Poverty, Inequality, and Inclusive Growth in Asia

Measurement, Policy Issues, and Country Studies

Edited by

Juzhong Zhuang

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5

Inclusive Growth through Full Employment: The Role of Investment and Industrial policy

Jesus Felipe[1]

5.1 Introduction: What is inclusive growth?

While developing Asia has done remarkably well during the last 4 decades, achieved high growth, and reduced poverty significantly, Felipe and Hasan (2006) estimate that there are still about 500 million people unemployed and/or underemployed in the region. Perhaps for this reason during the last few years, terms such as "harmonious society" in the People's Republic of China (PRC), "sufficiency economy" in Thailand, and the like in other countries, have made their way into policy making discussions across Asia. The Indian government, for example, boasts of having fostered "inclusive growth". By this it means that the budget has increased allocations to school meals or rural road-building (The Economist 2008). The message in all cases is similar: development is more than growth. The high-growth policies implemented across the region since the 1960s were successful and led to increases in per capita income and dramatic reductions in poverty; helping to close the gap with the developed world. But there is a feeling today that these policies have become obsolete and citizens in Asia demand more than growth. Issues such as inequality, the environment, health, or climate change are becoming increasingly important in the agendas of policy makers. Institutions such as the World Bank or the Asian Development Bank also acknowledge the issue and argue that growth and globalization have to be inclusive.

What is inclusive growth? Though the term has not been formally defined, Ali and Zhuang (2007) claim that a consensus is emerging as to what it means and entails, namely, "growth with equal opportunity" (Ali and Zhuang 2007). In a related paper, Ali and Son (2007) further

1 The author is grateful to Juzhong Zhuang for useful discussions, comments, and suggestions. This chapter is based on *Inclusive Growth, Full Employment, and Structural Change: Implications and Policies for Developing Asia* (Felipe 2009). The usual disclaimer applies.

argue that inclusive growth is "growth that not only creates new economic opportunities, but also one that ensures equal access to the opportunities created for all segments of society. Growth is inclusive when it allows all members of society to participate in, and contribute to, the growth process on an equal basis regardless of their individual circumstances."

This chapter discusses the implications of inclusive growth for policy making in developing Asia. If the term inclusive growth is a useful concept for developing countries, how should it be interpreted for policy purposes? What sort of policies should policy makers implement to achieve it? Can it be achieved? The central argument is that to achieve inclusive growth, governments must commit effort and resources to the pursuit of the full employment of the labor force. The most important way for a person to participate in society and contribute to its progress as a productive member is through a productive and decent job. Moreover, maintaining the economy as close as possible to full employment will lower the need to develop safety net expenditures for disadvantaged groups. Full employment is the most direct way to achieve the ultimate objective of economic policy, that is, to improve the long-run well-being of all the people in the country, especially the most disadvantaged.

This does not mean that growth is unimportant. It is fundamental for developing countries. For example, there is agreement on the close relationship between growth and structural change (Felipe and Estrada 2008, Felipe et al. 2007), and understanding the dynamics of the latter is essential to comprehending the difficulties in achieving full employment. However, there is evidence that the elasticity of employment with respect to output in many parts of Asia is not particularly high, and in some cases is decreasing (Table 5.1). What does this mean? To cite Felipe and Hasan in discussing the PRC's employment elasticity: "In the 1980s, it took 3 percentage points of growth in output to induce one percentage of increase in employment. By the 1990s, however, it took more than twice as much growth, about 7.8 percentage points, to achieve the same result" (Felipe and Hasan 2006, 113).

The expectation that labor could be released from agriculture and be rapidly absorbed by industry has largely not been realized during the last 15 years. While the share of employment in agriculture has declined in much of developing Asia, labor has found new employment in the services sector (formal or informal) in relatively low-productivity occupations in trade and personal services. In other words, it is not clear today whether a high-growth economy necessarily generates the level and quality of employment that many developing Asian countries need. And without creation of employment it will be very difficult to reduce poverty. If growth is inclusive, it has to reduce poverty; in particular, a faster decline in poverty for a given growth rate should be observed. The empirical evidence (Pasha 2007), however, indicates that, with the exception of East Asia, the degree of inclusiveness of Asian growth is relatively low. This is especially true of South Asia.

Table 5.1 Employment elasticity of growth in Asia

Economy	1980s	1990s
Bangladesh	0.550	0.495
China, People's Republic of	0.330	0.129
Indonesia	0.435	0.379
India	0.384	0.312
Korea, Republic of	0.223	0.225
Malaysia	0.683	0.406
Pakistan	0.406	0.553
Philippines	0.535	0.731
Singapore	0.375	0.711
Thailand	0.315	0.193
Taipei,China	0.242	0.139

Source: Felipe and Hasan (2006, Table 3.6).

The Philippines is a telling example. In 2007, the country registered its highest growth in decades, 7.3%. However, there is a general view that this growth is not benefiting the majority of Filipinos. Obviously, the mere quantity of economic activity—as measured by a common indicator like gross domestic product (GDP) growth—taken alone, "says virtually nothing about whether life for the common Filipino is getting better or worse. It ignores the distribution of income and makes no distinction between workers with top-paying jobs and those who can barely eke out a living. It ignores the fact, for instance, that the record remittances which make economic figures rosy have a heavy social toll in terms of broken families. The booming mining industry which the government touts has environmental costs too which should count for something when you're calculating economic balance" (Herrera 2008).

A preliminary conclusion is that policy makers should, perhaps, reverse the causality between growth and employment, and start thinking that a full employment economy has a lot of virtues, and that this is what will lead to high growth.

Section 5.2 of this chapter frames the full employment problem in the context of the discussion of the main constraint that developing countries face. This is the shortage of capital equipment and productive capacity. Section 5.3 elaborates on the virtues of full employment as an objective of policy making and argues that society makes the government responsible for its achievements. Section 5.4 discusses investment, the most important issue in achieving full employment of the labor force in

developing countries. The section also discusses the roles of the public and private sectors. Section 5.5 looks at the role of planning and industrial policy. Section 5.6 concludes.

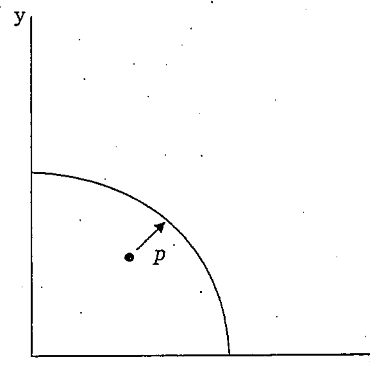
5.2 What is the main constraint developing countries face?

At the most aggregate level, the fundamental constraint of most developing countries is the unemployment/underemployment of an important segment of the labor force. Caused by the shortage of capital equipment and productive capacity, this is what constrains potential output. This view is consistent with the analyses of the classical authors. According to Kalecki (1944, 43), "if the maximum capacity of equipment is inadequate to absorb the available labor, as will be the case in backward countries, the immediate achievement of full employment is clearly hopeless." It is also in line with modern treatments such as that of Hausmann et al. (2005).

Suppose the quantities produced of two goods are represented by the transformation curve in Figure 5.1. This curve depicts the different combination of goods x and y that the economy can produce using its resources fully. But also suppose that the economy produces the combination of goods represented by point *p*, inside the curve. It is clear that in this case some of the available resources are not fully utilized (e.g., people are unemployed). Under such circumstances, growth can be achieved through increasing utilization of the country's production capacity. The country has to try to get closer to the transformation curve. This is the typical problem most developing countries suffer from.

This does not mean that developing countries do not suffer from inadequacy of effective demand or from allocative efficiency problems. Indeed they do. Effective demand problems are not entirely absent in developing countries and they can even become binding constraints on production at a fairly advanced stage of industrialization (e.g., PRC, Malaysia, Thailand).[2] Effective demand problems can also be the result of being balance-of-payments-constrained (McCombie and Thirlwall 1994). Certainly, the problem of markets, that is, that due to their small internal demand there will be no outlet for the products of the newly built factories, thus, limiting developing countries' growth rates; or, in other words, it is not just enough to produce a good, but there is need to find a market. Hence, industrialization will prove impossible unless it is oriented toward external markets. This problem could also potentially be solved if investment were sufficiently high, as this would generate demand for both investment and consumption goods.[3]

Figure 5.1 Economy with underutilized resources



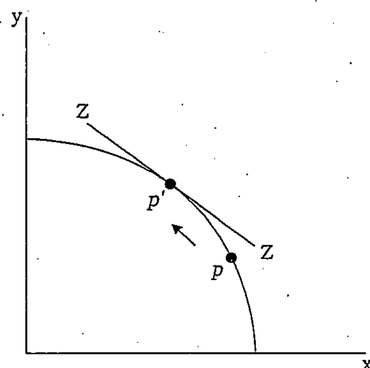
Allocative efficiency problems are also present in developing countries. The combination of goods and services being produced in developing countries is often not the one that maximizes the value of output at the prevailing prices. In Figure 5.2, *p* is on the transformation curve. The problem is that the combination of goods and services produced may not be the optimal one, in the sense that it may not maximize the value of total output at the prevailing prices. The relative prices of the two goods are shown in line ZZ. Point *p'* is the combination of the two goods that maximizes the value of goods at these prices. Growth will occur by moving from *p* to *p'*, thus producing a different combination, even with constant productive capacity. Growth in this case is said to be due to an improvement in allocative efficiency. This is a problem that affects mostly developed countries, and their efforts are directed toward eliminating this inefficiency, e.g., through reforms in product and factor markets. Growth, therefore, might occur, even at a constant productive

2 Even in these cases one must be careful not to confuse bottlenecks in some markets with a generalized problem of effective demand. The People's Republic of China, for example, still suffers from weak domestic demand, and while there are a few isolated bottlenecks in the economy, in general there are plenty of inputs, mostly labor, available to increase production.

3 For productive capacity to be fully utilized there must be sufficient effective demand. Classical (and neoclassical) economists believed this to be the case due to their belief in Say's Law (that is, supply creates its own demand) and the neglect of demand factors. Hence, they concluded that the level of production would correspond to productive capacity. The belief in Say's Law ultimately derives from the view that markets function efficiently and competitively so that the prices of all factors and goods speedily adjust to their equilibrium level at which demand equals supply. On these assumptions, all factors of production are fully utilized. Moreover, market forces allocate the resources available at any time in such an optimal manner that the total value of all goods and services produced in an economy is the maximum that can be attained.

capacity, by producing a different combination of goods and services (which, at the prevailing prices, would lead to higher output).[4]

Figure 5.2 Growth due to improvements in allocative efficiency



But while this problem is pervasive in most developing countries, it is not as important as the lack of productive capacity that prevents the fuller utilization of resources. Indeed, from the point of view of the national economy as a whole, the major obstacle to the development of many poor countries in developing Asia is the shortage of productive capacity. This is obvious in policy discussions in countries like India, Pakistan, or Philippines, where there are constant references to the "low investment" problem. This constraint prevents the elimination of unemployment and underemployment, even when an increase in demand would make the expansion of output profitable.[5, 6, 7]

4 This was the problem of the former Soviet Union, namely, the lack of market signals guiding production decisions (together with the fact that the budget was severely misallocated toward military expenditures).

5 It is important to stress, however, that increasing productive capacity does not guarantee full employment.

6 Certainly, developing countries do have many other candidates for fundamental problems. McCombie and Thirlwall (1994) discuss the importance of the balance of payments constraint. Easterly (2002) emphasizes lack of incentives and argues that good policy must provide the right economic incentives. Rajan and Zingales (2003) stress the importance of financial development. However, especially for purposes of the questions raised in this chapter, the starting point of analysis of developing economies should be their lack of productive capacity.

7 An increase in a country's productive capacity consists of an outward shift in the transformation curve. Many growth theories (e.g., neoclassical model) have concentrated on explanations of growth of this type. These theories assume that the countries efficiently allocate their available resources. The problem is thus how to expand the frontier. The truth is that whether productive capacity is fully utilized or not, for economic growth to be sustained over a long period, there must be an expansion of productive capacity. What will

Developed economies and a number of semi-industrialized economies possess a level of capital equipment that is adequate for the existing labor force. This allows them to generate high labor productivity and, consequently, a high income per capita, provided that capital is fully utilized and is used productively.[8] The problem in many developing countries is different. It is true that their capital equipment, however small, may be underutilized. The issue, however, is that even if equipment were fully utilized, it would not be capable of absorbing the available labor force, leading to low capital-labor ratios—a form of underemployment. In other words, the problem of many developing countries is the deficiency of productive capacity rather than the anomaly of its underutilization (Kalecki 1966). Hence, most developing countries are often below full employment. Most likely, the poorer the country, the more important the problem of lack of productive capacity will be; while the more advanced the country, the more important the problem of lack of effective demand will be. Therefore, for purposes of the discussion here, it is assumed that the binding constraint is the former. From this point of view, the objective of development is to increase productive capacity, and the process of economic development may be described as a generalized process of capital accumulation.

The above analysis implies that the objective of public policy in developing countries should be to increase productive capacity with the purpose of attaining the full employment of the labor force (defined as a situation such that no one who is ready and willing to work for an appropriate wage is without a job). Full employment must be the basic measure of a socially just economic policy. This is not an easy objective and it will be discussed below. But the point to stress is that it will be very difficult (and even almost pointless) for a government that does not place this objective at the top of its agenda and that does not aim at achieving it to set ambitious objectives for reducing poverty and inequality, and for achieving inclusive growth. What this means is that a society must achieve a "...steady expansion of the economy and therewith a steady and reliable increase in the number of workers employed" (Galbraith 1996, 33). This is even more compelling in developing countries. The reason is that the ultimate cause of lack of inclusive growth in developing countries is the nonexistence of adequate employment opportunities (Felipe and

make this happen? Most probably this is the result of a dynamic interaction between capital accumulation and technological progress.

8 One could visualize this chain through the following two identities: (i) income per capita $(Y / P) = (Y / L) \times (L / P)$, where (L / P) is the employment–population ratio; and (ii) labor productivity $(Y / L) = (Y / K) \times (K / K^*) \times (K^* / L)$, where (Y / K) is capital productivity measured in terms of the actual or utilized level of capital (K), (K / K^*) denotes the level of utilization of the existing capital (K^* is the trend of the capital stock), and (K^* / L) is the trend of the capital–labor ratio.

Hasan 2006). It is important to keep in mind that increasing a country's productive capacity is a long-term issue that will take, in most cases, generations (as it took in the developed countries).

5.3 Why full employment and who should be responsible for achieving it?

If achieving full employment should be the main objective of developing countries, it is fair to ask whether policy makers are implementing policies to achieve it. To answer this question it is important to first note that full employment means different things to different people. There are two important issues in this respect. The first one concerns the resource the term refers to. In this chapter, full employment refers to labor. Full employment of plant and equipment is not the problem that developing countries face, as noted above. The second issue regards the level to which "full" refers. During the last 3 decades, the term "full employment", as used in orthodox circles, refers to the "Non-Accelerating Inflation Rate of Unemployment" (NAIRU), one of the most powerful notions in economic policy since the 1970s. This is the level of unemployment that is associated with price stability even if that means that many workers ready and willing to work are unemployed. The basic proposition underlying the NAIRU is that policy makers cannot use deficit spending or an increase in the money supply to reduce unemployment below some "equilibrium" rate, except at the cost of accelerating inflation.[9] This is an important departure from the Keynesian view that inflation poses a problem only when the economy approaches full employment.[10]

Full employment in the framework of the NAIRU obviously places fighting inflation above combating unemployment (as a macroeconomic objective). Indeed, the view that price stability requires maintaining a pool of unemployed means that the fiscal and monetary brakes have to be slammed as soon as economic growth causes unemployment to drop below a certain level. Many policy makers and politicians also seem to

9 This implies that those who believe that full employment is incompatible with macroeconomic stability (inflation) will be hesitant to implement policies that lead to the full employment of labor.

10 To be precise, the NAIRU is that level of unemployment where the labor market is said to be in equilibrium. This occurs at the so-called natural rate of unemployment. Here, actual and expected rates of inflation are equal (that is, inflation is fully anticipated). At this point (that is, the natural rate of unemployment), the Phillips curve is vertical and there is no long-run trade-off between unemployment and wage inflation. In the NAIRU view the Phillips curve is only a short-run relationship. Models of inflation targeting, for example, associate full employment with the NAIRU.

have accepted this concept and hold the view that there is a natural rate of unemployment that is invariant to aggregate spending. They argue that this natural rate can only be reduced through supply-side measures, such as deregulation, privatization, welfare reforms (e.g., cutting the minimum wage, eliminating unemployment benefits), or upgrading the skills of workers. For those who view the economy through this lens, supply-side measures are the only way to reduce unemployment. Moreover, when it is close to the level associated with the NAIRU, the monetary authorities must take prompt anti-inflationary action to prevent the economy from overheating. If this is not done, inflation will not only be higher but will accelerate. However, it is also possible to conceive of a situation where low unemployment leads to low inflation (Eisner 1995). Indeed, low unemployment is most likely associated with a more efficient use of resources. Increases in wages derived from low unemployment may encourage the substitution of capital for labor and raise anticipated future productivity, which would lower inflation. With profits high, firms may decide to keep prices low to prevent others from entering the market.

Full employment in the context of the discussion in this chapter, on the other hand, refers to zero involuntary unemployment. It means that no one who is ready and willing to work for an appropriate wage is without a job. This also means zero involuntary part-time employment, a type of underemployment pervasive across the developing world.[11] In the context of a developing country the latter aspect is very important. The reason is that underemployment is a much more serious problem than open unemployment. For this reason, the goal of full employment in developing countries is about reducing unemployment as well as reducing underemployment (Felipe and Hasan 2006).

Felipe and Hasan (2006) distinguish four types of underemployment: (i) time-based, (ii) high-skilled workers forced to take up low-paying jobs, (iii) overstaffing, and (iv) workers carrying out their work with very little capital. Therefore, the objective of full employment must be complemented with that of generating productive employment. Naturally, the question to consider here is the meaning of productive.[12] The objective of policy making must also be to generate decent employment (that is, employment

11 Ideally, full employment à la Beveridge (1944) comes to mind, that is, full employment holds when there are at least as many unfilled job openings as there are unemployed individuals seeking work. That is, society's responsibility is to create more positions than job seekers, so that firms do the search for workers, not the other way around. Certainly this is very unrealistic given the conditions in developing countries, hence this idea is used simply as a target.

12 Is flipping hamburgers (a job created by the private sector) more productive than cleaning streets or taking care of the elderly (jobs created by the public sector)? Does productivity (simply) reflect the technical conditions of production, as in neoclassical economics (that is, a low wage is the reflection of a low marginal productivity)? Or is it socially determined?

that provides living wages, benefits and reasonable job security, and a healthy work environment).

The point of departure of this chapter's arguments is that the free market system does not guarantee full employment in a developing country. Traditional neoclassical theory puts forward a theory of how, under certain conditions, a market economy will tend toward full employment. This occurs through the workings of the price mechanism. However, the assumptions used to derive this result do not apply and the reality, that is, the existence of persistent unemployment and underemployment, is that this theory is not too useful. As Keynes (1936) showed, even with flexible wages an economy has a tendency toward unemployment. To do this, he demolished the classical notion of "supply curve of labor" and showed that there was no reason to expect that an excess of unemployment would drive down real wages. Keynes showed that even with high unemployment, the employed workers would resist reduction of their nominal wages; and even if this opposition failed, the subsequent reduction in nominal wages would bring down prices, leaving real wages unchanged.[13]

The analysis of the "labor market" as if it behaved like the market for oranges is fallacious. For this reason, Galbraith (1997) speaks of a "job structure", that is, "a historically, socially, and politically specific set of status and pay relationships in the economy, within and between firms and across industries" (Galbraith 1997, 15). The elements of a job structure are much more complex than the simple supply and demand characterization of textbook analyses. This means that wages are not determined by the workings of supply and demand, but by a very complex process of comparisons within and across occupations and industries, as well as the qualifications of the worker. Once the notions of supply and demand of labor (as in the market for oranges) are questioned, the idea of the NAIRU crumbles.

Before moving on to the arguments for full employment, two digressions are in order. The first is that inclusive growth is obviously related to inequality. In this sense, inclusive growth essentially means broad-based growth, which implies rising living standards for all socioeconomic levels.[14] There is a wide perception that the more unequal the distribution of income the more dysfunctional a society becomes and the worse its prospects for growth and development in general. Therefore, as excessive inequality is inherently damaging, a society will

13 Felipe and McCombie (2008 and 2009) show that empirical estimations of the so-called "labor demand curve", that is, the inverse relationship between the level of employment and the wage rate (used to show since the 1930s that both variables are indeed inversely related) are driven by an accounting identity that forces the inverse relationship. This invalidates the standard interpretation of the labor demand curve and, in particular, renders empirical estimates pointless.

14 For an excellent introduction and review of income distribution in Asia, see Fields (1995).

need to take care of those groups that are left behind.[15] Although from an optimality perspective the acceleration in the incomes of some segments of the population without the rest of the population being worse off would be welfare-enhancing, from a social and moral point of view this is not acceptable (Sen 1999). In chapter 24 of the General Theory, Keynes argued as follows: "...I believe that there is social and psychological justification for significant inequalities of incomes and wealth, but not for such large disparities as exist today" (Keynes 1936, 374). Keynes believed that there are activities that justify the accumulation of wealth. But he clearly argued that "...it is not necessary for the stimulation of these activities and the satisfaction of these proclivities that the game should be played for such high stakes as at the present" (Keynes 1936, 374).

This chapter argues that neither human nature nor the market system is consistent with equality; and that the process of development is inherently not egalitarian. People have different commitments to excelling in the business of making money. This should be acknowledged. And capitalism as an economic system rewards according to one's contribution to the product. Hence, this need not be unfair. However, it can lead to a highly unequal and socially adverse distribution of income, especially when one's talents are unclear or when compensation bears little relationship to the contribution to the product. Excessive inequality can be neither accepted nor intellectually justified; much less argued that it responds to a "moral entitlement" (Galbraith 1996, 61).[16]

If inequality is a fact of life, it is important to understand the forces that drive the distribution of income with a view to designing an adequate policy on income distribution. It is true that some individuals work "harder" than others under the same set of opportunities and they should be rewarded for that. But this is not the main reason underlying the huge income inequalities pervasive in many societies.[17] For example, today, the modern corporate and financial world rewards, in a disproportionate manner, a group of privileged people through astronomical salaries, stock options and, at times, illegal means.

Are the high inequalities observed today across much of developing Asia (ADB 2007a) the result of individual effort (Roemer 2006)? While

15 It is somewhat difficult to determine the point at which inequality becomes, technically speaking, "excessive". Rather, it is something that is perceived by the different groups of society. On this see in particular section 2 of ADB (2007a).

16 Akerloff (1982) argued that wage rates that are not a "fair" reflection of a firm's ability to pay will result in poor worker morale and hence, lower productivity.

17 Chapter X in Book I of the Wealth of Nations (Smith 1776) contains a discussion of "inequalities arising from the nature of the employments themselves". Smith discusses five reasons: (i) the agreeableness or disagreeableness of the employments themselves; (ii) the easiness and cheapness, or the difficulty and expence of learning them; (iii) the constancy or inconstancy of employment in them; (iv) the small or great trust which must be reposed in those who exercise them; and (v) the probability or improbability of success in them.

Roemer's arguments do have weight and in some cases effort may be more important than circumstance in explaining inequality (though it is very difficult in general to disentangle both effort and circumstance), it is very difficult to justify inequality in many developing countries as the result of individual effort; much less support the argument with hard empirical evidence. CEOs and highly educated knowledge workers in these countries belong to a narrow aristocracy. Are their high wages and other benefits exclusively the result of returns to education?[18] If this were the case, it would suggest that nobody is to blame for rising inequality as this would be the result of demand and supply at work. The super-high paychecks of some CEOs (whose talent may be dubious) are then easily justified. The way to mitigate inequality would then be to improve the educational system. However, these inequalities, supposedly the result of individual effort, are more the consequence of power relations than of market forces.[19, 20] The point of this discussion is that full employment can be an important tool in the fight against inequality.

The second digression is that diametrically different views about the world, namely those of Karl Marx and Milton Friedman, come to the same conclusion: unemployment is functional to a market (capitalist) economy, the result of class struggle over the distribution of income and political power. Marx called unemployment the reserve army, while Friedman called it the natural rate (Pollin 1998). Both held that high unemployment in capitalist economies occurs when workers have the capacity to use their bargaining power.[21] The difference in their theories lies in how they reached the same conclusion: Friedman (and other orthodox economists) reached it by arguing that workers demand more than they deserve, while for Marx, capitalists use unemployment as a weapon to prevent workers from getting their fair share.[22] But both Marx and Friedman thought that full employment was not attainable.[23]

It is very unfortunate that the goal of creating a full employment economy has been abandoned by many central banks of developed countries, national governments, and international organizations (with the exception of the International Labor Organization), although all of them talk today about the seriousness of the unemployment–underemployment problem.[24] Why have policy makers abandoned this goal? Between World War II and the early 1970s, the so-called Golden Age of Capitalism, governments and central banks in most advanced western nations were committed (in different forms and degrees) to this goal and most central banks were integrated into the government's macroeconomic policy apparatus. For this purpose, they manipulated their spending levels (fiscal policy) and could adjust interest rates and the availability of credit (monetary policy) to maintain a level of aggregate demand close to full employment. Likewise, during this period, there was a tacit accord between the social classes according to which progressive taxation financed an expanding welfare state and a set of social rights, which in turn

18 In a recent paper, Dew-Becker and Gordon (2005) have argued that the biggest cause of increased wage inequality in the United States has not been a rise in returns to education and skills, but instead it has been the result of increased payments to superstars such as baseball players, and out-of-control pay rises for chief executives. Think also of how lucky some workers in India are as a result of outsourcing from developed countries. This has automatically increased their salaries.

19 On the other hand, the individual effort and talent of opera singers such as Placido Domingo or Luciano Pavarotti is an exception.

20 For this reason, Galbraith (1996, 63–5) proposes some basic policies to address income inequality: (i) a support system for the poor; (ii) the need to deal with the tendencies of the financial world, e.g., insider trading, speculative behavior; (iii) the need for stockholder and informed public criticism to address the personal income maximization of corporate management; (iv) the removal of tax concessions to the affluent should they exist; and (v) a progressive income tax.

21 Eisner noted that: "I have only half jokingly accused [financial and business circles] of being closet Marxists, wedded to the notion that a "reserve" army" of unemployed is necessary for a private-profit economy to function successfully...[E]conomists over the last several decades have most unfortunately offered modern rationalizations in seemingly rigorous theory of this old bit of Marxian dogma. The seeds were planted in the enshrinement of the old Phillips curve" (Eisner 1997).

22 Galbraith has argued that "Unemployment has, in fact, some socially and economically attractive effects: services are well staffed by eager workers forced thereto by the lack of other job opportunity; employed workers, fearing unemployment, may well be more cooperative, even docile, as may their unions. And even more significantly, for most citizens, including those with influential political voice, joblessness is not a threat" (Galbraith 1996).

23 Reminiscent of Marx's ideas concerning the reserve army of labor, Shapiro and Stiglitz (1984) developed a shirking model that stresses the difficulties of monitoring workers' on-the-job effort in order to explain the persistence of involuntary unemployment. In essence, if firms pay more than the going wage, workers will work harder because the cost of being fired for shirking increases. When all firms do this, increased wage levels result in unemployment. On the other hand, employers will not reduce wages to the market clearing level because this will result in lower work effort. Shapiro and Stiglitz conclude that persistent unemployment may actually be required in a market economy as a "worker discipline device." It is worth noting, though, that Shapiro and Stiglitz's (1984) argument is not identical to Marx's. Marx argued that the reserve army is the result of rising labor intensity via mechanization. This exerts downward pressure on the wage rate. However, in Shapiro and Stiglitz's model, unemployment is supposedly generated by the firm's need to raise wage rates above the market clearing level to induce workers not to shirk.

24 Ironically, one of the roles envisaged for the International Monetary Fund at its foundation in 1944 was to help finance the external gap (that is, trade deficit) when the market does not close it, so as to guarantee that full employment policies can be pursued. Developing countries do not have an open commitment to full employment. At most, they acknowledge the employment problem. As an example, Felipe and Hasan (2006, 497, endnote 44) indicate that the main objective of the central bank of the Philippines, as stated by the central bank itself, is to ensure price stability. Objectives such as balanced and sustained growth and employment are secondary to the main objective. And these other objectives have not quantified targets.

translated into a relatively low degree of social confrontation.[25] During a large part of this period, wages increased hand in hand with productivity and full employment and expanding social benefits gave workers the upper hand in wage bargaining, while the rapid pace of investment in new technologies provided a countervailing force that kept inflation in check. This period was marked by the willingness of governments to maintain levels of aggregate demand that would create enough jobs to meet the preferences of the labor force.

Since the late 1960s, this state of affairs started to change and, in the mid-1970s, the failure of the OECD economies to contain inflation following the oil shocks led to the downfall of full employment as an objective, as governments became convinced that low unemployment and low inflation were incompatible. As a consequence, intellectual support for these policies vanished and the use of budget deficits to maintain full employment started being openly opposed. Friedman's notion of the natural rate of unemployment was instrumental in this change of focus. The result was a battle that led to the victory over inflation but at the cost of sluggish growth, high unemployment, and income inequality in many parts of the world.

Despite this state of affairs, there are powerful reasons today to argue the case for full employment, if key institutions in developing countries, as well as multilateral lending institutions, are serious about reducing poverty, making growth inclusive, and achieving the Millennium Development Goals. First and foremost, an economy running at full employment creates a high level of overall purchasing or spending power. This leads to more buoyant markets, businesses, investment, and employment. A full employment economy will provide opportunity for everyone.

Second, an economy operating at full employment has the capacity to deliver great individual and social benefits. The economic and social costs of unemployment and underemployment are huge. It causes not only direct economic costs (e.g., loss of potential output and income, lower tax revenues due to a lower tax base, deterioration of labor skills and productivity) but also poverty, misery, malnutrition, and social injustice

25 Kalecki (1943) argued, in the context of the 1930s and 1940s in Europe, that there were two solutions to the unemployment problem. One was the authoritarian solution in the form of fascism, which replaces the discipline of unemployment by the direct repression of the working class by force. The other was the democratic solution (which he favored), in which trade unions cooperate with employers in return for income redistribution and other egalitarian measures. This type of cooperation became widespread in Northern Europe after World War II. Sweden, for example, implemented policies that kept the economy close to full employment with low inflation and provided decent wages between 1951 and 2000. The key to it was the development of a system based on cooperation among different groups. In the absence of this cooperation, employers and the financial sector will turn against full employment policies.

(Rawls 1971, Sen 1999).[26] Persistent unemployment and underemployment act as a form of social exclusion that violates basic concepts of membership and citizenship, and thus they do not allow inclusive growth.

Third, employment is a right, and full employment as an objective of economic policy is found in the International Covenant on Economic, Social and Cultural Rights, the International Covenant on Civil and Political Rights, the International Labor Organization Conventions, the Charter of the United Nations (Article 55 and 56), and in the UN Universal Declaration of Human Rights (Article 23). In the United States, high employment is a mandate of the Federal Reserve. The Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978 makes high employment, balanced growth, and price stability specific policy goals.[27]

Fourth, since 2006, decent work is a target of the first Millennium Development Goal, namely, to eradicate extreme poverty and hunger.

Fifth, full employment in the developing world could play a crucial role, as it would contribute to ensuring a fair degree of political stability as the levels of consumption of large segments of the population would be higher than under conditions of unemployment. Moreover, peace and prosperity in the developed world also depend on the well-being of the people in the developing world. And finally, full employment should be an ethical imperative in today's world.

It is important to stress that even if full employment could never be achieved due to the failure of the market mechanism to attain it, this should not be a justification not to pursue it by other means, e.g., government involvement and commitment to it.[28]

The benefits of full employment outweigh the costs of its achievement. It benefits everyone, including—and contrary to Marx—capitalists. These may end up getting a smaller share (in terms of percentage) of the pie, but the size of the pie will possibly be growing faster than with significant levels of unemployment. Therefore, it is more rational to argue that developing countries cannot afford unemployment and underemployment, rather

26 As Stiglitz et al. (2006, 42) put it vividly: "For conservatives who believe that the unemployed have chosen not to work, the mystery of the unemployed's profound unhappiness is a matter for psychologists more than economists."

27 The Employment Act of 1946 commits the United States to the goal of "maximum employment, production and purchasing power". Most likely, although the term was not used, it meant "full employment." The Humphrey-Hawkins Act refers, on the other hand, to "high" employment, not to "full". In practice, the United States government has never adopted policies that guarantee the latter outcome. Rather, it has adopted a variety of "supply-side" policies and some "demand-side" policies in the hope that markets would operate at a sufficiently high level to ensure high employment. Since the market has not done this, the government has been forced to supplement these policies with various "welfare" programs.

28 It is often argued that Keynesian economics has little to offer developing countries in terms of economic policy. This is utterly incorrect. See Thirlwall (1987).

than to suppose that they cannot afford full employment. In the words of Paul Krugman: "An unsold commodity is a nuisance, an unemployed worker a tragedy; it is terribly unjust that such tragedies are created every day by new technologies, changing tastes, and the ever-shifting flows of world trade" (Krugman 1999, 15).[29] Expressing a similar sentiment, Alan Blinder stated that "...high unemployment represents a waste of resources so colossal that no one truly interested in efficiency can be complacent about it. It is both ironic and tragic that, in searching out ways to improve economic efficiency, we seem to have ignored the biggest inefficiency of them all" (Blinder 1987, 33). For this reason, full employment must be the natural point of reference for economic policy and for evaluating a government's performance.[30]

Finally, if full, as well as productive and decent employment is a desirable state of the economy (so that it must be the basic measure of a just society and the goal of economic policy), one has to ask who should be responsible for achieving it and for keeping the economy as close as possible to it. Unemployment and underemployment may be the result of skills mismatch or of problems with the individuals who are unemployed, in which case the solution might be training. This is a widely held view of the causes of unemployment and underemployment. These tend to be viewed as individual problems. Policies to solve them directly target those affected by it. But if the problem is a shortage of jobs because the economy does not generate employment for all those in the labor force and willing to work, that is, a systemic failure of the aggregate economy to create enough jobs, then training will not do much.

In a market economy the private sector must be the generator of wealth and employment. To do this, the private sector must operate in an enabling environment, which the government must provide. However, this role of the private sector is compatible with the existence of significant involuntary unemployment and underemployment.

Who is, therefore, ultimately responsible for the achievement of full, productive and decent employment? Unfortunately, society makes the government responsible. The reality is that if at the end of the year unemployment has increased in a country, it is the government, not the private sector that is blamed for it. And indeed, many governments make promises about reductions in unemployment and employment creation during election campaigns (while they do not create these jobs). For these reasons, it is of paramount importance that private and public sectors coordinate their actions and understand each other's role in employment generation (and elimination of unemployment).

29 The former Soviet republics of Central Asia present a peculiar case. After the collapse of the Soviet Union, most of these republics went into recession and the industrial sector collapsed, causing massive unemployment. One way to cope with it was a shift of many workers to the agricultural and service sectors. The experience of these countries cannot be taken as evidence that the pursuit of full employment is the "wrong" policy. Full employment was not what caused their collapse.

30 Pollin (1998) tells the story of a visit to Bolivia in 1990. There, he was told that the country did not suffer from any employment problem: people begging, shining shoes, or hawking in the streets were indeed employed.

5.4 What is the role of investment in delivering full employment?

Achieving full employment requires the synchronization of policies on many fronts: fiscal, monetary, exchange rate, etc. But following the arguments in Section 5.2, developing countries' main problem is the unemployment of the labor force. This is caused by a shortage of capital equipment. This section discusses the role of investment, while the next, that of planning and industrial policy.

Kalecki (1944) distinguished three ways to achieve and maintain full employment: (i) by government spending on public investment (e.g., schools, hospitals, highways, etc.) or on subsidies to mass consumption (e.g., family allowances, reduction of indirect taxation, subsidies to keep down the prices of necessities, etc.); (ii) by stimulating private investment (e.g., through a reduction in the rate of interest, lowering of income tax, or other measures assisting private investment); and (iii) by redistributing income from higher- to lower-income classes. Kalecki favored the first and third methods.

A dynamic economy will need increases in the growth rate of the capital stock (that is, capital accumulation) in the form of, among others, investment in public transportation and in public utilities. Increases in the growth rate of the capital stock can be achieved in two ways. The first one is to increase the productivity with which capital is used (see Section 5.2). This route, however, is very difficult. In fact, the empirical evidence shows that capital productivity tends to decline in the long run (Foley and Marquetti 1999, Foley and Michl 1999, Marquetti 2003, Felipe et al. 2008). It seems that development entails increases in labor productivity combined with decreases in capital productivity.

The second mechanism to increase the growth rate of the capital stock is to increase the investment-to-output ratio. This is the basis for a policy of industrialization, and is the one followed by the successful East and Southeast Asian economies (see, for example, Lau 1990 on the Republic of Korea [Korea] and Taipei,China), and the PRC (see Wang and Li 1995). The importance of investment for development is crucial. There is no lack of candidate projects: schools, hospitals, transportation, power, and telecommunications, are all underserved in much of developing Asia. This is because investment plays a dual role. On one hand, investment

expenditures are a source of demand when they are incurred. On the other, investment increases the productive capacity of the economy in the long run. This second role is the one to be considered here.[31]

How did the successful Asian countries increase their investment-to-GDP ratios? To see this, it is worth considering the relationship between the labor share, real wage rates, and labor productivity.[32] In the context of full employment, if there is a rise in labor productivity, and if the labor share is approximately constant, real wages will have to increase. But it is also possible that the labor share decreases and yet workers see their real wages increase. This will happen if productivity increases quickly but such increases are not passed on to wages one-to-one (but these nevertheless increase quickly too). Under these circumstances wages will increase by a lesser amount than labor productivity and thus the labor share will decrease.[33] Although workers see their share in total income decrease, they will tolerate the situation. This was possible in many Asian countries because there was little militancy in the labor force, because of a substantial labor surplus in the economy, and because of repression by state agencies.[34]

While some Asian countries made huge effort to increase investment (much of it into the manufacturing sector), it is important to also understand that these countries were initially somewhat lucky. In the late 1960s, the developed world started experiencing important internal changes that led them to relocate entire industries or particular industrial processes to the Third World. One important reason was the

31 Kalecki (1939, 148–9) in his discussion of "what causes periodical crises?" argued that investment is both an expenditure and an addition to capital accumulation. The tragedy of investment is that it causes crises because it is useful. The basic contradiction underlying investment lies in the different time horizon of the effects of investments on demand and on capacity; that is, the fact that while the impact of the former is exhausted in a short time, the one on capacity lasts longer.

32 Algebraically, the relationship is as follows:
$s^L = \frac{W_n}{Y_n} = \frac{w_n \times L}{Y_n} = \frac{(w_n/P_w) \times L}{(Y_n / P_y)} \times \frac{P_w}{P_y} = \frac{w_r \times L}{Y_r} \times \frac{P_w}{P_y}$, where the subscript n denotes nominal values and the subscript r denotes real values. W is the overall wage bill, Y is output (hence s^L is labor's share), w is the wage rate, L is employment, and (P_w/P_y) is the ratio of the wage-to-output deflators.

33 From the definition of the labor share, the growth rate of the labor share is , $\hat{s}^L = \hat{w}_r - \hat{q} + (\hat{P}_w - \hat{P}_y)$ where the symbol ^ denotes growth rate, and q is labor productivity (i.e., Y_r / L). If $\hat{q} > \hat{w}_r$ (assuming the growth of the deflators is approximately similar), $\hat{s}^L < 0$ and the labor share will decline. In practice, the labor share cannot decline below a certain value. This is because, first, labor unions would not accept a constantly dwindling share in total output. Second, as countries develop and the service sector dominates the economy, productivity increases become smaller, which allows smaller increases in real wages. At this point, workers become much more conscious of their wage rate increases and of shifts in the labor share.

34 For example, in the Republic of Korea, real wages in the manufacturing industry rose rapidly through the 1960s and 1970s (see Hamilton 1986 and Deyo 1987).

increase in wages in the advanced economies, resulting from the fact that the social contract established after World War II favored labor. At the same time, rapid technological progress led to the development of highly standardized manufacturing processes. This made it possible to transfer particular stages of production, namely, the labor-intensive processes that required low-skilled workers. What options did companies in the developed world have? Only two: Latin America and East and Southeast Asia. However, Latin America was ruled out for being much more politically unstable. This left only Asia. Thus, in the late 1960s, a number of electronics firms, including Hewlett-Packard, Texas Instruments and others, built factories in Singapore to assemble components, particularly semiconductors. This process was extended to Malaysia, Philippines, and Thailand.

But, what were the internal conditions that enabled capitalist Southeast Asia to respond to the opportunities created by restructuring in the industrial core? Brown (1997, 262) argues that "one crucial condition... was the presence of a copious supply of cheap, largely unskilled, and essentially docile labour". To this one must add the role of women, whose "dexterous fingers and patient temperament fitted them for such repetitive, minutely detailed tasks as electronic components assembly or garment production" (Brown 1997, 262–3);[35] and weak labor unions. These same factors are today important components of what is referred to as "the PRC's competitiveness".

A second internal condition was that Southeast Asia was resource-rich (except Singapore). This gave it an important advantage in the production of manufactures such as wood products, processed foods, cement, chemical fertilizer, and paper, all of which involve the intensive use of local inputs. Finally, a third condition is that these countries possessed an acceptable level of communication, commercial, and administrative infrastructure.

However, a dose of luck and these internal conditions do not entirely explain East and Southeast Asia's success. The key lies in the social contract implemented in many countries, and in the political pressure derived from the communist threat (Rodriguez 2005). Underlying these, there was a series of complex structures of political, economic, and bureaucratic interests that favored the accumulation of capital.

Naturally, the counterpart of the decrease in the labor share was the increase in the capital share. A good deal of evidence suggests that capital accumulation for industrialization is largely financed by profits in the form of retentions, rather than by household savings (Akyüz and Gore 1996). Indeed, according to Arthur Lewis (1954, 157): "...the major

35 Today, much foreign manufacturing in the PRC is assembly activity and the workforce is disproportionately female and recruited from rural areas. The high female literacy rate has given the PRC a crucial advantage in attracting foreign investment in manufacturing vis-à-vis India.

source of savings is profits, and if we find that savings are increasing as a proportion of the national income, we may take it for granted that this is because the share of profits in the national income is increasing." Over the long run, a high rate of retained profits tends to be associated with a high rate of corporate investment. Using data for 30 developing countries for the 1980s, Ros (2000, 79–83) showed that there is a strong relationship between a high savings rate, a high share of manufacturing output in GDP, and a high profit share in manufacturing value added in East Asia.[36, 37]

It is important to emphasize a key point about this strategy of industrialization (that is, the increase in the investment-output ratio). This is that real wages should not fall in the process. This requires both a high rate of labor productivity and that the prices of essential consumer goods be stable, which implies that their supply must rise in step with their demand. Achieving this will also require that investment in the different sectors of the economy, in particular in the capital and consumer goods sectors, be undertaken in the "right" proportions. And it will also necessitate the adjustment of the rate of growth of employment to the limit set by the increase in food supply and articles of mass consumption in general. Certainly this is not easy.

Moreover, maintaining the purchasing power of wages is also important because declines in real wages limit the expansion of the market for mass consumption articles. However, given the importance of the objective of full employment as the basic measure of a socially equitable economic policy, it may appear that the constraint that real wages do not decrease could pose a problem. For this reason, the lower acceptable limit for society should be that real wages be stable for the better-off workers and that wage rates of the bottom workers increase.

To be more precise, inclusive growth should favor policies that encourage faster wage growth for low-paying jobs than for highly paid work. This means that, at the low end, wage growth will exceed productivity growth, while at the high end, productivity growth will exceed wage growth. This proposal is consistent with the idea of broad-based growth, which should translate into development efforts directed toward raising the standard of living of those at the bottom. This policy implies that, most likely, prices will grow in the low-wage sector as costs rise. Preventing inflation will require some constraint on prices and wages in high-wage sectors (see Kalecki 1966; Minsky 1965, 1968, and 1973).

What is the impact of this development strategy on consumption? Given that workers have a high propensity to consume, the decrease in the labor share will affect overall consumption. How should policy

36 This is how the successful East Asian countries addressed the savings constraint. The foreign exchange constraint was addressed by following the export-led growth model.

37 See Morgan Stanley's surveys on the PRC and India (Ahya et al. 2004 and 2006).

makers proceed, that is, what consumption categories should be reduced? In order to accomplish this in a "fair manner", policy makers would have to restrain the consumption of non-essentials (something that is politically very difficult). For this, appropriate taxes should be imposed. In these circumstances, an acceleration of income (induced by the acceleration of investment) will be accompanied by an increase in the supply of necessities adequate to prevent inflationary pressures. Thus, a higher share of investment in output will be offset by a decline in the share of non-essential consumption via direct and indirect taxation of the upper classes.

At what point is the share of investment too high and that of consumption too low? This is difficult to ascertain, but there will be signals (Felipe et al. 2008). Profitability may decrease precipitously leading the economy into a profitability slump. On the other hand, if authorities are not careful and the share of consumption of essential goods goes down, the problem might be underconsumption.

There are, however, three important potential obstacles to increasing investment (Kalecki 1966). First, as noted above, in a market economy the private sector is the generator of wealth. However, in many developing countries, private investment may not collaborate due to, for example, low profitability, large uncertainty, high cost of investment, or because the full level of firms' savings out of profits is not reinvested.[38]

One possibility is, of course, to identify and relax the binding constraint on private investment. But perhaps doing this is not easy and may not be enough to increase investment to the necessary levels. For this reason, a policy of stimulating exclusively private investment may not be satisfactory. It is clear that, in these circumstances, the government will have to step in to reach the desired level of investment.

The role of government investment is not, it must be stressed, to replace or crowd out private investment, but to complement it due to the latter's insufficiency. Indeed, the most effective and egalitarian way to achieve full employment is through a program of public investments targeted carefully at location-specific high employment activities.

For this reason, it will be the government's responsibility to provide a large volume of public sector investment, e.g., in infrastructure. This, it must be stressed, is not to deprive the private sector of any active role in the economy—quite the opposite. The private sector has to invest in whatever activities it finds profitable. This is the way a market economy will prosper, although this does not guarantee the full employment of the labor force.

38 The reasons underlying this can be analyzed in terms of the growth diagnostics approach (Hausmann et al. 2005).

Indeed, in many developing countries the private sector cannot be relied upon to undertake the required volume, and appropriate structure, of investment (think, for example, of Afghanistan).[39] The reason is that nobody can force this sector to invest the required volume and in the areas that a developing country may need. Moreover, in some developing countries the business class does not play, on a large scale, the role of dynamic entrepreneur that it should (contrary to what occurred in today's developed countries at the time they underwent deep structural changes), driven by "animal spirits" (that is, a spontaneous urge to action and willingness to take risks), using the terminology of Keynes (1936).

In some cases it is due to a poor investment climate (e.g., difficulties in opening a new business), the result of government-imposed constraints; in other cases, the oligolopolistic characteristics of some sectors of the economy favor some privileged groups that enjoy rents. These groups lobby to perpetuate this situation. The problem is neither the high cost of investment nor low returns (in the growth diagnostics terminology of Hausmann et al. 2005) but the desire to maintain a situation of privilege. Investment takes place in the areas that these groups control and at the pace that suits them. At some point, and for strategic reasons, they might be unwilling to expand capital expenditures simply because doing so favors their objectives.

In many developing countries, the capacity for entrepreneurship that the private sector has must be nurtured and developed, since the driving force in a capitalist economy is the decision to invest and the rate of capital accumulation (and the demand for labor depends on it). But the objective of the private sector is not the maximization of employment and hence it *cannot* be, and should not be, made responsible for the achievement of full employment. Although some may not like it, this requires some planning (see next section).

Stimulation of private investment (the second of Kalecki's methods to achieve full employment) through, for example, reductions in interest and/or tax rates or through subsidies to private investment, will not deliver full employment. If the economy is already in a boom, measures to stimulate investment further will be pointless. And in a slump some of these measures may not work, e.g., reductions in interest rates may be ineffective due to the existence of excess capacity. Private investment depends, especially in developing countries, on expectations and political stability. Moreover, a "one-time" reduction in interest or tax rates does not eliminate a downturn (business cycle). Policy makers would have to

39 Of course, the private sector may bring in crucial expertise to countries like Afghanistan. Also, the public sector is poorly run and dysfunctional. This calls for even more planning and coordination between private and public sectors.

lower them successively and continuously to keep the investment rate going. Moreover, Vickrey (1993 and 1997) argued that firms' savings out of profits represent income not spent. These savings cause the income of others to fall (through the multiplier effect). This is because savings not immediately transformed into capital simply "vanish" and lead to reduced income.

Therefore, private sector investment is the mechanism through which the sector's profits are recycled into the income stream (that is, the mechanism through which non-spending is transformed into spending). If a country's total surplus were reinvested, the economy would get closer to the achievement of full employment. But when the total full employment level of firms' savings is not recycled into spending by private investment (in fact, Vickrey believed that the private sector would not recycle the full employment level of its savings), some of the full employment level of output will not be justified by actual sales, that is, part of the product will not be sold and goods will accumulate in stock. This will lead to reductions in production and employment. Unemployment is, therefore, the evidence of this gap (that is, savings that are "kept idle" and not put to productive investment). Income (the equilibrating variable, and not interest rates) will fall and consequently savings will also decline until they are brought back to match the below full employment level of private investment. For Vickrey there is only one solution to closing this gap and bringing the economy to full employment: government deficits.

However, achievement of the full employment of labor through a large volume of public investment faces serious political obstacles. Kalecki (1943, 138) argued that "The assumption that a Government will maintain full employment in a capitalist economy if it only knows how to do it is fallacious". He gave three "reasons for the opposition of the 'industrial leaders' to full employment achieved by Government spending" (Kalecki 1943, 139): (i) the opposition against government spending based on a budget deficit and the dislike of government interference in the problems of employment; (ii) the opposition against this spending being directed toward public investment (or toward subsidizing consumption, for example through subsidies to keep down the prices of necessities), except when it is confined to objectives that do not compete with private investment, that is, for construction of hospitals, schools, highways, etc. It is interesting, however, that even these areas are contested today as domains of the private sector, and some argue that public investment crowds out private investment on the grounds that the former lowers the real rate of return of the latter (e.g., Tatom 2006); and (iii) the opposition against maintaining full employment as this may give workers a very strong and dangerous position at the bargaining table (on this see also Shapiro and Stiglitz

1984). No wonder Kalecki (1943, 138) asked: "...why do not they [businessmen] accept gladly the 'synthetic' boom which the Government is able to offer them?"[40]

Kalecki's (1966) second potential obstacle to increasing investment is that the investment goods sector (e.g., the construction sector) may be already running at close to or full capacity and thus it may not be possible to increase its output.

The third and final obstacle is that the country may run into the problem of how to secure an adequate supply of necessities to cover the demand resulting from the increase in employment. This increased demand will induce inflationary pressures as the supply of necessities (especially food) is limited.[41] This situation has an additional implication. Suppose that the economy is capable of increasing investment. This will lead to more employment and to a higher total nominal wage bill. However, the overall wage bill in real terms will remain unchanged as a result of the increase in the price level. What is the implication? That although the level of employment has increased (certainly a positive outcome), the real wage rate (that is, wage per worker) will have declined, and this is an unfair way of financing the acceleration in growth. The conclusion is that the increase in investment under conditions of an inelastic supply of food will cause both a fall in the real wage and the acceleration in prices. For this reason, it is important to expand food production in parallel to industrial development. Investment in public transportation and public utilities should be accompanied by measures to expand agricultural production, such as land reform and easy credit to farmers.

This discussion means that inclusive growth cannot throw the costs of capital formation on the wage earners and, in general, on the poor. In a command economy investment is funded out of the incomes of state institutions and not out of the savings of private individuals (Dobb 1959); but in countries that have followed the capitalist path of development (that is, where savings and investment decisions are distinct), who bears the cost of capital accumulation is an important political economy question that needs to be answered. In the same way that governments must be accountable for their actions, policies, goals, and ultimately for their performance and capacity to deliver, the domestic upper and business class of developing countries, in many cases a relatively small group

40 It is worth considering the grounds underlying these arguments, given that higher output and employment benefit both workers and firms, as profits rise. Moreover, a policy of full employment based on loan-financed government spending does not affect profits as it does not require additional taxes. Despite that Kalecki wrote this article more than six decades ago, the argument is still valid and relevant today. One just has to read some newspapers or listen to the business segment of the news.

41 Of course, inflation may not show up if entrepreneurs are unwilling to expand their capital expenditures.

of individuals and families, must also be made ethically and politically responsible for the development of the country.[42] Domestic investment often depends on the decisions of a reduced group of businessmen. As long as private investment cannot be "enforced", the public sector will have to cover the gap up to full employment. In many developing countries, however, the tax collection system is not strictly enforceable, tax evasion is rampant, and the implementation of progressive financial reforms is an uphill battle.[43] Under these circumstances, the funds for investment are hard to extract. Both agriculture and manufacturing fail to develop efficiently and growth of total output is swallowed up in growing consumption.

Two final comments on investment are needed. First, Keynes (1936, chapter 24) argued that since it is investment that causes saving (and not the other way around, as in classical theory), and investment is promoted by a low interest rate, it is important to maintain low interest rates. However, he continued, since it is unlikely that banking policy will be sufficient by itself to determine an optimum rate of investment, he argued that a "somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative. But beyond this no obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community" (Keynes 1936, 378).

Second, the role of investment in development is not well understood, and even agreed upon, by economists. While the proposition that investment is a key variable for growth seems obvious, the empirical evidence is not conclusive. See, for example, Easterly (2002, 39–42) or Oulton and O'Mahony (1994), who claim that capital does not play any special role. On the other hand, Prichett (2003, 217–21) claims that "except for the causality issue, the role of physical investment in growth is well understood". On the issue of causality, Blomstrom et al. (1996) used causality tests and found that a faster rate of GDP growth causes a higher investment–output ratio and not vice versa. If this is true, the implication is that investment is not a key determining exogenous variable in the growth process. Once growth is

42 Haque (2006) refers to 22 controlling families in Pakistan. See Coronel et al. (2004) for an in-depth analysis of how a group of wealthy families dominates politics in the Philippines.

43 One such case is the Philippines, where collecting direct taxes is a serious problem. In 2005, the Philippine government extended the value-added tax (VAT) to previously exempt energy products. And in 2006 it raised the VAT rate on all taxable products (including energy) from 10% to 12%. Given that most energy is consumed by the wealthier groups, and because the government used part of the proceeds from VAT to reduce taxes on kerosene and to increase spending on infrastructure and social services, the negative effects on the poor were somewhat reduced. Nevertheless, VAT is not a progressive tax and the big loophole is in direct taxation.

under way, the resulting profits will cause the investment rate to increase in a Keynesian fashion. As Kaldor (1970) pointed out, Henry Ford did not build up his automobile business from high initial savings, but from the profits his factory generated. Moreover, as argued by Hausmann et al. (2005), investment matters for purposes of igniting growth. However, if the country's objective is sustaining growth, then the problem is one of developing institutions. Felipe and Usui (2008) elaborate on the issue and show that, historically, higher growth has been possible in many cases without a high investment-output ratio; and that a higher investment-output ratio does not lead systematically to higher growth.

Likewise, Lewis (2004) has criticized the view that capital accumulation is the key to growth and development, as well as the public debate around the prescription that what poor countries need is more capital. He makes two crucial points: (i) capital does not automatically increase labor productivity; and (ii) what capital does is to increase the capacity for growth. This means that developing countries could increase their performance dramatically without any significant increase in capital. To become rich, however, they need additional capital. The problem in most developing countries lies in the low efficiency with which the existing capital is used. To see this, one can write the growth rate of the capital stock as the product of the investment-output ratio and capital productivity.[44] This means that capital accumulation depends on two factors: one is the amount of investment (as a share of output), and the other one is the productivity with which this investment is used. Lewis seems to reverse the role of capital in development with respect to Hausmann et al. (2005): in the short run, developing countries do not need more capital; what they need is to use more efficiently the capital they have. To achieve this, reform of the rules and regulations governing competition is the key. It is in the long run, on the other hand, that developing countries will need more capital.

Lewis' point is that developing countries' performance could improve substantially by improving the productivity of capital. Lewis insists that "improving the rules and regulations governing competition would improve not only labor productivity *but also capital productivity*" (Lewis 2004, 251; emphasis added).[45] Naturally, in the long run, and in order to become a rich country, developing countries with spare labor capacity (that is, labor surplus), need to build offices and manufacturing plants where these workers can work. That is, countries need to increase the capacity to produce goods and services. In his own words: "Of course, the total capital required to increase capacity depends on the efficiency with which the capital is employed" (Lewis 2004, 250).

44 Algebraically: $\hat{K}=(\Delta K/K)=(I/K)=(I/Y)\times(Y/K)$, where $\hat{K}$ is the growth rate of the capital stock, (I/Y) is the investment share, and (Y/K) denotes capital productivity.

45 Section 5.4 argues that the empirical evidence shows that capital productivity tends to decline as countries develop.

The increase in private consumption can be a powerful complementary mechanism to achieve full employment. As Kalecki (1944) argued, public and private investment should be carried out only to the extent to which they are considered useful. If the effective demand that they generate fails to provide full employment, then the gap should be filled by increasing consumption and not by undertaking further investment, which most likely will be unproductive. This (that is, promoting consumption) is the advice that some Asian countries (e.g., PRC, Malaysia, Thailand) are receiving today, that is, to shift their growth strategy from investment-driven (and export-driven) to domestic demand-led growth by activating private consumption through, for example, decreases in indirect taxation, opening markets to induce price competition, or by developing the credit card market. As argued above, a number of East and Southeast Asian countries relied on investment for decades and this strategy paid off. Now, the argument goes, it is about time to shift strategy. There are many other countries in the region, however, that still would benefit considerably from an increase in investment (this is a constant issue in countries like India, Pakistan, or Philippines), not for the case of generating effective demand, but to accelerate expansion of productive capacity indispensable for the rapid growth of output.

In practice, governments should pursue a sensible combination of public and private investment, and subsidies to consumption. The private sector should invest in all those activities that it considers profitable;[46] the public sector should invest in all those areas that are needed for the development of the country (and that help the private sector); and the gap to full employment (if there is still any) should be covered by higher consumption. How is the government's spending program to be split? This is a matter of social priorities, and the government will have to decide whether in a given year it builds more schools or provides more milk for children.

Finally, what role can income redistribution (Kalecki's third method) play in the pursuit of full employment? The idea is that when income is redistributed from the higher to the lower income earners total consumption will increase, as the latter group has a higher propensity to consume. One possible policy would be to increase the income tax on the rich (and use it to subsidize private consumption) and simultaneously decrease indirect taxation on necessities consumed by the poor. The problem with this type of policy is that governments have to watch the overall impact on private investment.

46 One option being considered today is the so-called public–private partnership (PPP) as a mechanism to develop physical infrastructure. PPPs act as an alternative to traditional public sector finance—freeing up resources and accelerating investment programs. They have the advantage of reducing the fear of deficits and encouraging private participation.

5.5 Planning and industrial policy

One important implication of the discussion in the previous section is that the strategy of full employment based on stepping up investment requires "planning", a term that, unfortunately, has acquired a bad name (see Easterly 2006), although it is done everywhere. Indeed, most, if not all, medium and long-term term development plans of both developed and developing countries specify the amount of total (public) investment as well as the allocation across sectors.[47] For example, the Ninth Malaysia Plan (2006–10) and the Third Industrial Master Plan (2006–20) contain policies to push Malaysian industry up the value chain and have well defined targets in terms of growth rates and sectors' shares in output. Through the Malaysian Industrial Development Authority (MIDA), the government executes policies and initiatives intended to shape an industrial base to face the future challenges of the country. MIDA assumes the key roles of planning, coordinating and promoting the growth of industries in the manufacturing sector.

A balanced development path requires coherent planning not only of the forthcoming volume of investment, but also of the composition of investment (sectors and types of goods), which must be directed purposefully toward the breaking of bottlenecks in supply. However, given that resources are scarce, perhaps "planners" ought to think, and surely many do, not in terms of balanced growth but in terms of unbalanced growth à la Hirschman (1958), that is, by selecting the projects that make the greatest contribution to development.

Planning does not mean establishing a command economy, or even a developmental state, but the development of a partnership between public and private sectors to coordinate their activities in a way that complement each other (Hausmann and Rodrik 2006). Planning the development of a country is necessary because development is a long-term process. This consists in the introduction of new industries, and in this process there are substantial time lags between the decisions to build new facilities and the output that they produce.

Second, as discussed above, private investment may not go into all areas of the economy. The private sector will direct investment to the areas where it expects its venture will be profitable (and this is how it should be) and not necessarily to where a developing country needs capital the most. This argument applies to private foreign investment as well. Will it go into education and health? What about the objectives of employment and job creation? The government will therefore have to step in. Full employment is the government's responsibility. The private sector alone

47 And certainly so do the so-called "country strategy programs" prepared by the development institutions that lend to the developing countries.

cannot be responsible for the achievement of full employment simply because, as argued in Section 5.3, it is not its responsibility. Private investors are not driven by concerns for social well-being. What must be accepted with regard to the general level of employment and output is that there is no invisible hand channeling self-interest into some social optimum. Surely growth in a market economy has to be driven by a dynamic private sector. But the role of the government cannot be reduced to that of mere support to private sector activities, especially when achievement of full employment as a means to reduce poverty is at stake. Government has two key roles in a developing economy. First, it has to allow the operation of the free market dynamics whereby the government reduces its interference through deregulation. And second, it has to intervene actively in selected areas, the most important being the creation of physical infrastructure and the provision of a platform to enable the workforce to participate in productive activities.[48]

Third, and related to the previous point, it will be necessary to coordinate with the private sector to avoid mismatches, bottlenecks, and waste of scarce resources.

Fourth, planning is necessary because only when the structure of investment across sectors and types of goods has been determined will the country be able to decide the choice of technique of production—a key issue for economies with considerable labor surpluses. Some sectors of the economy, by their own nature, require capital-intensive techniques. These will absorb large shares of investment but will not absorb too much labor. This is also the case of much foreign investment, as it embodies techniques with relatively high capital-labor ratios. What can developing countries do? A solution could be to favor labor-intensive techniques that absorb the labor surplus in areas such as public investments (infrastructure), housing construction, and agriculture as long as this is permitted by the supply of food surplus (these new workers would not be highly productive though). Another solution is to simultaneously favor capital-intensive techniques in other areas of the economy where this is unavoidable.

But, there is an additional issue that must be taken into account. This is that most likely the sectors that will lead to the largest increase

48 This means that claiming, for example, that the role of government is simply to develop and maintain a private sector; promote a business-friendly environment that addresses market failures, institutional weaknesses, and policy shortcomings; as well as invest in infrastructure and human capital, build institutions, maintain macroeconomic stability, protect property rights, and maintain the rule of law is to recognize openly that the role of government in development is huge. If governments have to do all these things, it is difficult not to acknowledge that they do play a key role. The problem is that governments in many developing countries cannot execute these functions adequately (hence these countries have both weak private sectors and weak governments). This is why reforms of the public sector are necessary in many cases.

in total output are those intensive in capital, while additional demand resulting from the increase in the overall wage bill would be directed to consumer necessities, whose supply is probably not increasing at the same pace. Summing up, to embark upon a large investment program without a coherent plan will mean a great deal of wasted effort as it will surely lead to disproportional (across the different sectors of the economy) and disruptive growth.

As noted above, planning in a modern economy should be understood as the development of a partnership between public and private sectors to coordinate their activities in a complimentary way. This is the essence of modern industrial policy (Hausmann and Rodrik 2006).

Industrial policy has traditionally been understood as any type of selective intervention or government policy that attempts to alter the sector structure of production toward sectors that are expected to offer better prospects for economic growth than without such intervention. Use of this type of intervention has its adherents (those who believe in market failures) and its detractors (those who believe in the efficient working of markets). The latter argue that industrial policy interventions have often degenerated into an exercise in "picking winners", a game played by government officials deciding what activities and sectors to promote and to spend public money on.[49]

In a series of papers, Rodrik (2004 and 2006) has argued in favor of a new type of industrial policy. He acknowledges the existence of generic market failures, but argues "that the location and magnitude of these market failures is highly uncertain" (Rodrik 2004, 3). He argues that information and coordination externalities are more important than technological externalities, for the former weaken the entrepreneurial drive to restructure and diversify low-income economies.

Rodrik argues that industrial policy is not about addressing distortions in the traditional way (that is, by enumerating technological and other externalities and then targeting policy interventions on these market failures), but about eliciting information from the private sector about significant externalities and about the constraints to structural transformation (hence industrial policy also encompasses activities in agriculture and services) and the opportunities available. This requires "strategic collaboration" between the public and private sectors to determine the areas in which the country has a comparative advantage. The reason is that entrepreneurs may lack information about where the comparative advantage of a country lies and governments may not even know what it is that they do not know. And certainly most governments do not have the adequate knowledge to pick winners.

49 The literature evaluating the pros and cons of industrial policy is inconclusive. While some authors argue positively about it (e.g., Amsden 1989), others are critical (e.g., Pack and Sagi 2006).

Moreover, uncertainty arising from lack of communication, that is, from one decision maker having no way of finding out the concurrent decisions and plans made by others, complicates things to the point that, if sufficiently great, it may inhibit investment decisions and arrest growth. In these circumstances, markets alone are likely to undersupply the incentives and demand for new activities necessary to transform the economy. These market failures are more prevalent in developing economies. As Rodrik notes: "The trick for the government is not to pick winners, but to know when it has a loser" (Rodrik 2004, 12). This requires the development of the appropriate institutional arrangements for industrial policy.

Industrial policy should be conceived as a process whereby the state and the private sector jointly arrive at diagnoses about the sources of blockage in new economic activities and propose solutions to them. Industrial and technological upgrading requires purposeful effort in the form of industrial policy, in particular, effective government action and public–private collaboration. But this needs, first, a government that does not take any particular view or stand on the activities to be promoted or the instruments to be deployed. It only requires the government to build the private–public institutional setting from which information on profitable activities and useful instruments of intervention can be extracted. The key issue is not whether to protect, but how to protect and promote industry in order to ensure technical progress leading to higher labor productivity.[50] Second, it needs a private sector that is willing to do its part of the deal, that is, invest.[51]

Understood this way, industrial policy is a very powerful tool for successful industrialization and structural change. Perhaps a market-driven development model could not have, by itself, accelerated transitions between different patterns of specialization and delivered the high growth rates that some Asian countries experienced. This is not because market-based successes were absent. The reason is that theory suggests exactly the opposite, namely, that market forces are unlikely to address efficiently the coordination problems that arise in the transition across production and trade patterns. Indeed, coordination failures are

50 Amsden (2000) and Amsden and Hikino (2000) argue that the new rules of the World Trade Organization (WTO) allow countries to promote their industries, including the manufacturing sector, in particular under the umbrella of advancing science and technology (e.g., by setting up technology parks). Subsidies in exchange for monitorable, results-oriented performance standards are acceptable. Countries can, for example, target national champions. The hurdles that developing countries face are of the following nature: (i) informal political pressures by the developed countries in favor of market opening; (ii) countries that make use of WTO rules to promote their industries are subject to "reciprocal control mechanisms"; and (iii) their lack of "vision".

51 This is important in some developing countries, where a well-established elite may not see change with good eyes.

likely to arise in the transition from old to new patterns of production and trade specialization. This situation is characteristic of semi-industrialized countries, in which old comparative advantages in labor-intensive industries are being eroded, and new ones in capital and technology-intensive activities emerge only slowly. This view explains the successes of not only Korea and Taipei,China, but also of Singapore. Young (1992), in a well-known paper, compared the growth record of Singapore and Hong Kong, China, arguing that Singapore's had been based exclusively on capital accumulation (Soviet style according to Krugman 1994). Felipe (2000 and 2008), Felipe and McCombie (2001 and 2003) have discussed this literature, and have argued that its theoretical and empirical problems make the results and implied conclusions far from correct. It is true that at one point Singapore's government pushed the economy into new and more advanced sectors and perhaps the effort was not a complete success, but there is no doubt that without such a push the economy would not have ventured "by itself" into many of the areas in which it is doing well now.[52] As ADB (2007b) documents, Singapore's manufacturing sector is the most technologically advanced (after Japan's) in Asia.

In conclusion, the key to a successful transformation of the economies of many developing countries lies in embedding private initiative in a framework of public action that encourages restructuring, diversification, and technological dynamism beyond what market forces on their own are capable of generating.

5.6 Conclusions

This chapter has argued that in order to achieve inclusive growth, governments must commit effort and resources to the pursuit of full employment. The reason is that the main problem developing countries face is massive unemployment and underemployment. This is the result of the shortage of capital equipment and productive capacity. Why is the pursuit of full employment desirable? The reason is that a full employment economy creates a high level of overall purchasing power. Moreover, a full employment economy has the capacity to deliver great social benefits as it eliminates misery, poverty, and social injustice. Therefore, it is more rational to argue that developing countries cannot afford unemployment and underemployment than to suppose that they cannot afford full employment. Given the importance and relevance of the notion of full employment, governments must be held responsible for their achievement.

52 An example is the post-1979 rapid rise in real wages, partly encouraged by the Singaporean government in an attempt to stimulate productivity growth.

The chapter has also argued that the main policy to achieve full employment in developing countries is to step up investment. However, in reality, this is not so simple, for the private sector may decide not to collaborate, either because it decides to invest in areas that may be profitable but not relevant to the development of the country; and/or because the public sector may face obstacles to implementing a large program of public investment (e.g., budget deficits may not be politically acceptable).

Finally, the chapter has argued that investment requires planning, and that this should be understood as a partnership between public and private sectors to coordinate their activities in ways that complement each other. Industrial policy should be conceived as a process whereby the state and the private sector jointly arrive at diagnoses about the sources of blockage in new economic activities and propose solutions to them.

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