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DEVELOPMENT AND DYNAMIC EFFICIENCY: "FRAMEWORK APPROACH" VERSUS "INGREDIENTS APPROACH"[1]

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This note identifies two philosophical perspectives on economic development that inform debates about development and structural adjustment policies: the "framework approach" typical of Western aid donors, particularly multilateral development finance institutions such as the World Bank, and the "ingredients approach" adopted by the government of Japan in its development assistance policies. Discussion focuses on general conceptual clarification of issues differentiating these two approaches, with only occasional reference to specific experiences. Discourse at this level of generality will help clarify the nature and extent of philosophical differences between Japan and multilateral institutions on specific development policy issues.

"Framework" and "ingredients"

There are two contrasting ways of understanding and analyzing economic development and structural adjustment. One focuses on the "framework" of an economic system and its management; the other focuses on an economy as the sum total of its "ingredients" or component parts.

The "framework" represents rules of the game according to which economic agents make decisions and take action in a given economy. In the framework approach, which dominates thinking in Anglo-American university economics departments and multilateral development institutions like the World Bank, an economy is conceived in terms of the functions of institutions and mechanisms (the invisible hand), and its performance is evaluated in light of the extent to which the rules of the game are established and enforced among key economic agents.

In contrast, the "ingredients" refer to tangible organizational units such as enterprises, official bureaus, and industrial projects and their aggregations such as

industries, sectors and regions. They may, however, also relate to factors of production – land, labor, capital and technology – at different levels of aggregation and specificity. The ingredients approach conceives the economy as a collection of these components. It envisions economic development as the quantitative expansion and qualitative upgrading of the components, accompanied by shifts in composition.

These approaches see development and structural adjustment policies in distinctly different ways. In the "framework approach" the central task of policy and institutional reforms is correcting distortions in the incentive scheme, defined by the policy environment and institutional arrangements. By contrast, in the "ingredients approach" policies and institutions are viewed as tangible inputs, like conventional factors of production, that shape the process of economic change. They are the means to achieve a future vision of the economy, typically depicted in terms of a collection of industrial or regional economies.

In essence, the "framework approach" is principle-oriented while the "ingredients approach" is results-oriented. In the former, setting the framework right is considered a necessary, if not always sufficient, condition for successful development which will be manifested in improved macroeconomic indicators. By the very essence of this approach, little consideration is given to what sort of real-sector economy will result once the framework is in place: that is left to the market to determine.

Conversely, in the ingredients approach the economic outcome in terms of concrete sectoral composition or industrial organization occupies center stage, while the mode of economic management remains flexible and uncommitted. Certain economic orientations, such as what sectors or activities ought to be given priority, come into play but they are derived from, and therefore subordinate to, the ultimate goal – or premeditated result – of economic development.

The World Bank approach

The *World Development Report 1991* presents the concept of "market-friendly" government intervention as its key conceptual innovation. The report advises governments to intervene reluctantly, thus placing the burden of proof squarely on those who advocate activist government: "Let markets work unless it is demonstrably better to step in" (p. 5). Public goods not adequately provided by the private sector – basic education, infrastructure, poverty alleviation programs, population control and environmental protection – pass this test. Other actions usually fail: " . . . it is usually a mistake for the state to carry out physical production, or to protect the domestic production of a good that can be imported more cheaply and whose local production offers few spillover benefits" (p. 5).

In cases where governments do attempt intervention, the "market-friendly" approach offers three pieces of advice. First, interventions should be designed to maintain domestic and international competition. Second, they should be

moderate in the sense of minimizing price distortions. Third, they must be subjected to market discipline and should be withdrawn if they fail to produce competitive industries.

From this perspective, the Bank argues that the success of East Asian economies – Japan and Korea in particular – confirms the rules of market-friendly intervention. "First, these governments disciplined their interventions with international and domestic competition. . . . Second, these governments, on the whole, were careful to ensure that intervention did not end up distorting relative prices unduly. . . . Third, their intervention was more moderate than in most developing countries." In sum, "these economies refute the case for thoroughgoing dirigisme as convincingly as they refute the case for *laissez-faire*" (p. 5).

This is a fair statement; however, the question remains whether strict application of the market-friendly approach is advisable. The central issue here is how one understands the process of economic development and the nature of dynamic efficiency. In *World Development Report 1991* and other documents, the World Bank bases its case for the market-friendly approach on observed regularities between degree of intervention and price distortion on the one hand and output growth and productivity gain on the other. These statistical associations are cited as evidence for a theoretical position that argues that investment, innovation and production decisions are made in response to market signals and assumes that critical market failures are absent. This view sees development as essentially the result of investment and innovation decisions by individual economic agents responding to evolving conditions in goods and factor markets. Dynamic efficiency is realized, so it is claimed, because undistorted markets send the right signals for these private decisions.

Japanese critique

The Japanese government has engaged in co-financing with the World Bank on structural adjustment lendings (SALs) since the mid-1980s through the Overseas Economic Cooperation Fund (OECF) and the Export-Import Bank of Japan (Ex-Im). All along, many Japanese have felt uncomfortable with the Bank's thinking on structural adjustment though their concerns were not voiced until recently. Of late, the Japanese government and its agencies have adopted a more activist stance, advocating alternative perspectives based on Japanese and East Asian experiences. The most systematic manifestation of this activism to date is found in the OECF document, "Issues Related to the World Bank's Approach to Structural Adjustment: A Proposal from a Major Partner" (OECF Occasional Paper No. 1, October 1991). [See also Chapter 3 of this volume]

The OECF document is a Japanese manifesto that adopts the ingredients approach in interpreting Japanese and East Asian development experiences. It implicitly criticizes the framework approach that informs Bank structural adjustment as only half the truth and proposes its own set of policy prescriptions

as the missing half. The document criticizes the lopsided emphasis on "efficient resource allocation through the market mechanism" in Bank-led structural adjustment. The OECF raises four issues:

1. the need for "measures aimed 'directly' at promoting investment" in order to achieve sustainable growth;
2. the need for a long-term approach to development, including a conscious industrial policy to promote potential leading industries;
3. the value of subsidized policy-directed credit for the promotion of investment and infant industries;
4. the need to consider a developing country's economic, political and social conditions in making privatization decisions.

On the first point, the paper advocates a results-oriented approach: the use of direct policy measures to realize desirable investments ("ingredients"). Fiscal and financial policies utilized for the promotion of strategic growth industries in postwar Japan are suggested as potentially valuable in today's developing and transitional economies. Such measures are presented as a necessary complement to the Bank's principle-oriented approach that focuses on correcting distortions in the incentive structure ("framework") through policy and institutional reforms.

On point 2, the Bank's advocacy of indiscriminate trade liberalization ("framework approach") is criticized for relying exclusively on the notion of static comparative advantage, in contrast to Japan's proactive, promotional approach to creating desirable industries ("ingredients approach"): "To expect that the next generation of industries will pop up automatically through the activities of the private sector is overly optimistic." [See also Chapter 3 of this volume]

Point 3 makes a frontal attack on World Bank thinking on financial sector reform. While the Bank criticizes policy-directed, subsidized credits as causing distortions in the market framework of the financial sector, the Japanese alternative argues that the financial sector of many developing countries is underdeveloped and suffers widespread market failure. As a result, the market mechanism does not function as expected – and thereby fails to provide a meaningful "framework" for capital allocation. Under such circumstances, directed and subsidized credits can play a critical role in encouraging desired economic development activities ("ingredients").

Point 4 criticizes the World Bank's emphasis on the leading role of the private sector and its advocacy of privatization of state-owned enterprises as often infeasible or undesirable. The Bank is viewed as simple-mindedly and unduly concerned with efficiency criteria ("framework") in total neglect of socio-political conditions and national sentiments with regard to ownership structure within developing economies ("ingredients").

Allocative efficiency and unit efficiency

The two conceptual approaches derive to a large extent from different definitions of efficiency. The approach that dominates Anglo-American university economics departments and most multilateral development banks defines efficiency in allocative terms: efficiency is achieved by shifting resources from less to more productive sectors or firms. In Japan, efficiency is primarily conceptualized in relation to individual economic units: make as efficient use as possible of resources where they are now in order to increase the efficiency of all units and make everyone better off.

More efficient use of economic resources involves changes in "allocative efficiency" and in "unit efficiency." Allocative efficiency relates to the operation of economic institutions and mechanisms that impinge upon the mobilization and allocation of resources. Unit efficiency on the other hand refers to the capacity of specific organizational units such as enterprises, official bureaus, and industrial projects. These two determinants of the overall economic efficiency interact with each other. In other words, institutions and mechanisms define the incentive and selection environment for economic units; and conversely, efficiency at the level of economic units may affect the operation of institutions and mechanisms.

The two determinants of efficiency in an economy correspond to the contrast between the framework and ingredients approaches. Roughly speaking, the framework approach is concerned with efficiency of resource allocation or allocative efficiency while the ingredients approach focuses on efficiency of resource utilization or unit efficiency.

A number of supplementary remarks are necessary here. First, the framework approach may encompass factors relating to unit efficiency insofar as the policy and institutional framework determines the incentive environment for economic units, thus affecting their X-inefficiency.

Secondly, the ingredients approach has its own way of discussing allocative efficiency, which is mostly, if not exclusively, in terms of resource shift over time rather than at a given point in time. "Ingredients" advocates conceptualize allocative efficiency in terms of a vision of industrial composition at a future date. The notion of opportunity cost, central to the framework approach, is only implicitly reflected in the ingredients approach in the guise of the choice of industry for the future.

Final remarks

The Japanese are not comfortable with the notion that a universally applicable "framework" for development exists. Instead, they find a different approach based on the recognition of different stages of development more satisfying. In the clearest official statement of this view to date, the May 1988 report *Sekai to tomo ni ikiru nihon* [Japan Living with the World], put out by the Economic Council under the sponsorship of the Economic Planning Agency, calls for

country-specific aid programs based on development stages and types. Japanese development finance agencies are urged to approach structural adjustment with a clear understanding of real sector differences across economies.

Japanese understanding of their own economic development process is not based on the Anglo-American framework but rather on ingredients – for example, production and trade targets set for industry. Targets have usually been announced in so-called "visions", most notably MITI industry visions. Once targets are set, policy debate focuses on the means ("ingredients") to achieve them. The approach is quintessentially results-oriented, conceptualized in tangible rather than functional terms (building new factories versus enhancing the market mechanism in general). Development strategy aims to achieve economic expansion via accumulation of appropriate ingredients to increase productive capacity at the firm or project level.

A fundamental disagreement exists over the role of government in a developing economy. On the one hand, the framework approach emphasizes liberalization – trade liberalization and overall domestic deregulation; on the other hand, the Japanese believe this is not always appropriate, particularly in economies at an early stage of development.

A corollary to the important role for government is that industrial policy matters in development. In Japan, industrial policy is conceptualized in the form of visions, a series of concrete medium- and long-term goals.

Credit policy is a second concrete area where views diverge. Drawing on their own development experience plus that of Korea, Japanese believe that directed credit policy is more effective in promoting economic development than freely market-determined credit allocation. This, of course, presupposes the existence of an industrial policy.

Another area of disagreement with the Anglo-American framework approach is in attention to history. This is half an academic point and half common sense. Heavily influenced, consciously or unconsciously, by the German historical school, Japanese analysts and decision-makers tend to view economic problems in a historical time-series perspective as opposed to a functional cross-sectional approach that characterizes Anglo-American economics. The latter concentrates on the allocation of resources across an economy at a specific point in time. The Japanese approach instead views an economy by taking each unit and examining its historical evolution. In this sense the Japanese approach is essentially developmental; it is integrally aware of the evolution of an economy's component parts – "ingredients" – over time. This point captures an underlying attitude that crystallizes in more specific debates over issues such as industrial policy or credit policy.

Where does this leave the Japanese as far as formulating policy analysis goes? Again, the issue can be meaningfully addressed in comparison with the standard framework approach.

In the tradition of Anglo-American economics, the economy is treated as a functional cross-sectional model with policy inputs and performance outputs.

Cause–effect relationships between inputs and outputs are then turned around and viewed as ends–means relationships. The model itself is often not well understood: the economy is typically treated as a black box. Much policy analysis that is attributed to deductive reasoning is really inductive: economists compare several existing economies and attribute divergence in performance to differences in policy.

The Japanese approach begins with the initial conditions of an economy. These initial conditions undergo various historical processes en route to producing economic performance. Rather than being inputs into an economic black box, policies intervene at certain junctures in certain types of historical processes to affect performance. Economic development is viewed as a process in which economic agents and the market mechanism emerge and become increasingly more efficient with time, while at the same time productive and technical capabilities are accumulated and upgraded. Policy analysis must be rooted in the understanding of the mechanism of development and the nature of economic institutions at different stages and in varied types of economic development.

This is a tall order, but I believe that this type of alternative methodology needs to be explored if Japanese views are to be presented as an alternative framework for policy making.

Note

1 This manuscript, dated November 12, 1992, has not been published previously [Editors].

Chapter 4, in Japanese Views on Economic Development: Diverse paths to the market eds. Kenichi & Izumi OHNO, Routledge 1998

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AFTERWORD TO THE JAPANESE TRANSLATION OF THE WORLD BANK REPORT *THE EAST ASIAN MIRACLE*

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It was September 1989 – soon after I was dispatched by the Ministry of Finance to assume the post of Executive Director of the World Bank on behalf of the Japanese Government. I received a copy of a puzzling letter, addressed to the Japanese Government from the management of the World Bank. To be exact, the letter was from a Senior Vice President of the World Bank to the president of Japan's Overseas Economic Cooperation Fund (OECF). The letter asked that OECF reconsider its subsidized policy-directed loans to developing countries. The letter stated that such loans would militate against market determination of interest rates, "could have an adverse impact on the development of the financial sector," and hence "would create unnecessary distortions and set back financial reforms" which had been supported by the Bank and the IMF. This argument was hardly acceptable to us, both for practical reasons and in light of Japan's postwar experience of economic development.

OECF provides so-called "two-step loans" at concessional interest rates with long maturities to governments or public financial institutions in developing countries. Loan funds are on-lent by borrower governments at below-market interest rates to target groups, including small- and medium-sized businesses. Because "two-step loans" are one of the main vehicles for Japan's ODA loans (yen loans), denying their usefulness would have had a serious negative impact on implementation of Japan's ODA. Moreover, it is a well-known fact that the Japan Development Bank made a great contribution to industrialization in Japan's postwar economic reconstruction and high growth eras by channeling long-term financing (often backed by World Bank loans) to key strategic industries at subsidized interest rates. Other financial intermediaries – for example, the Export-Import Bank of Japan, the People's Finance Corporation, the Small Business Finance Corporation, the Agriculture and Forestry Finance Corporation, and Housing Loans Corporation – also played significant roles in their respective