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A macroeconomic perspective on Asian development

Amit Bhaduri*

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Abstract: Macroeconomic strategies and policies have differed significantly among Asian countries over the last fifty years, and yet some common issues recur despite their immense diversity in inherited historical initial conditions, differences in political systems, geo-political situations, location and size, and natural resource endowments. The present paper examines from a comparative perspective some of the issues like unemployment, role of the state and market, domestic versus foreign market, degree of openness in trade, investment and finance, industrial and technology policy, and economic and social inequality. We attempt to ascertain why some countries have been more successful in dealing with these issues through policy and institutional innovations. Our comparative perspective presents developmental choices and challenges as moving targets requiring flexible institutional and policy response at each stage of development, which makes uniform guidelines misleadingly over-simplistic.

Keywords: initial conditions, unemployment, openness, state, market, decentralization, inequality
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* Jawaharlal Nehru University (JNU), New Delhi, India, email: amit.bhaduri@gmail.com.

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Information and requests: publications@wider.unu.edu

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Katajanokanlaituri 6 B, 00160 Helsinki, Finland

1 Introduction

As a multi-dimensional historical process, the development of a country involves economics, politics, society, technology, environment, and culture. Such a process, if forced for long, would create serious distortions, but becomes sustainable over time only through strong internal reinforcing mechanisms. Macroeconomic policies have the role of helping this process with supporting government initiatives and institutional set-up, while involvement of the people is at the core. This resonates to some extent with Gunner Myrdal's vision of development in his *Asian Drama* as the merging of many economic, social, and political processes that result in 'cumulative causation' to usher in an overall process of development. Similar although narrower visions, restricted mostly to the economic aspect are also to be found in Young (1928), who linked economic progress with 'increasing returns', and Kaldor (1972), who attempts to capture industrialization, especially manufacturing, as a process of 'dynamic increasing returns' characterized by a mechanism of mutually reinforcing strong positive feedbacks. Myrdal's intellectual ventures (1957, 1968/1977) had consistently been wider, integrating many aspects cutting across artificial intellectual boundaries of academic disciplines.

History is essential to this perspective because these processes work on historically inherited specific 'initial conditions'. Consequently, any discussion of usual macroeconomic policy instruments like monetary, fiscal, or exchange rate policies can be misleadingly limiting, unless placed in this wider framework proposed by Myrdal to reckon adequately with the initial conditions and institutional requirements. The objectives of development, as well as the relevant instruments and institutions, are inter-related in an inextricable manner shaped by the context. Policies and economic performances focusing exclusively on particular aspects like the growth rate of gross domestic product (GDP), rapid industrialization, or international competitiveness might trivialize the problem if they fail to capture adequately the transformative process operating on initial conditions.

From this point of view, the role of macro policy needs to be viewed not merely in terms of economists' traditional preoccupation with efficient allocation of given scarce resources among alternative means and the efficacy of the price mechanism. It must concern itself also with measures needed to augment and transform the resource base for the purpose of development, its utilization through expansion of markets, as well as accompanying income and wealth distribution. The inherited initial conditions set limits but also provide opportunities. Their inter-play is the story of successes and failures in development, as would be seen from comparative experiences of various Asian countries.

Reckoning with the variety of factors that come into play in the making of these stories necessarily implies that macroeconomic policies for development are not mere application of a given set of instruments aimed at a given set of targets (Tinbergen 1954). The instruments and their supporting institutions, as well as the targets, are moving over time, with evolving initial conditions throwing up new challenges and opportunities. The perspective on developmental macroeconomic policies presented here attempts to cope with this broader view of development as a dynamic process involving moving targets, instruments, and institutions over time. If the developmental experience of a particular country is captured by time series, experiences of several countries provide a moving cross-section of the grand 'Asian Drama' of development unfolding over time.

Since the capability of a country is always limited in some ways, a major question facing macroeconomic policy for development is the sequence and relative priorities to be assigned to augmenting and transforming resources. Traditional view might leave it to the price mechanism, but that is usually inadequate and, at times, even misleading. To illustrate the point, immediate employment expansion linked to productive asset and infrastructure creation may have priority in the time sequence in situations of vastly underutilized and unemployed manpower, which coexist extensively with precarious livelihoods. The priority would be to deal simultaneously with both resource augmentation and distribution through labour utilization. Human capital development through better education, health, and housing may acquire similar priority in some other situations, while expansion of the market for skilled labour might be an equally pressing need. Other situations may call for access to foreign capital inflow, technology and industrial policy, and strategic integration with the world economy on a priority basis.

Each one of these examples would usually require creating or strengthening supporting institutions as well as different policies like fair price rationing of essential goods for the poor, land reform, agricultural credit or services reform, nature and degree of decentralization, environmental policy linked to decentralization and livelihood, as well as regulatory reforms. They go beyond the reach of standard macro policy instruments relating to monetary, fiscal, or exchange rate policies. These examples also illustrate why actual experiences of development seldom respect the artificial neat boundaries of academic disciplines, and a better appreciation of historical experiences requires us to travel through less chartered territories of macro policies for development.

The strategy we follow is to take up some major themes which have repeatedly arisen in diverse development experiences in Asian countries and comment on their significance in terms of view of macroeconomic theory and policy. The discussion in Section 2 begins with the question of how to strike a balance between our theoretical understanding and historical description of 'initial conditions' using the diversity of the economies of Asia as background. History enters in an essential way in so far as policies have to be tailored to the stage of development. For instance, utilization of vast surplus labour is often a priority in the early stage of development, which is discussed in Section 3 as labour utilization through the strategy of extensive growth followed by some Asian countries. This leads in Section 4 to a macroeconomic discussion of the constraints that operate on such labour utilization strategies. Productive utilization of surplus labour also raises the issue of the size and nature of the market that can absorb the output produced. This is discussed in Section 5 under the issue of domestic versus foreign markets.

The relative importance assigned to them concerns the strategy of export promotion versus import substitution, which in turn is related to issues of technological capability, acquisition of foreign technology, extent of external indebtedness, and international competitiveness. These inter-related issues are the themes of Sections 6 and 7. However, usual discussions of these issues overlook decentralization, particularly in large countries, which can add a different policy dimension. The nature of decentralization, which can have a direct bearing on the question of popular involvement in development, is explored in Section 8 while Section 9 discusses the issue of economic and social inequality, which in turn has a direct bearing on decentralization. The concluding observations in Section 10 recapture some of the main points. Asian experiences emphasize how some successful experiments with development policies have often meant going against conventional wisdom in development thinking, but invariably paying attention to the specificities of initial conditions and evolving economic context.

2 Initial conditions

Emphasis on initial conditions has strong deterministic overtones of classical physics. Some decades after the spectacular success of Newtonian mechanics, the great French mathematician Laplace claimed with chilling arrogance that one could completely predict the future and the past on the basis of scientific laws of motion, if only one had knowledge of the initial conditions of all particles. When emperor Napoleon asked how God fitted into this scheme, Laplace is said to have replied that he did not need that particular hypothesis. Replace 'God' by 'uncertainty' and we encounter similar arrogance in a deterministic view of modern macroeconomics. On the assumption of a representative, all-knowing, all-seeing representative rational agent, temporal and inter-temporal optimization techniques are applied to describe the macroeconomy, whose assumed optimal properties naturally minimize the economic role of government intervention and serve an ideological purpose by claiming implicitly that we live in the best of all possible worlds, in which the working of a free market economy cannot be improved upon (Lucas 1983; Sargent 1987). Ironically this amounts to the same case once made for bureaucratic centralized planning. The distinction between an economy guided by planning from the top and by the market from below is obliterated, merging logical extremes in a display of mathematical virtuosity.

However, the starting point of discussion must be the undeniable fact that historical processes are typically non-repetitive, unlike motions of deterministic classical mechanics, or even that of less deterministic quantum theory at sub-atomic level. The indeterminacy goes deep in economics. Experimental economics at the level of the individual shows not only the limitation of the rationality postulate, but its ambiguity and the pitfalls of viewing economic actions and policies in terms of individual rationality. At the macro level that problem gets hugely magnified as we look for repetitive patterns involving interactions among numerous individuals and groups with diverse interests and power.

With hindsight it might be possible to identify some of the sources of the irregularity of historical processes, but far more difficult to decide how best to deal with them. If macroeconomic policies are viewed as experiments, usually not replicable, a policy may have different outcomes in different situations. Such ambiguity and unpredictability are summed up as 'differences in initial conditions', which arise partly from the inescapable incompleteness of specifying initial conditions. It resonates with the great French mathematician Poincare's (1908) oft-repeated warning: 'we could still only know the initial situation approximately… It may happen that small differences in the initial conditions produce very great ones in the final phenomenon…Prediction becomes impossible' (English translation by Gandolfo 1996: 504).

Given the incompleteness, it usually becomes the historian's prerogative to choose critical elements to characterize the initial condition. At the formal level, the use of a priori (Bayesian), ex ante subjective probability in place of statistical frequency distributions is one such attempt; introducing critical nonlinearities may be another. Myrdal's more historical approach laid particular emphasis on analysing the consequences of distortions caused by colonial rule and traditional hierarchical stratification of caste, gender, etc. in India (Myrdal 1977). However, the critical elements would be different when initial conditions differ.

Drawing an analogy from non-linear dynamical systems, one could think of these critical elements as being similar to 'bifurcation points' whose small perturbations tip the balance dramatically. In some cases macro policies can set in motion cumulative changes, due to small changes in some parameter values which affect the 'structural stability' by altering the qualitative properties of a system. They might give rise to such phenomena as discrete jumps or 'catastrophic change', 'hysteresis', and 'chaotic' dynamics, of which many examples are available even in simple macroeconomic models (e.g. Day 1983; Bhaduri and Harris 1987). Popularly known as 'the butterfly effect', such sensitivity to initial conditions picturesquely captures how the flap of the wings of a butterfly could create a storm across the ocean in some distant land. In a parallel vein, an insignificant-looking initial advantage of a firm can add up cumulatively to such decisive advantage as to transform the market structure from competition to monopoly (Sraffa 1926), or make an initially inferior technology dominate others under increasing returns (Arthur 1994; David 1995).

The purpose of macro policy analysis would lie in searching for such critical tipping points in relation to initial conditions, so that meaningful policy perturbation can set in motion cumulative causation for escaping from underdevelopment. However, indeterminacy would arise in economic policy precisely because the same policy might not have the same effect of tipping the balance in relation to other initial conditions. Subject to this qualification, some policies in development economics search for greater generalization for breaking the 'vicious cycle of poverty' by tapping unutilized surplus labour (Nurkse 1953). A 'big push for industrialization' (Rosenstein Rodan 1943; Murphy et al. 1989), advocating simultaneous investment on a range of related industries to create mutual positive feedbacks, and the 'spread effect' on the supply as well as demand side (Myrdal 1977) is another such idea.

Some specific aspects of initial conditions may be identified in the Asian context to analyse their possible role as 'critical points' for understanding diversity in development experiences across countries in Asia. They relate to:

a. Difference in size and natural resource endowment (especially oil);
b. The initial nature of their political economies—from Chinese and Vietnamese socialism evolving towards one-party market economies, to the strong market orientation of Taiwan, Thailand, Malaysia, and the Philippines, democratic planning trying to combine market and state in India and Sri Lanka and tilting increasingly towards the market, to South Korea's authoritarian model moving towards multi-party democracy, and countries of Central Asia who rather abruptly ceased to be parts of the former economy of the Soviet Union;
c. Similarities and differences in colonial experience under Britain, Japan, France, Spain, and later the US, which left imprints on the respective colonies as examples of 'hysteresis'; and
d. Culture, identities, and social stratification. India for instance is prolifically full of such divisions—religious, caste, and ethnic. Comparatively, most other countries are more homogenous, but many also have to deal not merely with distinct minorities but manufactured identities for political purposes. Korea, despite being politically divided, appears more homogenous in many cultural aspects. While many would argue that considerable similarity exists between India, Pakistan, and Bangladesh in many respects, their differences play a significant role. How overall situation is shaped, resulting in conflict, cohesion, and cooperation for mutual benefit, must be an integral part in the orientation of macroeconomic policies.

Although the influence of history through initial conditions is crucial, it does not have a decisive influence. Elements of unpredictability, arising from low-probability events like 'black swan' and non-foreseeable sensitivity to initial conditions like 'butterfly effects', defy incorporation in a rigidly pre-determined policy framework. A striking example in Asia is the contrasting experiences of oil-rich Gulf States and similarly endowed parts of Central Asia. Their policies towards natural resource extraction and trading shaped by initial conditions of geo-politics differed, leading to unpredictably large macroeconomic differences. They often led to 'hysteresis' in the sense that the effects persisted even when the initial cause was removed.

Since policies towards economic openness and development were conditioned in large parts of Asia by the geo-politics of Cold War, preferential access particularly to the North American external market played a part in making outward-looking industrialization more successful in some countries (e.g. South Korea, Taiwan). Similarly, initial land reform by an authoritarian occupation force (the US) and wider access to basic education as an initial condition created by some colonial powers (especially Japan) created unforeseeable preconditions for more balanced industrialization at later stages, when contrasted with the spread of education in some Central Asian countries that were part of the former Soviet Union. Indeed, when asked why India could not carry out a thorough land reform like Japan or South Korea, former Indian Prime Minister Indira Gandhi was said to have retorted that carrying out reform on someone else's land was much easier than on one's own.

Because chance elements that cannot be foreseen, even with best available information about initial conditions, matter in the development process, it should be a humbling lesson against detailed optimality calculation on paper. It is often more desirable to maintain flexibility to respond to unforeseen conditions with policy designed for trade-off between efficiency and flexibility, as suggested in 'bounded rationality' and 'satisfying behaviour' (Simon 1979). From this angle we need to consider several important issues usually left out of the development debate, like decentralization, economic social and political mobility, and livelihood opportunities.

3 Labour utilization and extensive growth

The foremost requirement of inclusiveness in development is rapid expansion of employment and livelihood opportunities in situations of huge surplus labour and mass unemployment. Assuring fuller utilization of labour with high employment in the shortest possible time has been achieved most successfully in post-revolutionary situations in China and Viet Nam. Using a strategy of 'extensive growth', they showed how underutilized massive 'surplus' labour can be fruitfully absorbed for capital formation in a short time through huge, centralized public projects like building irrigation dams, roads and waterways, infrastructure for production, and delivery through agricultural communes. This helped in taking the first step in development. With various schemes of quantity and price rationing of essential goods, the market mechanism was largely replaced. The link was strong between centralized one-party political systems and institutional support for extensive growth, and this strategy runs the danger of excessive state authoritarianism. Nevertheless, a moderate variation of this model through decentralized programmes could be attempted with smaller projects being decided and implemented by local communities in accordance with their local priorities.

Financial autonomy and respect for traditional local knowledge are necessary prerequisites. India's rural employment guarantee scheme (2005) was a step in that direction, but failed to realize its full potential, partly due to rigid rules set by higher levels of bureaucracy and politicians. The loss of flexibility was visible in many ways: delays in the release of funds for payment of wages; the definition of rural asset creation according to uniform rules set by a bureaucracy distant from the local reality, like 100 days of work per year; payment according to amount of soil moved by manual labour; applying a uniform ratio of human to mechanical power irrespective of soil conditions; and uniform local child care arrangements for female labour. More importantly perhaps, a lack of arrangements for on-the-spot access to public distribution of essential goods reduced the effectiveness of the policy. Generating income without creating locally useful productive assets became normal, as did corruption by following rules on paper without substance. Enormous variation in the performance of the employment guarantee scheme across Indian states pointed not merely to the differences in efficiency and interest taken by bureaucrats and politicians but to the importance of mobilization of public involvement through local activists. At least in India, this showed how greater local involvement of elected representatives at 'Panchyat' and 'Gram Sabha' levels (for which the Indian constitution had made provisions in law) was crucial but largely thwarted by attempts to maintain party control in the competitive multi-party democracy. The broad political economy lesson for macro policy formulation is the need for greater flexibility through greater local autonomy by factoring in more carefully the political compulsions that are typically generated by such schemes.

It is also instructive to note in this context that a 'minimum income support scheme' intended to raise the purchasing power of the poor might strengthen the bureaucratic tendencies further through a 'patron–client' relation between the state and poor, leaving even less space for popular initiatives and participation. A decentralized employment guarantee scheme driven by local initiatives on the other hand would have the potential of impacting both income generation and local production, while strengthening a sense of the economic rights of the poor.

4 Macroeconomic constraints on labour use

A critical requirement for any extensive growth strategy is the downward flexibility of the real wage rate. Its purpose is to make 'redistribution of limited wage goods from the already employed to the unemployed' (Kahn 1972) a politically feasible proposition through some version of rationing. The issue of redistribution, if left unattended by macro policy, might get resolved by the market through 'forced saving' imposed on the workers. This is undesirable because it also finances greater consumption out of profit by the rich through 'profit inflation' (Keynes 1930, 1940), or results in a persistent 'inflationary barrier' in the case of downward flexibility of the real wage (Robinson 1956). For financing such programmes, even a direct tax on wages can be more equitable than redistribution through inflation against workers (although its apparently unjust nature makes it politically undesirable), while taxing profit is considered politically unwise in capitalist democracies (Bhaduri 1986). However, this unjust nature of forced saving due to inflation is not a justification for fiscal austerity in financing such programmes. Instead, it calls for rationing of essential consumption goods through extension of the public distribution system, as was done in post-revolution China and Viet Nam or even in immediate post-war England.

The basic model of inflexible real wage rate with unlimited supply of labour in a dual economy was proposed by Lewis (1954). He viewed the shift of labour from traditional agriculture to industry as a voluntary process induced by a higher wage in industry until the 'turning point' is arrived at when all excess labour in agriculture is absorbed by industry (Fei and Ranis 1964). Because of the downward inflexibility of the real wage rate throughout the process, relative price, or the terms of trade, regulates the pace of industrial growth. If it becomes too high, the relative price of agricultural goods rises in relation to industrial goods and reduces industrial profitability. The first order condition for profit maximization requires the marginal product of labour in industry to equal the product wage rate, i.e.$MPL_i = {}^{w}/_{p_i}, = \left({}^{w}/_{p_c}\right)\left({}^{p_c}/_{p_i}\right)$, where w is money wage rate and $p_c$and p_i are price levels of consumption and investment goods respectively. A constant real wage rate in terms of consumption goods $\left({}^{w}/_{p_c}\right)$ would entail lower product wage in industry $\left({}^{w}/_{p_i}\right)$ if the terms of trade $\left({}^{p_c}/_{p_i}\right)$ move in favour of agricultural goods. This would lower profit-maximizing demand for industrial labour and slow down the pace of industrialization.

The main lesson is that agricultural surplus becomes the binding constraint when real wage is insufficiently flexible in terms of consumption goods.

In such cases, production technique maximizing investible surplus (or profit) would also maximize long-run economic growth (Dobb 1960; Sen 1960). However, this can be misleading (Kalecki 1993). If limited agricultural surplus is the problem in a predominantly agricultural economy like China, India, Indonesia, or Pakistan in their early stage of industrialization, then the emphasis should be on combining some rationing measures with raising current agricultural output by focusing on decentralized local investments for raising productivity of land rather than that of labour.

In contrast to wage goods, if availability of capital goods is identified as the binding constraint, the macroeconomic policy has to be directed towards choice of industries rather than production techniques. In situations of limited capacity to produce or import capital goods due to foreign exchange constraints, the compulsion to industrialize faces barriers of unavailability of capital goods. China and India, despite differences in their political systems, tried to overcome the constraint by expanding rapidly their capacity to produce capital goods. China's justification for this lay in one of the 'ten great relationships' propounded at that time (1950s) following the Marxian scheme of 'expanded reproduction', which assigns a 'leading role' to capital goods producing Department 1. A similar path was followed by India using a two-sector (later four-sector), non-shiftable, capital goods model (Mahalanobis 1953) closely resembling the Soviet model of industrialization formulated originally by Feldman (Domar 1958).

Nevertheless, a very significant difference arose between China and India. In post-revolutionary China, land reform, agricultural communes, large scale irrigation, and a transport network created through 'extensive growth' significantly increased the productivity of land and agricultural surplus. Early excesses with the 'Great Leap Forward' for industrialization in China caused acute food shortage and famines that were tackled through liberalization of agricultural communes in the 1980s. In contrast, land reform in post-independence India was moderate, mostly replacing former large revenue-collecting intermediaries for the colonial state by large farmers and money lenders as Myrdal had perceptively observed (Myrdal 1977). As a result, India faced a chronic balance of payments deficit on account of food imports until the 'Green Revolution' eased the situation in the 1980s. This was followed in the early 1990s with economic liberalization, when India was able to attract sufficient inflow of foreign private capital to cover its continuing current account deficits. China, in contrast, started to have persistent export surplus, with increased openness to trade from around the same time.

5 Domestic versus foreign markets

A country's domestic and foreign markets are linked mostly through trade surplus or deficit. An export or import surplus would magnify positively or negatively the size of the domestic market through the foreign trade multiplier. However, when the export surplus is a small fraction of total domestic demand ($Y = C + I + E - M$, in usual notations), which is usually the case with large countries, it provides relatively weak support for expanding the domestic market. It is wiser in such cases to view export promotion as a way of facilitating primarily international payments and earning foreign exchange. The situation is usually reversed for small countries.

However, while this broad direction for openness in trade in relation to the domestic market size might be the guideline for trade policies, national governments' control over them has been weakened not only because of new institutions like the World Trade Organization but also by intra-firm trade by transnational corporations, which accounts for over 60 per cent of foreign trade. As a result, much of the exports generated by corporations become structural, spreading demand as well as employment to various international locations, driven by compulsions of sub-contracting, international supply chain, and the pull of countries with lower corporate tax rates. This, in turn, has weakened revenue collection by national governments encouraging the ideology of fiscal austerity.

At the same time, to enhance their international competitiveness in a global market, the focus of large corporations shifted from employment generation to raising labour productivity for lowering unit cost, quality control, and on-time delivery through mechanization, automation, and robotization. The main consequence has been a widening gap between output and employment growth. Independent small and even medium-sized firms in developing countries are at a disadvantage in so far as finance, technology, and access to the international supply network are concerned, even when they are better placed to provide more employment. With large corporations as their main players, two of Asia's most populated countries, China and India, succeeded in raising their share in the world economy in manufacturing value added and export. During their high-growth years (roughly 1993 to 2013) China grew by nearly three times (approximately 9 per cent) and India two times (approximately 7 per cent) the world average, but regular employment grew by barely more than 1 per cent in China, and slightly less than 1 per cent in India.

The inter-connections of corporate-led jobless growth, rural-urban migration, destitution, an expanding informal sector, and environmental degradation can be illustrated briefly with an arithmetical example (Bhaduri 2018). Suppose 10 traditional livelihoods with a low average labour productivity of 2 are destroyed for land acquisition from traditional agriculture, typically to let corporations have cheap access to natural resources like minerals, rivers and water bodies, village commons, forests, mountains, and coast lines, etc. However, given the limited size of the domestic and foreign markets, corporations with their higher labour productivity, say 6 times more, i.e. 12, can absorb only 2 persons. The result is higher output at 12x2=24, but employment is lower at 2, with 8 unemployed. For corporations to absorb all, i.e. 10, displaced labour, the domestic and international market have to be of much larger size of 12x10=120. And yet, the more corporations try to capture the international market through greater international competitiveness, the greater the pressure for raising labour productivity and the stronger the negative pressure on job creation, leading to a growing informal sector where displaced jobless persons try to make a desperate living by encroaching on natural resources, urban space, and infrastructure. Congestion costs reduce corporate efficiency through shortages of regular water, electricity, and space lowering corporate competitiveness to complete the vicious circle. This range of problems is increasingly faced by many high-growth Asian countries.

These Asian experiences of jobless high growth contradict Schumpeterian optimism about 'creative destruction' as well as the Lewisian vision of approaching a 'turning point' at which all surplus labour is absorbed in high productivity industry. With unemployment growing, rural to urban voluntary migration, due to the pull of higher expected industrial wages, is usually not the dominant factor (Harris and Todaro 1970). Instead, the major problem arises from destroyed rural livelihoods, exacerbated by degrading of environment and the taking over of traditional village commons by corporations to produce natural resource-intensive outputs. Adam Smith's observation that the extent of division of labour is limited by the size of the market seems more in conformity with recent Asian experiences when growing pressure on environment and rural livelihood are factored in, rather than with either Schumpeter's or Lewis's versions. The emphasis on the importance of the domestic market particularly in large economies is its main lesson.

6 Import substitution versus export promotion

While the two largest countries of Asia focused on building the domestic base for capital goods production in their early phase of industrialization, some smaller countries successfully followed different paths. The geography of their smaller size had an influence, but their initial conditions in other respects might have exerted an even bigger influence.

The spectacular success of export-promoting industrialization in a group of South East and East Asian countries such as South Korea, Hong Kong, Taiwan, Singapore, and Malaysia deserves special attention, while Thailand and the Philippines followed a similar path somewhat less successfully. These countries had a distinctly greater orientation towards economic openness from the beginning without concentrating on capital goods industries and import substitution. Although two relatively large countries among them, South Korea and Taiwan, developed quite early some heavy industries with import substitution potential, they maintained their outward orientation, and shifted gradually through quality improvement to outward-looking export promotion policies. While China and India followed a similar trajectory, their import-substituting heavy industrialization policies lasted longer.

The real contrast is the two little city states of Singapore and Hong Kong. They were poor in land and other natural resources, and depended decisively on international trade in goods and services from the very beginning as integral part of industrialization, but shared with Korea and Taiwan a massive education drive, and systematically nurtured an industrially skilled labour force. Singapore followed the innovative strategy of using its geographical location by placing itself strategically in the various international supply chains of multinationals, as did Malaysia at a later date. It started with trade in goods but gradually included related services, finally extending to financial services. Hong Kong was more naturally placed as a 'port' for the huge hinterland of China. Both city states have managed to traverse the path of development with considerable skill, which becomes clear when contrasted with the experiences of some other similarly placed small South Asian countries like Sri Lanka, particularly because it is comparable on several social indices like high literacy. In general, small countries that seem to succeed internalize the external market, whereas large countries externalize their internal markets; exports by firms become the beginning of the market expansion path of the former, but are the end destination for the latter (Nayyar 2013).

Developing a domestic capital goods production base in the early phase would be easier the less severe is the foreign exchange constraint. The role of an under-valued currency or exchange rate as a policy instrument tends to be over-emphasized due to exclusive focus on the price mechanism. Instead it might be noticed that many East and South East Asian countries were placed in a relatively advantageous position regarding foreign exchange availability because of their geo-political situations, which were absent to varying extents for countries like China, Viet Nam, India, and Indonesia, particularly in the early phase. As a result, the compulsion of building a domestic capital base was stronger and lasted longer. This was often exacerbated by the wrong policy of not producing sufficient agricultural surplus which also needed foreign exchange. In contrast, many South East and East Asian countries had a more favourable situation due to their political economy, mostly dictated by geo-politics, which privileged them with preferential trade treatment and access to greater capital inflows. However, this in no way belittles their imaginative macro policies that helped them to exploit these advantages more successfully compared to some others in Asia, such as Pakistan, the Philippines, or Thailand.

An inference about macroeconomic policy might be drawn from these varied experiences. It points to the importance of getting the time sequence right in moving towards economic openness. Successful industrialization of many large and medium-sized countries had an early phase of building infrastructure and a capital goods industry for import substitution, followed by potential for export promotion. The sequence acted as a disciplining device on quality control. Countries that failed were saddled with unwanted 'infant industries', partly discrediting the strategy. However, reversing the sequence would be a mistake of over-simplification. They do not produce the same result, somewhat like 'non-commutativity' of matrix multiplication where AB and BA are usually not the same. Unfortunately, the importance of time sequence is often forgotten in many econometric cross-country analyses, leading to over-simplified debates about import substitution versus export promotion.

7 Technological capability and capital account openness

Prior to financial globalization involving large private capital flows, Asian countries mostly had to depend on aid and grants. With the US dollar as international 'money', countries more closely aligned politically to the United States typically faced less problems. Nevertheless, technological capability for industrial success is not a readily purchasable commodity on the international market. Both South Korea and Taiwan developed much of their industrial base simultaneously with domestic technological absorptive capacity and a strong emphasis on education and skill formation. South Korea, like Japan after the Second World War, relied heavily on commercial borrowing instead of direct foreign investment, paying required licence fees while accumulating a very high level of per capita foreign debt. However, it gradually generated a sustained export surplus to pay back and became a member of the OECD with full capital account convertibility, almost like a textbook success story. Singapore and Malaysia also attained comfortable foreign exchange positions with consistent balance of payments surpluses (averaging about 2 per cent of their GDP over two decades), but the latter still maintains some capital account control, which left it relatively unaffected by the late 1990s (1997) financial crisis in Asia.

State-led industrialization under tariff and non-tariff protection in China and India during the early phase of industrialization moved towards increasing openness in trade under globalization. Both have diversified their exports and increased their share of manufactured goods in world trade along with six other newly industrialized Asian countries over the last quarter century (Nayyar 2013). However, there are important differences in that China built up huge foreign exchange reserves from the time it gradually opened up its capital account. It attracted foreign investment and increasingly invested abroad. India too attracted large foreign capital inflows, but with a high proportion of relatively short maturity portfolio investment to enjoy an apparently comfortable foreign reserve position covering continued current account deficit. On the trade front, the services sector, especially less advanced software services rather than manufacturing, has been India's most important export earner since early 2000, and much of its manufactured exports are to other developing countries (Ghose 2016); whereas, China, like South Korea and Taiwan, is penetrating increasingly into the export market of developed countries. This suggests India's comparatively lower technological capability as a result of its industrial policy in transiting from the import substitution to export promotion phases.

Some of the more successful smaller exporters in Asia had a different industrial policy. Singapore and Hong Kong placed themselves strategically in international supply chains fairly early and became integrated in them. Some others in the ASEAN region received considerable foreign investment related to supply networks first from Japan, then South Korea, and now increasingly from China. Along with trade, they had a high degree of openness in foreign investment and to a lesser extent in finance. Their technological capability was typically influenced by foreign investors' requirements. Occasionally described as the 'flying geese pattern', in which the position vacated by the leading bird is taken over by a follower, the acid test for these countries would be their ability to acquire sufficient independent technological capability. The role of the state also has to change by guiding investment towards channels considered more promising for either attracting foreign investment or directly promoting domestic investment for economic development through a combination of the budgetary, fiscal, and monetary 'carrot and stick' policy that had been typical of Japan, South Korea, and Taiwan. The East and South East Asian countries, perhaps best exemplified by South Korea, seemed more successful in this respect. This often verged towards authoritarian 'managed democracy' with restrictions on real wages and long working hours in the early phases, and has emerged only gradually out of this phase (Amsden 1989; Wade 1990; Chakravarty 1993).

Borrowing from private rather than official sources under financial globalization created both unprecedented opportunities for attracting massive inflows coupled with the danger of capital flights. This has become a major challenge for the appropriate fiscal, monetary, and exchange rate policy mix in all countries. Most Asian developing countries have used various degrees of direct control over their capital accounts in addition to these standard policies. Assuming sensitivity of capital flows to interest rate variation, the argument was made that monetary rather than fiscal policy would generally be more effective under flexible exchange rates (Mundell 1968). Fiscal policies based on borrowing heavily from the market were discouraged due to their possible impact in raising the rate of interest, especially in a flexible exchange rate regime, but such fiscal discipline was used very flexibly in the successful cases of East and South East Asia. In the cases of accumulated foreign debt with a high fraction of short maturity debt, as in India and Indonesia, expansionary fiscal and monetary policies became more restrictive to comply with the sentiments of international financiers to avoid sudden capital flights. Keynesian policies for fighting unemployment became the most important casualty as austerity was imposed in the name of fiscal discipline.

The ability to service debt depends on several factors, but ultimately on the ability to generate enough export surplus. This requires acquiring technological capabilities through continuous up-gradation and the ability to build complex goods where price competitiveness is not the only factor. Building such a technological niche where product novelty captures increasing market share becomes the goal (Lall 1987). That path was traversed in Asia initially by Japan and later by South Korea and Taiwan, and now probably China. Availability of foreign exchange is not enough to reach this destination, as it requires effective industrial policy. Some oil-rich Middle-Eastern Asian countries with export surplus have so far not been able to acquire similar technological capability, pointing to a gap between their industrial and financial power. Some oil-rich Central Asian countries that were part of the former Soviet Union suffered distortions in industrial development partly due to industrial policy based on regional division. They produced components of heavy and complex industrial products (e.g. large tractors, rockets, space ships, etc.) in a highly centralized system. After the collapse of the Soviet Union, these industrial sites became largely useless for the newly born sovereign countries with insufficient reorientation of skills to suit altered demand patterns. The lesson needs to be learnt that availability of external finance is at best a necessary, but not a sufficient, condition for successful industrial policy.

Serviceability of debt becomes critical particularly when countries with limited foreign exchange pursue independent industrial policies. Suppose one unit is borrowed at interest rate i; if invested, it produces a steady flow of b units of output (incremental output–capital ratio). Assuming a constant fraction s of output is saved, $1 > s > 0$, sb would be the country's ability to repay, and for $sb > i$, the repayment becomes viable. Since, by definition, the growth rate of the economy, g equals sb, this implies g has to exceed the interest rate i for servicing debt. This rule provides a useful benchmark against over-dependence on foreign borrowing. It may be supplemented by the analogy with a firm whose cash flow may require occasional outside finance, normally manageable as 'hedge finance' from expected profit flows. More frequent dependence on external finance over longer periods becomes 'speculative' but continuous dependence on injections from outside indicates 'Ponzi' finance and financial fragility (Minsky 1985).

However, the problem of debt servicing has been almost reversed in recent years as poorer East Asian countries with high growth and persistent surpluses on current account (e.g. South Korea, Singapore, Malaysia, Taiwan, Hong Kong, and now China) have been lending, i.e. exporting capital to richer countries (Presad et al. 2007). In this context, confusion between 'capital' as finance and as physical equipment needs to be avoided. Lucas (1990), for example, puzzled as to why sufficient 'capital' does not flow from relatively capital-abundant rich countries to relatively capital-poor countries, since the former have lower compared to the latter's higher marginal product of capital. Capital in this context means physical capital, whereas international capital mobility refers to financial capital. It is not only that physical capital does not have that kind of mobility, the very proposition that marginal product of physical capital equals the rate of profit was proved logically unacceptable outside a one-commodity world precisely on account of this confusion between physical and value of capital (Sraffa 1960; Samuelson 1966).

8 The role of decentralization in the state versus market debate

Successes and failures in Asian experiences teach us that recognizing the limits of economic and social engineering in formulating industrialization strategy is as important as being flexible in the use of fiscal and monetary policies to suit different circumstances. Overly rigid macroeconomic policies are faulty in their very design, not merely in implementation. And yet, experience shows that centralized policy formulation in several Asian countries often erred in this respect. At times they have over-emphasized rule-bound, bureaucratically top-heavy execution. Such faultily designed policy, even if well implemented by a bureaucracy or a party, soon loses momentum. Mao Tse Tung's 'Great Leap Forward' in China in the 1950s might be such an example. Another example from India and elsewhere might be insistence on forcible population control in the 1970s and insistence on large dams causing massive displacement and dispossession. Asia has had its share of such 'authoritarian high modernism' associated with undertaking giant projects due to bureaucratic over-simplification in centralized decision making (Scott 1998).

On the other hand, the problem is avoided only in the idealized model of a perfectly competitive market. With numerous atomistic individuals having no price-setting power and working in a complete set of future markets that avoids all hazards of uncertainty, the market economy settles to a Pareto optimal equilibrium (Debreu 1953). Unfortunately, however, this construction begs most real-life questions. And yet, this ideologically powerful but unrealistic view of the market economy continues to dominate development discourse with its implied message that government intervention is necessarily counter-productive, and that 'leaving it to the market' with a minimalist state is the best policy option.

In reality, however, both the state and the market are open to manipulative abuses of power, and the design of economic policy has to start by escaping the simplistic binary choice between the state and the market. Counter-posing the state and the market in a 'double movement' for balance against excesses by either is desirable (Polanyi 1944), but has the strong possibility of one persistently overpowering the other in many political circumstances. We need to explore alternatives in decentralization particularly in constitutional democracies of large countries. This means bringing communities more directly into decision making in a wider three-tier federal structure. The counter-argument that there is a large trade-off between efficiency and decentralization is often fictitious. A centralized large dam or a nuclear power project run by a few highly skilled technocrats may appear more efficient, but a larger number of smaller projects for water or unconventional sources of power management that allow greater community participation may turn out to be more efficient in practice due to their greater flexibility and suitability to local conditions.

The basic logic for decentralization in large countries where the central power is distant and remote is to incorporate implementability into the plan, because success often eludes without the involvement of the interested local community. The state would still have the role of coordinating, resolving disputes, providing assistance to less able communities, and preventing elite capture of local institutions. However, the paradigm of macroeconomic policies for development has the important task of placing the institutions of the state, the market, and the decentralized communities in an effective functioning arrangement. Although the extent to which this is feasible remains an open issue and the jury is still out, not always with a favourable verdict (Crook and Manor 1998; Bardhan and Mukherjee 2006; Brancati 2006), the undeniable importance of the issue in the light of experience requires its integration into the macroeconomic thinking about development.

The problem may be approached from three different angles. The first challenge is creating powerful group incentives for development without leaving it either to the market mechanism or a distant authoritarian bureaucracy. The biggest obstacle is that groups are divided by opposing interests of gender, caste, and religion, which is indeed a replica of society. Typically, such incentives are more likely to be effective when they do not come into sharp conflict with other sectional interests. Perhaps the clearest example of this has been the preservation of forests and the environment by local participants against a few profit-seeking outside contractors. Other examples are the local rather than centralized storage of grains, nurseries suited to local environments, and water conservation. Indeed, during the extensive growth phase of labour utilization, such decentralization may be more effective and less authoritarian. The market solution has often meant the familiar 'free rider' problem and the tragedy of the commons, which would also appear here. Decentralized planning is not merely the intermediate level of planning between the state and market, but a way of exploring how to find the maximum feasible level of achieving direct democracy in developmental projects by raising awareness of the rights and self-regulating capability of citizens against free-riding.

The second challenge lies in dealing with the typical failures of centralized bureaucracy for the delivery of basic needs in areas such as public distribution of food, education, health, housing, child care, and old age insurance. The opposite failure of the market is most glaring in poor countries where poorer sections are excluded through the price mechanism, denying them access to basic needs. This is the same market logic of 'one dollar one vote' that discourages the production of the most needed goods, such as safe drinking water, basic preventive medicines, and health care, because they are unprofitable. To counter such exclusion, decentralization could be designed to provide new concepts in macroeconomic policies, like the concept of social rather than private wages paid in terms of improved community services in elementary and preventive local health care, facilities for child and old age care, and better local common schooling. They typically provide labour-intensive employment and greatly help poorer members of the community in particular. One very important characteristic of a social wage that is seldom stressed is that it can achieve a very high degree of incentive compatibility between the provider and the user of these goods and services, and might avoid many of the abuses (e.g. asymmetric information) of either an anonymous bureaucratic or market system. Similarly, community needs are often better served by small and medium local firms, rather than multinational large firms.

Finally, both capitalist multi-party democracies as well as more authoritarian one-party democracies are increasingly showing tendencies of converging in so far as interests of large corporations are concerned. They span diverse areas like globalization of trade, investment and finance, obsessive concern with international competitiveness, and neglect of employment for higher labour productivity through acquisition of latest technology, etc. The rules of the game are increasingly biased in favour of corporations to the neglect of traditional knowledge and local possibilities. Strengthening communities through greater awareness of their duties and rights and use of community traditional knowledge through participation in the development process can at least partly act as countervailing power. Some would say this has become almost a compulsion of our time. And, this perhaps is the most pressing justification for exploring the role of decentralization in the more conventional state versus market debate.

9 Economic and social inequality

The oft-told story of a Latin American military dictator who reported to the American president that his country's economy was doing well, but not its people, sums up the usual consequences of the strategy of 'growth at any cost'. The strategy suits large corporations more than the people because the benefits of growth do not automatically trickle down in the absence of supporting policies. Slow growth in formal employment, livelihood-destroying policies and transferring of common resources to incentivize corporate investment enormously increased corporate wealth, but at the cost of higher inequality. Both China and India witnessed unprecedented growth in their GDPs along with significant increases in inequality of income and wealth during the same period. And yet, several other Asian experiences have shown that reasonably stable income distribution, with social mobility through measures like initial land reform, improved public health, and education along with labour-intensive infrastructure for generating employment created preconditions for high growth. An almost exclusive focus on labour productivity and reduction of unit cost without concern for employment level impose severe restriction on the home market, pushing economies towards the foreign market.

In this zero-sum game of increasing market share, even the losers, due to their dependence on large multinational corporations, tend to forget the importance of enlarging the home market through greater income equality by raising the level of employment. Instead, social inequality of various kinds based on caste, race, gender, ethnicity, region, and religion tend to increase in situations of shrinking employment and income opportunities. Gender equality suffers greatly, as evidenced in the Indian case, in a disproportionately large fall in the participation rate of women in the work force in times of shrinking employment opportunities. Under pressures of legitimization by the majority or dominant minority, government follows discriminatory policies to create loyalties. Examples are conflicts in Sri Lanka (Tamil–Singala), India (caste-based reservation), Pakistan (sect-based religious conflicts) in contrast to multi-ethnic, multi-cultural Singapore or Malaysia where similar traditional tensions decreased with greater prosperity. Democratic multi-party politics often has the unfortunate tendency to magnify such tensions, while the one-party totalitarian solution is suppression by force. And yet, rapid employment generation creating social mobility is seldom considered as part of the solution. 'Structural' anthropology suggests that tensions of different cultures are often subsumed under wider governing principles like the linked kinship system (Levi-Strauss 1963). Increased local employment opportunities under decentralization, which also reduce alienation, and family separation of migrant workers could be an important component of a similar governing principle.

Several Asian experiences point to the importance of health care, education, land reform, and infrastructure as ways of moving towards more equitable development. And yet, these are necessary but not sufficient conditions for social cohesion or development. For instance, some Central Asian countries of the former Soviet Union which had attained many of these conditions have not yet been on a trajectory of sustained development. In particular, their examples show that human capital development through education under the former Soviet regime did not lead to realization of productive potential in the absence of an adequate market on the demand side. Creating better supply conditions including human capital development is like making more powerful boats. It is not useful unless there is enough water in the river. Myrdal's observation sums it up: 'Supply does not create its own demand, while demand does not call forth its own supply' (Myrdal 1977: 227). In more successful cases, the state played a key role in matching demand with supply measures according to its political economy pre-disposition. The mixing market forces with monetary, fiscal, and exchange rate policies of the state often focused on investment and directly undertook public investment for economic and social infrastructural development, while guiding the volume, pattern, and timing of private investment. The idea of 'crowding out' of private investment by public investment and blanket rules of a ceiling on fiscal deficit or public debt found little support.

Based on the experiences of East and South East Asian countries, even if industrialization is considered to be at the core of the process of development, the importance of manufacturing must be put into proper perspective. Macro policy framework must not overlook either the need for developmental prerequisites or the unfolding negative implications for employment and the environment of corporate-led emphasis on growth of manufacturing. Nevertheless, creating the prerequisites of development often runs the danger of a 'managed' democracy with paternalistic overtones. Several economically successful Asian countries have had this experience, from which some are gradually finding their way out, while in the worst cases paternalism persists without the developmental prerequisites. Greater income equality coexisting with relatively less-developed political rights faces increasing tension. While multi-party democracies in South Asia might appear better at protecting the political rights of ordinary citizens, their economic rights are diminished greatly by massive poverty and social inequality magnified by competition for capturing votes at election times. Thus, the challenge of how best to combine economic with political and social, especially gender, equality continues in Asia.

10 Concluding observations

Increasing inequality of income and wealth presents serious problems along the trajectory of development. The tensions generated are not only political and social, but also economic. Even if matching demand with supply is accepted as a general principle in macroeconomic policies, increased inequality in favour of the rich tends to shrink the size of the domestic market because the rich save more in financial assets and on up-market imported goods. Both are detrimental to the expansion of the volume as well as the demand pattern in a poor country.

In relatively large South Asian countries such as India, Bangladesh, and Pakistan, the priority must be to utilize particularly rural labour more effectively as much as possible in rural areas without following the conventional wisdom that industrialization led by corporations with external market orientation would someday solve the problem. Under democratic accountability at regular intervals of elections, the time permitted to any elected government is not compatible with this macroeconomic strategy because labour absorption in high productivity industry, even if it happens, is a much slower process. The compulsions for democratic legitimization without moving towards authoritarianism require shifting attention to the domestic market and production of goods needed by ordinary citizens. This is how macroeconomic policies might hope to bring a closer together economic, political, and social equality. However, this requires providing rural areas with better production and earning opportunities, necessitating at least some reforms in land use and ownership rights coupled with land-improving investments for small scale agriculture.

Whenever necessary, this has to be supplemented by public works providing electricity, infrastructure, and connectivity, but as far as possible on a decentralized basis with smaller, short-yielding, locally operated projects by smaller firms. It would absorb the maximum amount of labour in the shortest possible time.

However, even within the same region of South Asia, the policy mix has to be different for small countries with relatively small domestic markets like Sri Lanka, Maldives, and land-locked Nepal. They have to rely more on imports and devise ways of increasing their export earnings through location advantages in international supply chains, tourism, and exploitation of forest and marine resources, accompanied by development of food- and other natural resource-processing industries. When they are able to meet this challenge like some of the smaller South East and East Asian countries, they will have a road map pointing to outward-oriented, export-led development.

As a general rule, instead of obsessive concern for catching up with the industrially advanced countries through greater international competitiveness, the focus of industrial policy should be on producing goods compatible with the purchasing power of the ordinary people in the domestic market and its up-gradation through improved technology. Macroeconomic policies for industrialization have to reckon with the problem of producing improved quality goods for the domestic market in poor countries where the vast majority have purchasing power far below the international standard. Otherwise, wrong policies will be promoting inequality by concentrating investible resources on a composition of goods biased in favour of the richer sections, even when they achieve balance between demand and supply. For an alternative macroeconomic policy paradigm, the defining issue for more equitable and inclusive development might be to view output growth as the outcome of decentralized high employment growth, rather than employment growth as the outcome of high output growth.

However, the importance of these factors will vary from case to case, depending on the specificity of the initial conditions and stage of development of a country. In East and South East Asian countries that have already achieved greater prosperity and have a greater outward orientation, the consumption pattern of ordinary citizens in many ways would be closer to that of high-income countries, and their path to industrialization and service sector development would be different. Not only catching up, but overtaking, may well become their objective. The main lesson to be learnt from the diversity of experiences of Asian countries is that inclusive development requires compatibility between the level of prosperity of average citizens in a country and the domestic production pattern which must technologically improve over time without undue concern for international image and position. It is not wise in this respect for any country to try to skip the stages of its developmental history by ignoring the majority. This is the essence of strategic but not blind integration with the global economy in terms of openness in trade, investment, and finance, as well as industrial policy and technology acquisition.

In the course of development as a historical process, the meaning and content of the notion of development must change. Recalling Wittgenstein, we might say words, utterances, as well as signs acquire their meaning not as abstractions, but through use in an appropriate 'form of live' (Wittgenstein 1958: 8–14). The word 'development' is no exception. Asian countries are a vast laboratory of living experiments with development in different ways. Some are more successful than others, but all have lessons for us. We are invited to observe this changing and fascinating scene opened to us by Gunner Myrdal half a century ago.

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