and rules of promotion, as observed in the irrigation systems of India and the Republic of Korea (Wade 1993). A good understanding of the rules governing the behavior of those in charge of policy implementation in any country should be a prerequisite for giving advice. For example, irrespective of the results of the debate about the role of microeconomic interventions in East Asia, it would be of small practical service for Sub-Saharan Africa unless it can explicitly tackle the different institutional foundations of the civil service in these countries.

Between Necessity and Sufficiency

Basic education is necessary for rapid growth. Growth is necessary for a persistent reduction in poverty. Adjustment is necessary for the resumption of growth. And fis-
cal and monetary restraint are necessary components of adjustment. These conditions, met in the success stories of the past twenty-five years, cut across diverse experiences and have withstood the test of time. But the necessary conditions are not sufficient. The definition of adjustment remains ambiguous. And several questions raised here call for additional research, especially on the role of government.22

Because development and adjustment are inherently uncertain and complex, it is futile to attempt to get at necessity and sufficiency for the general case. A less ambitious and more realistic research agenda would reduce the area of ignorance that lies between the two poles and sift out from theory and empirical evidence all that is general and invariant.

There should be an attempt to minimize the residual country-specific or situation-specific factors (recognizing that they will always be there to qualify the efficacy of our policy prescriptions). For a better understanding of the difference between necessity and sufficiency in prescribing development policy, we need deeper knowledge of institutions and political factors. And we have to make this knowledge operational across a broad array of countries and experiences.

By all indications world trade will grow considerably faster than output. The demise of the Council for Mutual Economic Assistance, the successful completion of the Uruguay Round, and the trade-increasing regional trade arrangements all point to a better harmonization of institutions and regulations. Flows of private capital and of ideas have increased rapidly, and the global business environment is increasingly competitive. This observation is also applicable to the World Bank. As a major player on the world scene, what mix of capital and ideas is it best equipped to deliver? The reality is likely to continue to induce very unequal responses by developing countries. This likelihood will continue to make the comparative country approach to policy all the more important.

Will the current upbeat assessment of a stable and competitive world economy prove to be more accurate than the earlier ones? Is there indeed a better capacity to prescribe and implement policies that lead to sustained growth and reduced poverty? A sober assessment of past predictions should instill humility. But a hard core of knowledge—small but increasing—has been sustained and buttressed through the turbulence. There is also the comforting thought that it is surprises that make the worlds of development research and policy design so challenging.

Notes

1. Since 1973 per capita growth rates in the industrial countries, and particularly in Europe, have fallen to what looks like a permanently lower rate—roughly half the postwar quarter-century average.
2. The estimates are based on Birdsall, Ross, and Sabot (1994). Summers (1992) also has provided very pertinent analysis.
3. Based on the same study the figures for Brazil and Pakistan are intermediate: 8.5 times Kenya's number and 3.5, respectively.
4. The theoretical argument for the role of technological spillover effects was made by Lucas (1993) and the empirical estimates appear in World Bank (1993) and in Young (1993).
5. This fact is not brought out clearly in World Bank (1993), where short-term macroeconomic policy and long-run growth are treated separately even though during this turbulent period they should really have been considered jointly both in the East Asian context as well as in other regions of the world. Quantifying this element of path-dependence remains a task for further study.
6. The presumption is that in an open economy internal imbalance may express itself in either inflation (open or repressed) or external imbalance or, very often, in both.

7. Admittedly the term is somewhat flexible. Other elements like fiscal and labor market reforms would also be included here. Long-run fundamentals like education or health, mentioned earlier, or the very basic pillars of a market economy (property rights, payment systems) that are crucial components of reform in the transition economies would normally be considered complementary to the adjustment package.

8. This is not to deny the importance of supplementing growth-targeted policies with pro-poor public expenditure programs within a balanced budget framework.

9. Direct action on health, education, and nutrition could always improve the quality of life for the poor, even if their improved human capabilities may not translate into higher income or wealth (see Dreze and Sen 1990). Even that, however, requires public expenditure, which is unlikely to come out of a diminished aggregate pie.

10. The argument is that initial conditions, in terms of both existing human capital and greater equality at the outset, help explain post-1960 growth at least as much as growth accounts for subsequent better distributional outcomes. Better distribution enhances political stability, which in turn makes for less political disruption of sound macroeconomic policies (see also Alesina and Rodrik 1994). For a detailed evaluation of the two-way links in the East Asian case see Birdsall, Ross, and Sabot (1994).

11. For measurement of the effects of protection in agriculture see, for example, Schiff and Valdes (1992).

12. An interesting study just launched at the World Bank attempts to build the evaluation methodology into the household survey prior to the intervention itself so as to enable a structured “before” and “after” comparison.

13. It was relatively easy to fall into this trap because of the apparent empirical existence of multiple inflationary equilibriums—the fact that different inflation rates may be consistent with the same budget deficit. It is interesting that countries hardly ever learn from other countries’ past mistakes and have to repeat the same painful experience before they turn around; Russia may be no exception.

14. Even in Israel’s extreme crisis, the fact that its export sector was kept immune from external shocks helped keep growth from dropping to negative rates.

15. The replacement of quantitative restrictions with relatively high tariffs and a preannounced across-the-board gradual removal of tariffs may have employment and fiscal revenue advantages (if the right long-term signals to investors are maintained) as compared to a ‘big bang’ removal of all restrictions at once. Weak commitment capability and the danger of reversal may dictate the second approach.

16. In this context one should also mention the variety of ways in which the market is gradually entering the provision and financing (helped by the surge of capital flows) of infrastructure services, a central subject of World Development Report 1994.

17. The natural bias of economists against any arguments that are not quantifiable often results in a less than optimal approach to policy and project planning. Suppose an effort were made to attach to each project loan (money) or piece of policy advice (ideas) some ex ante probability of successful implementation involving such nonquantifiable attributes as good governance, degree of social consensus, and ownership of reform. Could this be a first step in the right direction?

Getting to know more on these seemingly nonquantifiable attributes is important both in the context of the political economy of sustainable reform, from the reforming country’s point of view, and in the context of assessing the effectiveness of development assistance, from the donors’ point of view. How can we give operational content to the dictum “offer help only to those that help themselves?”

18. Inflationary processes, for example, are remarkably alike in different countries and their elimination requires very similar standard therapies (including our third necessary condition) in different countries. Ability to implement the same medicine will of course be institution-dependent.

19. I believe that the typical role of a central bank goes considerably beyond commitment to a monetary rule—that is, successful central banks take care of the efficient regulation of financial activity, provide independent and credible macroeconomic policy assessment and advice (through a high-level research department), and so on. But we abstract from these aspects here.

20. For example, prior to 1990, the Central Bank of Argentina ranked high according to any formal index, but was extremely low on actual revealed independence, with governors changing at the average of one a year.

21. Similar statements could be made to invoke the comparative importance of informal rules. For example, the governor of the Bank of England’s “raised eyebrows” may play the role that only the credible threat of imprisonment would bring about in another country.

22. The questions are far from exhaustive. Not mentioned, but important, are research on the environment, urban issues, and on the new international environment.
References


