The Great Divide in the Global Village

Bruce R. Scott

INCOMES ARE DIVERGING

MAINSTREAM economic thought promises that globalization will lead to a widespread improvement in average incomes. Firms will reap increased economies of scale in a larger market, and incomes will converge as poor countries grow more rapidly than rich ones. In this "win-win" perspective, the importance of nation-states fades as the "global village" grows and market integration and prosperity take hold.

But the evidence paints a different picture. Average incomes have indeed been growing, but so has the income gap between rich and poor countries. Both trends have been evident for more than 200 years, but improved global communications have led to an increased awareness among the poor of income inequalities and heightened the pressure to emigrate to richer countries. In response, the industrialized nations have erected higher barriers against immigration, making the world economy seem more like a gated community than a global village. And although international markets for goods and capital have opened up since World War II and multilateral organizations now articulate rules and monitor the world economy, economic inequality among countries continues to increase. Some two billion people earn less than $2 per day.

At first glance, there are two causes of this divergence between economic theory and reality. First, the rich countries insist on barriers to immigration and agricultural imports. Second, most poor nations have been unable to attract much foreign capital due to their own

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government failings. These two issues are fundamentally linked: by forcing poor people to remain in badly governed states, immigration barriers deny those most in need the opportunity to "move up" by "moving out." In turn, that immobility eliminates a potential source of pressure on ineffective governments, thus facilitating their survival.

Since the rich countries are unlikely to lower their agricultural and immigration barriers significantly, they must recognize that politics is a key cause of economic inequality. And since most developing countries receive little foreign investment, the wealthy nations must also acknowledge that the "Washington consensus," which assumes that free markets will bring about economic convergence, is mistaken. If they at least admit these realities, they will abandon the notion that their own particular strategies are the best for all countries. In turn, they should allow poorer countries considerable freedom to tailor development strategies to their own circumstances. In this more pragmatic view, the role of the state becomes pivotal.

Why have economists and policymakers not come to these conclusions sooner? Since the barriers erected by rich countries are seen as vital to political stability, leaders of those countries find it convenient to overlook them and focus instead on the part of the global economy that has been liberalized. The rich countries' political power in multilateral organizations makes it difficult for developing nations to challenge this self-serving world-view. And standard academic solutions may do as much harm as good, given their focus on economic stability and growth rather than on the institutions that underpin markets. Economic theory has ignored the political issues at stake in modernizing institutions, incorrectly assuming that market-based prices can allocate resources appropriately.

The fiasco of reform in Russia has forced a belated reappraisal of this blind trust in markets. Many observers now admit that the transition economies needed appropriate property rights and an effective state to enforce those rights as much as they needed the liberalization of prices. Indeed, liberalization without property rights turned out to be the path to gangsterism, not capitalism. China, with a more effective state, achieved much greater success in its transition than did Russia, even though Beijing proceeded much more slowly with liberalization and privatization.

Economic development requires the transformation of institutions as well as the freeing of prices, which in turn requires political and social modernization as well as economic reform. The state plays a key role in this process; without it, developmental strategies have little hope of succeeding. The creation of effective states in the developing world will not be driven by familiar market forces, even if pressures from capital markets can force fiscal and monetary discipline. And in a world still governed by "states rights," real progress in achieving accountable governments will require reforms beyond the mandates of multilateral institutions.

GO WITH THE FLOW

IN THEORY, globalization provides an opportunity to raise incomes through increased specialization and trade. This opportunity is conditioned by the size of the markets in question, which in turn depends on geography, transportation costs, communication networks, and the institutions that underpin markets. Free trade increases both the size of the market and the pressure to improve economic performance. Those who are most competitive take advantage of the enhanced market opportunities to survive and prosper.

Neoclassical economic theory predicts that poor countries should grow faster than rich ones in a free global market. Capital from rich nations in search of cheaper labor should flow to poorer economies, and labor should migrate from low-income areas toward those with higher wages. As a result, labor and capital costs—and eventually income—in rich and poor areas should eventually converge.

The U.S. economy demonstrates how this theory can work in a free market with the appropriate institutions. Since the 1880s, a remarkable convergence of incomes among the country's regions has occurred. The European Union has witnessed a similar phenomenon, with the exceptions of Greece and Italy's southern half, the *Mezzogiorno.* What is important, however, is that both America and the EU enjoy labor and capital mobility as well as free internal trade.

But the rest of the world does not fit this pattern. The most recent *World Development Report* shows that real per capita incomes for the richest one-third of countries rose by an annual 1.9 percent between

1970 and 1995, whereas the middle third went up by only 0.7 percent and the bottom third showed no increase at all. In the Western industrial nations and Japan alone, average real incomes have been rising about 2.5 percent annually since 1950—a fact that further accentuates the divergence of global income. These rich countries account for about 60 percent of world GDP but only 15 percent of world population.

Why is it that the poor countries continue to fall further behind? One key reason is that most rich countries have largely excluded the international flow of labor into their markets since the interwar period. As a result, low-skilled labor is not free to flow across international boundaries in search of more lucrative jobs. From an American or European perspective, immigration appears to have risen in recent years, even approaching its previous peak of a century ago in the United States. Although true, this comparison misses the central point. Billions of poor people could improve their standard of living by migrating to rich countries. But in 1997, the United States allowed in only 737,000 immigrants from developing nations, while Europe admitted about 665,000. Taken together, these flows are only 0.04 percent of all potential immigrants.

Global markets offer opportunities for all, but opportunities do not guarantee results.

The point is not that the rich countries should permit unfettered immigration. A huge influx of cheap labor would no doubt be politically explosive; many European countries have already curtailed immigration from poor countries for fear of a severe backlash. But the more salient issue is that rich nations who laud liberalism and free markets are rejecting those very principles when they restrict freedom of movement. The same goes for agricultural imports. Both Europe and Japan have high trade barriers in agriculture, while the United States remains modestly protectionist.

Mainstream economic theory does provide a partial rationalization for rich-country protectionism: Immigration barriers need not be a major handicap to poor nations because they can be offset by capital flows from industrialized economies to developing ones. In other words, poor people need not demand space in rich countries because the rich will send their capital to help develop the poor countries.

This was indeed the case before World War I, but it has not been so since World War II.

But the question of direct investment, which typically brings technologies and know-how as well as financial capital, is more complicated than theories would predict. The total stock of foreign direct investment did rise almost sevenfold from 1980 to 1997, increasing from 4 percent to 12 percent of world GDP during that period. But very little has gone to the poorest countries. In 1997, about 70 percent went from one rich country to another, 8 developing countries received about 20 percent, and the remainder was divided among more than 100 poor nations. According to the World Bank, the truly poor countries received less than 7 percent of the foreign direct investment to all developing countries in 1992–98. At the same time, the unrestricted opening of capital markets in developing countries gives larger firms from rich countries the opportunity for takeovers that are reminiscent of colonialism. It is not accidental that rich countries insist on open markets where they have an advantage and barriers in agriculture and immigration, where they would be at a disadvantage.

As for the Asian "tigers," their strong growth is due largely to their high savings rate, not foreign capital. Singapore stands out because it has enjoyed a great deal of foreign investment, but it has also achieved one of the highest domestic-savings rates in the world, and its government has been a leading influence on the use of these funds. China is now repeating this pattern, with a savings rate of almost 40 percent of GDP. This factor, along with domestic credit creation, has been its key motor of economic growth. China now holds more than $100 billion in low-yielding foreign-exchange reserves, the second largest reserves in the world.

In short, global markets offer opportunities for all, but opportunities do not guarantee results. Most poor countries have been unable to avail themselves of much foreign capital or to take advantage of increased market access. True, these countries have raised their trade ratios (exports plus imports) from about 35 percent of their GDP in 1981 to almost 50 percent in 1997. But without the Asian tigers, developing-country exports remain less than 25 percent of world exports.

Part of the problem is that the traditional advantages of poor countries have been in primary commodities (agriculture and minerals), and these categories have shrunk from about 70 percent of world trade

in 1900 to about 20 percent at the end of the century. Opportunities for growth in the world market have shifted from raw or semiprocessed commodities toward manufactured goods and services—and, within these categories, toward more knowledge-intensive segments. This trend obviously favors rich countries over poor ones, since most of the latter are still peripheral players in the knowledge economy. (Again, the Asian tigers are the exception. In 1995, they exported as much in high-technology goods as did France, Germany, Italy, and Britain combined—which together have three times the population of the tigers.)

ONE COUNTRY, TWO SYSTEMS

WHY is the performance of poor countries so uneven and out of sync with theoretical forecasts? Systemic barriers at home and abroad inhibit the economic potential of poorer nations, the most formidable of these obstacles being their own domestic political and administrative problems. These factors, of course, lie outside the framework of mainstream economic analysis. A useful analogy is the antebellum economy of the United States, which experienced a similar set of impediments.

Like today's "global village," the U.S. economy before the Civil War saw incomes diverge as the South fell behind the North. One reason for the Confederacy's secession and the resulting civil war was Southern recognition that it was falling behind in both economic and political power, while the richer and more populous North was attracting more immigrants. Half of the U.S. population lived in the North in 1780; by 1860, this share had climbed to two-thirds. In 1775, incomes in the five original Southern states equaled those in New England, even though wealth (including slaves) was disproportionately concentrated in the South. By 1840, incomes in the northeast were about 50 percent higher than those in the original Southern states; the North's railroad mileage was about 40 percent greater (and manufacturing investment four times higher) than the South's. As the economist Robert Fogel has pointed out, the South was not poor—in 1860 it was richer than all European states except England—but Northern incomes were still much higher and increasing.

Why had Southern incomes diverged from those in the North under the same government, laws, and economy? Almost from their

inception, the Southern colonies followed a different path from the North—specializing in plantation agriculture rather than small farms with diversified crops—due to geography and slavery. Thanks to slave labor, Southerners were gaining economies of scale and building comparative advantage in agriculture, exporting their goods to world markets and the North. Gang labor outproduced "free" (paid) labor. But the North was building even greater advantages by developing a middle class, a manufacturing sector, and a more modern social and political culture. With plans to complete transcontinental railroads pending, the North was on the verge of achieving economic and political dominance and the capacity to shut off further expansion of slavery in the West. The South chose war over Northern domination—and modernization.

Although the Constitution guaranteed free trade and free movement of capital and labor, the institution of slavery meant that the South had much less factor mobility than the North. It also ensured less development of its human resources, a less equal distribution of income, a smaller market for manufactures, and a less dynamic economy. It was less attractive to both European immigrants and external capital. With stagnant incomes in the older states, it was falling behind. In these respects, it was a forerunner of many of today's poor countries, especially those in Latin America.

What finally put the South on the path to economic convergence? Four years of civil war with a total of 600,000 deaths and vast destruction of property were only a start. Three constitutional amendments and twelve years of military "reconstruction" were designed to bring equal rights and due process to the South. But the reestablishment of racial segregation following Reconstruction led to sharecropping as former slaves refused to return to the work gangs. Labor productivity dropped so much that Southern incomes fell to about half of the North's in 1880. In fact, income convergence did not take off until the 1940s, when a wartime boom in the North's industrial cities attracted Southern migrants in search of better jobs. At the same time, the South began drawing capital as firms sought lower wages, an anti-union environment, and military contracts in important congressional districts. But this process did not fully succeed until the 1960s, as new federal laws and federal troops brought full civil rights to the South and ensured that the region could finally modernize.

THE GREAT DIVIDE

ALTHOUGH slavery is a rarity today, the traditional U.S. divide between North and South provides a good model for understanding contemporary circumstances in many developing countries. In the American South, voter intimidation, segregated housing, and very unequal schooling were the rule, not the exception—and such tactics are repeated today by the elites in today's poor countries. Brazil, Mexico, and Peru had abundant land relative to population when the Europeans arrived, and their incomes roughly approximated those in North America, at least until 1700. The economists Stanley Engerman and Kenneth Sokoloff have pointed out that these states, like the Confederacy, developed agricultural systems based on vast landholdings for the production of export crops such as sugar and coffee. Brazil and many Caribbean islands also adopted slavery, while Peru and Mexico relied on forced indigenous labor rather than African slaves.

History shows that the political development of North America and developing nations—most of which were colonized by Europeans at some point—was heavily influenced by mortality. In colonies with tolerable death rates (Australia, Canada, New Zealand, and the United States), the colonists soon exerted pressure for British-style protections of persons and property. But elsewhere (most of Africa, Latin America, Indonesia, and to a lesser degree, India), disease caused such high mortality rates that the few resident Europeans were permitted to exploit a disenfranchised laboring class, whether slave or free. When the colonial era ended in these regions, it was followed by "liberationist" regimes (often authoritarian and incompetent) that maintained the previous system of exploitation for the advantage of a small domestic elite. Existing inequalities within poor countries continued; policies and institutions rarely protected individual rights or private initiative for the bulk of the population and allowed elites to skim off rents from any sectors that could bear it. The economist Hernando de Soto has shown how governments in the developing world fail to recognize poor citizens' legal titles to their homes and businesses, thereby depriving them of the use of their assets for collateral. The losses in potential capital to these countries have dwarfed the cumulative capital inflows going to these economies in the last century.

The legacy of these colonial systems also tends to perpetuate the unequal distribution of income, wealth, and political power while limiting capital mobility. Thus major developing nations such as Brazil, China, India, Indonesia, and Mexico are experiencing a divergence of incomes by province within their economies, as labor and capital fail to find better opportunities. Even in recent times, local elites have fought to maintain oppressive conditions in Brazil, El Salvador, Guatemala, Mexico, Nicaragua, and Peru. Faced with violent intimidation, poor people in these countries have suffered from unjust law enforcement similar to what was once experienced by black sharecroppers in the American South.

Modernization and economic development inevitably threaten the existing distribution of power and income, and powerful elites continue to protect the status quo—even if it means that their society as a whole falls further behind. It takes more than a constitution, universal suffrage, and regular elections to achieve governmental accountability and the rule of law. It may well be that only the right of exit—emigration—can peacefully bring accountability to corrupt and repressive regimes. Unlike the U.S. federal government, multilateral institutions lack the legitimacy to intervene in the internal affairs of most countries. Europe's economic takeoff in the second half of the nineteenth century was aided by the emigration of 60 million people to North America, Argentina, Brazil, and Australia. This emigration—about 10 percent of the labor force—helped raise European wages while depressing inflated wages in labor-scarce areas such as Australia and the United States. A comparable out-migration of labor from today's poor countries would involve hundreds of millions of people.

Of course, Latin America has seen some success. Chile has received the most attention for its free market initiatives, but its reforms were implemented by a brutally repressive military regime—hardly a model for achieving economic reform through democratic processes. Costa Rica would seem to be a much better model for establishing accountability, but its economic performance has not been as striking as Chile's.

Italy, like the United States in an earlier era, is another good example of "one country, two systems." Italy's per capita income has largely caught up with that of its European neighbors over the past 20 years, even exceeding Britain's and equaling France's in 1990, but its *Mezzogiorno*

has failed to keep up. Whereas overall Italian incomes have been converging toward those of the EU, *Mezzogiorno* incomes have been diverging from those in the north. Southern incomes fell from 65 percent of the northern average in 1975 to 56 percent 20 years later; in Calabria, they fell to 47 percent of the northern average. Southern unemployment rose from 8 percent in 1975 to 19 percent in 1995—almost three times the northern average. In short, 50 years of subsidies from Rome and the EU have failed to stop the *Mezzogiorno* from falling further behind. Instead, they have yielded local regimes characterized by greatly increased public-sector employment, patronage, dependency, and corruption—not unlike the results of foreign aid for developing countries. And the continuing existence of the Mafia further challenges modernization.

Democracy is not enough to ensure that the governed reap the gains of their efforts.

Democracy, then, is not enough to ensure that the governed are allowed to reap the gains of their own efforts. An effective state requires good laws as well as law enforcement that is timely, even-handed, and accessible to the poor. In many countries, achieving objective law enforcement means reducing the extralegal powers of vested interests. When this is not possible, the only recourse usually available is emigration. But if the educated elite manages to emigrate while the masses remain trapped in a society that is short of leaders, the latter will face even more formidable odds as they try to create effective institutions and policies. Although Italians still emigrate from south to north, the size of this flow is declining, thanks in part to generous transfer payments that allow them to consume almost as much as northerners. In addition, policymaking for the *Mezzogiorno* is still concentrated in Rome.

The immigration barriers in rich countries not only foreclose opportunities in the global village to billions of poor people, they help support repressive, pseudodemocratic governments by denying the citizens of these countries the right to vote against the regime with their feet. In effect, the strict dictates of sovereignty allow wealthy nations to continue to set the rules in their own favor while allowing badly governed poor nations to continue to abuse their own citizens

and retard economic development. Hence the remedy for income divergence must be political as well as economic.

GETTING INSTITUTIONS RIGHT

ACCORDING TO ECONOMIC THEORY, developing nations will create and modernize the institutions needed to underpin their markets so that their markets and firms can gradually match the performance of rich countries. But reality is much more complex than theory. For example, de Soto's analysis makes clear that effectively mobilizing domestic resources offers a much more potent source of capital for most developing nations than foreign inflows do. Yet mainstream economists and their formal models largely ignore these resources. Western economic advisers in Russia were similarly blindsided by their reliance on an economic model that had no institutional context and no historical perspective. Economists have scrambled in recent years to correct some of these shortcomings, and the Washington consensus now requires the "right" institutions as well as the "right" prices. But little useful theory exists to guide policy when it comes to institutional analysis, and gaps in the institutional foundations in most developing countries leave economic models pursuing unrealistic solutions or worse.

The adjustment of institutions inevitably favors certain actors and disadvantages others. As a result, modernization causes conflict that must be resolved through politics as well as economics. At a minimum, successful development signifies that the forces for institutional change have won out over the status quo. Achieving a "level playing field" signifies that regulatory and political competition is well governed.

Economists who suggest that all countries must adopt Western institutions to achieve Western levels of income often fail to consider the changes and political risks involved. The experts who recommended that formerly communist countries apply "shock therapy" to markets and democracy disregarded the political and regulatory issues involved. Each change requires a victory in the "legislative market" and successful persuasion within the state bureaucracy for political approval. Countries with lower incomes and fewer educated people than Russia face even more significant developmental challenges just to achieve economic

stability, let alone attract foreign investment or make effective use of it. Institutional deficiencies, not capital shortages, are the major impediment to development, and as such they must be addressed before foreign investors will be willing to send in capital.

Although price liberalization can be undertaken rapidly, no rapid process (aside from revolution) exists for an economy modernizing its institutions. Boris Yeltsin may be credited with a remarkable turnover, if not a coup d'état, but his erratic management style and the lack of parliamentary support ensured that his government would never be strong. In these circumstances, helping the new Russian regime improve law enforcement should have come ahead of mass privatization. Launching capitalism in a country where no one other than apparatchiks had access to significant amounts of capital was an open invitation to gangsterism and a discredited system. Naive economic models made for naive policy recommendations.

HOW THE WEST WON

THE STATE'S crucial role is evident in the West's economic development. European economic supremacy was forged not by actors who followed a "Washington consensus" model but by strong states. In the fifteenth century, European incomes were not much higher than those in China, India, or Japan. The nation-state was a European innovation that replaced feudalism and established the rule of law; in turn, a legal framework was formed for effective markets. Once these countries were in the lead, they were able to continuously increase their edge through technological advances. In addition, European settlers took their civilization with them to North America and the South Pacific, rapidly raising these areas to rich-country status as well. Thus Europe's early lead became the basis for accumulating further advantages with far-reaching implications.

Europe's rise to economic leadership was not rapid at first. According to the economist Angus Maddison, Europe's economy grew around 0.07 percent a year until 1700; only after 1820 did it reach one percent. But the pace of technological and institutional innovation accelerated thereafter. Meanwhile, discovery of new markets in Africa, Asia, and the Americas created new economic opportunities. Secular political

forces overthrew the hegemony of the Catholic Church. Feudalism was eroded by rising incomes and replaced by a system that financed government through taxes, freeing up land and labor to be traded in markets. Markets permitted a more efficient reallocation of land and labor, allowing further rises in incomes. Effective property rights allowed individuals to keep the fruits of their own labor, thereby encouraging additional work. And privatization of common land facilitated the clearing of additional acreage.

The nation-state helped forge all these improvements. It opened up markets by expanding territory; reduced transaction costs; standardized weights, measures, and monetary units; and cut transport costs by improving roads, harbors, and canals. In addition, it was the state that established effective property rights. The European state system thrived on flexible alliances, which constantly changed to maintain a balance of power. Military and economic rivalries prompted states to promote development in agriculture and commerce as well as technological innovation in areas such as shipping and weaponry. Absent the hegemony of a single church or state, technology was diffused and secularized. Clocks, for instance, transferred timekeeping from the monastery to the village clock tower; the printing press did much the same for the production and distribution of books.

Europe's development contrasts sharply with Asia's. In the early modern era, China saw itself as the center of the world, without real rivals. It had a much larger population than Europe and a far bigger market as well. But though the Chinese pioneered the development of clocks, the printing press, gunpowder, and iron, they did not have the external competitive stimulus to promote economic development. Meanwhile, Japan sealed itself off from external influences for more than 200 years, while India, which had continuous competition within the subcontinent, never developed an effective national state prior to the colonial era.

The Europeans also led in establishing accountable government, even though it was achieved neither easily nor peacefully. Most European states developed the notion that the sovereign (whether a monarch or a parliament) had a duty to protect subjects and property in return for taxes and service in the army. Rulers in the Qing, Mughal, and Ottoman Empires, in contrast, never recognized a comparable

responsibility to their subjects. During the Middle Ages, Italy produced a number of quasi-democratic city-states, and in the seventeenth century Holland created the first modern republic after a century of rebellion and warfare with Spain. Britain achieved constitutional monarchy in 1689, following two revolutions. After a bloody revolution and then dictatorship, France achieved accountable government in the nineteenth century.

Europe led the way in separating church and state—an essential precursor to free inquiry and adoption of the scientific method—after the Thirty Years' War. The secular state in turn paved the way for capitalism and its "creative destruction." Creative destruction could hardly become the norm until organized religion lost its power to execute as heretics those entrepreneurs who would upset the status quo. After the Reformation, Europeans soon recognized another fundamental tenet of capitalism: the role of interest as a return for the use of capital. Capitalism required that political leaders allow private hands to hold power as well as wealth; in turn, power flowed from the rural nobility to merchants in cities. European states also permitted banks, insurance firms, and stock markets to develop. The "yeast" in this recipe lay in the notion that private as well as state organizations could mobilize and reallocate society's resources—an idea with profound social, political, and economic implications today.

Europe led in establishing accountable government, although it was not easy or peaceful.

Most of Europe's leading powers did not rely on private initiative alone but adopted mercantilism to promote their development. This strategy used state power to create a trading system that would raise national income, permitting the government to enhance its own power through additional taxes. Even though corruption was sometimes a side effect, the system generally worked well. Venice was the early leader, from about 1000 to 1500; the Dutch followed in the sixteenth and seventeenth centuries; Britain became dominant in the eighteenth century. In Britain, as in the other cases, mercantilist export promotion was associated with a dramatic rise in state spending and employment (especially in the navy), as well as "crony capitalism." After World War II, export-promotion regimes were adopted by Japan, South Korea, Singapore, and Taiwan

with similar success. Today, of course, such strategies are condemned as violations of global trade rules, even for poor countries.

Finally, geography played a pivotal role in Europe's rise, providing a temperate climate, navigable rivers, accessible coastline, and defensible boundaries for future states. In addition, Europe lacked the conditions for the production of labor-intensive commodities such as coffee, cotton, sugar, or tobacco—production that might have induced the establishment of slavery. Like in the American North, European agriculture was largely rain-fed, diversified, and small-scale.

Europe's rise, then, was partly due to the creation and diffusion of technological innovations and the gradual accumulation of capital. But the underlying causes were political and social. The creation of the nation-state and institutionalized state rivalry fostered government accountability. Scientific enlightenment and upward social mobility, spurred by healthy competition, also helped Europe achieve such transformations. But many of today's developing countries still lack these factors crucial for economic transformation.

PLAYING CATCH-UP

GLOBALIZATION offers opportunities for all nations, but most developing countries are very poorly positioned to capitalize on them. Malarial climates, limited access to navigable water, long distances to major markets, and unchecked population growth are only part of the problem. Such countries also have very unequal income structures inherited from colonial regimes, and these patterns of income distribution are hard to change unless prompted by a major upheaval such as a war or a revolution. But as serious as these disadvantages are, the greatest disadvantage has been the poor quality of government.

If today's global opportunities are far greater and potentially more accessible than at any other time in world history, developing countries are also further behind than ever before. Realistic political logic suggests that weak governments need to show that they can manage their affairs much better before they pretend to have strategic ambitions. So what kind of catch-up models could they adopt?

Substituting domestic goods for imports was the most popular route to economic development prior to the 1980s. But its inward

orientation made those who adopted it unable to take advantage of the new global opportunities and ultimately it led to a dead end. Although the United States enjoyed success with such a strategy from 1790 until 1940, no developing country has a home market large enough to support a modern economy today. The other successful early growth model was European mercantilism, namely export promotion, as pioneered by Venice, the Dutch republic, Britain, and Germany. Almost all of the East Asian success stories, China included, are modern versions of the export-oriented form of mercantilism.

For its part, free trade remains the right model for rich countries because it provides decentralized initiatives to search for tomorrow's market opportunities. But it does not necessarily promote development. Britain did not adopt free trade until the 1840s, long after it had become the world's leading industrial power. The prescription of lower trade barriers may help avoid even worse strategies at the hands of bad governments, but the Washington-consensus model remains best suited for those who are ahead rather than behind.

Today's shareholder capitalism brings additional threats to poor countries, first by elevating compensation for successful executives, and second by subordinating all activities to those that maximize shareholder value. Since 1970, the estimated earnings of an American chief executive have gone from 30 times to 450 times that of the average worker. In the leading developing countries, this ratio is still less than 50. Applying a similar "market-friendly" rise in executive compensation within the developing world would therefore only aggravate the income gap, providing new ammunition for populist politicians. In addition, shareholder capitalism calls for narrowing the managerial focus to the interests of shareholders, even if this means dropping activities that offset local market imperfections. A leading South African bank has shed almost a million small accounts—mostly held by blacks—to raise its earnings per share. Should this bank, like its American counterparts, have an obligation to serve its community, including its black members, in return for its banking license?

Poor nations must improve the effectiveness of their institutions and bureaucracies in spite of entrenched opposition and poorly paid civil servants. As the journalist Thomas Friedman has pointed out, it is true that foreign-exchange traders can dump the currencies of poorly

managed countries, thereby helping discipline governments to restrain their fiscal deficits and lax monetary policies. But currency pressures will not influence the feudal systems in Pakistan and Saudi Arabia, the theocracies in Afghanistan and Iran, or the kleptocracies in Kenya or southern Mexico. The forces of capital markets will not restrain Brazilian squatters as they take possession of "public lands" or the slums of Rio de Janeiro or São Paulo, nor will they help discipline landlords and vigilantes in India's Bihar as they fight for control of their state. Only strong, accountable government can do that.

LOOKING AHEAD

INCREASED TRADE and investment have indeed brought great improvements in some countries, but the global economy is hardly a win-win situation. Roughly one billion people earn less than $1 per day, and their numbers are growing. Economic resources to ameliorate such problems exist, but the political and administrative will to realize the potential of these resources in poor areas is lacking. Developing-nation governments need both the pressure to reform their administrations and institutions, and the access to help in doing so. But sovereignty removes much of the external pressure, while immigration barriers reduce key internal motivation. And the Washington consensus on the universality of the rich-country model is both simplistic and self-serving.

The world needs a more pragmatic, country-by-country approach, with room for neomercantilist regimes until such countries are firmly on the convergence track. Poor nations should be allowed to do what today's rich countries did to get ahead, not be forced to adopt the laissez-faire approach. Insisting on the merits of comparative advantage in low-wage, low-growth industries is a sure way to stay poor. And continued poverty will lead to rising levels of illegal immigration and low-level violence, such as kidnappings and vigilante justice, as the poor take the only options that remain. Over time, the rich countries will be forced to pay more attention to the fortunes of the poor—if only to enjoy their own prosperity and safety.

Still, the key initiatives must come from the poor countries, not the rich. In the last 50 years, China, India, and Indonesia have led the world in reducing poverty. In China, it took civil war and revolution,

with tens of millions of deaths, to create a strong state and economic stability; a de facto coup d'état in 1978 brought about a very fortunate change of management. The basic forces behind Chinese reform were political and domestic, and their success depended as much on better using resources as opening up markets. Meanwhile, the former Soviet Union and Africa lie at the other extreme. Their economic decline stems from their failure to maintain effective states and ensure the rule of law.

It will not be surprising if some of today's states experience failure and economic decline in the new century. Argentina, Colombia, Indonesia, and Pakistan will be obvious cases to watch, but other nations could also suffer from internal regional failures—for example, the Indian state of Bihar. Income growth depends heavily on the legal, adminsitrative, and political capabilities of public actors in sovereign states. That is why, in the end, external economic advice and aid must go beyond formal models and conform to each country's unique political and social context.