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AN INDIAN SOCIAL DEMOCRACY

INTEGRATING MARKETS,
DEMOCRACY AND
SOCIAL JUSTICE

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Jean Dreze
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JOSEPH E. STIGLITZ

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JOSEPH E. STIGLITZ

Introductory Remarks

A few facts describe what has been going on in most countries around the world. There are growing inequalities even in developed countries like the US. It is not just growth in inequality. Those at the bottom and even in the middle are actually worse off in absolute terms than they were a decade ago. It is not just inequality; it is actually growth of poverty and stagnation, or worse, in the middle class.

In the discussions earlier, one of the defining characteristics of social democracy is opportunity. In some countries like the US, there is actually a decrease in social mobility. Things in that sense are getting worse. Even some of the singularly committed social democratic countries like Chile have got no kudos for instituting social democratic policies. Their only actual success has been mainly in preventing things from getting worse.

There are many factors that have contributed to this and a diagnosis of them is obviously important in thinking about the solution. Globalisation is one of the factors and I hope we talk about why globalisation has had that impact. How can we shape globalisation to reduce that impact? Most importantly, how can India manage globalisation in a way that mitigates these adverse effects? There are several ways in which globalisation can contribute to this growing inequality. The first is that there is an asymmetrical relation between capital and labour. This has two very large impacts. One of them is it changes the bargaining power. Capital says we will leave, if you tax us. We will leave if you insist on environmental regulations, on Merkel conditions. Workers,

particularly young skilled workers, cannot leave and asymmetry affects outcomes inevitably.

Secondly, it affects the scope of taxation so that around the world, countries face the threat that capital and skilled labour will move away if you impose progressive taxation, so that too reduces the scope for response.

Thirdly, resources are available to countries, but the problem is worse where the resources available have diminished. Many aspects of globalisation increase volatility; in particular, financial market inequity and deregulation. We saw that most vividly in the recent crisis where America's toxic mortgages were exported around the world and the recession that began in the US then became a global phenomenon. There are many other instances like this.

The fourth relates to part of the earlier discussion which is that globalisation involves not only economic globalisation, but also the spread of ideas. Good ideas have spread around the world, like ideas of democracy, but so have some bad ideas, including a set of ideas that are used against the welfare state; a whole set of views about how economies ought to be organised. Some of these views have become less persuasive in the wake of the economic crisis. That particular model is not in vogue. It was there before the crisis, but clearly there has been the spread of ideology. It is interesting, particularly in the light of Eric Solheim's remarks earlier, that the success of the Scandinavian and Nordic countries doesn't get the attention that it deserves. Eric put it very clearly. This is not the view of much of the world and this matter was not talked about. When they did, people said Scandinavia is different. Without exploring why it is different, it is to tell you they are peculiar up there in the north and that is why somehow there is some difference. Others said that the Scandinavians have other characteristics, that we couldn't do what they do. I think that is wrong.

These ideas have a particular effect on inequality. For instance, when it comes to issues like privatisation of education, which can, in many countries, lead to perpetuation of inequality. This, I think,

is one of the forces that have led to decreasing opportunity and the change in social mobility that I referred to earlier.

I want to make a few remarks about how to counter these arguments and then suggest some policies to mitigate the adverse effects. Some arguments were put forward this morning. The first was that social protection actually allows for more risk-taking. People are more able and want to take more risks if there is a fallback that is better.

Secondly, greater utilisation of all the resources makes the economy more competitive. This has really been the part of the framework under which many Scandinavian countries are bringing women into the labour force. But it is also necessary to bring in the poor to the labour force in a more productive way by giving them education.

Thirdly, social protection increases political support for openness. Openness is viewed by many people as risk and this is a way of mitigating that risk.

Finally, we come to greater social protection and greater equality in general support for wealth-increasing government programmes. There are many aspects of economic activity that are better conducted or framed collectively, like public goods, R&D, infrastructure, education and I would also say, health. There are a whole set of activities that are more efficiently done; if they can't be done by inefficient governments, there are many cases of doing and financing them through the market. We have problems of adverse selection and a whole set of other problems. There is considerable evidence that in societies where there is more inequality, there is more concern on the part of those at the top that there will be redistributive politics and an attempt to decelerate the state. Therefore, redistributive politics undermines the ability to do wealth-enhancing public activities. Over the long run, I think that this is one of the reasons why the US is weakening; failures in education, infrastructure will, in the long run, be bad for long-term economic growth. I think it is a vicious cycle.

I shall quickly mention the policies to promote and deal more effectively with the consequences of globalisation. The

first social equality-propounding social protection initiative is full employment. That is why I think employment schemes are so important but in general, creating an economy that gets the economy towards full employment is the most important item in the social agenda. Unemployment is probably the greatest source of poverty and inequality.

Beyond that, there are two other things that I think are critical. One is realising that some policies expose countries to more volatility and more risk and that macroeconomic risks are inevitably hard to manage and adversely affect the poor. I have long been a critic of unviable capital market and financial market liberalisation for that reason. One wants to open up economies to foreign direct investment thinking that it will create more jobs. But one ought to be very sceptical of short-term money. We cannot create new employment from money that comes in and goes out overnight. Financial market and capital market liberalisation, I think the evidence is pretty clear, does not lead to faster growth but does lead to more instability.

Finally, a modern economy requires adaptability. That is where education becomes absolutely critical because one of the attributes of good education is the ability to adapt to changing circumstances.

As I said earlier, there are two aspects of social democracy; one is the social and economic agenda that we have been talking about, and the other is democracy. Other complex issues are associated with how globalisation interacts with democracy. I want to highlight one, which is that countries that are open capital markets and get themselves into debt are at the risk of economic, social and other policies dictated from abroad. This was very clear in the case of Brazil where on two occasions, Lula lost elections. On the third occasion, he succeeded but the capital markets even then had some tremors though it was managed. In a global world, the more money is dependent on the bond market, the more subject one is to these international judgements which tend to be very short-tagged; their interest would not coincide with the long-run interest of the growth of India. It is like saying that it is good to have an outside referee to pass a judgement about whether you are doing the right

thing. But in fact, the bond market interests are short-term and not coincident with India's long-term growth interest and particularly, the long-term interest of social democracy. Subjecting yourself to that kind of discipline, erratic as it is, is actually, I think, a fundamental mistake. I am really concerned with how you integrate yourself into the global economy.

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Afterword

JOSEPH E. STIGLITZ¹

A Social Democratic Agenda for a More Dynamic Indian Economy

Creating an Innovative and Learning Society²

Jawaharlal Nehru has become a symbol of the fight for freedom, independence and democracy throughout the world. He had high aspirations for a resurgent India, aspirations that are today being fulfilled. But the struggle for dignity, equality and democracy, and for improving the living standards of all citizens within the country is a never-ending struggle. It is about this struggle, about the transformations of the economy, politics and society that are necessary to achieve victory in this struggle, that I wish to speak.

India has played a large role in shaping my views of development. I first visited India more than 43 years ago, and the transformation that has occurred in the almost half century since are hard to believe. I should also note the deep and long lasting connections between my university, Columbia and India's struggle for independence, freedom and human rights. B.R. Ambedkar, widely claimed as the architect of India's constitution and the champion for the rights of all—not just the untouchables, but also women's rights—spent some of his formative years at Columbia, receiving both an M.A. and Ph.D., as well as an honorary doctorate.

India, the world's largest democracy, should be proud of the successes that it has achieved over the past 25 years, and even more

1. The 2010 Jawaharlal Nehru Memorial Lecture, Delivered on November 18, 2010.

2. In this lecture, I bring together several strands of my work on development. I am particularly indebted to my co-authors Bruce Greenwald and Karla Hoff.

so of its growth in recent years. GDP per capita in 2009 was 2.3 times what it was in 1990, and, at least according to World Bank data,³ poverty has been reduced from just short of 50 per cent of the population in 1994 to 42 per cent in 2005. Yet India cannot rest on these laurels. There are still more than 400 million in poverty and per capita income is still less than half of that of China in purchasing power parity (PPP).

The successes in development in Asia during the past quarter century were not only unprecedented, they were also unanticipated. Gunnar Myrdal described, just a few short years before these successes began, his pessimism about whether it would ever emerge from the poverty in which it had been mired for centuries.⁴ Today, the questions have changed dramatically. Successful countries like India are asking how they can ensure that that growth will be sustained. And less successful countries, many of them in Africa, wish to know what the essential ingredients were that led to these successes. Can they be imitated? The successes and failures around the world provide a set of natural experiments, a laboratory in which we can make some inferences about what contributes to development, and what impedes it.

But even within the successful countries, there are questions, and not just about sustainability: Are economic policies leading to the well-being of citizens? Are the benefits of the growth being equitably shared?

Events of recent years have called into question long-standing presumptions, the conventional wisdom in much of the world about the right answers to these questions. The set of ideas known alternatively as the Washington Consensus, market fundamentalism, or neoliberalism has failed in the very country from which those ideas emanated. The institutions and policies that were put forth as examples for others to follow have failed: they failed to produce sustainable growth, and the fruits of what

3. World Bank (2010).

4. See Gunnar Myrdal's Nobel Prize Lecture, 1974 available at http://nobelprize.org/nobel_prizes/economics/laureates/1974/myrdal-lecture.html (accessed November 3, 2010); or his work Myrdal (1968).

growth occurred went to a few. Today, most Americans are worse off than they were in 1999, well before the previous recession.⁵ Even before the crisis, trickle-down economics—the notion that so long as growth is ensured, all will benefit—was discredited. But American growth had not only been anti-poor; even the middle class has suffered. There is ample evidence of social distress that goes beyond these economic indicators—one of the highest murder rates in the world⁶ and the highest rate of incarceration in the world.⁷ Other factors contributing to individual well being—like social connectedness—also seem to not be faring well.⁸

In this paper, I want to put forward three hypotheses:

1. Successful and 'sustained' growth requires creating a learning society. And this is especially so in the 21st century as we move to a knowledge economy.
2. An open, democratic society is more conducive to the creation of a learning society.
3. Successful and sustained democratic growth must be inclusive.

Before turning to each of these propositions, I want to briefly review the history of development thinking over the past 50 years.

A brief history of development thought from projects to policies

In the years immediately after World War II, the view was that what separated developing from developed countries was a

5. Real median household income in 2009 is 5 per cent lower than that of 1999. See *Census Current Population Survey*, Table H-6, Regions—All Races by Median and Mean Income: 1975 to 2009, available at <http://www.census.gov/hhes/www/income/data/historical/household/index.html> (accessed November 3, 2010).

6. The United States was 16th in the world in 2002, with a homicide rate of 5.6 per 100,000 inhabitants, compared to, say, Sweden or Canada with rates of 2.45 and 1.67 respectively. See *The Eighth United Nations Survey on Crime Trends and the Operations of Criminal Justice Systems (2001-2002)*, accessible at <http://www.unodc.org/unodc/en/data-and-analysis/Eighth-United-Nations-Survey-on-Crime-Trends-and-the-Operations-of-Criminal-Justice-Systems.html> (accessed November 3, 2010).

7. A rate of 700.22 per 100,000 in 2002. Ibid.

8. See, e.g. Putnam (1995); and the discussion to which it gave rise, e.g. in Sander and Putnam (2010).

disparity in resources. Developing countries lacked capital. Global capital markets were imperfect.⁹ Hence, what was required was the creation of a bank—the World Bank—to facilitate the flow of funds and help developing countries undertake projects that would raise income per capita.

It soon became apparent that providing money by itself would not lead to a developmental transformation. The focus then shifted to implementing the ‘right policies’, which usually meant the Washington Consensus, neoliberal, market fundamentalist policies.

The failure of the Washington Consensus policies

Even before the recent crisis provided the nail in the coffin of neoliberalism, these ideas had been thoroughly discredited: their intellectual premises had been undermined, and almost without exception, the most successful countries, the countries in East Asia, followed a markedly different course.

To a large extent, neoliberalism/Washington Consensus policies were the application of Reagan/Thatcher conservatism to developing countries. They were predicated on the notion that markets by themselves were efficient and stable, and that the benefits of growth would trickle down to all citizens. Even before developing countries were exposed to these new policy experiments, under the aegis of the international financial institutions, both theory and evidence had called into question these beliefs. My own work on the economics of information (with Bruce Greenwald) had shown that the reason that Adam Smith’s invisible hand often seemed invisible was that it was, in fact, not there (Greenwald and Stiglitz, 1986). Markets with imperfect and asymmetric information and incomplete information were not efficient—and since all markets are characterised by imperfect and asymmetric information, this meant that markets were essentially never efficient. We should have learned from, the Great Depression that not only are markets not necessarily efficient but they are also not

9. At the time, there was little discussion over why capital markets were imperfect.

stable and self-correcting (at least, not in the relevant time frame). We have now learned these lessons again.

The experience with the Washington Consensus (WC) policies has now further undermined each of its central policy tenets. For instance, deregulation and liberalisation may not improve efficiency and stability. Indeed, the only period in which market economies have not been subject to financial crises was the three to four decades after the Great Depression when the US and other countries imposed strict banking and financial sector regulations. These decades happened also to be a period of rapid growth, with fruits widely shared.

Because under these well-designed regulatory structures, markets seemed to be so stable, some made the wrong inference that regulation was not needed. And the predictable results followed as regulations were stripped away, as governments refused to impose new regulations for the ‘innovative’ but dangerous financial products—derivatives—that were being invented, and as regulators were appointed who didn’t believe in regulations. There were more than 120 crises around the world in the succeeding years, of which this crisis, wearing a made-in-USA label, is by far the largest.

While macro-stability is important, the notion that price stability was the only, or the most important, aspect of macrostability was wrong; the focus on price stability under the WC—the notion that low and stable inflation was necessary and almost sufficient for rapid growth—was misguided. This was an idea that didn’t even work in the country from which the WC policies emanated, the US.

While WC policies promoted neither growth nor stability, what growth did occur didn’t trickle down. Trickle-down economics never had much empirical support, but in recent years, it is an idea that has fared particularly badly. In the US, for instance, between 1999 and 2009, real median household income in the US fell by five per cent. Today, most Americans (and let me stress that: most Americans) are worse off than they were a decade ago. All of the benefits and more have gone to those at the top. We have had trickle-up growth, not trickle-down. Today, between a fifth and a

quarter of all income goes to the upper one per cent.¹⁰ Inequality in wealth is even worse.¹¹

But from a developmental perspective, perhaps the greatest failing of the WC was just that: it was not concerned with development. It pretended that there was no difference between developed and developing countries, so that there was no developmental transformation. It was simply concerned with the efficient allocation of resources. It was almost as if the advocates of WC policies believed that this was all that was required. In a way, it followed from the belief in the simplistic neoclassical model, which had undergirded the first view: if resources were efficiently allocated, then the shortage of capital would be evidenced in a higher return to capital, and that would ensure the flow of capital from rich countries to poor. One didn't need to turn to an international institution to ensure the transfer of capital. This approach simply didn't recognise the existence of global capital market imperfections—other than those created by misguided governments. (There is an especial irony in this crisis: in the years prior to the crisis, money actually flowed 'uphill,' from poor countries to the US. The defenders of this anti-gravity phenomenon suggested that it was because the US was so much more efficient than developing countries that the return to capital was higher, even though capital was more abundant. This explanation seems less persuasive today; the US misallocated capital badly, so that the net return was probably much, much lower than it would have been had the capital been invested in, say, emerging markets.)

While I have stressed the ideology underlying the advocacy of WC policies, I would be remiss not to note that they did serve some special interests. Ideas and interests are intimately intertwined. Capital markets, and especially the big banks, made money as capital flowed into East Asia in the years before the East Asian crisis; they made money in the restructuring that followed, and IMF

10. If capital gains are included, the top 1 per cent of income earners in the US accounted for 20.95 per cent of income in 2008; in 2007 they accounted for 23.5 per cent. See Piketty and Saenz (2003).

11. Households in the top 1 per cent of the wealth distribution hold around 32.7 per cent of the wealth; the top 5 per cent hold 57.7 per cent. Source: Davies et al. (2009).

bailouts ensured that they were repaid their loans—no matter how bad their lending decisions.

Now, Americans are angry as they watch the big banks walking off with billions, and they confront the aftermath of the crisis: budgetary deficits forcing cutbacks in social programmes, millions facing extended unemployment and millions more struggling to make ends meet. But this is a familiar picture in many developing countries, one which I inveighed against in *Globalization and its Discontents* (Stiglitz, 2002).

So too privatisation served certain interests well. It is noteworthy that some of the most ardent advocates of privatisation—who claimed foreign ownership should not be a source of concern suddenly changed their tune as the sovereign wealth funds or Chinese companies tried to buy American assets.¹² A new set of arguments were put forward—private owners, whether foreign or domestic, could be trusted; it was only foreign governments that couldn't. The lack of alignment between social and private interests, so evident in the run-up to the global financial crisis, as American banks engaged in predatory lending and deceptive and dishonest practices on a massive scale, should lay to rest such contentions.

Needless to say, this approach of getting policies right was no more successful than the first approach, largely because what was conceived of as the 'right policies' were in fact the wrong policies. But even if the policies had been successful in ensuring the efficient allocation of resources, they would not have led to successful development. There is more to development than that.

In their defence, many in the international institutions used to say that the problem was not so much with the policies, as with the way that they were implemented. (Today, this refrain is heard less often, as it becomes increasingly clear that they were not the right policies.) But this defence is unpersuasive: good policies are policies that can be implemented by mortal individuals working within fallible institutions. If they fail repeatedly—as they did—then by definition, they are not well designed.

12. See, for example Summers (2007).

From policies to institutions

With the discrediting of the 'getting policies right' approach to development came a third approach, getting institutions right. But this approach too has had only mixed success, partly because we can't be sure what constitutes good institutions, and even if we did, we may not know how to create one.

Again, the crisis has brought out the problems. Before the crisis, many might have pointed to America's central bank, the Federal Reserve, as a model institution. But as the crisis has unfolded, confidence in the institution has eroded, and more fundamental defects have been exposed. It is clear that it was 'cognitively captured' by the financial sector that it was supposed to regulate; it came to reflect the ideology and interests of the banks. For instance, while it was given the powers to regulate the housing sector—and to prevent the kind of bubble and abuses that arose—it chose not to do so.

The bywords in good governance are transparency and accountability and the avoidance of conflicts of interest. With the head of the New York Federal Reserve Bank nominated by a committee that included the chairman of Goldman Sachs and AIG, institutions which received billions from the Fed, it is hard not to raise questions of good governance. When an American court ruled that the Fed, like other public institutions, was subject to the Freedom of Information Act (America's right-to-know law), the Fed fought to keep its secrecy. It fought to ensure that Americans would not know that the largest single beneficiary of the AIG bailout which it had helped engineer was Goldman Sachs. It fought to keep secret the terms under which the credit default swaps were settled, which were so disadvantageous to America's taxpayers. It never provided an explanation for the give-away that would pass muster.

These are matters of America's dirty laundry. I raise them here simply to emphasise that what might at one moment seem an exemplary institution, at another moment may seem full of blemishes. We should strive to create open, democratic, accountable institutions, but the task is not easy. India is lucky in having a Central Bank that has earned recognition for its integrity—it is one

of the few central banks that were not effectively captured by the financial sector. It will be a struggle to ensure that that is the case in the future.

But these examples help bring to the fore several central issues concerning institutions. One of the important strands of modern research stresses the role of institutions in filling gaps left by markets. In this view, institutions help correct market failures. But a closer look at how institutions work in practice is that often their role is to enforce inequalities and preserve the interests of special interests.

The push for independent central banks, when taken too far, may do exactly that. To whom are such banks accountable? In many countries, the result has been a Central bank that has served the interests of the financial sector, not the broader interests of society.

Jim Crow was an institution in the US that enforced segregation, a system of discrimination against African-Americans that deprived them both of their rights and of economic opportunity. The caste system in India is an institution that has had similar adverse effects on large portions of the population in this country.

Institutions, like markets (which can be thought of as a particular kind of institution), are instruments. They can be used to promote development, or to impede it. Details matter. Everyone talks about the rule of law—and no one would defend a lawless society. But for almost a century after America's Civil War, the law was used as an instrument to deprive African-Americans of their rights and economic opportunities. In 2005, American banks used their money and political influence to change our bankruptcy laws, to institute what can only be called a system of partial indentured servitude, where a poor individual who is deceived by the banks to undertake debts that, say, equal his income, will have to turn over a quarter of his income for the rest of his life to the banks. There is no fresh start—rich corporations are treated, in effect, more favourably than poor individuals. Today, in America, the so-called rule of law is being used to take away homes from individuals who were never even indebted, and to transfer title to others who can't even prove their rights of ownership. The law is supposed to be the

protector of the poor and powerless against the rich and powerful; but the rule of law can be used in just the opposite way.

Changing institutions is difficult, but that is what is required in the process of development. When there are institutions that preserve inequities and impede development they have to be stripped away. That has to be one of the central tasks of development; but neither of the first two strategies I described even recognised this as being at the core of successful development.

A balanced role between government and markets

The one positive aspect of the new institutional analysis is the recognition that government is important and that private firms (which are at the centre of markets) may also suffer from governance problems.

Indeed, one of the main lessons to emerge from the 'debacle' of the WC is that every successful economy requires a balance between government and the market (and civil society). That balance was lost in the WC policies. Government has a role in restraining markets (from the excesses exhibited, for instance, by financial markets), and in making markets work (ensuring, for instance, that they do not engage in anti-competitive practices, as is their wont). But, especially in developing countries, government has a catalytic role, in promoting entrepreneurship, ensuring access to capital, and promoting education, research and technology. (There are other roles too, most importantly in social protection.)

The modern theory of market failures has explained why government must fill these roles, why, for instance, markets, by themselves, will under-invest in R&D.

Once one recognises the importance of government, one has to ask two questions: how can we improve its performance (for example through better governance, better management practices)? And how can we best design how it interacts with markets and civil society? Among my most exciting responsibilities when I served as Chairman of the Council of Economic Advisers was my engagement in our efforts at 'reinventing government', which were directed at answering these questions.

Each of these strands—projects, policies and institutions—is part of the story of development. I have emphasised the complexity associated with each, and that we have been perhaps too facile in believing that we knew what good projects, policies and institutions were.

The comprehensive approach to development

One of the advances in development thinking that occurred while Jim Wolfensohn was President and I was Chief Economist of the World Bank was the recognition that any successful development strategy had to be comprehensive. It did little good to educate people, if there were no jobs; without entrepreneurs to create new enterprises and financial institutions to support them, trade liberalisation would destroy jobs faster than markets would create new jobs to replace them.

The failure of the series of approaches I have described lies, however, not so much in the pursuit of the 'magic bullet'—the single key to success—but more in not having a clearer understanding of what development entails. It is, as I have suggested, more than building dams and roads and ensuring that resources get efficiently allocated, or maintaining inflation at low and stable levels, or in having independent Central Banks committed to a monetary regime that ensures that inflation is low and stable. These may be necessary, essential parts, but they are clearly not sufficient.

I want now to turn to what I think of as the essential ingredients in successful development—creating what I call a 'learning society'. I want to explain why it is essential, and what has to be done to create and sustain it.

Creating a learning society¹³

In this section, I want to put forward three propositions:

1. The transformation to 'learning societies' which occurred around 1800 for Western economies, and more recently for

13. This part of the lecture represents joint work with Bruce Greenwald. These ideas are elaborated in our forthcoming book, *Creating a Learning Society: a New Paradigm for Development and Social Progress*, New York: Columbia University Press. A shortened version of these ideas is available as Greenwald and Stiglitz (2006).

those in Asia, appears to have had a far, far greater impact on human well-being than improvements in allocative efficiency or resource accumulation.¹⁴

2. Markets, on their own, are not efficient in promoting innovation
3. The policies that promote a transformation to a learning society are markedly different than those advocated by the WC. Indeed, from the perspective of creating a learning society, those policies may be counterproductive.

The importance of technological progress

From Roman times, when the first global data on per capita output are available, until 1800, average human standards of living increased only imperceptibly, if at all (Maddison, 2003). Consumption for the great majority of human beings consisted predominantly of food, and food was largely limited to staples—rice, wheat and other grains. Housing entailed barn-like living conditions with no privacy and climate control consisting only of necessary heat in winter. Clothing was utilitarian and rarely involved more than single outfits with the seasonal addition of over-clothes. Personal and medical care was almost nonexistent. Travel was rare, largely local, difficult and uncomfortable. Recreation was self-generated and primitive. Only a small aristocratic minority enjoyed what we would consider today an appropriate human standard of living—varieties of fresh food including meat, private well-warmed accommodations, multiple sets of clothing for varied occasions, rudimentary personal and medical care and opportunities for travel and sophisticated entertainment.

Beginning in 1800 and accelerating markedly after the mid-to-late 19th century, that privileged standard of living began to diffuse throughout Europe, North America and Australia. In the 20th century, elite standards of living became pervasive in these areas and in many parts of Asia, a trend which continues in much of Asia today.

14. The two are not fully separable, since investments in human and physical capital embody this learning.

The significance of these transformations can be seen in another way: until the beginning of the 19th century, most individuals spent most of their time meeting the basic necessities of life—food, shelter, clothing. Today, for most of those in the advanced industrial countries—and for an increasing number in the emerging markets—satisfying these basic necessities of life takes but a few hours of work a week. Individuals can choose whether to spend the ‘extra’ time available to work, to earn enough to consume more (higher quality ‘necessities’ or luxuries) or to enjoy more leisure.¹⁵

Although economists, such as Joseph Schumpeter (1943), had identified the source of these transformative developments as technological progress, it was not until Robert Solow (1957) that there was a way of quantifying the relative importance of capital accumulation *versus* technical progress. Changes in capital intensity could account for at most a third of changes in output per worker. The remainder, identified as the Solow residual, was attributable to various forms of technical progress.¹⁶

Kenneth Arrow (1962; 1962a) pioneered ideas in examining the economics of these ‘learning processes’—the factors that promote or retard them, their likely response to normal market incentives and their relationship to the broader macro and microeconomic environment, notably in his papers on the economics of R&D and learning-by-doing (See also Solow, 1957a). He called attention to the fact that while some knowledge was produced as a result of the deliberate allocation of resources to research and development, much of technical progress was a byproduct of production or investment.

15. How they make those choices will, of course, have profound effects on *measured* growth, since increasing leisure does not show up in conventionally measured GDP. See Stiglitz *et al.* (2010). Keynes (1930) sparked a discussion of how those choices would be made. I speculated about why the U.S. and Europe seem to have gone in different directions in how they dealt with the ‘productivity dividend’ in Stiglitz (2008). (The original Keynes’ article appeared in his 1931 book, *Essays in Persuasion*, London: Macmillan, pp.358-74.) See also the other chapters in the 2008 Stiglitz volume and the references cited there.

16. Subsequent literature suggested that the quantification was perhaps less robust than seemed initially the case. See, e.g. Griliches and Jorgenson (1966) which entailed a number of ways of calculating the value of capital that suggested a much smaller role for technical progress. Further problems were identified in the quantification of labour input, as economists attempted to assess the role of human capital in economic growth. See also, Klenow and Rodriguez-Clare (1997).

Markets, on their own, are inefficient in promoting innovation

Most importantly from the perspective taken in this paper, Arrow recognised that market failures in the production and dissemination of knowledge (whether as a result of the allocation of resources to R&D or as a result of learning) were pervasive.^{17, 18} Analysing the nature of these inefficiencies—and their implications for public policy—requires the construction of a general equilibrium model in which R&D or learning is endogenous, which in turn requires hypotheses about knowledge spillovers and industrial structure (which is itself endogenous).¹⁹

While a full analysis is complicated, the basic ideas are simple: Knowledge is different from an ordinary commodity. The accumulation of knowledge is inherently associated with externalities—knowledge spillovers. Inevitably, many besides the inventor benefit from innovations like the computer, the laser, the transistor—and from the myriad of smaller innovations that mark the progress of society. Knowledge itself is a public good.²⁰ The use of knowledge by one person does not decrease what was available for others (non-rivalrousness), so that it is inefficient to exclude anyone from the benefits of knowledge, once acquired; and exclusion is often difficult, so that it is often difficult for innovators to appropriate more than a fraction of the value of what they contribute to society. Private and social returns can be markedly different.

17. In his earlier work on the efficiency of competitive equilibrium, he had taken the state of technology as given. But if technology is affected by human activity, then there was no presumption that the resulting market equilibrium was dynamically efficient. To the contrary, there was a presumption that it was not. Although Arrow did not frame the market failure in this way, it was clear from his analysis that knowledge was a public good, in the sense that Samuelson (1954) had defined public goods a few years earlier; See e.g. Stiglitz (1987; 1999).

18. Kenneth and Debreu (1954).

19. Learning and R&D naturally give rise to increasing returns-to-scale effects, which mean that markets in which these effects are important are not likely to be well described by perfectly competitive model. At the same time, imperfections in competition in the presence of imperfections of capital markets affect the level of profits available for investment in R&D. Thus, we typically need to describe the market structure and the level of R&I simultaneously. See, for instance, Dasgupta and Stiglitz (1980; 1980a).

20. Although Arrow did not frame the market failure in this way, it was clear from his analysis that knowledge was a public good, in the sense that Samuelson (1954) had defined public goods a few years earlier; see e.g., Stiglitz (1987a; 1999).

The failure of the Washington Consensus²¹

Once one recognises that there will be persistent differences between social and private returns, it is clear that the presumptions and premises underlying the WC/market fundamentalist policies are wrong. For the WC policies were based on the notion that markets allocate resources efficiently, enabling the structure to change as the (endogenous) endowments change.

As we have noted, classical economic development policy prescriptions were based on two ideas:

- (1) Government should promote—and should certainly not interfere with—static allocative efficiency. (Indeed, in extreme versions of this perspective, governments need not even promote savings, because individuals are in the best position to make those intertemporal trade-offs on their own.)
- (2) Growth in productivity arises chiefly from resource accumulation—physical, human and scientific capital. But these prescriptions do not apply in these dynamic learning environments.

As I have also noted, the standard market failures approach criticised these conclusions by focusing on a variety of market imperfections: for instance, there are pervasive externalities—not only environmental externalities but also those associated with systemic risk, so evidenced in the current crisis. Research over the past 20 years has explored the consequences of market failures like imperfect capital markets, traced these imperfections back to problems of imperfect and asymmetric information, and proposed a set of remedies, which in some countries, in some periods, have worked remarkably well. Imperfections in capital markets meant that finance was often not available to finance new enterprises required as part of this sectoral adjustment. Individuals on their own couldn't finance their education. Good financial regulations in countries like India protected them against the ravages of the global financial crisis.

21. This part of this lecture is adapted from Stiglitz (forthcoming).

But the perspective of a 'learning society' adds an important new dimension to the analysis.

Policies to promote learning

Policies to promote learning processes are especially important for developing countries. For more than a decade, economists have recognised that what separates developed from less developed countries is not just a gap in resources but a gap in knowledge. Thus, a central focus of development policy should be closing that gap—and that means enhancing learning.²²

Traditional policy prescriptions not only don't focus on how to maximise learning, but are also often significantly at odds with those which are appropriate to enhance 'learning' performance.²³ As a result, though well-intentioned, they may actually lead to a reduction in societal well-being.

I want now to illustrate the contrasting implications between the static, neoliberal perspective and the dynamic one that I am advocating here by looking at one of the central questions in developmental policy—should government intervene in the market's sectoral allocation of production.

Static versus dynamic comparative advantage

Standard neoclassical theory emphasises that countries should focus on what constitutes their comparative advantage. The problem is that some of the most important elements of comparative advantage are endogenous. Switzerland's comparative advantage in watchmaking has little to do with its geography. What matters is dynamic comparative advantage, and government has an important role in shaping that.

Standard Heckscher-Ohlin theory (emphasising that trade in goods was a substitute for movement in factors) was formulated in

22. This perspective was reflected in the 1998-99 *World Development Report, Knowledge for Development*. See also Stiglitz (1998).

23. In that sense, our work is similar to that of Schumpeter *op. cit.* (See also Stiglitz, 2008). But while Schumpeter was correct in his critique of neoclassical economics, he never formulated a coherent 'analytic' nonnative or positive theory. For instance, his defence of monopoly was, as a result, not well-grounded.

a period before globalisation allowed the kinds of flows of capital that occur today. With fully mobile capital, outside of agriculture, resource endowments need not provide the basis for explaining patterns of production and specialisation.²⁴ In short, there is no reason that countries need limit themselves to patterns dictated by endowments, as conventionally defined. More important is the 'endowment' of knowledge and entrepreneurship. A major focus of policy should be how to enhance and shape those endowments.

Even if a government would like to avoid addressing these issues, it cannot, for what the government does (or does not do) has consequences, positive and negative, for the development of the 'learning society.' This is obviously so for investments in infrastructure, technology, and education; but also so for financial, trade, intellectual property rights and competition policies.

Industrial policies to create a learning society

Shifting the focus from short run comparative advantage to a country's long term or dynamic comparative advantage does not, however, fully capture the perspective I am advocating here.

At the centre of creating a learning society is identifying sectors more amenable to learning, with benefits not captured by firms themselves, so that there will be underinvestment in learning. Elsewhere, Greenwald and I have argued that an implication is the encouragement of the industrial sector, which typically has large spillovers to other sectors.²⁵

This approach provides an interpretation of the success of Asia's export led growth.²⁶ Had Korea allowed market forces on their own to prevail, it would not have embarked on its amazing development successes. Static efficiency entailed Korea producing rice; Korea

24. Indeed the work of Krugman (2008) has emphasised that today most trade is not related in fact to differences in factor endowments.

25. I use the term industrial policy in this context to refer to any policy which seeks to shift the structure of production from that which would have arisen through market forces alone. Thus, a policy to encourage agro-business or telecommunications is, in this terminology, an industrial policy.

26. Successful import substitution policies have also had similar objectives. The import substitution policies were perhaps more successful than critics suggest: the lost decade of the 1980's owes more to macro-economic failures than to the failure of these micro-economic policies.

might today have been among the most efficient rice farmers—but it would still be a poor country. As Arrow pointed out, one learns by doing (and one learns how to learn by learning) (Stiglitz, 1987). Korea's success, though, is not just in the development of the particular sectors (like the chips industry) which its industrial policy encouraged. Its success arose in no small part from the spillovers that those sectors had to the entire economy.

This discussion highlights the fundamental difference with neoclassical approaches emphasising short-run efficiency. The fundamental trade-offs between static and dynamic efficiency should be familiar from the debate over patent laws. These laws not only restrict the flow of knowledge, but even may create monopolies, all justified because of the increased knowledge that (allegedly) results.

This discussion also highlights what's wrong with the standard criticism of industrial policies: the government is in no position to pick winners, and in particular to 'outsmart' markets. The objective of government is different: it is to identify externalities, and to encourage sectors with large positive spillovers.²⁷ Some governments actually have a very credible track record in doing so.

A major concern with industrial policies²⁸ concerns implementation—do developing countries have the requisite capacities? We need to put that question in context.

There is probably no country that has grown successfully without an important role—not just in restraining and creating markets, but also in promoting growth through industrial policies—from the countries of East Asia today to the advanced industrial countries, not just during their developmental stages, but even today.²⁹ The task is to adopt policies and practices, to create institutions, like an effective civil service, that enhance the quality of the public sector and its ability to carry out industrial policies

27. Such spillovers were an essential aspect of Hirschman's (1958) work, though he did not focus explicitly on learning spillovers.

28. We use the term broadly, to embrace any policy attempting to affect the direction of the economy.

29. Richard R. John (2010) presents a persuasive account of the large role of government in the development of the telecommunications sector in the 19th and 20th centuries.

effectively. The successful countries did so. Policies that either intentionally or unintentionally weaken the state (as critics suggest the WC policies did) are not likely to do so.

Economic policies have to reflect the capacity of the state to implement them. One of the arguments in favour of exchange rate policies that encourage export industries is that they are broad based: the government does not have to pick particular 'strategic' firms, or even products, to support. As always, there are trade-offs: efficiency might be enhanced if the sectors with the largest externalities could be targeted.

There are other broad-based policies, such as a development-oriented intellectual property regime and investment and financial policies that encourage transfer of technology and the promotion of local entrepreneurship, that can help promote a learning and innovation society (Emran and Stiglitz, 2009; Stiglitz, 2004; Hoff, 1997; Hausmann and Rodrik, 2003). Some forms of financial and capital market liberalisation may be counterproductive.

Interventions will never be perfect, nor need they be to effect an improvement in economic performance.³⁰ The choice is not between an imperfect government and a perfect market. It is between imperfect governments and imperfect markets, each of which has to serve as a check on the other; they need to be seen as complementary, and we need to seek a balance between the two—a balance which is not just a matter of assigning certain tasks to one, others to the other, but rather designing systems where they interact effectively.

Governments are sometimes criticised for their wasteful practices. When we talk about waste, we should remember that the full economic consequences of the dysfunctional American financial market—a cost in the trillions of dollars—entail waste on a scale probably beyond anything done by any democratic government (outside of war) in the history of the planet. We should remember too that as government has acted to address the recession, we often face unpleasant choices: a massive waste of resources as a result of

30. Indeed, if all projects were successful, it suggests that the government is undertaking too little risk.

the economy operating for an extended period below its potential, or a much smaller waste as a result of less than ideal government spending. So too for industrial policies: industrial policies may not be perfect, but the absence of industrial policies may be even worse.

Social transformation and the creation of a learning society³¹

While I have been discussing the economics of development, that subject cannot be separated from broader aspects of societal transformation,³² as Hirschman (1958) emphasised in his writings. For instance, race and caste are social constructs that effectively inhibit the human development of large parts of the population in many parts of the world. The study of how these constructs get formed, and how they change is thus a central part of developmental studies. So far in this paper, I have emphasised the creation of a learning society. The economics of doing so entails policies that change sectoral composition. But at the root of success is changing mindsets. At the centre of that task is the education system, and how it inculcates attitudes towards change and skills of learning. Other policies (e.g., legal systems, gender based microcredit schemes, affirmative action programs) too can play an important role.

Myrdal (1968), in his studies of South Asia, focused on these issues. He argued, in effect, that certain social constructs affect behaviour and were part of what might be called a dysfunctional economic and social equilibrium that could persist. But he did not address the question of the mechanisms by which such social constructs are created, evolve or collapse. Nor did he ask how we might reconcile such constructions of the developmental process with the usual approaches taken by economists. In recent work with Karla Hoff, I have been attempting to construct a general approach to societal evolution that clarifies the critical—and unrealistic—assumptions about individual behaviour and cognition that underlie what has become the dominant developmental model within the economics literature. This work provides some insights

31. This part of my lecture draws heavily from Hoff and Stiglitz (2009; 2010).

32. See Stiglitz (1998).

into why Myrdal's predictions concerning Asia's prospects could have been so far off the mark.

In our work, we are concerned with what collective beliefs are an equilibrium, and how they change. There are three critical hypotheses:

1. Perceptions (beliefs) affect actions (choices) and are shaped by cognitive frames; the infinite set of potentially observable data and the infinite ways in which that data could be processed are limited by the finite set of socially constructed categories that are a part of what are called ideologies (or belief systems). Individual behaviour is based on beliefs that are more complex (or at least different) in their formation than is reflected in standard Bayesian theories about the determination of probabilities of the occurrence of different states of nature. Indeed, in our work, we employ well-documented results in psychology, where individuals recognise and process information that is consistent with their prior beliefs in a way that is different from the way they treat other information, to show that, in equilibrium these beliefs can be self-confirming even when, in a fundamental sense, they are wrong. That is why we refer to them as equilibrium fictions. As in Rational Expectations (RE) models, beliefs affect behaviour, which affect outcomes, which affect beliefs. But unlike a RE model, beliefs also affect what is perceived, the categories into which information is placed, and how information is absorbed and filtered. Biases—at every stage of the formation of beliefs—shape perceptions, widen the set of possible equilibria and make them history-dependent.³³
2. The categories that shape cognition are social constructions. A second difference from the neoclassical perspective is that many beliefs, such as the categories into which information is placed, are social constructions. Individuals do not choose their 'software' in isolation but within a social context. A

33. On the other hand, the set of equilibria in our approach is much more constrained than the 'animal spirits' equilibrium, which presumes that virtually any set of beliefs could be sustained.

set of collective beliefs (ideologies) that serves a society—or some group in society—well under one set of economic circumstances may serve it less well under another.

3. Because belief systems affect the equilibrium, e.g., by shaping perceptions, elites have a strong incentive to influence people's beliefs. In contrast, in a RE equilibrium, this is not relevant—cognitive frames play no role. But the elites cannot simply 'choose' the cognitive frames that work best for themselves (nor can non-elites simply choose the beliefs that might work best for themselves). The task of 'choosing' for themselves and imposing on others cognitive frames is more complicated and is itself constrained by higher-order beliefs. Those in 'power' typically do not control all the determinants of the evolution of beliefs. Cultures are always contested.
4. The general beliefs about the world are a state variable that determine which beliefs are acceptable. Acceptance and legitimacy are a function, too, of collective beliefs. An institution³⁴ (like Jim Crow) may be accepted at one time, and not at another. It may be part of an equilibrium at one time, and not at another.³⁵ Redistributive institutions, too, function because they have 'legitimacy', because they are accepted. The acceptance and performance of institutions depend not only on economic variables, but also on the set of general beliefs about the world, which can at any moment be treated a state variable. Collective beliefs that emerge in one period shape the possible institutions in the next.

34. But it is not as if that group got together and figured out a set of beliefs that would accomplish what they sought. Our theory is thus incomplete. But we believe it is a step forward to break out of the mold of rational expectations, in which the variables described above play no role.

35. At one time, some economists suggested that institutions have a simple role in society—to fill in the 'holes' in markets, to remedy market failures (see North, 1971). Arnott and Stiglitz (1991) and Hoff and Sen (2006), as well as others, showed that non-market institutions purportedly resolving a market failure (like incomplete insurance markets) could, in this sense, be dysfunctional—they could lead to Pareto inferior outcomes. More recent literature has highlighted the role of institutions in preserving inequalities—in the context of repeated games, equilibria in which one group is exploited by others may be sustained. See, among others, Mookherjee and Ray (2003); Acemoglu and Robinson (2000).

Incorporating 'cognitive frames' (ideologies) as state variables provides part of a general theory of societal change that is markedly different from traditional theories, in which only capital and the distribution of power and wealth are state variables. If ideologies change, the equilibrium can change, with no change in the 'fundamentals'. At the same time, this perspective helps explain why institutional change can be so difficult and societies so rigid. A set of beliefs that may have been functional at one time, but is no longer so, can persist after the economics/technology that had led to the adoption of the beliefs has changed.

How such belief systems change—and how those (like governments) who seek to deliberately change belief systems—is thus a core part of developmental analysis, but regrettably, pursuing this question would take me beyond the confines of this paper.³⁶

I want to turn now to one particular set of beliefs that have enormous importance in shaping societies in recent decades.

Democracy and the creation of a learning society

Ideas concerning human rights and democracy have been among the most important in shaping what is and is not acceptable. In the US and Europe, these ideas eventually led to the abolition of slavery, though there were large groups for whom the continuation of this institutional arrangement was advantageous, and those who opposed it reaped no economic gain from the abolition.

Democratic ideals question authority. When America's Declaration of Independence said, All men are created equal, it didn't mean that they were of equal physical or mental capacities, but of equal rights, including the right to put forth their ideas into a competitive market place of ideas. Democracy and an open society are intrinsically interlinked.

36. The complexity of the issues is illustrated by vicissitudes in attitudes towards government policies to re-stimulate the economy. In the aftermath of the collapse of Lehman Brothers, there was a moment in which all the world adhered to Keynesian ideas. But within two years, there was a shift towards 'Hooverite' fiscal austerity policies—even though the empirical (scientific) evidence that such policies would lead to slower growth with disappointing results on deficit reduction had actually mounted in the interim.

But it is exactly that same frame of mind which is so essential for creating a dynamic, learning economy and society.

A more open society generates more ideas, a flow of 'mutations,' which provides not only excitement, but the possibility of dynamic evolution, rather than stasis.

Unfortunately, even if in the long run, a more dynamic society benefits most members of society, in the short run, there can be (and normally will be) losers. And not surprisingly, those who might lose seek to prevent such changes through any means they can. The political process is one way that is often taken. Those who seek to maintain inequalities in wealth and power do so is not only through policies (economic, legal, etc.) which perpetuate existing bases of power and wealth, e.g., by creating entry barriers; but also through policies which attempt to maintain the legitimacy of these inequities of wealth and power. Media policies (control of the airwaves, right to know laws, and so forth) thus become important instruments for shaping public perceptions, and thus public policies. The political processes themselves evolve over time, shaped not just by history, but economics, especially in today's world. Firms long ago learned that they could partially shape individuals' preferences. Those with wealth have more recently learned how to use such tools to shape perceptions in ways that lead to outcomes in the political process that are more favourable to themselves. Sometimes, this entails creating a less open and transparent society—a more open society might lead to a questioning of the persistent inequities, a more transparent society might expose the nefarious ways by which inequities are maintained. When that happens, the long term success of the economy may be put into question.³⁷

Inclusive growth

So far, I have emphasised the importance of creating a learning economy and society; that success requires not just an economic transformation but a social transformation; I have also argued

37. Earlier, we noted how, in the US, those wanting to insulate the Fed from scrutiny as it provided massive subsidies to certain banks opposed Fed transparency.

that, over the long run, democratic and open societies will be more dynamic. But, as I have noted, democratic processes can be shaped, and there are incentives on the part of some to maintain existing inequities. Democratic processes can then lead to the antithesis of an open and transparent society.

There is thus at least one more requirement for long-term success: inclusive growth. Earlier, I explained that trickle-down economics doesn't work. The critique of many of the WC policies though was not just that they were not pro-poor, that is, that the poor did not share in the benefits. Rather, it was that they were anti-poor. Policies that lead to greater volatility (which arguably capital and financial market liberalisation do) are anti-poor. It is the poor that bear the brunt of crises—nowhere evidenced more than in this crisis, where the bankers who caused the crisis are walking home with multi-million dollar bonuses. Policies that lead to higher levels of unemployment are anti-poor. Trade liberalisation destroys jobs, so that unless such liberalisation is accompanied by measures that lead to job and enterprise creation, it can be anti-poor. That is why it is so important that trade liberalisation be accompanied by appropriate financial sector and aid-to-trade measures to ensure that job creation occurs in tandem with job destruction. Markets, on their own, do not ensure this, even in seemingly well-functioning advanced industrial countries.

One of the big advances in development in recent years is that we understand not only that some policies can be anti- or non-pro-poor growth, but that we have instruments and policies (from broad policies, like micro-credit, to specific instruments, like more efficient cookstoves) to enhance the likelihood that the poor share in the growth that occurs.

My argument for why inclusive growth is so important goes beyond the standard one that it is a waste of a country's most valuable resource, its human talent, to fail to ensure that everyone lives up to his or her abilities.

The political economy of inclusiveness and openness

Rather, it is based on political economy, of an analysis of how inequality affects political processes in ways which are adverse to long term growth and inclusive democracy.³⁸

Earlier I argued that government needs to play an important role in any economy, correcting pervasive market failures, but especially in the 'creative economy', e.g., financing basic research and providing high quality education. Moreover, innovation is always risky, and in societies with better systems of social protection, individuals are willing to take more risk. So too, societies (like Sweden) in which there are stronger social protections are more willing to expose themselves and their citizens to growth-enhancing risks, such as those associated with openness.

Consider, for a moment, a society in which there is very little inequality. The only role of the state then is to provide collective goods and correct market failures. A consensus can be developed on what that entails—since interests are aligned.

But this is not so in societies in which there are large inequalities. Then interests differ. Liberals may want to use the state to redistribute income. While ostensibly conservative high income individuals may claim that they are only trying to prevent such redistributions, a more careful look at the policies they advocate often entail redistributions toward themselves; and at the very least, they entail ensuring that the government does not curtail their activities exploiting the poor and extracting a disproportionate share of public assets. Distributive battles inevitably rage.

Often, the 'ideology' of the battle takes the form of an attempt to circumscribe government (an 'independent' central bank, in reality, a central bank accountable mainly to the financial sector, budget constraints that severely limit the scope of government activity, even when there are very high investment opportunities in the public sector).

38. I am deeply indebted to Tim Besley for discussions on the ideas in this section. See Besley and Persson (forthcoming); Besley et al. (forthcoming). In earlier work with Karla Hoff, I attempted to model the political economy of transition from communism to a market economy, employing analogous ideas. See Hoff and Stiglitz (2004; 2004a; 2007). See also Acemoglu and Robinson *op. cit.*, who have also written about inequality and institutional change.

Many in the US are concerned that we have embarked on an adverse dynamic, moving us towards an equilibrium in which we will become a less dynamic and a less equal economy and society. As social protections erode and public investments weaken, including in education, inequality increases. The rich turn to private education, private parks, private health insurance, etc., even though public provision might be far more efficient. Rather than working to improve the efficiency of the public sector, those who seek to limit the scope of government work to tear down the public sector, to undermine its credibility, knowing that if they succeed, then there will be a broader consensus for limiting the role of government, and thus limiting the extent to which the government can engage in redistributive activities, even if in doing so, the government is limited in its ability to engage in collective wealth enhancement. As this happens, inequalities increase, confidence in public provision erodes, and the state takes on a less important role. It is problematic to gauge whether, in the end, even those at the top benefit; but what is not questionable is that the vast majority in the society lose out.

A casual look around the world suggests that different societies have taken different courses. The Scandinavian countries, by and large, have limited inequalities, have efficient and large public sectors, high standards of living for the vast majority of their citizens, and have succeeded in creating inclusive dynamic economies and societies. There are important differences among the political parties in these countries, but still, there is a broad consensus about most of the elements of the 'social contract'. America in more recent years has taken a different course. The image of a society with a high degree of social mobility is belied by the statistics, which suggest that such mobility is less than in many 'old' European countries. Social and economic mobility has decreased in the US, while it has increased in many of the European countries. In the beginning of this paper, I laid out some of the consequences for the US: decreasing standards of living for the majority of citizens combined with increasing social pathologies.

India, as a young democracy, has before it important decisions about which course it will take.

Concluding comments

I have attempted in this paper to cover a broad terrain. Economics, politics and society are interconnected. Too often, economists have lost touch with these broader dimensions—though I have argued that much of the conventional wisdom of economists even missed out on the most important economic elements in creating a dynamic and creative society.

In discussing the importance of creating an open, democratic and inclusive society as necessary conditions for the creation of a dynamic economy, I don't want to underestimate the importance of these as ends in themselves. Creativity, voice, security are all important ingredients to individual well-being and a sense of dignity. The central message of the International Commission on the Measurement of Economic Performance and Social Progress was that GDP was not a good measure of well-being, and policies which narrowly focused on increasing GDP were misguided (Fitoussi *et al.*, 2010).

India has had enormous success over the past 25 years in its increase in GDP, and it now seeks to ensure that the success continues and that the benefits of that success are shared by all of its citizens. The financial crisis has shown how misguided policies of financial market liberalisation and deregulation were. These were policies that the US and international institutions foisted on countries all over the world. These are policies that served special interests well, and the voices of these special interests are often heard more loudly than the voices of those that are hurt by these policies. Indeed, those in the financial sector touted the so-called financial innovations of recent years, suggesting that they brought on a new era of growth and prosperity, Paul Volcker was absolutely right in pointing out that there was not a single innovation (other than the creation of the ATM machine) that had been linked to improved economic performance. The innovations often enhanced the coffers of the banks and the bankers, but at the expense of the rest of society. And what we can say unequivocally is that the innovations introduced an unprecedented level of instability into the economy.

I have couched most of this talk in broad strokes. But the principles have strong implications for policy. I have hinted directly at the implications for financial and capital market liberalisation and the design of monetary policy and institutions. But the principles translate too into policies regarding intellectual property regimes, investment treaties, taxation, and expenditures on infrastructure, education and technology.

I hope that this paper has provided a new lense through which one can examine these and other policy choices facing India in the coming years. India might like to pretend that it could avoid matters of industrial policy—following the neoliberal doctrines that these are matters to be left to the market. But it cannot. For the choices it makes in each of these arenas will inevitably shape India's economy and society, for better or for worse, for decades to come.

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