Introduction

On a visit to a small Latin American country a few years back, my colleagues and I paid a courtesy visit to the minister of finance. The minister had prepared a detailed PowerPoint presentation on his economy's recent progress, and as his aide projected one slide after another on the screen, he listed all the reforms that they had undertaken. Trade barriers had been removed, price controls had been lifted, and all public enterprises had been privatized. Fiscal policy was tight, public debt levels low, and inflation nonexistent. Labor markets were as flexible as they come. There were no exchange or capital controls, and the economy was open to foreign investments of all kind. "We have done all the first-generation reforms, all the second-generation reforms, and are now embarking on third-generation reforms," he said proudly.

Indeed the country and its finance minister had been excellent students of the teaching on development policy emanating from international financial institutions and North American academics. And if there were justice in the world in matters of this kind, the country in question would have been handsomely rewarded with rapid growth and poverty reduction. Alas, not so. The economy was scarcely growing, private investment remained depressed, and largely as a consequence, poverty and inequality were on the rise. What had gone wrong?

Meanwhile, there were a number of other countries—mostly but not exclusively in Asia—that were undergoing more rapid economic development than could have been predicted by even the most optimistic economists. China has grown at rates that strain credulity, and India's performance, while not as stellar, has confounded those who thought that this country could never progress beyond its "Hindu" rate of economic growth of 3 percent. Clearly, globalization held huge rewards for those who knew how to reap them. What was it that these countries were doing right?

The Primacy of Economic Growth

These are some of the greatest economic puzzles of our time, and they are the questions around which the chapters in the book revolve.

Fascinating and challenging as they are from a scholarly standpoint, their significance runs much deeper. Our ability to answer these questions will help determine the extent to which the world's poor lift themselves out of destitution, improve their standards of living, achieve better health and education, and attain greater control over their lives. Economic growth *is* the most powerful instrument for reducing poverty. If you look at a map of the world today and ask where there is the greatest incidence of poverty, the simplest answer is: where there has been the least amount of growth since the onset of modern economic growth around the middle of the eighteenth century. Economic growth can be powerful over much shorter periods of time as well. China's rapid growth since 1980 has allowed more than 400 million of its citizens to pull themselves above the poverty line.[1] Of course, growth is not a panacea, and there are certainly cases where health and social indicators have not improved despite sustained growth over periods of a decade or more. But historically nothing has worked better than economic growth in enabling societies to improve the life chances of their members, including those at the very bottom.

As the vignettes with which I started indicate, these have been interesting times for students of economic growth. Some countries have embarked on rapid growth after years of stagnation; others have collapsed following a period of high growth; yet others have never experienced sustained growth. This book represents my attempt to understand the growth successes and failures of the last few decades and to distill general lessons from this experience. My objective is as much to shine a guiding light on future policies as it is to interpret the past. I aim in these essays to elucidate the nature of the institutional arrangements—national and global—that best support economic development over the longer term.

All of this diverse experience with growth has happened in an era of rapid globalization, during which countries have become increasingly open to forces emanating from outside their borders. The fact that they have responded so differently is evidence enough—if any is needed—that *national* policy choices are the ultimate determinant of economic growth. At the same time, successful countries are those that have leveraged the forces of globalization to their benefit. China and India would not have done nearly as well without access to relatively open markets for goods and services in the advanced countries. But their success was also due to their governments' concerted efforts to restructure and diversify their economies. If China and India had nothing other than garments and agricultural products to export, the gains from foreign trade and investment would not have been nearly as large. Understanding how the forces of globalization interact

[1] The poverty line here refers to the one-dollar-a-day benchmark. See Chen and Ravallion 2004.

with national economic policies is therefore indispensable as we interpret the past and draw lessons for the future. This helps us rethink global economic governance from a slightly different perspective: instead of asking, "What do countries have to do to live with globalization?" we can ask, "How should the institutions of economic globalization be designed to provide maximal support for national developmental goals?" I devote a good chunk of this book to the latter question.

The chapters that follow cover a wide range of topics—growth, institutions, globalization—but they advance, I think, a unified framework motivated by a number of common predilections and preoccupations. It may be useful to lay out those predilections—some will call them biases—at the outset.

A Credo of Sorts

First, this book is strictly grounded in neoclassical economic analysis. At the core of neoclassical economics lies the following methodological predisposition: social phenomena can best be understood by considering them to be an aggregation of purposeful behavior by individuals—in their roles as consumer, producer, investor, politician, and so on—interacting with each other and acting under the constraints that their environment imposes. This I find to be not just a powerful discipline for organizing our thoughts on economic affairs, but the only sensible way of thinking about them. If I often depart from the consensus that "mainstream" economists have reached in matters of development policy, this has less to do with different modes of analysis than with different readings of the evidence and with different evaluations of the "political economy" of developing nations. The economics that the graduate student picks up in the seminar room—abstract as it is and riddled with a wide variety of market failures—admits an almost unlimited range of policy recommendations, depending on the specific assumptions the analyst is prepared to make. As I will argue in the chapters to come, the tendency of many economists to offer advice based on simple rules of thumb, regardless of context (privatize this, liberalize that), is a derogation rather than a proper application of neoclassical economic principles.

Second, I believe in the importance of a careful reading of the empirical evidence. In particular, our prescriptions need to be based on a solid understanding of recent experience. This may seem like a trivial point to emphasize, but it is remarkable how frequently it is overlooked. It is common for policy advisors to recommend growth strategies to countries without having a solid grasp of the ups and downs of their recent economic performance—that is, without understanding the nature of the growth process in that economy. Econometricians are still hard at work looking for the growth-promoting effects of policies that countries in Latin America and elsewhere embraced enthusiastically a quarter century ago. I am not a purist when it comes to the kind of evidence that matters. In particular, I believe in the need for both cross-country regressions and detailed country studies. Any cross-country regression giving results are that not validated by case studies needs to be regarded with suspicion. But any policy conclusion that derives from a case study and flies in the face of cross-national evidence needs to be similarly scrutinized. Ultimately, we need both kinds of evidence to guide our views of how the world works.

Third, I remain a believer in the ability of governments to do good and change their societies for the better. Government has a positive role to play in stimulating economic development beyond enabling markets to function well. This view is to be contrasted with two alternative perspectives. One of these, the public-choice or rent-seeking perspective, thinks of the government as the malign tool of private interests. When the government interferes, it does so only to enrich supporters, cronies, or the intervening bureaucrats themselves. From this perspective, the more we can restrain government action, the better. The second perspective, that of the political-economy school, does not take an ex ante position on whether government is a positive or negative force, but fully endogenizes the behavior of government, and in doing so leaves it with no room to do anything (whether good or bad) that has not already been foreordained by long-standing structural determinants. To adherents of this perspective, the question "What should the government do?" is meaningless—or at least one that they have difficulty dealing with. While both schools have contributed important insights, I believe they underestimate the roles that serendipity and imperfect knowledge play in policy formulation. In the world of public policy, lots of $100 bills are left lying on the sidewalk. The role of economists is to point those out, while that of political leaders is to engineer the bargains that will allow them to be picked up.

Fourth, I believe that appropriate growth policies are almost always context specific. This is not because economics works differently in different settings, but because the *environments* in which households, firms, and investors operate differ in terms of the opportunities and constraints they present. "You don't understand; this reform will not work here because our entrepreneurs do not respond to price incentives," is not a valid argument. "You don't understand, this reform will not work here because credit constraints prevent our entrepreneurs from taking advantage of profit opportunities" or "because entrepreneurship is highly taxed at the margin" *is a* valid argument—assuming those borrowing constraints or high taxes can be documented. Learning from other countries is always useful—indeed, it is indispensable. But straightforward borrowing (or rejection) of policies without a full understanding of the context that enabled them to be successful (or led them to be failures) is a recipe for disaster. Once one understands that context, there will always be variations on the original policy (or different policies altogether) that will do a better job of producing the intended effects.

A fifth preoccupation is with prioritization, sequencing, selectivity, and targeting of reforms on the most binding constraints. One of the professional deformations of economists is to see an economy's problems almost exclusively from the perspective of their own area of specialty. A trade theorist will turn to developing economies and see lack of openness to trade as the key obstacle to growth. A financial market economist will identify imperfections in credit markets and lack of financial depth as the main culprit. A macroeconomist will worry about budget deficits, levels of debt, and inflation. A political-economy specialist will blame weakness in property rights and other institutions. A labor economist will point to labor-market rigidities. Each of them will then advocate a demanding set of institutional and governance reforms targeted at removing the presumed defect. So trade openness will require not just removal of tariffs and quotas on imports, but also improved governance, less corruption, better education, and smoothly functioning labor and credit markets. Financial depth requires prudential supervision and regulation, an open capital account, appropriate macroeconomic management. Macroeconomic stability requires fiscal rules, central bank independence, adherence to international financial codes, and sundry "structural reforms." Rarely will the advisor ask whether the problem at hand constitutes a truly binding constraint on economic growth, and whether the long list of institutional reforms on offer are well targeted at the economy's present needs. But governments are constrained by limits on their resources—financial, administrative, human, and political. They have to make choices on which constraints to attack first and what kind of reforms to spend political capital on. What they need is not a laundry list, but an explicitly diagnostic approach that identifies priorities based on local realities.

Finally, modesty. Economists have probably had more influence on policy in recent decades than at any other time in world history. But the sad reality is that their influence in the developing world has run considerably ahead of their actual achievements. Winston Churchill famously quipped that Clement Attlee, his rival and successor as prime minister in 1945, was "a modest man, with much to be modest about." To turn the quip on its head, economists are an arrogant bunch, with very little to be arrogant about. I hope the reader will agree that the essays in this book are different, for they were written in a spirit of humility. As social scientists, economists have neither the ability of physicists to fully explain the phenomena around us, nor the expertise of physicians to prescribe effective cures when things go wrong. We can be far more useful when we display greater self-awareness of our shortcomings. The emphasis on pragmatism, experimentation, and local knowledge that permeates the essays in the book is grounded in such considerations.

A Road Map of the Book

The chapters in the book are organized in three parts: growth, institutions, and globalization. Each part includes two substantive chapters plus a shorter piece of synthesis. These essays were written at different times over a period of around six years. All except one (chapter 4) has been published previously. I selected them among my publications not because they are my favorites or are better known, but because they fit well together and are thematically well linked. In preparing them for inclusion in this book, I undertook only some minor updating and edits, mainly to provide for smoother transitions across the chapters and eliminate repetition.

Part A of the book focuses on economic growth: why have some countries grown more rapidly than others, and what we can learn from this experience as we design growth strategies going forward? Chapter 1 offers a broad review of the evidence and presents two key arguments. One is that neoclassical economic analysis is a lot more flexible than its practitioners in the policy domain have generally given it credit for. In particular, first-order economic principles—protection of property rights, market-based competition, appropriate incentives, sound money, and so on—do not map into unique policy packages. Reformers have substantial room for creatively packaging these principles into institutional designs that are sensitive to local opportunities and constraints. Successful countries are those that have used this room wisely. The second argument is that igniting economic growth and sustaining it are somewhat different enterprises. The former generally requires a limited range of (often unconventional) reforms that need not overly tax the institutional capacity of the economy (as discussed in chapter 2). The latter challenge is in many ways harder, as it requires constructing over the longer term a sound institutional underpinning to endow the economy with resilience to shocks and maintain productive dynamism (see chapters 4 and 5). Ignoring the distinction between these two tasks leaves reformers saddled with impossibly ambitious, undifferentiated, and impractical policy agendas.

Chapter 2 (coauthored with Ricardo Hausmann and Andres Velasco) focuses on igniting economic growth. It presents a framework for identifying "binding constraints" on growth, so that reform strategies can focus on areas with the biggest immediate impact. The diagnostics revolve around a decision tree. Starting from the very top, growth can be constrained by inadequate social returns, by a large wedge between social and private returns (lack of appropriability), or by poor access to finance. Economies suffering from each of these different constraints throw out different signals. For example, a finance-constrained economy is one where real interest rates are high, current account deficits are large, and investment is highly responsive to exogenous foreign inflows (e.g., remittances). The diagnostic analysis begins by trying to identify which of these areas presents a more serious constraint, and then moves one level down. For instance, if low social returns are identified as the constraint, the next question turns on whether the reasons for that have to do with poor geography, low human capital, or inadequate infrastructure. The analysis continues in fractal fashion at successively finer levels of resolution until the list of binding constraints is narrowed to a set small enough to be amenable to policy. The chapter discusses the application of this approach to three Latin American countries: El Salvador, Brazil, and Dominican Republic.

Chapter 3 is a shorter, synthetic essay that pulls the key themes in the previous two chapters together and lays out a broad vision for formulating growth strategies. It emphasizes three steps in the process. The first step consists of an analysis of growth diagnostics, along the lines discussed in the previous chapter. The second step involves policy design, where the objective is to remove the identified constraint(s) with targeted, imaginative policies that are cognizant of the local realities. The third step is an ongoing one, requiring the institutionalization of the diagnostic and policy design activities, with the goals of strengthening the institutional infrastructure of the economy and maintaining productive vitality.

This provides a transition to part B of the book, which focuses on institutions specifically. The first chapter in this part (chapter 4) picks up the theme of productive vitality and asks: what kind of institutions best enable developing economies to diversify their productive structures so that they can sustain economic growth in the longer run? The hallmark of development is structural change—the process of pulling the economy's resources from traditional low-productivity activities to modern high-productivity activities. This is far from an automatic process, and requires more than well-functioning markets. It is the responsibility of industrial policy to stimulate investments and entrepreneurship in new activities, especially those in which the economy may end up having comparative advantage. The usual argument against industrial policy is that governments can never pick winners. I show that this is the wrong way of thinking what industrial policy does. Appropriately structured, industrial policy is a *process* of strategic collaboration between the private and public sectors, where the objectives are to identify blockages and obstacles to new investments and to design appropriate policies in response. The chapter describes the institutional features that such an industrial policy regime needs to have.

The focus of chapter 5 is the full gamut of market-supporting institutions that ensure economic prosperity in the long run. The chapter opens with a typology of institutions that allow markets to perform adequately. While we can identify in broad terms institutional prerequisites, I argue that there is no unique mapping between markets and the nonmarket institutions that underpin them. The chapter emphasizes the importance of "local knowledge," and advances the view that a strategy of institution building must not overemphasize best-practice "blueprints" at the expense of experimentation. The question is, how do we design such institutions sensitive to local knowledge and needs? I argue that participatory political systems are the most effective mechanism for processing and aggregating local knowledge. In effect, democracy is a metainstitution for building good institutions. I end the chapter with a range of evidence that shows that participatory democracies enable higher-quality growth.

Chapter 6 concludes part B by providing a guided tour of some of the key issues and controversies spawned by the huge outpouring of literature on institutions in recent years. If we focus on institutions—the rules of the game in a society—as the fundamental determinant of long-run growth, does that mean that economic policies themselves have little role to play? If it is true that colonial history has had a big hand in shaping today's institutional outcomes, does that mean that patterns of development are historically determined? If institutions "trump" geography as a deep determinant of incomes, does that mean that geography is of no consequence? If property rights are critical, does that imply that developing countries should adopt the property rights regimes that prevail in the United States or Europe? I argue in this chapter that the answers to each of these questions is no.

Part C of the book is devoted to globalization. In chapter 7, I identify the central dilemma of the world economy as the tension between the *global* nature of many of today's markets in goods, capital, and services, and the *national* nature of almost all of the institutions that underpin and support them. The needs of efficiency, equity, and legitimacy cannot all be met. If we want to advance economic globalization, we need to give up either on the nation-state or on democracy. If we want to retain the nation-state, we need to give up on either deep economic integration or mass democracy. And if we want to deepen democracy, we must sacrifice either the nation-state or deep integration. But the overall message of the chapter is not a pessimistic one. Our challenge is not markedly different from that confronted by the designers of Bretton Woods system in the aftermath World War II. By designing appropriate institutions of global economic governance—incorporating mechanisms of escape clauses and opt-outs—we can retain much of the benefit of economic globalization while endowing national democracies with the space they need to address domestic objectives.

Chapter 8 works out the implications of this line of reasoning for the international trade regime in particular. I argue that a World Trade Organization whose primary goal was to enable countries to grow out of poverty, rather than maximize the volume of trade, would look different from the WTO we have. In view of how open the global trade regime is currently, the big bucks in terms of growth are no longer in pushing for further increases in market access for developing countries in rich-country markets. The real challenge going forward is to how to make the tightening web of global trade regulations compatible with developmental needs. Connecting with the arguments made earlier in the book, a desirable trade regime would be one that provided much greater policy space to developing countries to pursue domestically crafted growth strategies, possibly including "unorthodox" policies such as export subsidies, trade protection, weak patent rules, and investment performance requirements. It should be possible to design institutional safeguards to ensure that such policy space does not deteriorate into crass protectionism, and the chapter discusses what such safeguards might look like. Under this new vision, the role of the WTO would be to regulate the interface between different national regulatory regimes rather than to narrow the differences among them. Developing countries would no longer short-change themselves by engaging in a game of reciprocal market access instead of ensuring that they have access to the full range of policy tools they need.

Chapter 9 is a short final essay that brings together some of the book's main themes of the relationship between economic growth and globalization. It ends with a proposal that was somewhat tongue-in-cheek when first formulated. If global trade negotiators are serious about making globalization work for developing countries, they should drop everything else on their agenda and focus on a temporary work permit program that allows unskilled workers from poor nations to take up employment (for periods of three to five years at a time) in rich countries. If globalization has an unexplored frontier, it is that of labor mobility. Nothing else promises as big a welfare bang for developing country workers as a relaxation of the restrictions on their international mobility. Remarkably, this pie-in-the-sky proposal has entered policy discussions. Ideas do matter.

A Final Word

Making a book out of a collection of one's previously published essays requires a certain hubris, which sits ill at ease with the spirit of humility that I claimed marks the essays themselves. I can say in my defense that this is not the first time I have attempted an effort of this kind. But previously, each time I put a table of contents together, I found that the book did not hang together. This time seemed different. Important themes—important in the sense that I still believe in them and feel the need to get them across—thread through the essays and connect different parts of the volume together. I will leave it to reviewers to judge whether the proverbial whole is greater than the sum of the parts. But I do hope that even the reader who has encountered some of these essays before will find new nuggets in rereading them in the context of the entire collection.