RETHINKING THE CONCEPT OF ECONOMIC DEVELOPMENT
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It is a pleasure to be here at this innovative conference on economic development and the changing roles of the public and private sector in that process. Nothing is more central to economics than the issue of development. The improvement of living standards goes to the very heart of the discipline of economics and of economic policy institutions like the Federal Reserve, the central bank of the United States. Today I would like to give a brief overview of some profound changes taking place in thinking about economic development and what those imply for both public policymakers and the private sector.

Early History of Economic Development

From the inception of economics as a discipline in the eighteenth century and for the next hundred years or so, economic development was, in many respects, the dominant theme of economic inquiry. One need only think of the title of Adam Smith's famous work, *An Inquiry into the Nature and Causes of the Wealth of Nations* to see my point. While early economists did not agree on what made some nations wealthier than others, much, if not most, of the intellectual effort of early economists like John Stuart Mill and David Ricardo was devoted to explaining how countries grew and evolved. More importantly, there was a fairly widely shared view that all nations could develop--that is, not just grow but also change--if they merely adopted the proper policies. The experience of countries like the United States, France, and Germany, of course, validated this viewpoint because these nations were able to catch up to the industrial exemplar of the era, namely, Great Britain.

Moreover, the experience of these countries suggested that economic development did, in fact, further the ultimate goal of higher living standards. Pockets of poverty persisted among certain social strata and geographic regions, but the trends were clearly positive. If areas of Africa, Asia, and Latin America were not growing and evolving as rapidly as desired, the lags in improvement could be blamed upon colonial political structures or their vestiges in former colonies.

Post-War Shift in Thinking

The economic events of the first half of the twentieth century--particularly the worldwide depression of the 1930s--helped set the stage in the advanced economies for a more skeptical view of the inevitability of such progress. At the same time, the early successes of the Soviet model of socialism as a means of speeding industrialization in underdeveloped countries put laissez-faire approaches to economic development further on the defensive. Even market-oriented economists and policymakers advocated some kind of public-sector intervention to launch countries into a sustained trajectory of growth, industrialization, and ultimately, higher living standards. Trade barriers were erected to protect infant industries from competition by producers in advanced economies. Import substitution was the buzzword of the day. Likewise, public investment in infrastructure--transportation, communication, and energy sources, in particular--was financially encouraged by organizations like the World Bank. While these kinds of policies have become much maligned, growth rates in many developing countries during the 1950s and 1960s were high.

Nonetheless, by the 1980s, views about the proper policies for promoting development in less industrialized countries began to shift. The reasons were numerous. Public sectors had become large and bloated, introducing distortions into resource allocation. Moreover, such interventionist policies were not supported by commensurate tax revenues. The resulting excessive fiscal stimulus was fueling rampant inflation. The rapid development of Taiwan, Hong Kong, and other Asian countries began to offer a new model of development, one oriented strongly toward exports and without the same extreme degree of subsidization, protection, and intervention on the part of the public sector that had become commonplace elsewhere.

It had also become evident that advances in measures like GDP had not resulted in the kind of widespread improvement in living standards that had accompanied industrialization in Western Europe and the United States. This disparity was especially confounding in view of the overt equity orientation of many developing country policies like land reform. In addition, environmentalists began raising worldwide awareness of the toll being exacted by development and industrialization projects in various countries.

Implications for Public Policy

Does this shift mean that the entire experiment of the 1950s and 1960s was misguided and ill-advised? Not necessarily. More importantly, what are the implications for the future? Should the public sector play a minimal role in fostering economic development in the future? In my view, we need to beware of categorical and absolute answers, particularly in the realm of economic policy. After all, economics is not a laboratory science. Thus experiments in policy reforms must always be conducted with a degree of prudence and self-doubt, given the complexity of any modern economy.

As I see it, there are meaningful roles for public policy institutions to play--ones that are much less intrusive than what had become the norm in many developing countries--but roles that are nonetheless highly significant. The Federal Reserve, itself an amalgam of public- and private-sector elements, offers examples of the kinds of activities I envision. Since its inception, the Fed has played a key role in the payments system of the United States, ensuring that checks could be cleared across the nation and later initiating important moves toward electronic payments. We have done this without having a monopoly on either the banking or the payments system, unlike the case in many developing countries. Rather, we have increasingly had to compete against private-sector providers in the payments system, while being cognizant of our public-policy objectives, such as limiting risk.

In a somewhat different vein, more and more local governments are coming to the realization that they can provide effective public services in some cases through outsourcing, paying for a service through tax revenue but utilizing the competitive bidding process to acquire a low-cost, technically up-to-date service provider from the private sector. They have also increasingly turned to user fees. The point of these two rather different examples is that public policy can influence outcomes without being the sole provider of socially demanded services or without providing services for free.

The question that follows from this observation is: What specific directions should public policymakers move toward in this world of limited resources? One of the most promising areas relates to education. First of all, we know that countries with more highly educated labor forces do better. Although this outcome may be a chicken-and-egg question of which came first, the intuition is obvious. Second, to keep pace with technological change, labor must be flexible. Third, technology is making location less dependent on physical presence and more on underlying labor force characteristics.

As a result, some contemporary economic researchers are arguing that growth is increasingly a function of investment in human capital rather than physical capital. Whereas a few years ago it was thought by a fairly large segment of the academic community that growth was the result of unpredictable technological shocks like the invention of computers, now it seems that such technological shocks themselves may be the result of a highly educated work force. It is not just that it takes a cadre of well-educated people to create technological advances; in addition, to utilize and apply R&D widely requires an educated pool of managers and laborers. If these circumstances are in place, it should also mean that the consumer population will accept new technologies faster.

If these rather abstract arguments are not convincing, one need only think of the example of countries like Taiwan. There, public-sector efforts to improve education have not been focused primarily toward college and university students as is the case in so many developing countries. Instead, Taiwan has emphasized elementary and high school education and, as a by-product, graduates more engineers per capita than most industrialized economies including the United States. Since society as a whole benefits from such a situation, it makes sense for public policy to continue playing a role in regard to education, particularly at the elementary and high school levels. It is particularly important for public policy to support broad investment in human capital because the individual payoff to schooling is a long time in coming. In the interim, many individuals are likely to give up, choosing the more immediate gratification offered by a job they can obtain with their present level of skills. The ultimate result is underinvestment in education, and society as a whole suffers the opportunity loss.

Conclusion

In closing, I would like to emphasize that I embrace the reorientation toward a greater role for private-sector solutions to economic development challenges. At the same time, I believe that the public sector can play a very useful role, particularly by keeping sights on the long term, which is, after all, the time frame in which true development occurs.