

Success and Failure in Development: Insights from the Lewis Model

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Lewis Model Shaped Thinking About Development

- Growth based on capital accumulation
- Dual economy: growth in industrial sector provided little benefit to the rural
- Surplus Labor: kept wages suppressed, and facilitated capital accumulation
- High savings rates of industrialists: while there was great inequality of income and wealth, most of income of industrialists went to expand economy and create jobs
- Lewis turning point: eventually, surplus labor would be absorbed, and then wages would start to rise

Lewis model formulated just before East Asia Miracle

- Unprecedented growth—beyond anything imaginable before that time
 - Growth based on different precepts
- Elsewhere (Africa and Latin America) success was much more modest
 - In Africa, structural adjustment led to a lost quarter century and deindustrialization
 - Growth recovered, partly as a result of China's involvement (infrastructure, buying commodities and natural resources) in this century
 - Will it be sustained as China slows?

Lewis in his own work took much broader perspective

Anticipating many of the later developments in development thinking

- Importance of improving agricultural productivity
- Importance of inequality, understanding sources, policies to address
 - Non-market forces in wage/income determination
 - Race, class, caste, ethnic discrimination
 - Land reform
- Development as a transformation
 - Importance of knowledge
 - Role of industrial policies
- Role of institutions, governance

Post Lewis-model Revisionist thinking

- What separates developed and developing countries not just a gap in resources, but a gap in knowledge
 - So closing knowledge gap is key
 - Lewis in his writing emphasized
- Policies aimed at promoting resource accumulation, and even static efficiency, may be counterproductive in terms of creating learning society
 - Greenwald and Stiglitz, *Creating a Learning Society*
 - Education is important
 - Going beyond just primary education

Preventing a dual economy

- There can be significant spillovers across sectors
 - Linkages are key
- Requires appropriately designed development strategies
 - Economies don't have to be dual

Promoting Savings

- National savings rates can be high, even without high inequality
- Government programs to promote savings
 - Singapore, Malaysian provident funds
 - Postal savings banks, providing security and low transactions costs
 - Savings can be promoted even with low real interest rates
 - Mild financial suppression may be helpful

Wages

- Urban wages can increase even before surplus labor has been eliminated
 - Highlighting importance of *other* determinants of wages—efficiency wage theory
 - Giving rise to urban unemployment
- Government policies can simultaneously increase rural incomes and well-being, through provision of agricultural education, health services, agricultural extension

Inequality

- There are other ways of promoting savings
- And inequality has a variety of adverse consequences for economic performance

In many of these areas the public sector is critical

- Promoting savings
- Promoting creating a learning society
 - Promoting education
- Industrial policies can play critical role in structural transformation, reducing knowledge gap, promoting equality, preventing the creation of a dual economy
- Promoting equality
 - Preventing growing gap between productivity and wages

Developmental State

- In the most successful developing countries in both East Asia and Africa, the government has assumed the role of a *development state*
 - Even in most successful advanced countries, government has played an important role in promoting technology—the *entrepreneurial state*

A variety of institutional arrangements

- Not just for-profit institutions and government
- In US, some of the most successful institutions are not-for-profit foundations (e.g. universities)
- Many examples of successful cooperatives
- Township and Village Enterprises (TVEs) were among important institutional innovations in China

The public good is a public good

- So there will be an undersupply of efforts to make sure that the public sector is run well (just as there is an undersupply of efforts to make sure large corporations with wide share ownership are run well)
- Government can subsidize the institutions that can strengthen monitoring and participation—media, think tanks, education
- Important role for civil society and other forms of voluntary collective action

Preventing government failure and capture

- What is needed is more than checks and balances within government, but *within society*—and that can only be achieved if the extent of economic inequality is limited, and if there is a break in the transmission of economic advantage across generations

Big failures of Washington Consensus

- Focused too narrowly on capital accumulation, primary education
- Paid too little attention to inequality
- Paid little attention to closing knowledge gap, creating learning society
- Had too much faith in markets
 - In absence of government regulation, often inefficient, exploitive, and unstable
 - Restraining Role for government
 - Typically incapable of making developmental structural transformation
 - Presumption against efficiency of markets with endogenous knowledge
 - Catalytic role for government and public institutions (including development banks)

- Need to take pragmatic view—in some countries state institutions can even be more efficient than private
 - South Korea's state owned steel companies were more efficient than US private steel companies
 - US largely private health care sector most inefficient in world
 - Large scope for rent seeking
 - US social security (retirement) program much lower transactions costs than private programs

Failure of Washington Consensus

- Policies focused on limiting the role of the state, limiting the ability of the state to increase its capacities
 - The countries that achieved macro stability and “good governance” didn’t see a flow of foreign investment except in natural resources
 - Increased exposure to risks (e.g. with globalization and deregulation) lead to more instability and inequality, lower overall economic performance
 - Even when there was growth, it was not shared prosperity

Even institutional analysis was overly simplistic

- Talking about relying on markets
 - When vast evidence and theory of pervasive market failures
 - General theorems (Greenwald-Stiglitz) showing with imperfect risk markets and asymmetric information, markets are not efficient
 - Even free trade may lead to Pareto inferior equilibrium
- But markets don't exist in a vacuum
 - They have to be structured
 - They are structured by public policy
 - How the rules are written makes a difference for both efficiency and distribution
 - *Rewriting the Rules of the American Economy: An Agenda Growth and Shared Prosperity*, (Stiglitz et al, W.W. Norton, 2015)

Even institutional analysis was overly simplistic

Importance of *rule of law* has rightly been emphasized in modern discussions of development

- But there has often been confusion about meaning
- What matters is what kind of “rule of law”
- The wrong kind of rule of law can be used by the powerful to take advantage of ordinary citizens and maintain and extend inequalities
 - US bankruptcy law
- What most mean by a rule of law is a legal system that protects ordinary citizens against the powerful

Lewis model continues to provide an analytic frame and insights

China: Is it reaching Lewis inflection point

- As surplus labor gets absorbed from the rural sector
- Driving up wages
- What will that imply for the future growth of China?
 - As it seeks to develop domestically demand driven growth
 - Moving away from export led growth
- And what will it imply for future growth in Africa?

America's dual economy

- Increase in productivity in hi-tech sector has not been translated into an increase in median wages
- Growing gap between the growth in productivity and growth in compensation
- Growing gap between the rich and the poor, between the top 1% of labor and the rest, between marginalized and the rest
- Increase in productivity in hi-tech sector is not being translated into increased productivity for the economy as a whole
- What has led to the development of this dual economy? What policies can restore shared prosperity?
- Markets won't do it on their own

Lewis' work continues to be an
inspiration in the Twenty-first
century