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NAFTA Renegotiation: An alternative approach to foster upward economic convergence

By Robert A. Blecker, Juan Carlos Moreno-Brid and Isabel Salat

[Editor's Note: This is a shortened version of a paper that will be published in December 2017 in the Real-World Economics Review.]

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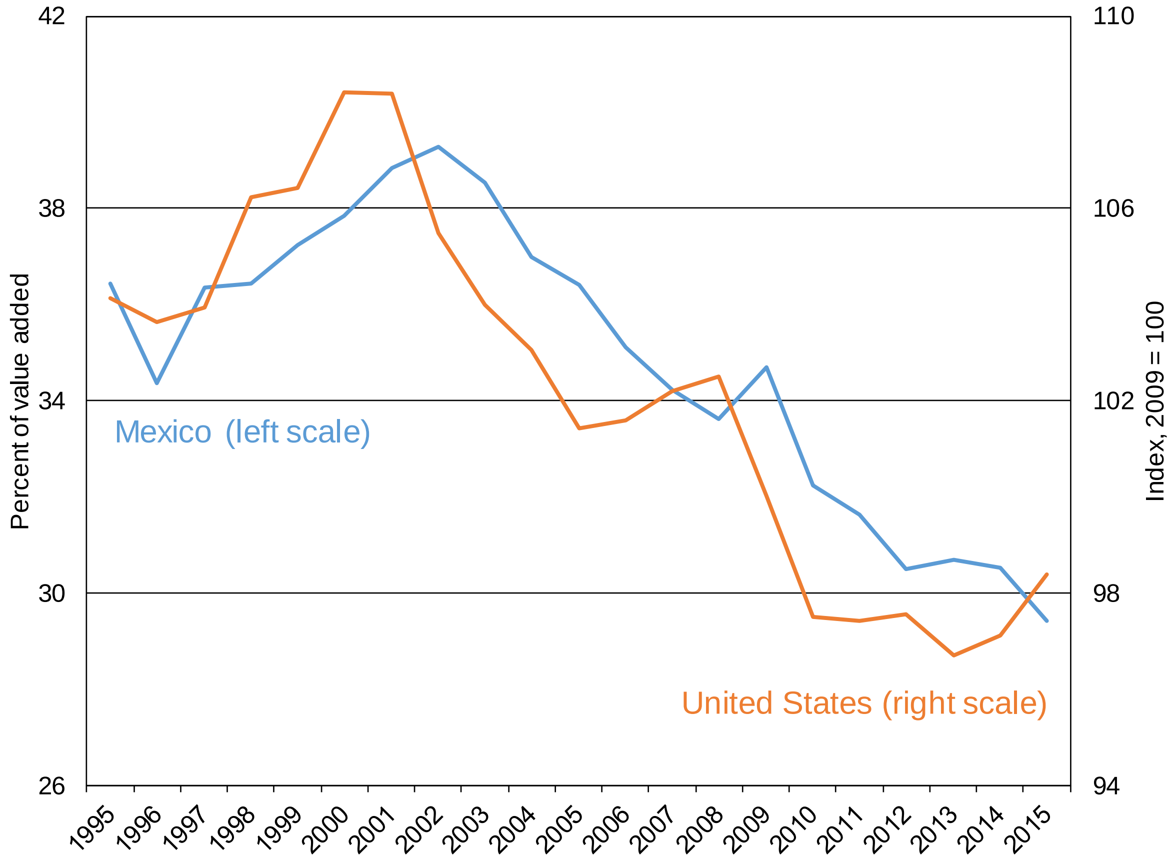
The election of Donald Trump as US president has put the future of the North American Free Trade Agreement (NAFTA), as well as US-Mexican relations generally, back onto the political agenda. The political success of Trump's demagoguery (and faux populism) partly reflects the failures of the neo-liberal policy regime in place since the Reagan era (for example, adjustment costs that were not offset, industrial policies that were not adopted, inequality that grew out of control, and a dollar that was allowed to become overvalued). The aftermath of the 2007-08 financial crisis has not produced a hopeful outlook for many Americans. Even though the rising inequality was not caused solely by the subprime crisis and the downturn that followed – it had been building up over the past three decades – the crisis made matters worse, to the point where it could no longer be ignored (Stiglitz, 2015)

Indeed, globalization and regional integration have not worked well for most Americans and Mexicans. Recent research shows that the US has experienced significant localized job market effects (mostly depressed wages and dislocation of less educated workers) as a result of NAFTA's tariff reductions (Hakobyan and McLaren, 2016), as well as much larger job losses attributed to increased imports from China and worsened inequality attributed in part to trade and outsourcing more generally (see Autor et al., 2016; Bivens, 2017).

In both countries, real wages have failed to keep up with rising productivity of labor in key tradable goods industries, especially manufacturing, resulting in falling shares of wages in national income at least since the late 1990s (see Figure 1; see also Mishel et al., 2012; Ibarra and Ros, 2017). Moreover, the Mexican economy has made no progress in convergence with the US in per capita income or wages since NAFTA went into effect in 1994.

Figure 1. Private business sector labor shares, Mexico and United States, 1995-2015



Sources: Ibarra and Ros (2017), data used with permission; U.S. Bureau of Labor Statistics (BLS), www.bls.gov; and authors' calculations.

The great paradox about NAFTA

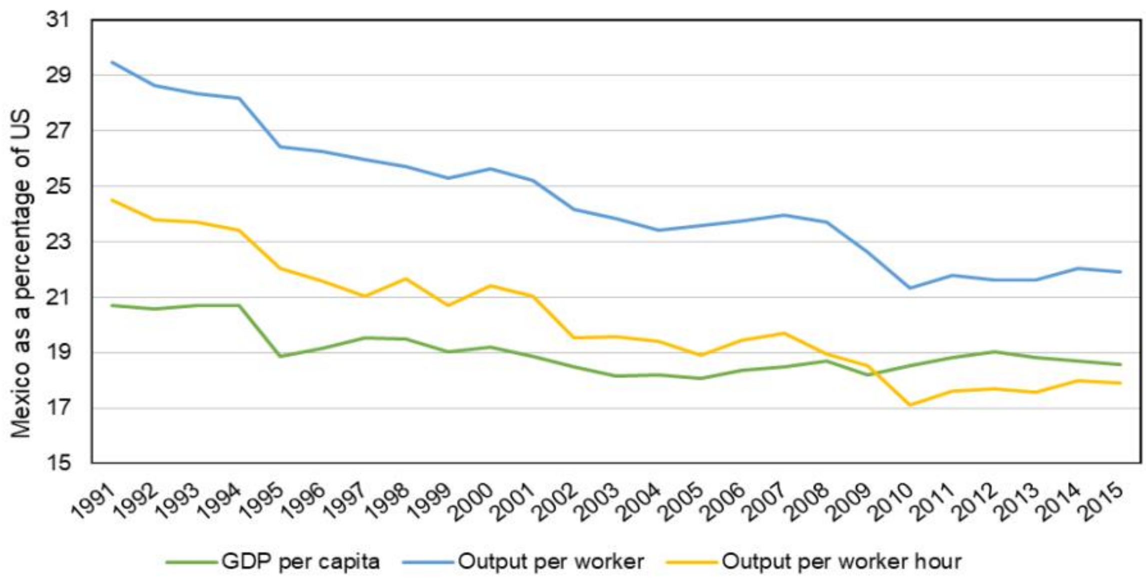
NAFTA appears to have been successful in its immediate objectives of promoting greater volumes of trade and flows of foreign investment. Regional trade increased sharply over the agreement's first two decades, from roughly $290 billion in 1993 to more than $1.1 trillion in 2016. Inflows of foreign direct investment (FDI) into Mexico have also increased since NAFTA went into effect in 1994, from an average of 1.2% of Mexico's GDP in 1980–1993 to 2.7% of GDP in 1994–2016.

However, recent research finds that only part of the post-NAFTA increase in regional trade can be attributed to the causal impact of the tariff reductions in this trade agreement. Romalis (2007) estimated that the tariff reductions in NAFTA increased bilateral US-Mexican trade by only 23%, while Caliendo and Parro (2015) – using a model that emphasizes trade in intermediate goods – estimated that the impact was to slightly more than double US-Mexican trade. These are not negligible increases, but they suggest that US-Mexican trade has grown for many reasons besides NAFTA. In any event, bilateral Mexican-US trade has clearly become very important for both countries: as of 2016, the Mexican economy was the third largest supplier of goods imports into the US, and the second most important destination (after Canada) for US exports, while the US was by far Mexico's largest trading partner accounting for about 80% of its exports and 50% of its imports.

In spite of the increases in trade and FDI, however, the larger goals that the Mexican government proclaimed for NAFTA when it was adopted in 1994 have not been achieved. Contrary to the assertion by then-president Carlos Salinas de Gortari that NAFTA would transform Mexico into a "first-world country," there has been no convergence between Mexico and the US in per capita income or labor productivity since NAFTA went into effect (see Figure 2). Indeed, Mexico has suffered from a disconnect from the promises of some of NAFTA's supporters that the pact would deliver rapid growth, raise wages, and reduce emigration. Between 1993 and 2013, Mexico's economy grew at an average annual rate of just 1.3 percent, during a period when most of Latin America was undergoing a major expansion. In spite of the increase in FDI as a percentage of GDP, there is no evidence that the ratio of domestic investment to GDP has increased in Mexico in the post-NAFTA era.

Poverty in Mexico remains at about the same levels as in 1994. Also, the expected "wage convergence" between US and Mexican wages never occurred. As Figure 3 shows, as of 2016, real hourly compensation in Mexican manufacturing was still below its absolute level from 1994, while as of 2015 (the last year for which comparable data are available) Mexican hourly compensation was also a lower percentage of the US level than in 1994. Furthermore, Mexico's per capita income rose at an average annual rate of just 1.2% in the 1993-2013 period – far slower than in other Latin American countries such as Brazil, Chile, and Peru (McBride & Aly, 2017).

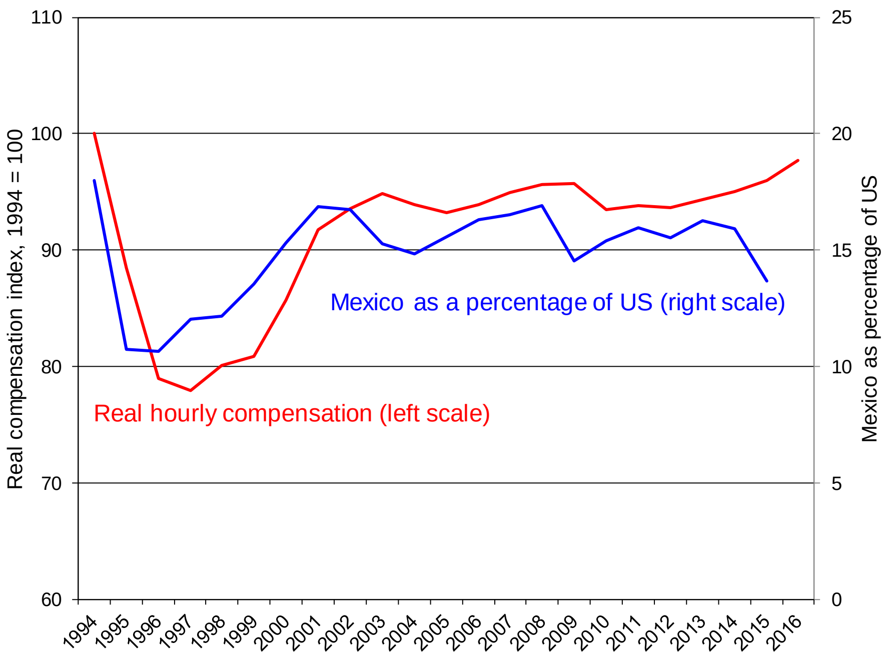
Figure 2. GDP per capita and labor productivity in Mexico as a percentage of US, 1991-2015



Sources: Data from World Bank, World Development Indicators, and OECD Statistics, accessed October 15, 2017, and authors' calculations.

Figure 3. Hourly compensation of Mexican production workers,

in real terms and as a percentage of the US, 1994–2016



Sources: Authors' calculations based on data from Banco de México, www.banxico.org.mx; INEGI, EMIM, www.inegi.org.mx/; BLS, International Labor Comparisons, www.bls.gov; accessed 26 June, 2017 and earlier; and Conference Board, https://www.conference-board.org/ilcprogram/, accessed 9 August, 2017.

This brings us to the great paradox about NAFTA and Mexico. On the one hand, NAFTA and related policies of trade liberalization and neo-liberal reforms adopted since the late 1980s have been an abject failure from a development standpoint: after three decades, these policies have never achieved the promised convergence to first-world (US) levels of real wages or per capita incomes or any progress in that direction. On the other hand, NAFTA (in combination with those same related policies) has locked Mexico onto a growth trajectory along which whatever growth does occur – however slow and inadequate – derives most of its momentum from the performance of exports, and hence is highly dependent on the growth of the US market and other external factors (Blecker, 2009).

As a result, any changes to NAFTA that would impede Mexican exports would undermine the chief dynamic factor in the Mexican economy, and a US withdrawal from NAFTA or the imposition of higher tariffs and other trade barriers could be catastrophic in the short and medium term. Yet, the failure of the current development model implies that Mexico needs to re-think its economic strategy anyway, and ironically the threats from Trump could provide an opportunity to accelerate that re-thinking and shift Mexico's policy paradigm to a more development-oriented, less externally dependent, and more equitable and sustainable model.

The road ahead: towards a new agenda of development and shared prosperity

Mexico has an urgent need for a new development agenda based on strengthening the internal market (equality + structural transformation + fiscal reform). This is true and will remain true independently of any outcome of the NAFTA renegotiation. To the extent that the renegotiation is based on a Trumpian view of trade as a zero-sum game, the outcome will not favor Mexico's development prospects.

The US also needs a new policy regime to reverse rising inequality, secular stagnation, and regional divergences. The Trump negotiating agenda for NAFTA would do little if anything to achieve this. Protection could potentially benefit particular industries or areas, but would not reverse the national trends and could worsen competitiveness in other, unprotected sectors (and even some of the protected ones, such as automobiles, if their costs rise). In the extreme case that Trump would withdraw the US from NAFTA, important US export sectors such as corn farming and agricultural equipment could lose substantially from higher Mexican tariffs. However, a revised NAFTA that promotes industrial growth and competitiveness throughout North America could help the US along with other measures. A progressive response to Trump must address concerns of US workers over disappearing jobs and stagnant wages, or it will be a political non-starter. Raising incomes and wages in Mexico as well as legalizing undocumented immigrants and enabling them to obtain higher wages are win-win policies for US and Mexican workers.

In the past few decades, what has made the impact of globalization and regional trade agreements more painful than necessary in both countries is the fact that they have occurred in an environment in which adequate safety nets are not in place, full employment is not guaranteed, and the likely earnings from alternative employment (for example, in the service sector instead of manufacturing, especially informal activities in Mexico) are often much lower than in the occupations lost due to trade or offshoring. Governments supporting trade agreements and integration projects have been reluctant to admit the severity of the potential adjustment costs, lest they lose support for their liberalization efforts – even though such efforts at denial are not only intellectually unjustified (even in theory, trade generally creates losers as well as winners), but also have often backfired politically (as in the success of the Trump and Brexit campaigns).

Moreover, all this is occurring in an era (since roughly the 1980s) when macroeconomic policies (especially monetary policy) have shifted in many countries (including Mexico and to a lesser extent also the US) toward a greater focus on price stability and balanced budgets than on full employment and economic growth. Mexican growth during the entire neo-liberal era (since the late 1980s) has been less than half as rapid as it was during the import substitution era (1940s-70s), while US employment growth has slowed down notably since the US began to experience "secular stagnation" in the early 2000s (Blecker and Esquivel 2013; Blecker 2016).

Thanks in part to the US Great Recession and slow growth since 2008 and in part to Trump's threat to withdraw from NAFTA, today the external market has stalled as an engine of expansion for Mexico. There is thus an urgent need to implement a new agenda of development in Mexico based on strengthening the domestic market, in the context of an open economy. The new agenda has three main priorities: i) income redistribution to tackle inequality; ii) structural transformation to, in particular, strengthen backward and forward linkages of the productive sector; and iii) much more active state intervention in the economy.

In that sense, addressing industrial policies, financial policies, regional policies, and public investment with the aim of strengthening backward and forward linkages of the productive sectors and including the export sector, promoting backward regions and boosting infrastructure are essential to transform the process of North American integration to one of "upward convergence" (defined as a process in which Mexico approaches US levels of wages and per capita income, but with those levels continuing to rise in the US and not being pulled down). The idea is not to disregard export capacities, but rather to supplement them with a strong impulse from the domestic market.

In order to achieve more inclusive and sustainable growth in both Mexico and the US, given their current degree of inte-gra-tion and the changing character of global production and technology, we believe that is neccesary to devise economic policies that can move the two neighbors back to such a trajectory of upward conver-gence, on which real wages would increase in line with productivity growth in both countries.

Policy actions with a long-run perspective

In this endeavor, we propose some policy guidelines. First, as inequality has became a constraint for growth on both countries, tax policies for income redistribution can be an alternative. For the US, the best approach would be to restore high marginal tax rates on very high incomes and inherited wealth, which would help to reverse the heightened inequality that the US has experienced since the 1980s (Mishel et al., 2012).

In Mexico, a fiscal reform is urgently needed to bolster Mexican government tax revenue in a progressive way. This would provide funding for infrastructure investment and social expenditures, strengthen the state's capacity to implement countercyclical policies, and put in place a much more transparent and efficient system of public investment across the nation aligned with the priorities of the National Development Plan.

Second, public investment and industrial policies are needed to reduce the tremendous infrastructure "deficits" in Mexico and the US, as a result of inadequate and declining public resources being invested in public capital in recent decades. A massive increase in infrastructure spending in both countries would boost demand and employment in the short run, while augmenting capacity and productivity in the long run.

Third, to promote upward economic convergence by pulling up wages and living standards at the bottom end of the income scale while also putting upward pressure on median wages it is essential to raise the minimum wage in both countries. It should be noted that for decades, in Mexico, minimum wages have not followed the evolution of productivity. If minimum wages had been linked to market conditions and the performance of their own efficiency, those salaries would have seen a path of rise, not of deterioration.

Increasing minimum wages in the context of a full commitment to give a more relevant role to the state in promoting a less unequal functional distribution of income is key to reducing the unacceptably high levels of inequality and poverty in Mexico. However, many Mexicans have been understandably reluctant to press for wage increases in response to the demands of the Trump administration, which seem aimed only at reducing Mexico's competitive advantages. Of course, minimum wages do not generally apply in most export industries, but by setting a floor under the entire wage structure, they can influence other wages as well. That is why it is also important to also raise the minimum wage in the US at the same time as it is increased in Mexico, so that there is little or no net competitive impact and instead there is simply a redistribution of income toward lower-paid workers in both countries.

Finally, to promote a new agenda of development in the US and Mexico, what are most important are macro-level policies that can boost demand, augment supply capacity, and ensure full employment. By "macro-level," we mean not only traditional fiscal and monetary policies, but also other types of measures that are economy-wide and can have a national impact on the bargaining power of workers in labor markets and competitiveness in external markets. And we do stress that increasing produc-tive capacity is essential in order to prevent inflationary outcomes (especially in the Mexican context), which means that any fiscal stimulus should focus heavily on capacity-enhancing measures such as infrastructure, education, and innovation.

In this regard, placing inequality at the center of economic policy concerns is a central requirement for Mexico, as is successfully responding to Donald Trump's threats, in order to escape the slow-growth trap in which Mexico is currently stuck, thereby reducing social vulnerabilities and political instability in the long term. At the same time, we hope that the US will reverse the trend toward nationalism, xenophobia, and isolationism that has emerged under the Trump administration, and will turn instead to a more cooperative approach to fostering upward convergence of Mexico within North America as well as a return to more progressive social and economic policies at home. In all of this, the renegotiation of NAFTA can play at most a small part, if it is done with a cooperative, win-win spirit; whereas a nationalistic rewrite of NAFTA or a hasty US withdrawal from it would only complicate the task of making North American integration work more in the interest of average US and Mexican citizens.

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Nudges — their dark side

By Maria Alejandra Madi

The concept of **nudge** became popular after the publication of the 2008 book *Nudge: Improving decisions about health, wealth, and happiness*, written by Cass Sunstein and the most recent Nobel Laureate, Richard Thaler. According to the authors, nudge refers to "*any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives. To count as a mere nudge, the intervention must be easy and cheap to avoid. Nudges are not mandates. Putting fruit at eye level counts as a nudge. Banning junk food does not*" (Thaler and Sunstein, 2008).

In a previous paper, Thaler and Sunstien (2003) highlighted the paternalistic intention and the libertarian tone that overwhelm the concept. As a result, while policymakers shape contexts of individual choice towards optimal policy goals, individuals are *free to choose*.

Currently, nudges are used to foster social policy goals, such as the so called consumer protection. The aim of the nudge approach is both to test non-coercive alternatives to traditional regulation and to enhance cooperation between the public and the private sector. Indeed, after 2008, a Behavioural Insights Team (BIT) was created in the UK and in many others countries – like Australia, Canada, the Netherlands, Germany, U.S. and Qatar. Since 2010, the Behavioural Insights Team (BIT) in the UK has been exploring and testing policy options by means of randomised controlled trials (RCTs). Taking into account the American experience, the Obama's administration stimulated the introduction of nudges in new regulations to generate welfare with cost effectiveness.

Considering this background, the relevant question is: **which are the reasons that explain the increasing acceptance of the nudge approach to public policy?**

First, the use of nudges in public policy seems to be associated to the broader processes of deregulation and privatization in the context of financialization.

Second, the focus on individual behaviour is consistent with a neoliberal agenda where the new approach to public policy enhances the *illusion of free individual choice*. In this respect, Ramsey (2012) highlights the *rea*l burden on individuals that actually result from labor market flexibility and increasing indebtedness. In his own words: "*Deregulation and privatisation often imposed greater choices on individuals (e.g. pensions). Forced to make choices, individuals were invited to regulate themselves according to particular norms of behaviour. Thus in consumer finance markets individuals must learn the appropriate norms of credit and savings behaviour and become financially literate. More recently insights from behavioural economics have been harnessed to 'nudge' individuals to change their behaviour*"

Third, behind the partnerships between the public and the private sectors that aim at developing new forms of non-coercive regulations, there is, in truth, a set of economic and political interrelations that shape the financialization of corporate strategies in sectors that used to be related to public services. For example, in relation to the health sector, Maryon-Davis (2016) addresses: "*Today's most liberal governments tend to resist calls for regulatory approaches to health behaviour. They are averse to regulating industries such as the tobacco, alcohol and food industries for fear of interfering with companies' rights to sell their legal products and their legal obligation to shareholders to maximise profits. They tend to be even more reluctant to pass laws directly curtailing the personal freedoms and behaviour of individuals*."

Following the nudge approach, the responsibility for public welfare is shifted to individuals. In spite of encouraging active civic engagement, this approach to public policies seems to neglect the social constraints that restrain individual autonomy. Finally, it is worth noting that, while putting emphasis on individual behaviors and choices, the nudge approach dismisses the global increasing economic, social and political challenges at national, state and local levels.

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My evening with Joan Robinson and the Tractatus

By Edward Fullbrook

The General Theory of Employment, Interest and Money was the first book I ever read with pleasure. I was 22.

From age five to sixteen the school system had me classified as borderline mentally retarded. My luck changed in my penultimate year of high school when a non-conformist English teacher gave me the chance to pretend I was not mentally deficient. She also taught me how to write a sentence, after which, inflated with fantasises of normality, I taught myself how to read textbooks and take exams, and soon became academically proficient and for a long time thereafter very neurotic.

As an undergraduate I cut classes as often as I attended them and waited till the night before an exam to open the textbook. Sometimes I only managed a C but in economics it was always an A and that was the only reason I had for becoming an economics graduate student.

Till then mine had been an all-American, all-textbook education. The textbook genre requires its authors to pretend to know it all and talk down to their readers. Reading *The General Theory*, I encountered for the first time an author who was openly struggling to understand what he was writing about. I too was struggling and so I – and what could have been more preposterous – immediately identified on an existential level with John Maynard Keynes. It meant that for the first time ever while reading a book my resentments and fears from my educational past receded to the background. And when they did the most astonishing thing happened. My brain started giving me an intensity of pleasure that, except for sex, I hadn't thought possible. So it was that an intellectual was born.

I had read the whole of *The General Theory* before I opened Alvin Hansen's *A Guide to Keynes*, the book we had been assigned to help us understand the original work. Reading it was a shock. Either Hansen was in some way corrupt or when it came to economics one of us was rather more intelligent than the other. Given my history, the second possibility was extremely worrying. But my emerging new self was saved when a fellow grad student loaned me a copy of Joan Robinson's *Introduction to the Theory of Employment*. It both confirmed my reading of Keynes and offered me one that was much deeper. Because of that and because Robinson's brilliance made serious inroads against my inherited sexist bigotry, she along with Keynes became one of my first two intellectual heroes.

Not long after my intellectual birth a conversational experience and its aftermath turned me off economics – and I thought forever. Having from five onwards been marginalized at school, I had compensated by outside of school organizing my peers in games, fort-building, expeditions, clubs, teams, a league, hell-raising and minor pranks. These organizing inclinations continued into my twenties, and as a graduate student I gathered some of my new peers into a discussion group. Once a month we would meet with a case of beer and a guest professor in one of our basement apartments. One month our guest was a young professor whom I liked and who was soon to make millions off his textbook. Halfway through our case of beer someone asked him, "What do you do if after you've been working on your dissertation for a year or longer you discover that the data you've collected doesn't support your hypothesis?" You reselect the data was his answer. "How do you do that?" The professor volunteered to hold a short series of seminars to show us how. When the time came for the first one, I couldn't make myself go. My peers came away from it enthused. Likewise for the second and third. I decided economics was not for me.

With a backpack half-full of books – I was reading widely and seriously now – I set off to see the world. Sixteen years and many adventures and misadventures later, I found myself living in Cambridge UK. One day walking on a back street near the centre, a shop window caught my eye. It was a photographer's shop belonging to the widow of Frank Ramsey, the philosopher, mathematician and economist who back in the 20s died at the age of 26. The shop window was full of old black-and-white photos, and soon I was recognizing faces from the Bloomsbury Group: Virginia and Leonard Woolf, Duncan Grant, Keynes and others. One photograph was larger than all the others and the longer I stood there, although I didn't recognize the subject, the more I found myself looking at it: a woman in her early to mid-twenties in an oddly patterned dress sitting on a sofa with her legs folded under her. It wasn't that she was particularly good-looking but rather that there was more character in her face than you would expect in someone her age. Eventually I leaned down to read the small print on the bottom of the frame: "Joan Robinson".

A few nights later I was at a chamber music concert. It had yet to begin and I was watching people taking their seats. An elderly couple, entering arm-in-arm, caught my eye. The woman sitting next to me appeared to recognize them, so I asked her who they were. "They're famous economists: Piero Sraffa and Joan Robinson."

A month later I was at a dinner party. Sitting opposite me was an Indian woman who was a Cambridge English don. We mostly talked literature until we got to the cheese course when she asked what I "read" in university. "Oh", she replied, "I too did a degree in economics. After my undergraduate degree in English I decided to get one in economics before going on for my doctorate in English." She said she still kept up her economics contacts and occasionally had "econ evenings" and would invite me to the next one.

I had zero interest in economics, but when a few weeks later I received the promised invitation I thought it might be interesting as a social occasion. So, more than a little nervous, I went along.

I was the last to arrive. Entering a large sitting room, there in an armchair directly in front of me was Joan Robinson. The gathering had been forewarned that an odd American was coming, and I had barely crossed the threshold when the great woman, with the whole room listening, asked me a question about the current state of the American economy. She did so with the kindest possible face, but I had not read anything about any economy for over a decade, and I froze. Thankfully, Sita, the hostess, covered for me and dinner was served.

After dinner – by now I had had a couple of glasses – I decided I had to make something of this once-in-a-lifetime opportunity to engage with one of my heroes. Joan – there was absolutely no edge to the woman so it already seemed natural to think of her as Joan – was in the armchair again, and I sat down on the floor facing her at her feet. I began by asking her what it was like being a student at Cambridge back in the Twenties. After recalling the lectures of the literary critic I. A. Richards, she moved on to Wittgenstein and Sraffa and their weekly one-on-one discussions over tea. It was one of those discussions – and in her raspy voice she repeated Sraffa's account of it – that led to Wittgenstein's famous turn from belief in a world comprised of atomistic sets of propositional facts to one where meaning depends on the anthropological setting in which propositions are conveyed. At this point Sita, who was now sitting on the floor beside me, sought to bring the whole room into the conversation by making a broad and potentially contentious statement about the meaning of Wittgenstein's *Tractatus*. I still had not read the book, but had read one or more books about it, and suspecting it was likewise with Sita, I decided as a way of becoming friends with her to argue against her. It was immediately obvious that she liked my challenge and soon the whole room of economists was debating the meaning of *Tractatus Logico-Philosophicus*. And, bizarrely, something was about to happen that would change the course of my life.

As the debate continued it occurred to me that perhaps no one in the room had really read the *Tractatus*. Joan Robinson stayed out of the debate and, although I was still sitting at her feet, I now had my back to her. Then suddenly from behind me her loud raspy voice broke into the conversation. Here are her exact words.

The world is all that is the case. The world is the totality of facts, not of things. The world is determined by the facts, and by their being *all* the facts. For the totality of facts determines what is the case, and also whatever is not the case. Those are the first four propositions of the *Tractatus*. I've never been able to understand them.

With her eyes turned away from us and into her thoughts, she tried to explain what she couldn't understand. She was not arguing; she was making a confession. Except for maybe herself, the singularity of her behaviour was lost on no one in the room. It was a magic moment for me – the relaxed *integrity* of her intellect was so plain to see. And such a contrast to the outcome of my conversation sixteen years before. I wasn't yet in a position where I could change my life's course, but in time I was, and if it hadn't been for that evening with Joan Robinson and the *Tractatus* I would never have become an economist.

Excerpt from, *What is Heterodox Economics: Conversations with Leading Economists*, Sebastian Berger, Andrew Mearman and Danielle Guizzo, (eds), Routledge, forthcoming.

One Ongoing and One Forthcoming WEA Conference

1. Economic Philosophy: complexities in economics, 2nd October – 30th November 2017

There is considerable interest in recent economics in the idea of complexity. There are also many different ideas about what complexity involves, making the subject of complexity itself a complex matter! Thus the plural form – complexities in economics – is purposefully chosen in order to accommodate a range of issues in this inaugural conference on Economic Philosophy

2. Monetary Policy After The Global Crisis: How Important Are Economic (Divisia) Monetary Aggregates for Economic Policy?

15th January – 15th February 2018

The recent financial crisis has induced central banks to undertake substantial steps. These steps include quantitative easing or a renewed focus on the quantity of money in the economy. Therefore, our main goal is to establish a good forum for confronting of the opposite views about the causes and consequences of the Great Crisis. Specifically, some economists acknowledge the importance of proper money aggregation in preventing future economic slowdowns.

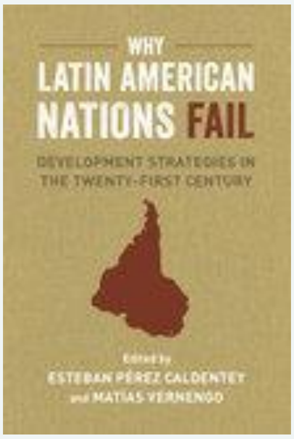
Deadline for submissions: 15th December

OPEN CALL FOR PAPERS

Why Latin American Nations Fail

By Matias Vernengo and Esteban Pérez Caldentey

*[Editor's note: Here the authors summarise the main themes of their recently published book, **Why Latin American Nations Fail*** (Matias Vernengo and Esteban Pérez Caldentey, 2017, University of California Press)*]*



Institutions are central to explaining the way in which, nations grow and develop. Traditionally the study of institutional economics focused on a very broad range of interests and made contributions in several different areas, including the structure of power relations, the beliefs systems, and also social norms of conduct. Contrarily the New Institutionalist turn in mainstream economics places the weight of its explanation on property rights.

Within the logical construct of neoclassical economic theory, the contribution of the New Institutional Economics is a necessity, basically because exchange and production in a market economy requires the prior definition of property rights (endowments and their distribution are part of the data jointly with technology and preferences that are needed to establish a market equilibrium). Because neoclassical theory is a-historical, the same framework derived from *a priori* reasoning must have universal validity and be applicable to any particular historical episode underscoring, in this way, the invariance of human behavior in space and over time. This dictates the New Institutionalist Economics´ approach to history which materializes in providing examples of hand-picked empirical evidence across different centuries, regions and countries and interpreting these as coherent with the deductive universal framework of neoclassical theory.

Acemoglu and Robinson's influential book *Why Nations Fail* (2012) constitutes one of the most comprehensive and illustrative examples of this line of thought. Its authors argue that the economic failure or success of countries depends on whether these have inclusive or extractive political institutions. Inclusive political institutions are those that distribute power broadly, constrain arbitrary exercise, and make it harder to usurp power or set the basis for rent-seeking behavior. Inclusive political institutions require well defined and secure property rights. Extractive institutions have the opposite characteristics.

Why Latin American Nations Fail is in part a response to this New Institutionalist turn in mainstream economics focusing on the case of Latin America.

Since the 1980´s up to the present day, for over three decades, Latin America as a whole has registered mediocre growth trend levels. The average rate of per capita GDP growth for the period 1980-2014 is 2%. This performance responds not only to the medium and long-run effects of successive crisis episodes within the region starting with the Mexican Tequila in late 1994 and culminating with the Argentinean default in early 2002, which many times were the product of unsustainable balance of payments difficulties, but also to expansions that, by comparison with other developing economies, are short-lived and less intense.

The most recent period of expansion (2003-2008) did not change the growth trend, in spite of improved international conditions including higher commodity prices and external demand and low international interest rates. Currently the region faces more stringent external conditions.

There has been a slowdown in external demand of developed economies and also of China, which had become a major trade partner for some of the economies in the region, coupled with a significant decline in commodity prices. These have affected those economies whose production structure and exports are resource based. Moreover, the decline in commodity prices has important balance sheet effects, as the liabilities of commodity producers and companies tend to increase while the value of assets tends to decline. As leverage rises and becomes one of the main sources of finance and profits, balance sheets become more fragile. Public and private debt associated with lower commodity prices may become an important issue in the near economic future for Latin America and an important obstacle to growth, in particular for countries with limited access to international capital markets and with a negative current account position.

Further, the fact that commodities have taken on the characteristics of financial assets and the fact that growth strategies are based on a financial asset increases the possibility of instability and uncertainty in the commodities market, a side effect of the process of financialization which was at the center of the Global Financial Crisis. For its part a strategy based on private debt, as is the case of some countries in Central American case, can rapidly lead to deleveraging and credit contraction. In addition, relying on remittances (i.e., the export of labor) can over time become an obstacle to growth. After all, exchanging a productive factor (labor) for a flow of income can eventually become extremely costly.

In spite of significant progress in some social areas, poverty remains a persistent phenomenon in Latin America. More importantly high inequality has become one of the trademarks of the region. In terms of the personal distribution of income Latin America and the Caribbean is the most unequal region in the world. Moreover, the commodity boom tilted the functional distribution of income away from wages and towards profits that in general have not been reinvested in productive uses. Finally, the spread of democracy in the region is being challenged by the failure of the government to respond to rising social demands and the impending corruption in some countries.

In *Why Latin American Nations Fail* we start from the premise that institutions are an essential component of Latin America's development problem. But we think that the New Institutionalist view and the focus on property rights is part of the lack of success of mainstream policies that have dominated development economics in theory and practice in the past decades.

Given their importance, we believe institutions deserve a broad, critical and multidisciplinary approach beyond the property rights approach, which could then provide a basis for alternative policy recommendations. This is what we try to show in the book and in its different sections and chapters. The book is divided into two sections. The first highlights several key problems associated with New Institutionalist arguments and, in particular, with the way it is applied to view and understand Latin American development.

The New Institutionalist approach provides a limited view of comparative historical analysis failing to read and understand history on its own terms. An illustrative example is Acemoglu and Robinson´s characterization of the Spanish and English colonizations as being extractive and inclusive respectively when in fact the historical record shows that both types of colonizations were at times extractive and inclusive. The more recent historical experience of Japan in the post-WWII era, South Korea and some other Asian nations such as Singapore shows that economic success was not based on inclusive institutions.

Also, the New Institutionalist view overplays the role of the market and downplays the role of the state in the process of economic development. Several institutions of the developmental state that promoted industrialization, including the bureaucracies that managed macroeconomic and commercial and industrial policies, development banks, publicly funded or directly public universities and research institutes were central in many experiences of development, and were also part of the Latin American experience until the debt crisis of the early 1980s. The reversal of many of these policies after the crisis, and the predominance of the Washington Consensus, have not led to vigorous growth as New Institutionalist views would have indicated.

Moreover, the institutions emphasized by the New Institutionalism are uniquely concentrated on the supply side of the economy, and the generation of incentives for productive investment (to buy machines and equipment). However in practice the institutions that allow for the expansion of demand, including those that allow for higher wages to expand consumption and to avoid the external constraints, are and have been central to growth and development.

The second section provides critical assessments of this development strategy, identifies the future challenges, and presents alternative policy proposals to the ones that are currently being followed and implemented.

The two sections provide important policy recommendations that can be summarized in five points. First, development policy must focus on improving the character and quality of national institutions. Second the most important condition to promote development is a strong, but flexible and dynamic, government involvement across a wide variety of areas including investment, industrial policies and innovation, education and other social policies, besides the areas that traditionally fall under the scope of public policies. Third, states and governments rather than limiting their functions to that of mere ´referees´, regulators or market plumbers, must assume the role of architects and market makers in the design and establishment of institutions. Fourth institutions, must allow the expansion of demand to promote growth and development. Financial markets permit the growth of domestic economies according to their potential. Demand oriented policies means placing the focus on income and not substitution effects. Finally, government involvement is not tantamount to centralized government. Development institutions and demand oriented policies cannot work properly without bureaucratic autonomy.

Microeconomics: An Islamic Approach

By Asad Zaman

At the heart of modern economic theory is the micro-economic model of homo economicus, who is cold, calculating and callous. This picture of humans as heartless rational robots is what leads to "Poisoning the Well: How Economic Theory damages our moral imagination" (Julie Nelson). I have provided a thorough critique of neoclassical utility theory in my paper: The Empirical Evidence Against Neoclassical Utility Theory: A Review of the Literature," *International Journal of Pluralism and Economics Education*, Vol. 3, No. 4, 2012, pp. 366-414. However, as Thomas Kuhn noted, paradigms cannot be changed by critiques; they can only be changed by providing an alternative paradigm. Thus to oppose neoclassical utility theory, we need an alternative model for human behavior. For western theorists, a natural alternative is the secular humanist model, which allows for a wide range of cognitive and emotive functions not captured in economics. For my purposes, Islam provide a more relevant model of human beings as having spiritual, emotional and rational dimensions. This model speaks directly to my audience. (see also "Spirituality and Development")

It is also true that, regardless of how we try, it is impossible to do economics without notions of morality, justice, equity and fair-play. Currently economics pretends to be positive, which means that it sneaks in very questionable (indeed, poisonous) value judgments (like that of Gauthier) into the framework, without explicit discussion. I have explained how the apparently objective concept of scarcity is actually built upon hidden foundations of three major value judgments about exogeneity of tastes, sacredness of property rights, and the idea that (unobservable) human welfare directly corresponds to (observable) human choice behavior:; see the *normative foundations of scarcity*, *real-world economics review*, Issue no. 61, pp.22-39. Again to oppose neoclassical micro, we must introduce an alternative ethical and moral framework. Here again it suits my purpose to use an Islamic framework for this purpose.

Below, I provide a link to a summary of the first lecture I gave, in a unique course on Microeconomics. Unlike Western epistemology which takes all knowledge as useful, Islam differentiates between useful and harmful knowledge. I am teaching my students that conventional micro is "Harmful" knowledge, which damages our natural tendencies for compassion and kindness, and teaches us to be selfish. It teaches us to accept poverty, misery, injustice, and exploitation as natural outcomes of an ideal economic system. The link below provides (1) a very brief summary of the lecture, (2) a link to the 91min video of the actual lecture, and (3) a more detailed 2500 word outline of the lecture, for people who don't have time to watch/listen to the 90 minute lecture.

https://asadzaman.net/am01-introduction/

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