1. Introduction

Perspectives on development have changed radically over the past half-century, and indeed over the past decade. New evidence and theoretical approaches have deepened and shifted the debates. We have a much better understanding of the relationships among markets, governance, and institutions. Our techniques of empirical analysis and the availability of data have advanced dramatically; indeed one of the encouraging features of the modern analysis of development is its growing respect for evidence. We now have a much less simplistic view of living standards and well-being, and therefore of poverty and inequality. Correspondingly, there is a much stronger analytical focus on understanding the economic and societal processes which enhance education and health, key factors influencing the capabilities, including spending power, of individuals. In this essay we provide an interpretative view of the development experiences of the past 50 years, focusing especially on the past ten (since much has already been written on the earlier periods).

What was the state of opinion ten years ago? One guide assessment, from a 1989 survey of the economics of development (Stern, 1989), is the following:

The ability of governments to plan comprehensively and effectively is now viewed with much greater skepticism than in the years following the Second World War. Thus many would now place equal or greater emphasis on government failure relative to market failure in the balance of the argument than was previously the case with the earlier writers, who concentrated heavily on market failure. The skepticism is born of experience but one must be careful not to be too sweeping. We have learned much about what governments can do effectively as well as where they are likely to perform badly. Whereas it is possible that they may be damaging to efficiency and growth if they try to exert detailed and universal control of production decisions, governments can be effective with direct action to raise standards of education, health and life expectancy, and in improving infrastructure such as water supply, roads, power. There is much to be learned about how to organize such action but we already know enough to realize that really substantial achievements are possible and to be able to begin to indicate the kinds of policies which will work and those which will not. (p. 669)
So, a decade ago those working on development had, by and large, absorbed the lessons of the importance of markets, and moved on to emphasize that in a market economy public action had the potential to transform the lives of the poor.

What happened in the 1990s? Many, but by no means all, developing and transition economies became more market oriented as a result of price reform, reductions in the size of the public sector, and trade liberalization. Some of these countries, including the largest, achieved spectacular reductions in poverty, but others stagnated, declined or suffered temporary collapses. On average the market-oriented reforms worked, but not in a reliable fashion. Our reading of the 1990s is that the reform process too often neglected the institutional foundations necessary for markets to be effective for poverty reduction. It is not enough to focus attention on ‘getting prices right’; public action is needed to ‘get the markets right’.

Markets depend upon a complex array of public institutions. For example, governments should encourage rather than penalize entrepreneurship and competition, provide for rule of law and limit bureaucratic harassment and corruption. In short, provide good governance. Services with large externalities or market failures such as transport, telecommunication, or power infrastructure, require regulation. This role of government as the builder and provider of institutions for the market economy will be the theme of the World Development Report for 2001.

But providing governance and building institutions to enhance the functioning of markets is only one part of a strategy to promote development. Markets must work for the poor. If they are to reap the benefits of market-oriented growth, poor people require the ability to participate in markets. Thus governments have special responsibilities in ensuring the provision of education and health to poor people. Beyond this, governments can help protect from insecurity: the fear of falling into poverty, or deeper into poverty, inhibits people from taking the risks inherent in market participation. And beyond this, poor people need to be empowered to participate politically, so that public action becomes shaped by their priorities. This triad of opportunity, security and empowerment is the theme of the forthcoming World Development Report for 2000: Attacking Poverty.

In understanding that triad it is vital to recognize that opportunity, empowerment and vulnerability are not simply about raising spending power. More fundamentally, they concern the ability of individuals to shape their own lives in the way they choose. Education, health and basic democratic rights are crucial here and not merely as instruments for raising income.

The main lessons that we draw from the experiences of the 1990s are that public action in the areas highlighted above is both more important and more difficult than was appreciated at the start of the decade. It is difficult for economic reasons: that is, it is hard to design effective institutions with the right incentives (in rich as well as poor countries, there are intense debates about how to organize schools in order to deliver education). Effective public action is also difficult for social and political reasons: even
when we believe we know how to deliver services to the poor, it is often impossible to build a political coalition in support of the change.

The challenges of improving governance and the provision of public services, and their focus on the poor, highlight the importance in development of institutions, norms, and behaviors. If we had to single out one key idea that has risen to prominence in development thinking in the 1990s, that would be it. We cannot call it a new idea: 30 years ago Moses Abramovitz (1973) was talking about the “social capacity for development” and how this was determined by history and culture. It has been well recognized by economic historians (e.g. Schumpeter). A striking expression of this view is the famous fourteenth century Siena frescos by Ambrogio Lorenzetti on the ‘Effects of Good and Bad Government’. What we have seen in the last ten years, with the growing recognition of the importance of these issues, is a deepening of their theoretical and empirical examination. We will draw attention to a number of examples in what follows.

A particularly powerful example of the importance of norms and behavior and their effect on development is the current spread of the AIDS epidemic. The spread of AIDS can be controlled through relatively simple changes in behavior, especially of high risk groups such as sex workers and their customers. A few governments, such as those of Thailand and Senegal, have focused on the problem and succeeded with targeted public campaigns to promote these changes. Elsewhere, even where HIV incidence is very high, governments either ignore the problem, or fail to target their programs on the high risk groups. For some countries in Africa, the consequences of this neglect will be catastrophic. Here is a clear case where the research community can provide real guidance, but has so far failed to convince governments of the importance of action.

As thinking about development has changed, so too has what we have come to expect from development agencies such as the World Bank. At the time when much of development thinking placed planning, at centre stage, the Bank helped finance the big projects which were at the heart of many of these plans. When the emphasis shifted to the policy environment, particularly getting prices right, the Bank promoted stabilization and trade liberalization and financed structural adjustment. Now, the agenda has stronger governance and institutional elements, including helping societies provide effective public services oriented to the poor. This calls for a different role for the Bank: one that puts still more emphasis on learning and knowledge. In many cases communities have to learn for themselves how to design effective institutions that work in their setting. Development agencies can help with some basic principles of design and evaluation, and of course with finance, but appropriate institutions have to be locally tailored for each society. The range of legitimate experiment must therefore be wider for institutional reform than for (say) macroeconomic and trade reform. The Bank, working in a range of partnerships, thus needs to combine conviction in those areas of policy where the evidence warrants it, with flexibility and a heuristic approach in those areas of institutional design which require experiment.

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2 Two cities are portrayed. One government is counseled by Justice, Wisdom and Compassion, the other by Pride, Wrath and Avarice. The former is orderly, happy and prosperous and the latter poor, corrupt and oppressed.
The next section provides a discussion of experience from the perspectives we have just described. This leads, in Section 3, to a brief summary of the ways in which development thinking has changed. We conclude, in Section 4, with an agenda for action and research.

2. The Lessons of Experience

Individual country experiences with growth and poverty reduction vary enormously. In the ten years from 1988 to 1997, East Asia’s headcount poverty rate (share of the population living on less than one dollar a day, evaluated at purchasing power parity) declined at 12% per year, while Eastern Europe and Central Asia’s poverty rate increased at nearly 4% per year (Figure 1). South Asia has also done relatively well on this measure, while poverty reduction in Africa, the Middle East, and Latin America has been modest at best. (These are population-weighted averages of the individual country experiences, so that the East Asia data primarily reflect China’s experience and the South Asia data, India’s.) One thing that stands out clearly in the figure is that growth and poverty reduction tend to go hand-in-hand. Their close association reflects the fact that the same historical factors, institutions, and policies that create a good environment for growth, also provide a good environment for poor households to move forward (Dollar and Kraay, 2000). But this observation, whilst of great importance, does not allow us to conclude that growth-enhancing policies alone are sufficient to reduce poverty. First, as we have emphasized, well-being and poverty concern much more than spending power. Second, the process of growth may exclude and dislocate large sections of the population. Hence the need for public action to promote not only growth but also participation and protection.

In this section we provide our interpretation of some of the important development experiences of recent decades, using examples from every region of the developing world (though of course we cannot cover every country). Our survey reveals that the variation in regional experiences partly reflects the extent of market reform in different countries. But we also want to stress the theme that the impact of market reform depends to a considerable extent on countries’ initial conditions, as well as on the development of complementary institutions that are needed to make markets work well and equitably.
2.1 Regional and Country Experiences

China

We start with China because its extraordinary growth and poverty reduction have been among the most important developments of the past 20 years. In the late 1970s this huge country was emerging from crisis. Its reform began in the 1970s with radical changes in incentives for households and individuals. Most important, for this largely rural society, was the return, over the period 1979–83, of farming to a family basis. Use rights over land together with some significant price liberalization transformed individual incentives very rapidly – with the result that agricultural production and household income rose dramatically.

An important aspect of China’s reform has been the introduction of new institutions. Indeed, key to China’s industrial growth from 1983, have been the township and village enterprises (TVEs). This arrangement, whilst collective, provided incentives which were fairly close to private ownership of small and medium factories at a time
when overt private property rights would not have been politically acceptable. At the same time China began to open up to foreign trade and to foreign direct investment. The combination of agricultural reforms, TVEs, greater openness and more generally the encouragement of entrepreneurship and the introduction of market-based incentives, yielded remarkable results. Following two decades of stagnation, China’s economy began to grow rapidly, and the initial benefits accrued to a large extent to the rural population, where poverty was most acute. Between 1978 and 1995, 200 million people were lifted out of absolute poverty in China.

A number of special features of China help explain why it got such spectacular results from strengthened incentives and more open markets. Part of Mao’s economic strategy had been to build self-sufficiency in each province (each major province literally produced its own brand of car). With the many staggering inefficiencies associated with this strategy came large potential gains from inter-provincial trade, leading to more specialization and economies of scale. The provincial self-sufficiency also provided some protection from the dislocations of change. Further, the large ‘overseas’ Chinese community played a positive role in China’s reform, providing finance, technology, and managerial know-how. Hong Kong entrepreneurs, who did not have a political conflict with Beijing, led the way. Their good results encouraged a later flow of investment from entrepreneurs based in Taiwan.

China’s advantageous initial conditions also included, notwithstanding the cultural revolution of 1966 -76, key elements of political stability and social adherence to the rule of law. There was also a fairly sound macroeconomic foundation resulting from the country’s high savings rate and cautious macro management. Of all the “transition” economies, China was virtually the only one not beset during its reform period by high inflation. These initial conditions were important, because they ensured that the reforms of incentives and prices would yield quick, positive results, thus building broad popular support for reform. The political and macro stability, together with the size of the country and a highly pragmatic philosophy, also created an environment in which the government could afford to experiment with certain reforms before introducing them country-wide.

While China has achieved impressive results so far, it faces important challenges ahead. It is beginning a new stage in which its further growth will depend to a large extent on the emergence of a ‘true’ private sector. The era of TVE-led growth is probably at an end. China’s accession to the WTO is a very positive move that will support market-based approaches, including legal reforms, necessary for private sector development. But the country still has a large number of inefficient state enterprises employing a vast urban workforce. These enterprises are supported by a state-dominated financial system that is increasingly beset by non-performing loans. Following through

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3 The role of the ‘diaspora’ has been important for development in other countries too, but its impact, whether positive or negative, depends on the specific historical and political aspects of the separation.

4 As reflected in Deng Xiao Ping’s famous remark, ‘It does not matter if the cat is black or white as long as it catches mice’.
on market, enterprise and related financial sector reforms are keys to keeping China on a successful path of growth.

We have focused here on China’s growth from the perspective of reform and institutions. It is important to recognize that China entered the reform period with very strong education and health conditions for a country of its income. For example, life expectancy in 1987 was 68.7 years and in 1998 was 69.9 years.

**Eastern Europe and Central Asia**

It is commonplace to describe China’s relatively successful reforms as gradual. Such a description is highly misleading relative to the dramatic change in agriculture at the end of the 1970s and the early 1980s which transformed the lives of hundreds of millions. Nevertheless, China’s approach and results are often contrasted with the experience of transformation of Eastern Europe and the former Soviet Union (FSU), often described as ‘shock therapy’. In fact, we actually see significant commonality between China and the successful Eastern European reformers (Hungary, Poland, Estonia), and important contrasts between that overall successful group and the deeply problematic reforms of Russia, the Ukraine, and other FSU economies.

The Stalinist ‘over-integration’ of the economies of the Soviet bloc implied that the collapse of the Soviet Union was a fundamental economic shock to all of the countries in the region, something that China did not have to face in its early reforms. But countries such as Hungary and Poland were able to reestablish macro stability relatively quickly, (very rapidly reorienting exports to the European Union). There are some further commonalities with China. The long-term commitment to reform across a very broad section of society was deep and never in serious doubt. There was a strong understanding of the importance of building institutions, although different approaches were followed. There was a living memory of a market system. Further, four decades under Stalinism had not completely eroded the fundamental social adherence to the rule of law. They had constructive diasporas contributing capital and knowledge. Thus, in these Eastern European economies, stable political commitment to reform, macro stabilization, attention to institution building, strengthened private incentives, and trade openness yielded good results pretty quickly.

Russia and other FSU countries unfortunately had much less favorable initial conditions than the Eastern European countries. Here the communist party was more deeply established, and there was a real fear in the early 1990s that it might return to power. On the one hand, this encouraged reformers to move very quickly with a seriously flawed mass privatization, and on the other hand it made it harder to attract investment and make reforms succeed. The problem of a rigid inter-locked economic structure were still deeper than in Central Europe. The Russian diaspora in the U.S. and Western Europe had mostly taken place many decades previously and was not closely connected. Far from experiencing net inflows, Russia suffered massive capital flight over the decade. The longer period of communist rule in Russia compared to Eastern Europe meant that adherence to the rule of law was weak. Furthermore, Russia had the kinds of
natural resources which, when combined with a ‘nomenklatura’ tradition, were highly susceptible to capture by oligarchies. The result of all these influences was that, in the Russian context, it was harder to get good results from reform, and thus harder to build, support and sustain reforms. Indeed, the early experiences of the market economy for most Russians were the ravages of hyper-inflation together with the observation of the grabbing of assets on an enormous scale. The result was a fundamental crisis of confidence in reforms which is itself an obstacle to moving forward. Russia does, however, now have a period of political stability and emerging growth which offers an opportunity for a ‘new start’. Taking that opportunity will require careful attention to the investment climate and institutional reform – involving, in many cases, confronting the vested interests that have established themselves all too strongly in the earlier period of reform.

**South Asia**

Turning to South Asia, India’s experience over five decades is basically a microcosm of the changes in development thinking. Whilst the formal planning system instituted in the early 1950s was largely discredited by the mid-1960s, for the three decades following independence India had an economic system dominated by government protection and regulation – closed to a large extent to the global economy. India had stable macro policies, and this package produced a fairly consistent outcome: GDP growth averaging 3.5 percent per year. This compared with population growth of 2.2 percent per year. Per capita income thus rose slowly, and there was little discernible reduction in the high level of poverty. This pace of change could be seen at the micro level as well: for example, India was producing cars in 1980 that looked about the same as cars in 1950.

Over the past two decades India has opened up to the world economy. Loosening of macroeconomic control in the second half of the 1980s generated a macro crisis in 1991 which led to aggregate retrenchment, but also an acceleration of reforms. India has reduced its external barriers to both foreign trade and foreign investment, and has begun to dismantle many of the other regulations and restrictions on investment and production. An important facet of India is that many of these latter restrictions are at the state level, and hence the pattern of liberalization has varied across the country.

Since 1993 aggregate growth in India has been remarkably rapid – averaging around 7% p.a. The experience of the last 6 or 7 years suggests that India may have now embarked on an extended period of rapid growth. Over these years growth has been comparable with or faster than that of China and much faster than OECD countries.

India is unique among developing countries in having fifty years of household distribution data of reasonable quality. In a series of papers based on these surveys, Ravallion and Datt have estimated that (1) the poverty rate goes down by one percent for every one percent increase in net domestic product per capita and (2) a decomposition of changes in poverty based on Indian data finds that 87 percent of the observed decline in
poverty was accounted for by the growth component (rather than by changes in distribution). 5

Thus, reform has delivered growth in India and growth has delivered poverty reduction. However, reform and growth have been uneven across states. In the post reform period, poverty is declining in the states of Andhra Pradesh, Gujarat, Karnataka, Kerala, Maharashtra, West Bengal, and Punjab, but not in Bihar, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh. The former states have better human capital and social indicators and, except for Punjab, are coastal (Srinivasan 2000). For both reasons they are better placed to benefit from economic reforms.

One of our important projects in the research department of the World Bank is investigating the regulatory/investment climate at the state level in India through enterprise surveys. Preliminary indications are that the first group of states in general has less burdensome and distortionary regulatory regimes. Better governance – particularly delivery of services plus efficient regulation and good location – are combining with openness to produce growth and poverty reduction in some states. Others lag behind.

As we have emphasized throughout, increases in well-being are much more than rising incomes. Still more striking, and arguably of still greater importance, have been the changes in health and education in many parts of India. In Kerala life expectancy is now greater than in China. Educational systems have been transformed in Himachal Pradesh and Andhra Pradesh [see Dreze and Sen, forthcoming].

Again, from this experience we see the importance of both good policies at the macro level – stability and openness – and effective governance and service delivery at the more micro level, particularly in the promotion of health and education.

Latin America

Latin America’s experience has interesting parallels with India’s. In the 1960s and 1970s, Latin American economic strategy focused on import substitution (influenced by the thinking of export pessimists such as Raul Prebisch). At the same time the continent relied much more on imported capital than did India. The combination of import protection and external borrowing eventually gave rise to macroeconomic instability – unsustainable fiscal deficits and external debt, high inflation, volatile exchange rates. Thus, the key reform for the region has been macroeconomic stabilization combined with greater openness to trade. The average inflation rate of Latin American economies declined 54 percentage points between the 1986-90 period and the 1991-93 period.

As with India, Latin America’s macro-level reforms have been both heartening and a disappointment. On the positive side, the increase in Latin American growth rates is what might be predicted from cross-country growth analysis: two percentage points higher growth over the medium term (Easterly et al. 1997). On the negative side, the

growth benefits have been reduced by the slower growth of OECD economies in the 1990s (which has a large spillover effect on the developing world). Furthermore, with the East Asian “miracle” performance as a reference, many in the region (and elsewhere) may have expected a lot more from these reforms. Paul Krugman (1995) used the Latin American experience to note that “the real economic performance of countries that had recently adopted Washington consensus policies… was distinctly disappointing” (p. 41).

The problem here was that development economists were attributing too much of East Asia’s success to the ingredients, macro stability and openness – admittedly important ingredients, but ones that need to be complemented with institutional development, notably improvements in the delivery of public services and in public sector efficiency. Further, Latin America’s progress with growth and poverty reduction was hampered by its extremely unequal distribution of assets – both land and human capital – problems that can be addressed through effective government institutions and policies. With macro reforms largely accomplished, the importance of these other issues appears all the more critical.

**Middle East and North Africa**

The Middle East and North Africa suffered the paradox of high investment in human and physical capital juxtaposed with stagnation. GDP per capita declined at a rate of 0.8 percent a year in the 1980s, and increased only 1.1 percent a year in the 1990s. And yet rates of investment in the Arab world have been impressively high, averaging more than 28 percent of GDP in 1974 – 1985 and more than 22 percent in 1986 – 1997. Although below the very high rates achieved in East Asia, they are several percentage points higher than in other developing regions (Makdisi, Fatah, and Liman, 2000). Similarly, the region has seen impressive growth in the educational attainment of its population. The gross enrollment rate at the secondary level increased from 42 percent in 1980 to 64 percent in 1996. These are close to East Asia, and better than other regions (World Development Indicators, 1999).

Given these statistics, the central question facing any student of development in the Middle East and North Africa must be: why have such high rates of investment in physical and human capital generated so little additional output? While the detailed answers will be country-specific, two general causes stand out. First, physical investment has not been directed to the most productive activities, in large part because it has been managed by the public sector and often dominated by political rather than market influences. And second, the institutional structure of the labor market has systematically misallocated labor, and especially educated labor, for essentially the same reason. Consider each in turn.

The simplest measure of the size of the state in economic activity is the ratio of public expenditure to GDP. In 1977 it stood at 38 percent in the Middle East and North Africa; by 1997 it was down to a still sizable 28 percent. By way of comparison, the share in Latin America in 1977 was 19 percent; and in East Asia it was 12 percent in
The oil price increases of the 1970s allowed both the oil-exporters and the recipients of assistance from these countries to finance a strategy of development which was dominated by the public sector. Public sector employment was both large and well paid. In the early 1990s, the central government wage bill amounted to almost 10 percent of GDP in the region compared with less than 5 percent in every other region except Africa (6.7 percent) (Pissarides, 2000).

Investment in the public sector was rarely subject to a market test and the quality of investment was very weak. Furthermore, policies were adopted to protect and nurture the growing public sector to the detriment of private investment and entrepreneurship. Consequently, net private transfers in several countries were negative, despite the inflow of worker remittances, as capital was moved abroad. The stock of savings held abroad in the case of Egypt, for example, is estimated to be $83 billion in 1991, or 271 percent of GDP (Diwan and Squire, 1995). This combination of unproductive public investment and private capital flight goes a long way to explaining the disappointing growth performance.

Turning to human capital, the institutional structure of the labor market was such that, for many, “rent-seeking” yielded a higher return to individuals than more productive and growth-enhancing activities. Two elements of the labor market in the Middle East and North Africa were especially important. First, high wages attracted the most qualified personnel to the public sector. Second, market flexibility has been limited by a variety of measures designed to protect existing employment with the end result that economies have been slow to adjust to changing circumstances.

The need to achieve a more productive environment for entrepreneurship, more efficiency from the public sector, and more complementarity between the public and private sectors is the main lesson to draw from the region. Some progress has been made. On the one hand, the fall in the price of oil has forced many countries to contract their public sectors. But on the other, a good climate for private investment has yet to be established. Major macroeconomic imbalances have been reduced in most countries but structural reforms are proceeding slowly at best. One revealing statistic: since the mid 1990s, the region has seen the smallest growth in FDI of any region in the world and today accounts for only 2.5 percent of total FDI flows to developing countries (Nabli, 2000).

Africa

Africa has been experiencing economic and social catastrophe. On average, per capita GDP is lower now than in 1980, although during the 1990s performance became more divergent, with rapid growth in a few countries juxtaposed against rapid decline elsewhere. Socially, life expectancy is now starting to decline, and the incidence of civil conflict is high and rising. The economic catastrophe was associated with a capital-hostile environment and poor public service delivery.
The region has suffered massive capital flight: by 1990 around 40% of Africa’s private wealth was held outside the continent, a higher share than any other region (Collier, Hoeffler and Pattillo, forthcoming). As a result, Africa had far less private capital per member of the labor-force than other regions. Despite this scarcity of capital, evidence suggests that the return on investment has been around one-third lower in Africa than in other regions (Collier and Gunning, 1999, for the period 1965-89). Evidently, Africans moved their wealth out of Africa at least in part because returns, taking account of risk, were unattractive. The region has had the worst investor risk ratings. Thus, it has been perceived both by Africans themselves and by foreign investors, as a capital-hostile environment.

Low private investment was offset by high public investment (much of it financed by aid): Africa has the highest ratio of public to private capital of any region. However, high public investment did not produce good public service delivery. On many indicators -- education, health, infrastructure -- Africa compares unfavorably with other regions.

Several factors have conspired to produce the capital-hostile environment. An economic geography argument (e.g. Bloom and Sachs, 1998) is that a combination of remoteness from the coast, malaria, and poor soils intrinsically disadvantage the continent. However, while these are indeed serious disadvantages, Africa grew reasonably rapidly until the mid-1960s, and some landlocked, malaria-ridden parts of the continent have done well during the 1990s. The World Bank has primarily focused upon weak institutions and poor policy as the problem. As measured by the Country Policy and Institutional Assessment, through which World Bank staff annually rate policy in over 100 countries, Africa has consistently had the worst ratings. Typical African policies have been over-valued exchange rates and high taxation of exports, although during the 1990s there has been significant improvement. A final explanation is that private investment has been discouraged by poor public service delivery: in particular, poor telecommunications, electricity and transport. As macroeconomic policies improve, poor service delivery and weak governance and institutions look increasingly to be the binding constraints.

Why are public service delivery and governance so problematic? At a general level, governments appear to have been less concerned with using the public sector for service delivery than for patronage through jobs. For example, A study of Ghana found that in the public sector wages were 25% higher if the worker was from the locally dominant tribe (Collier and Garg, 1999). Comparing Africa with South Asia, expenditures on inputs such as textbooks and drugs are only half as large relative to the wage bill. As long as the public sector delivered jobs, it was not subject to close scrutiny. For example, a survey in Uganda in 1991 found that only 2% of the money released by the Ministry of Finance for primary schools actually reached the schools (Reinikka, forthcoming). In the extreme, public employees not only failed to deliver the service they were supposed to provide, but were actively harmful. In Cote d’Ivoire, the private sector went on strike against police extortion: business was easier once the police were confined to barracks than when they were on the streets.
Yet the experience of the 1990s shows that Africa’s economic catastrophe is avoidable. Uganda is a hopeful example. Once the government reformed macroeconomic and trade policies, the country was able to attract back Ugandan capital – around 17% of private wealth was repatriated during 1993-97 (Collier, Hoeffler and Pattillo, forthcoming). Furthermore, empowering the rural population has helped public services improve. The Ministry of Finance started to send posters to local communities each time it released money for schools: by 1999 90% of the money was getting through. This increased transparency of the budget is an instructive example of an institutional change leading to better services.

The social catastrophe of falling life expectancy is largely attributable to the rapid spread of AIDS. Again, this is amenable to policy. This spread of AIDS reflects a failure of public services to focus effectively on the problem. It can be radically reduced if prostitutes are persuaded to use condoms and have health checks, behavioral changes which have been demonstrated to be well within the capability of public health campaigns (World Bank, 1997). African countries such as Uganda are moving on this issue, but some countries remain locked in denial.

The social catastrophe of civil conflict has roots in economic failure. Africa’s incidence of conflict is explicable in terms of five features of its economy (Collier and Hoeffler, 2000). High dependence upon primary commodity exports offers opportunities to rebel organizations to finance themselves through predation. Large disaffected diasporas provide a further source of rebel finance. Low income weakens the ability of the government to finance defense. Slow growth provides insufficient attractive career opportunities for uneducated youth. A geographically dispersed population makes it harder for the government to control its territory. Rapid growth and the consequent diversification of the economy, job creation and urbanization, can make African societies radically safer. The same environment that has been hostile to capital has been conducive to civil conflict.

International Developments

Aside from these individual country and regional experiences, there have also been important developments in the international arena that inevitably influence development strategy. The biggest change here has been the emergence of private capital flows from rich to poor countries. Economic models have always suggested that private capital should flow from locations in which capital is abundant to locations in which it is scarce. But throughout the 1960s and 1970s such flows remained modest by any scale. In our view, these flows were constrained both by weaknesses in international capital markets and by poor policies and institutions in many developing countries – noted above – which in sum created an environment which was often hostile to business and entrepreneurship. During the past twenty years – and especially during the past ten – there has been a tremendous surge in private capital flows to the developing world, resulting both from more efficient capital market institutions and from policy reform in much of the developing world.
These capital flows carry a potential for strong externalities – both positive and negative. On the positive side, direct investment in particular can be an important vehicle for bringing new technology and management skills to the developing world. The potential negative spillover from capital flows was made amply evident by the recent financial crisis in East Asia. No doubt macroeconomic policy mistakes were made. What is new for the developing world is the way in which apparently modest policy errors can be amplified by capital market reactions into crises of truly large proportions. The East Asia financial crisis was an experience that highlighted a key theme of this paper: the importance of complementing macroeconomic, trade, and capital account reform, with institutional development – in this case, development of the institutions for monitoring, regulating, and supervising banks, other financial institutions and credit markets.

A fundamental international development of the past ten years is the end of the Cold War and the rise of democratic political institutions worldwide. There have been major democratic revolutions in virtually every region of the developing world. In the early 1990s there was a hope that this political liberalization would lead to economic reform and better public services. The experience of the 1990s showed, however, that we must be wary of asserting the existence of a tight and inexorable link from political reform to economic reform. Some of the best performers in terms of economic reform and actual reduction of poverty (China and Vietnam) were not noted for formal democratic institutions, while some of the prominent democratizers (Nicaragua, Ukraine, Russia) remain plagued with poor economic policies. On the other hand, no famine has ever occurred in a democratic country with a free press and regular elections (see Dreze and Sen, 1995). Political freedoms and democratic institutions provide for protection and participation. Recent studies on the longer-term relationship between political structure and economic performance suggests that democracy is of particular importance in ethnically diverse societies (Collier, 2000). Unfortunately, the region with the greatest ethnic diversity, namely Africa, has to date had the least democratic politics.

A third key international development has been the revolution in information technology, international communication, and global transportation. Ideas spread much faster today because of innovations such as the internet. The changes in transportation and communication have spawned global production that was simply not imaginable forty years ago. Trade in goods has changed because different components of a particular product can easily be produced in different locations around the world in a coordinated fashion. And these changes have arguably had an even greater effect on trade in services. It is much easier to have international trade in financial services or consulting services than just a decade ago. Software companies in California can forward computer programs to firms in Bangalore to work on during India’s daylight hours, and then have them back for the next California work day. The technological developments provide an unprecedented opportunity for developing countries to integrate with the global economy.
2.2 Lessons of Experience

From the regional experiences and international developments of the 1990s we take the following key lessons:

- Growth can unleash poverty reduction;
- Macro stability, open trade regimes and a vibrant private sector facilitate growth;
- Good governance and policies have a crucial role in these processes. Governments should provide or foster the institutions which make markets work efficiently, thereby promoting entrepreneurship, competition and a positive investment climate. With weak institutions, poor governance and unsound policies, market reforms can go badly awry with great costs, particularly for the poor;
- Combating poverty involves much more than fostering sound market-oriented growth. It involves
  - enhancing the capabilities, particularly education and health, which are fundamental to well-being and which, further, allow participation in market opportunities;
  - promoting influence over the political, social and economic environment, often termed empowerment; of basic direct importance to well-being as well as defending participation;
  - protection against economic, political, social and natural vulnerabilities, including those arising from market reforms.

We now comment briefly on some aspects of these lessons.

**Macro and Trade Policy**

We are not going to say much more about macro and trade policy because the relevant lessons have, on the whole, been drawn by developing country policy-makers. Easterly (2000) looks at a wide range of macro policy indicators – such as inflation level, black market premium, and financial depth – and shows not only that the average quality of policy has improved in the developing world, but also that the dispersion of policies has declined enormously. For example, the median inflation rate of developing countries has been cut in half from about 15% in 1982 to 7% in 1997; more importantly, at the end of the 1990s only 5% of countries had inflation above 10%. There has been an even more dramatic decline in the black market premium, which is an indicator of macroeconomic instability as well as of restrictiveness of the trade regime. The 95% confidence interval on the black market premium stretched from 10% to 40% in the mid-1980s, but had declined to a range of 2-8% by the end of the 1990s. In practice this means that there are more developing countries today in which firms operate in a stable price environment and can easily purchase foreign exchange to participate in the global economy.

**Institutions**
With the macro battle increasingly won, attention has shifted to the importance of institutions and governance for creating a good investment climate. Our survey above emphasized that whilst large numbers of developing countries have undertaken macro reforms, the investment and growth response has varied considerably. The different responses result to a large extent from differences in the functioning of taxation, regulation, the rule of law and infrastructure – and these differences in turn trace to public institutions and behavior. There is no single, magic bullet to increase private investment following macro reform. Survey evidence suggests that different problems constrain investment in different countries and in the same country at different times. An effective government builds a mechanism for continuous feedback from domestic investors to keep track of changing problems. This is one reason why it is not sensible to focus on potential foreign investors while hoping that local investors are captive. Both the government and potential foreign investors get, or at least should get, their information about investment conditions to a large extent from local investors. Generally, what is good for domestic investment is also good for foreign investors.

Investors seek a stable institutional environment, and one which is governed by the rule of law, not by arbitrary bureaucratic decision making. All too often bureaucratic harassment cripples entrepreneurship and the effectiveness of investment. In such circumstances the promises of discretionary sweetheart deals negotiated between a foreign investor and a minister of trade or finance are not the answer. A firm might be offered an attractive deal, but may reasonably fear that a future entrant might secure even more favorable terms and so drive it out of business. Before the firm will invest it must be compensated for such risks by up-front benefits which are costly to the society and perhaps also to the government. Part of stability and predictability of government is equal treatment. Governments often try to reassure investors, but sometimes their attempts actually make the problem worse. Here is then-President Gorbachev trying to persuade foreign investors to commit themselves in 1990: ‘Those [companies] who are with us now have good prospects of participating in our great country…[whereas those who wait] will remain observers for years to come – we will see to it.’ (International Herald Tribune, 5th June 1990). Gorbachev clearly saw the problem that -- faced with high uncertainty -- firms would simply delay making irreversible commitments. However, his intervention probably made things worse. By threatening unspecified arbitrary action against future investors he was confirming the worst fears of his audience.

A second reason for equal treatment in a stable and predictable environment is that otherwise governments may disadvantage domestic investors. In high-risk environments foreign investors have various strategies for risk-reduction: they can get political risk insurance, and they can use diplomatic channels to gain some protection. This is one reason why foreign investors build international consortia, so that in the event of trouble many foreign governments and large banks have an interest in pressuring the host government. Domestic investors often lack this protection. They either seek foreign partners or simply move their assets out of the country.

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6 The point here is not to create high but equal pay-offs to political maneuvering for business purposes but to reduce it all round.
Governments with poor risk ratings often try to commit themselves to rule-based behavior through national investment codes. Those perceived as the most risky, notably African and Eastern European governments, may benefit from the additional credibility of signing an international code. Indeed, since actions by one government probably affect how investors perceive risks in neighboring countries, the resulting externality may justify some attempt at coordinating international discipline. However, the attempt to provide such a code two years ago was abandoned because of opposition from some developing country governments. A further reason for internationally, or at least regionally, coordinated action is to prevent a ‘race to the bottom’ in deals for investors. This is particularly important within South-South trade blocs. The combination of high external barriers and internal free trade places governments at a disadvantage vis-à-vis investors. A foreign investor can bargain among governments in the bloc, locating in the country which offers most, while marketing within the whole bloc and benefiting from protectionist rents.

However, many of the risks which investors face come not from the high politics of government policy, but from the workings of the government bureaucracy. If the commercial courts are corrupt, investors will build in a margin for the uncertainty of contract enforcement. If tax collectors are corrupt, they will build in a margin for the uncertainty of tax demands. If customs officers arbitrarily delay shipments of inputs, firms will carry large inventories, building in a margin for the cost of financing them. All these margins choke off and distort investment. There is very clear cross-country evidence that the rule of law and the related issues of bureaucratic harassment, criminality and corruption have a large effect on both domestic and foreign private investment.

**Public Service Delivery**

As we have argued, weak governance and institutions act as a tax on investors, implying a higher expected return to justify an investment and resulting in less investment than would otherwise occur. Poor public service delivery has a similar effect. Some services directly affect firms and investors: transport infrastructure or the public power grid, for example. Surveys of firms often reveal that these are key bottlenecks. Unreliable power in many developing countries leads to the result that any significant investment requires its own power production, often doubling the cost of power to the firm, compared to what could be delivered in an efficiently regulated and managed power sector.

There are other public services – notably health and education – that have direct benefits for people and indirect benefits for the investment climate: an educated and healthy workforce, i.e. strong human capital, can make a very big difference to reliability and effective operations, thereby complementing physical investment.

Providing effective public services requires resources. However, there is growing evidence that in many cases lack of resources is not the key problem for service delivery.
We cannot review this evidence in detail here but Table 1 suggests that weak reform may also be associated with wasteful expenditure and poor delivery.

The table picks out five developing countries that are noted reformers: for these countries, government consumption has, on average, been relatively low (8.8% of GDP in 1990) and virtually unchanged in the 1990s (9.5% of GDP in 1998). The table also shows some developing countries that have not done so well with reform. These tended to have higher government consumption at the beginning of the 1990s (18.7% of GDP), and this amount rose over the decade to 21.3%.

Table 1
Government Consumption, Selected Developing Countries, 1990 and 1998
(% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reformers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ghana</td>
<td>9.3</td>
<td>10.3</td>
</tr>
<tr>
<td>India</td>
<td>11.4</td>
<td>10.5</td>
</tr>
<tr>
<td>Mexico</td>
<td>8.4</td>
<td>9.4</td>
</tr>
<tr>
<td>Uganda</td>
<td>7.5</td>
<td>9.6</td>
</tr>
<tr>
<td>Vietnam</td>
<td>7.5</td>
<td>7.6</td>
</tr>
<tr>
<td>Average</td>
<td>8.8</td>
<td>9.5</td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Angola</td>
<td>34.5</td>
<td>34.7</td>
</tr>
<tr>
<td>Burkino Faso</td>
<td>14.9</td>
<td>14.7</td>
</tr>
<tr>
<td>Congo, Rep.</td>
<td>13.8</td>
<td>14.3</td>
</tr>
<tr>
<td>Jamaica</td>
<td>14.0</td>
<td>21.6</td>
</tr>
<tr>
<td>Kenya</td>
<td>18.7</td>
<td>16.1</td>
</tr>
<tr>
<td>Ukraine</td>
<td>16.5</td>
<td>26.1</td>
</tr>
<tr>
<td>Average</td>
<td>18.7</td>
<td>21.3</td>
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</tbody>
</table>

While the reformers have about half the level of recurrent government spending as the other examples, (much less committed to reform), they have done much better in the 1990s in terms of actually providing critical social services. In the former group, infant mortality declined from 74.3 (per thousand live births) in 1990 to 64.8 in 1998, while the secondary school enrollment rate increased from 55.1% to 59.9% over the same

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7 This includes military spending, administration and subsidies as well as spending on education and health.
period. In the slow reformers, the infant mortality rate increased from 46.0 to 54.2, while the secondary school enrollment rate declined from 54.2% to 47.4%.8

The point here is that many countries spend a lot of money on public services but achieve little in the way of results. Too often, the public sector has been used as a means of patronage to the well-connected, through employment generation, rather than as an instrument for service delivery to the larger community and to the poor. But even when the government wants to use public expenditure for the benefit of the poor, it is difficult to devise institutions which achieve this objective. If norms of social responsibility are weak among public employees, then strong incentive or sanctions may be needed in order to change behavior. Further evidence is accumulating (see WDR 2000) that political leadership and public action can have powerful effects.9

The lesson we draw from experience is that the efficiency of public service delivery is at least as important as the volume of resources devoted to the services. The example from Uganda cited above is a case in point: it hardly matters how much money from the budget is allocated to primary education if only 2% of the funds actually reach schools. On the other hand, the simple change of publicizing the amount of money that should reach each school had a huge effect on behavior and on the ultimate education service for the community.

Financial Sector

The importance of the financial sector emerges in several ways from our survey of experiences. First, some countries (e.g., in the Middle East and North Africa) have had high investment and little growth, indicating that investment efficiency has been poor. Recent research has established that the financial sector plays a significant role, not in directly raising the quantity of investment, but rather in improving its quality. That is, there is no significant link between financial reform and savings, but there is substantial evidence (with firm, industry, and cross country data) that better and deeper financial systems spur growth through a better allocation of savings. Recent studies show, for example, that countries with deeper financial systems did a better job of taking credit away from loss-making firms and re-allocating it to profitable investments.

A second key experience of recent years concerning the financial system was the East Asian crisis. Weak supervision and regulation of the financial system not only leads to misallocation in good times, but can contribute to genuine crisis when external shocks hit.

8 If the reader is wondering why the level of infant mortality is so high in the reformers, we have deliberately included here some of the poorest countries that have become noted reformers in the 1990s. For our “reform” group, the (population-weighted) average per capita GDP was $1732 in 1990, less than half the $3930 average of the others. This means that the former group was spending much less per person on total government services, yet achieving significant progress.

9 See, for example, the influence on local services in Bangalore, India of public ‘scorecards’ for different organizations, and the expansion of enrollment and education services in Himachal Pradesh and Andhra Pradesh.
When it works well, then, finance contributes importantly to the efficiency of investment and to growth; when it malfunctions, as demonstrated in many recent crises around the world, it lowers both, as well as the quantity of investment as banks retreat - usually for some time thereafter. What can developing countries do to make finance work well?

Finance is different from other sectors in its distinctive combination of information asymmetries – providers of funds know less about their ultimate employment than do users – and inter-temporal trade (a euro today in exchange for the promise of a euro, plus some return, tomorrow). Given this information problem, which affects insiders and outsiders, robust financial systems – those which can support growth and do not lead to crisis – are those in which there are many ‘watchful eyes’ overseeing the intermediaries – as the 1998 WDR put it. There are three possible monitors: owners, markets, and supervisors. Authorities can do more to strengthen each. Owners will have the incentive to get and act on information if they have something at stake – their current capital in the bank, future profits, and/or potential liability if they fail. On the other hand, when bankers can borrow their capital – so that they can default on the loans and lose nothing – and can put their losses easily to the government, we should not expect significant monitoring by owners.

Similarly, if creditors believe that they will lose their investment if a bank fails, and if they have reliable and prompt information, then research shows that they will discipline banks, pulling out as risk-taking rises. Forcing banks to issue uninsured junior debt at regular intervals is a promising way to encourage this monitoring.

Lastly, supervisors need reinforcements. If they are paid in line with most civil service scales, they will lag their private sector counterparts substantially, a proven recipe for at best weak skills and at worst corruption. Many industrial countries pay supervisors and central bankers above government scale. Tying regulators’ hands – requiring certain interventions as real net worth of banks declines – may also be an idea whose time has come.

With all these monitors working together, banking stands a chance of functioning well. Robust intermediation also requires diversification, and for most developing countries, this is not possible within their borders as they are too small. Sixty countries have financial systems in total that are equal to or smaller than the balance sheet of some credit unions, and two countries out of three, totaling 800 million people, have financial systems whose assets are less than $10 billion (World Bank, 1998). Even if the banks diversify inside such small systems, they will still go bust regularly. Broader diversification is the key, through regional banking systems and openness to good foreign banks (as in southern Africa, Argentina, Mexico).

The international community has a role to play here as well. The Bank and the IMF have developed a joint Financial Sector Assessment Program to highlight key vulnerabilities and developmental issues in financial systems, and are also participating in a variety of fora to assist in the development of international standards in accounting,
auditing, bank supervision, capital markets regulation, corporate governance, and other dimensions. Applying these standards in different contexts requires a sensitive rather than a formulaic approach. Much remains to be done, however, to reign in bouts of excessive risk taking and to re-write regulations for intermediaries in such a way as to dampen booms and busts in international capital flows. While developing countries can encourage this move, upgrading their own regulatory environments will be key for mitigating crises and stimulating growth.

3. Changes in Development Thinking

We have put most of the weight in this essay on development experiences and lessons from them, reflecting our judgement that changes in thinking on development have arisen primarily from experience. Here we want to provide a sketch of how development thinking has changed over the decades – not only in response to the experiences we highlighted above, but also in response to developments in economics. Indeed, our emphasis and language in describing change has been strongly micro and structural. This reflects changes in perception of the meaning of poverty. It also reflects increasing focus of the profession both on the way in which markets and organizations function in an imperfect world and on how change comes about. To some extent this has reflected developments in other social sciences.

Many economists in the 1950s and 1960s were arguing, from a number of perspectives, that markets and incentives worked inadequately in developing countries and that therefore government should play a major role in determining the allocation of resources, particularly of investment. In this, the economists of the 1950s were reacting to the experiences of colonialism and the Great Depression, which suggested that capitalism and external markets were not going to promote the broad-based development of the economy and society in poor countries. They were also influenced by a perspective on the achievements of the Soviet Union, a perspective which was to change over time, and the experience of war-time planning in the UK. Economists differed over strategies for government direction, for example, in the debates on balanced versus unbalanced growth, but the desirability of government intervention in the economies of developing countries commanded broad agreement. There were clear voices raised against this apparent consensus, however – in development economics, for example, those of Peter Bauer and Gottfried Haberler and against planning from political philosophers such as Friedrich von Hayek. Many economists from both industrialized and developing countries were studying and advising on the techniques of planning. The predilection for planning and direct controls in the profession was in many cases accompanied by pessimism concerning the prospects for exports from developing countries—a pessimism associated particularly with Hans Singer (1950) and Raúl Prebisch (1950). Thus import-substitution industrialization was recommended by many, even though the issues concerning planning and import substitution were logically distinct.

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10 This section is adapted from Stern (1997).
11 See, for example, Bauer (1972), Haberler and Koo (1985) and Hayek (1984).
A central viewpoint on the macroeconomics of development was formalized in the two-gap model, in which Hollis Chenery (1962) played a leading role. The two gaps concerned saving-investment and the balance of trade. Export pessimism was embodied in a perceived constraint on exports; domestic inflexibilities were incorporated through fixed import requirements for investment. Foreign aid, seen through the optic of these models, could be particularly productive in allowing investment to expand by overcoming the constraint on its foreign exchange component. In both the planning and two-gap models prices played a minimal role and production techniques offered little choice, with fixed coefficients being a fairly universal assumption.

The 1950s and 1960s brought intense work on aggregate models of economic growth for both developed and developing countries. Although those for developed countries were predominantly for only one sector, those for developing countries gave dualism a prominent role. Particularly influential was Lewis’s (1954) model of economic growth with unlimited supplies of labor. In this model the process of development was depicted as a transfer of resources out of a traditional sector into an advanced sector, with the growth of the advanced sector being driven by the investment of profits generated in that sector. Taking these various strands together, economic debate in the 1950s and 1960s can be seen as focused on growth through industrialization and import substitution, with the government playing a central role in the process.

The late 1960s and 1970s brought greater emphasis on the application of basic microeconomic principles. Concern about dubious industrial and project decisions taken in the face of distorted domestic prices, or without reference to prices at all, led many economists to work on the measurement of price distortion and on characterization of the consequences of some of the industrial and trade policies that had been followed during the previous decades. Many studies emerged, including those on effective protection, domestic resource cost, and shadow prices. In economic theory academics were becoming much more concerned than previously about problems of economic information and incentives and the way in which contractual arrangements developed to take into account or alleviate some of these problems. From this perspective there was particularly intense study during the 1970s and into the 1980s on rural factor markets and institutions (particularly in regard to labor, land, and credit) although in this theoretical research the perspective on ‘institutions’ was a fairly narrow one, focusing on contractual arrangements rather than policy design and the creation of institutions.

Both the 1960s and 1970s saw concern with the conceptual basis for the measurement of poverty and inequality but there was a concentration on the income dimension. Income distribution was tracked in formal models. There was considerable discussion of the influence of income distribution on savings and growth, and of how growth itself would influence income distribution [much of this discussion built on the work of Arthur Lewis (1955) and Simon Kuznets (1971).] This period saw growing interest in the empirical study of poverty and income distribution.

12 Robert McNamara, as President of the World Bank, made his famous Nairobi speech on income distribution and poverty in 1974.
The 1980s brought a shift of concerns, driven in part by availability of data and computing technology, and in part by the poor results from statist policies that had led to either slow growth and/or acute problems of structural adjustment and debt. There was much empirical work on structural adjustment. Toward the mid-1980s an increasing concern with theories of growth resurfaced, in part as a result of developments in the theory of industrial organization and in part from empirical work that made use of large, newly available bodies of cross-country data, in particular the Penn studies of Kravis, Summers, and Heston (1983). Empirical work with these macro data-sets was aimed, inter alia, at understanding what factors create a good incentive regime for efficient investment. Data, computing, and econometric advances allowed for the development of empirical studies using household survey data. These data sets were multipurpose and were applied to models of individual and household behavior, as well as in the evaluation of income-distributional and standard-of-living consequences of different policies.

Research in the 1990s, including that at the World Bank, shifted to focus on the role of institutions in development. The importance of institutions such as those associated with the rule of law and the financial system has been established. There has also been growing work on the political economy of policy reform and of institution-building. Social cohesion is now seen as an important foundation for sound policies and institutions (Easterly and Levine, 1997).

The term ‘social capital’ has been used fairly generally to cover norms, associations and networks which influence how individuals and communities react to different kinds of incentives and opportunities. At the most basic level, recognizing its absence can help us understand the kind of looting that went on in the 1990s in some of the countries of the former Soviet Union. More constructively, we can see how poor people depend on their networks to create credit and share risks. At the community level, there were innovative efforts to measure social capital and demonstrate its importance for provision of local public services (Narayan and Pritchett, 1999).

These strands of work laid a foundation for the reexamination of the role of foreign aid in development. Progress in a number of countries has been held back more by poor institutions and policies than by lack of resources, so that the financing of ‘gaps’ did not produce good results. Furthermore, policy change has turned out to be a complex social and political phenomenon, so that one must think more deeply than simply making assistance conditional on detailed policy measures. Success of some World Bank-supported reform programs has depended more on underlying political economy factors, than on the efforts of the Bank or other outside actors (Dollar and Svensson, forthcoming). Thus, this reexamination concludes that aid can be a critical support to communities and countries in which there is a genuine movement for change, but that the country must be “in the driver seat” if reform programs are to succeed.

Looking to the future, we have to go beyond recognition of the importance of institutions and ask how to create effective institutions for development. Similarly, on social capital, we must ask how it is determined and whether there are any policies or interventions that will help build it.
4. Agenda for Action and Research

The nature of the policy problems facing developing countries has changed in the past decade partly because of external factors (such as international capital flows), but mostly because they have made progress with macroeconomic and trade reforms and have moved on to a more complex set of issues. In the 1980s we could advise countries to stabilize and open up to trade, and suggest how to do it. There was broad similarity of reform programmes on these dimensions – and the advice was largely sound.

The analogous advice today is: to improve your investment climate; to ensure participation of the poor (health and education, vital in their own right, will be key to this participation); and to provide poor people with some protection from dislocation and risk. In these areas one can offer generalized advice, eg., on the role of sound tax regimes and tax administration and of reducing corruption and improving the investment climate. But the specifics are of great importance. Governments need to diagnose where specifically their problems lie, design and build institutions and programs to address the weaknesses, and get continuous feedback on whether services are improving.

In the area of investment climate, there is no substitute for systematic information from firms. All of the industrial countries conduct enterprise surveys; yet, even in the more advanced developing countries it is rare for the government to survey firms systematically. Informal consultations are useful too, but they risk giving excessive weight to large firms and to existing industries, whereas SMEs and new industries will be important for future growth. Also, good surveys steer away from the opinions of business people, and focus on the facts: How long does it take to clear goods from customs? How frequent are power outages? What is the cost of telecommunications, power, and transport services? How many different permits and licenses are required for the business to function? How much has to be paid in bribes for different decisions? This kind of information is necessary in order to diagnose the key bottlenecks in the investment climate. Comparing this kind of information across countries is extremely revealing and often useful in galvanizing support for change.

Typically, the key problems of the investment climate will vary from country to country (and from region to region within countries). The bottleneck will be weeks to clear customs in one location, or unreliable power in another. In most cases, the underlying problem will be an institutional failure - for example, involving corruption or inefficient regulation or poor incentives in the public sector – and the solution will require designing new institutional arrangements with proper incentives and monitoring together with regular feedback mechanisms We must include amongst the problems here the norms of behaviour of both public officials and private agents. Indeed, of great importance in future research will be the examination of the interactions between policy reforms, institutional change, and norms of behaviour.

We can make very similar points concerning participation of the poor in development. The analysis starts with diagnosing the specific problems – which could be
access to education, health, land, finance or insurance mechanisms. In many cases, systematic individual and household surveys are needed to make the diagnosis. As with the investment climate, key obstacles are likely to stem from institutional problems – weak markets and organisational structures for land services or for small-scale credit or ineffective provision of public services in poor communities. The solutions will involve designing, building and fostering institutions that actually work.

What is the role of the World Bank and the larger international community in supporting these efforts? We see the role as four-fold. First, the international community should provide finance to countries that are low-income and have embarked firmly on ‘the first generation’ reforms of macro adjustment and trade liberalization. Research has shown that financial aid can have a large impact on growth and poverty reduction in this context (Burnside and Dollar, forthcoming). Donors have responded by making their aid allocations more selective in the past few years. However, the overall volume of aid remains at historically low levels, and we would urge the rich countries to be more generous. Note that one way to think about this recommendation is as follows. We are suggesting that donors consider moving away from very detailed conditionality on a large range of policies (broadly, the current practice), and instead condition the level of aid on a few key policies for which there is clear evidence of effectiveness. We have learned that development assistance can deliver for the poor.

Second, the international community should support the provision of global or regional public goods. One interpretation of recent pressures on the IFIs is that there is a broad coalition in developed and developing countries for poverty reduction. In this very constructive sense, poverty reduction is one global public good, and our recommendations address it. There are public goods such as malaria control or an AIDS vaccine that would make big contributions to world welfare. Clearly, many of these global public goods are under-funded.

Third, we think that a development agency such as the World Bank can help countries with the process of diagnosis, institutional design, and feedback. The Bank has played a leading role in the development of household surveys to help with poverty analysis and design of anti-poverty programs. One of our initiatives in the research department now is to help countries more systematically collect information from firms that is comparable across countries. This should become an invaluable diagnostic tool for assessing the investment climate and for helping design institutional and other improvements. A lot of the Bank’s detailed, sectoral involvement is aimed at strengthening institutions that affect either the investment climate or the participation of the poor. We view the Bank’s role in the diagnosis/design/feedback process in large part a “knowledge” role, not necessarily involving finance or conditionality. What the Bank can bring to the process is broad knowledge of what has been tried and what has worked in other countries. Countries and communities will need to tailor this knowledge to their own local situation. In so doing it is very important that different agents and agencies have a clear understanding of how their activities complement those of others on the key dimensions for action – that is a basic contribution of a Comprehensive Development Framework.
Fourth, and dear to our own hearts, we think that the Bank, with its international perspective and experience, has a special responsibility and position to pursue an active social science research agenda and to link this to efforts to strengthen research capacity in the developing world. It had enormous advantages over other institutions, indeed it is uniquely placed, to carry out comparative research programs drawing on the best conceptual and empirical ideas and researchers from around the world. Often such research will require basic and creative examination of the underlying theoretical approaches.

Research is closely related to the process of diagnosis/design/feedback, but it is not the same thing. On some of the important new issues that have emerged in the 1990s, it is difficult to make recommendations because both our conceptual and knowledge bases are limited. For example, we have gone beyond the recognition of the importance of institutions, but are only in the early stages of understanding how to build them. Various pieces of research have shown that in ethnically diverse societies, the quality of public services tends to be low – this suggests that there may be some important social capital that affects service provision. However, we are only beginning to examine what determines social capital or what institutional arrangement might mitigate the impact of low social capital. We have identified in this paper a wide range of areas in which increasing knowledge could yield large practical benefits. If the World Bank is to fulfill the role of a knowledge partner helping communities with the process of diagnosis/design/feedback, then it will require a foundation in research. At the same time, success in that knowledge role will strengthen profoundly its ability to pursue research on issues at the cutting edge of development.
References


