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Dynamic Development: Innovation and Inclusion

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It is a great privilege and honor to receive the award of Distinguished CES Fellow. I am keenly aware of the distinction of my predecessors in this fellowship. I am deeply grateful for the warm words of welcome of Professor Huber and Professor Sinn and to the University of Munich and the Center of Economic Studies for the award. I am profoundly touched by the extraordinarily kind, I fear too kind, words of Angus Deaton, my close friend for more than thirty years and one of the world's great economists.

1 The Challenge and the Opportunity

Ladies and Gentlemen, we have lived through a remarkable 25 years. At the end of the 1970s, China emerged from the nightmare of the Cultural Revolution and embarked on the reforms initiated by Deng Xiaoping. As a result, more than a billion people, one-fifth of the population of this planet, have seen a sustained period of growth and poverty reduction that has been unique in human history. At the end of the 1980s, the Berlin Wall came down and four hundred million people of Central Europe and the former Soviet Union set off on an unprecedented transition from communism and a command economy, to, for most, democracy and a market economy. There have been both achievements and trauma. But the changes are irreversible and we are on the verge of welcoming into the European Union many countries that were previously separated from us by an Iron Curtain. More quietly in the early 1990s, India set off on the road to economic change and is now seeing growth and poverty reduction which few would have thought possible 20 years ago. Twenty-five years ago one-third of the countries of the world could, broadly speaking, be described as democratic; now the proportion is closer to two-thirds. It has been a great privilege of my post-graduate life to have lived in and worked on India and China at various points in this period and to have been directly involved in the transition in Central Europe and the former Soviet Union.

Remarkable too has been the overall improvement in living standards in the last few decades. In the past forty years, life expectancy in developing countries has increased from the mid-forties to the mid-sixties; it must have taken millennia to move from the mid-twenties to the mid-forties. In the developing world, the share of people who are illiterate has declined in the past thirty years from around one-half to around one-quarter, with particularly strong progress for girls and women. In the last 20 years, the absolute number of people living below one dollar a day has decreased by around 200 million people, the first sustained decrease since the early nineteenth century—or as far back as we can construct data. This decrease has occurred at a time when the population of the developing world rose by 1.5 billion.

Sadly, however, this progress has not been shared universally: all too many people have been left out of the story. While mortality for children under the age of five is 7 deaths per 1,000 children per year in rich countries, the average in developing countries is 84 deaths per 1000, and in sub-Saharan Africa it is a shocking 162 deaths per 1000. Half of women over 15 in both South Asia and sub-Saharan Africa are illiterate. Over one billion people in low and middle-income countries lack access to safe water for drinking and personal hygiene. Nearly one-quarter of worldwide cropland, pasture, forest, and woodlands has been degraded since the 1950s, and one sixth of this is so

severely degraded it is too costly to reverse. In Sub-Saharan Africa we have seen the scourge of AIDS, failings in the battle against malaria and tuberculosis, and the devastation of conflict. This region has seen little or no growth in average incomes for the past forty years.

Reaching those left behind presents many challenges, including overcoming disillusionment in many countries where growth has failed to take root despite undertaking difficult reforms. Average tariffs have been cut by half (from 15 to 7 percent) in developing countries between 1980 and 1998, inflation has been largely brought under control with average rates now in single figures. But many countries in Latin America and Sub-Saharan Africa have not seen the results in terms of growth and poverty reduction.

We also see the real possibility of a retreat into protectionism in rich countries. When the challenge should be to dismantle obstacles to developing country trade, rich countries are subsidizing their agriculture with over \$300 billion per year. This is six times the total amount of development assistance from OECD countries. These subsidies, along with protectionist anti-dumping actions and bureaucratic applications of safety and sanitation standards, block developing-country agricultural exports at enormous cost to farm incomes in

poor countries. And rich country protection goes far beyond agriculture, with deeply damaging effects, especially in textiles.

While we should not be under any illusions about the magnitude of the challenge, I believe, however, that we now face a special opportunity. Building on the optimism and good intentions of a new millennium, an extraordinary international commitment to promoting development and fighting poverty has been created. This has been crystallized in the Millennium Development Goals (MDGs) adopted at the UN in the autumn of 2000. These goals represent specific targets for improvements in income poverty, health, education, the status of women and girls, the environment, and international development cooperation for the period from 1990 to 2015. In *Doha* in November last year the international community agreed upon a new round of WTO trade negotiations, and for the first time placed the interests of developing countries at the top of the agenda. In *Monterrey* this March, the international community reaffirmed its commitment to the MDGs. Developing countries committed to making improvements in governance, institutions, and policies, and rich countries committed to increasing aid, opening to trade, and supporting capacity building. The *Johannesburg* meetings this August looked further ahead to address the challenges of achieving sustainable development and protecting the environment. Taken together with past achievements, and what we have learned

about development policy, these commitments put us in a strong position to take action to achieve the Millennium Development Goals. But with this comes a deep risk of failure that could cause lasting, and possibly irrevocable damage.

My lecture tonight, and in some greater depth in the seminar tomorrow, is about how to rise to this challenge. I will present a strategy for development based on what we have learned from development experience. The strategy is based on two pillars: creating an investment climate for dynamic growth to take place, and empowering poor people to participate in the growth process. These twin pillars, the investment climate and individual empowerment, are, I will argue, both sound in concept and intensely practical. After laying out the elements of this strategy, I will describe a plan of action for the international community. Innovation and inclusion are at the heart of this strategy and of the action plan, and hence we have the title of this lecture: Dynamic Development: Innovation and Inclusion.

2 The Basis of the Strategy in Development Experience

Development is about fundamental change in economic structures, about the movement of resources out of agriculture to services and industry, about migration to cities and peri-urban areas, and about transformations in trade and technology. Changes to social life—in health and life expectancy, in education

and literacy, in population size and structure, in gender relations, and in social relations—are at the heart of the story. The challenge to policy is to help release and guide these forces of change.

In characterizing what we have learned from development experience, I will draw out six key lessons in a way that can help inform effective development strategy. The first concerns the role of the state. The state is not a substitute for the market, but a critical complement. We have learned that markets need government and government needs markets; and that government action is crucial to the ability of the people to participate in economic opportunity. These lessons point to an active state which fosters an environment where contracts are enforced and markets can function, basic infrastructure works, there is provision for adequate health, education and social protection, and people are able to participate in decisions which affect their lives.

The second lesson is that the most powerful force for the reduction of income poverty is economic growth. Countries that have reduced income poverty the most effectively are those that have grown the fastest, and poverty has expanded most in countries that have stagnated or fallen back economically.

The third lesson is that, notwithstanding the importance of an active state, the strongest, and indeed the driving force for sustained economic growth is the

private sector. Within the private sector, small and medium-sized enterprises play a particularly important role in generating employment opportunities for poor people.

The fourth lesson is that trade has been a crucial engine of growth. Trade patterns have changed dramatically since the 1970s, when trade with developing countries was still dominated by commodity exports. China's opening to the world, and the shift away from import-substituting strategies in many countries, has led to a surge in labor-intensive manufactures, which now dominate aggregate trade flows for the more rapidly growing developing countries.

A fifth and highly important lesson is that development activities function much more effectively if poor people are empowered. We can define an individual as being empowered if she or he has the ability to shape the basic elements of her or his own life. This requires that people be educated and healthy, in other words the need for what economists call human capital. But empowerment goes beyond human capital. It also means effective participation which, in turn, depends on information, accountability, and the quality of local organizations. For example, we know that schools function better if the community is involved; that infrastructure, electricity, water, and the like work more effectively if consumers' voices are heard; and we know that poor people

are more productive and creative in their economic lives if they have reliable title to their own property. Effective participation and social inclusion mean better results.

The sixth and final lesson is that reform programs forced from outside, with weak societal commitment, are likely to fail. Ownership of the development agenda by a country and society is a vital ingredient for its effective implementation.

These lessons from development experience point to the strategy proposed here. But before we can define strategy we have to set objectives. Our perspective on the goals of development has changed substantially in the last 20 years. We now look beyond incomes to health and education, or human development. But it is still deeper than that. We now see the objectives or ends of development as concerning the ability of people to shape their own lives, or “Development as Freedom”, as Amartya Sen has put it. For poor people themselves, overcoming poverty means opportunity, empowerment and security, as learned from interviews with over sixty thousand poor people in more than sixty countries. We have learned that empowerment is both an end and a means of development.

3 The Strategy

3.1 The Two Pillars

Let us now turn to a strategy for development that emerges from examining these lessons of experience in the light of the objectives set out and our understanding that development is about fundamental processes of change. The strategy that I propose is in essence a strategy for ‘pro-poor growth’, although I do not much like the term. It is based on two pillars, both of which embody the idea of an active state complementary to markets.

- The first pillar is the creation of a good investment climate—one that encourages firms, both small and large, to invest, create jobs, and increase productivity. This pillar is founded on the lessons I mentioned earlier on the role of the private sector, of trade, and of growth for effective poverty reduction.
- The second pillar is to empower and invest in poor people—by enabling their access to health, education, and social protection, and by fostering mechanisms for participating in the decisions that shape their lives. This pillar is founded on the lessons on the role of social inclusion and ownership of reform in enhancing development effectiveness.

Consider the first pillar which focuses on the process of growth. The private sector is not only the main engine of aggregate growth, but is also the main provider of economic opportunity and activity for poor people. Of the 1.2 billion people in the world who live on less than \$1 a day, only a small fraction work in the public sector, or indeed in large firms. In India fewer than one-in-twenty poor households (those in the bottom quintile) have income from public employment; for households in the top quintile, the figure is one-in-five. Private-sector growth, particularly of smaller firms and farms on which most of the poor depend, is vital to the reduction of poverty. Thus a central policy question for poverty reduction is how we can construct policy to promote this growth. The answer proposed here is in terms of the investment climate. This looks at the environment for entrepreneurship and the process of investment and not simply at levels of investment. In this sense it is essentially Schumpeterian.

The second pillar, empowerment, guides action to help increase the capabilities of poor people. It fosters social inclusion and participation in growth, but it also promotes growth itself by bringing the assets and energies of poor people into the story. Thus the processes embodied in the two pillars are mutually reinforcing in their effects on growth and poverty reduction.

Before examining the pillars of the strategy in detail let us ask how this story differs from that of the standard received economic approaches to policy, as, for example, summarized by the term “Washington Consensus”. That consensus, as originally defined by John Williamson, emphasized fiscal discipline, market-determined exchange and interest rates, protection of property rights, liberalization, privatization, and openness to trade, as well as redirection of public expenditure toward education, health, and public infrastructure.

Whilst one can raise questions of balance, there is nothing wrong with these principles. Indeed it would be dangerous to reject them. The more important issue concerns what is left out. The consensus said nothing about governance and institutions, the role of empowerment and democratic representation, the importance of country ownership, or the social costs and the pace of transformation. The development community has learned the hard way, through the setbacks of the structural adjustment programs in developing countries of the 1980s, and the transition of the 1990s in eastern Europe and the former Soviet Union, that these elements are at the heart of the development challenge. They are what the strategy proposed here is all about.

This story also goes well beyond the standard theories of growth. Much of growth theory represents economic activity by a simple aggregate, and focuses on steady states. The strategy proposed here instead focuses on the processes

which drive the decisions of households, firms, and farms. It looks at what really works or does not work on the ground. It sees growth as a process of structural change and of learning. It examines the real drivers of growth and development.

3.2 The Investment Climate

Let me elaborate on some details of the strategy, beginning with the first pillar, the investment climate. I define “investment climate” as the policy, institutional, and behavioral environment, both present and expected, that influences the perceived returns and risks associated with investment. We think here not only of the quantity of investment but also of the productivity of investment and economic activity, and we think first of the investment climate for smaller, domestic firms. If it improves for them it will in all likelihood improve for larger and foreign firms as well.

The investment climate is a function of various elements that can be grouped under three broad headings: (i) macroeconomic and trade policies, (ii) governance and institutions, and (iii) infrastructure. Unstable macroeconomic conditions—often resulting from unsustainable fiscal positions—undermine the confidence of firms in making production decisions and engaging in production. Trade barriers in foreign markets and weak

competition and protection in domestic markets suppress incentives to innovation and entrepreneurship.

Bureaucratic harassment, corruption, and organized crime are all profoundly damaging to the investment climate, imposing barriers to entry, adding to operating costs, and creating uncertainty once the firm is established. This applies to both large and small firms, but it is especially important for smaller firms and farms, with their weaker capacity to finance the costs of dealing with regulation and to use “political contacts” and other means to resist harassment.

I recall vividly the experience, whilst at the EBRD in the 1990s, of speaking to a number of women running small businesses in St. Petersburg. They described the endless visits from tax officials, safety inspectors, the fire service, officials examining the structure of price lists, sanitation engineers, police officers, and so on. Many of these came in more than one version—from the city, region, and federation. And that was before the mafia arrived on the door step with the protection racket. It was extraordinary, and speaks volumes for their perseverance and courage, that they managed to start and stay in business. It is hardly surprising that small and medium-sized businesses have

grown so slowly in Russia. The story could be retold in transition and developing countries across the world.

No less important than the first two elements of the investment climate is the quality and quantity of physical and financial infrastructure, such as power, transport, telecommunications and banking and finance. So often in developing and transition countries entrepreneurship is smothered by failures in basic communications, and inadequate and unreliable supplies of water and electricity.

Improving the investment climate is about improving the connection between sowing and reaping, and indeed the ability to sow. Understanding investment and productivity is in large measure understanding whether investors can work effectively and reap the benefits of their efforts or whether their investments will be frustrated by uncertainty, instability, and predation.

3.3 Inclusion and Empowerment

Education and health are key elements in the second pillar of the strategy, empowering and investing in poor people. But just as important is participation in decisions affecting them and their families. So too is protection for their livelihoods and assets. These are the elements that allow them to shape their

own lives, invest in their future, build assets and be included in the society in which they live.

Our studies of empowerment in projects and programs at the World Bank indicate that successful efforts to empower poor people and increase their freedom of choice share four elements: access to information; participation; accountability; and local organizational capacity. These are closely related. Access to information is crucial for effective action, but without institutional mechanisms and accountability, citizens may not have the means to take such action. Examples of empowerment at work include community involvement in running schools, water users associations, and local health groups. We have seen that these mechanisms can play a powerful role in tailoring services to the needs of poor people. Let me describe briefly some examples:

- In the EDUCO program in El Salvador, the government empowered community associations to hire and fire teachers in community-managed schools. As a result, net enrollment rates were significantly increased, standardized test scores improved, and teacher absenteeism was reduced. It was the *accountability* of schools to the community and *local organizational capacity* that drove these results.

- In the late 1980s a publicity campaign for a public health program was launched in Ceara state in northeast Brazil, to inform communities of health opportunities and help them press local governments to adopt the program. This process led to a rise in child immunization rates from 30 percent to 90 percent, and a cut in infant mortality from 102 to 65 per 1000. *Access to information* was critical to successful community mobilization.
- As part of an *information* campaign to build awareness of corruption and resource diversion in Uganda in the mid-1990s, the central government began publishing and broadcasting the amounts of monthly education transfers to the districts. Schools were required to post information on their funding. The public awareness thus created helped to increase the share of non-wage funds that actually reached schools from 13 percent to around 90 percent.

We have also learned to look beyond education and health services if we are to understand improvements in education and health outcomes. Better water supplies save the time that girls spend in collecting water, for example, and thus can enable them to attend school. Improved nutrition contributes to better education outcomes. Electricity can provide the light by which to study and the

refrigeration to store vaccines. Thus the objective of promoting education and health requires us to look beyond schools and hospitals if we are to act effectively.

In many communities the empowerment of women is the most important challenge of the empowerment agenda. It is central to the objectives of development as we have defined them. But whether or not one accepts that objective, there is compelling empirical evidence that attention to opportunities for girls and women—what some call ‘engendering development’—not only improves their position in society but also has a major impact on overall development effectiveness. Education of mothers has a powerful effect on the health of their children. Control by women over income, productive assets, or transfers increases expenditure on food and clothing, for example, and reduces expenditure on alcohol and tobacco. Cross-country evidence reveals that lower investment in education for girls and women reduces overall growth performance. We are learning that greater involvement of women in public life reduces corruption. Effective action requires a keen awareness of the influence of gender issues across the whole spectrum of development.

I hope I have said enough about the strategy to show that it is possible to put real structure on the ideas embodied in the two pillars. They lead to a whole

set of interesting and important avenues of research into the effectiveness of actions to promote development. That research will be the subject of my talk on Thursday. Let me now turn to action.

4 A Program for Action

We have seen both the scale of progress over the last decades and the scale of the challenge. The Monterrey meetings signaled a clear recognition that international action and partnership is required to achieve the Millennium Development Goals. Poor countries committed themselves to improvements in policies, governance and institutions, and rich countries to greater assistance and market access. The challenge now is to turn commitments into specific actions. And in doing so we must look for results which are commensurate with the enormous scale of the challenge.

We examine the program for action by first looking at the promotion of change in developing countries, and then at flows between rich and poor countries, aid, other capital flows, and trade. We shall see that the Monterrey framework is supported by the principles of the strategy. Both the framework and the strategy emphasize good governance, institutions and policies, markets and trading opportunities, and investing in people. The strategy can provide real

guidance in putting structure on the framework for action and can show us where we have more to learn.

4.1 Change in Developing Countries

We have seen that change is central to development, and pointed to a development strategy based on innovation and inclusion. We also know, however, that country ownership and tailoring development strategy to local conditions and history is vital to success. Whilst there are basic principles for development strategy, no one size fits all. How do we translate analysis and strategy into action? Let us break this down into three basic questions. First, how can a locally-owned and country-tailored strategy be constructed? Second, how can we use ideas to guide change and shape action on the ground? And third, how will change be initiated and sustained, or what are the drivers of change?

(a) Constructing a strategy at the country level

The task of constructing a strategy at the country level should be shaped by the country itself. India, for example, has a system of five-year plans. For some time these have looked very different from the rigid quantitative plans of

the Soviet variety and have embodied a strategic approach to development in which private sector growth is central.

The World Bank has for several years now argued for a Comprehensive Development Framework. This framework takes account of the basic interrelationships of different institutions and sectors of an economy to provide a basis for partnership between different actors in the development community, be they local or external. The Comprehensive Development Framework not only recognizes interrelationships across sectors, activities, and actors, it also focuses on results, and it seeks ownership by the community as a whole. One vehicle for implementing this idea is the “Poverty Reduction Strategy Paper.” This involves a participatory process including both domestic stakeholders and external development partners. Poverty Reduction Strategy Papers are now on the agenda of 70 low-income countries and are forming the basis for domestic cohesion around a strategy and also for harmonization of donor support. The approach is evolving over time and it increasingly embodies both the Millennium Development Goals, suitably modified to reflect countries priorities, and country-specific approaches to pro-poor growth.

(b) Translating ideas into action

What I believe matters the most for the success of efforts to support change and development are strong and practical ideas which are implemented effectively. In the long run the generation and application of good ideas, about what works and what does not under local circumstances, are still more important than external aid. Aid flows can provide an important source of finance and can foster change. But we must recognize that, on average, the flows are small: they represent less than 1% of the GDP of developing countries and less than 3% of total investment in those countries. Second, as experience has shown, external support in the absence of an appropriate and effective strategy risks wasting resources, and at times may have postponed much needed policy change. It is good ideas, supported by aid flows, that will drive rapid development. Whilst this understanding of the role of ideas is important, we must recognize that there are some circumstances, such as emergencies, and very severe conditions, for example, in much of sub-Saharan Africa where the volume of aid will be critical. Indeed it is already above 4% of GDP for sub-Saharan Africa as a whole and much higher for some countries.

Implementing ideas effectively goes beyond the creation of the ideas themselves and requires innovation, evaluation, dissemination and capacity building. Let us examine these in turn.

Innovation requires openness to new ideas and instruments. It also requires that we avoid limiting ourselves to activities we know will succeed, or those that have succeeded in the past. I will return to this with some examples in a moment.

When there is rigorous evaluation of innovations or experiments, they lead to more precise and effective lessons, and can provide strong evidence to convince others to follow success. Too often the value of piloted approaches, or even large-scale projects, is lost or compromised by the failure to build in adequate and well-designed evaluation features. One approach is to build a randomized control group as in medical trials. Where programs cannot be introduced across the board at one go we can learn along the way by randomizing the order of program introduction. And sometimes, by modeling the process of selection in a program, we can construct ‘quasi’ control groups.

We must go further, however. If successful experimental approaches are to be taken elsewhere and adapted and used, they must be publicized. Thus an important role for development agencies and NGOs is to disseminate ideas and

promote the use of knowledge for action and change. This is an area where, I believe, international agencies need to challenge themselves to do more.

Let me provide some examples to help illustrate the translation of ideas into actions. Successful experimentation and innovation were central to the single most dramatic instance of poverty reduction in history: China's reduction in rural poverty from 250 million people living in absolute poverty in 1978 to about 34 million in 1999.¹ China has been very successful at experimenting in one region and then scaling-up across the country. The approach was known in China as 'feeling the stone ahead as we cross the river' (*muo shi guo he*). For example, China's agricultural reforms of 1979-83 started with the initiative of farmers in Anhui province and were extended rapidly to all provinces and the whole country by the early 1980s. Similarly, experimentation with the township and village enterprises from the early 1980s allowed China to discover a powerful engine for growth that was compatible with the political context at the time. Subsequent statements by Deng Xiaoping make it clear just how unexpected this rapid growth of the TVEs was, but the results were sufficiently striking that the Chinese government allowed the experiment to expand across the country.

¹ Based on the Government poverty line which is approximately the equivalent of 70 cents per day using 1993 PPP figures as applied by the World Bank. (Source: China Rural Poverty Monitoring Report 2000, National Bureau of Statistics, Beijing)

Powerful examples are often set without conscious experimentation by government. NGOs, religious groups, the private sector, local government and inspired individuals can generate all kinds of ways to enhance their communities and solve problems. I have visited AIDS groups in South India, a leper rehabilitation project in Indonesia, environmental protection groups in the Niger delta, a center for attended childbirth in rural Peru, IT activities for children in the favelas of Rio de Janeiro, and so on. All of these arose from local, private or individual initiative.

However, as we have argued, if examples are to provide a sound basis for further action and help generate results on scale, careful evaluation and dissemination of results are crucial. Surveillance and monitoring systems have been vital to tracking progress in health interventions and understanding effectiveness— for example, in fighting malaria in Vietnam; HIV/AIDS in Senegal, Thailand and Uganda; and measles in Malawi. Mexico's PROGRESA program of cash transfers to poor rural families to keep children in school and give them medical checkups is another example where evaluation has been strong. Notwithstanding changes in the governing party in Mexico, strong evaluation and clear results made this program unassailable in the political arena.

(c) Drivers of change

In light of the evidence on the importance of change, how can government and international institutions trigger and sustain innovations in institutions, governance and policies? I want to emphasize five key drivers of change. First, I believe strongly in the *power of evidence*. There can be a strong demonstration effect from evidence of which programs and approaches work well, and under what circumstances they can be adapted and used elsewhere. Negative evidence, particularly evidence that embarrasses, can also have a strong impact. The ‘power of embarrassment’ worked well in Uganda, as we saw in the example, that I mentioned earlier, of leakage of school funds.

Second, certain *policy choices* can encourage or impede movement toward the right kind of change. As has long been pointed out by economists, quotas and licensing requirements—what is called the Permit Raj in India—breed corruption and arbitrary use of discretion by government officials. This diverts entrepreneurial energy from the innovation needed to create new products and institutions to lobbying for permissions and privileges. In this case, removing bad policies can promote much-needed institutional change and India is seeing the results in terms of more rapid growth.

Third, leadership for political action by policy entrepreneurs can promote change. Like markets for private goods, markets for policy and institutional innovation are not characterized by a spontaneous combination of inputs. It takes leadership and entrepreneurship to recognize an opportunity and exploit it—someone like Muhammad Yunis of the Grameen Bank for micro-credit in Bangladesh, or Meechai, the self-proclaimed Condom King in Thailand, who launched a program to combat AIDS in Bangkok. His approach to publicity has been very creative and humorous—he even has a restaurant called “Cabbages and Condoms”—and he has been highly effective.

Fourth, the press and media can be an important provocation for policymakers to change or indeed to a change in policy makers. In one recent example a television station in Peru broadcast a video of an opposition legislator being bribed by the national security chief. The story was picked up in other publications, and the resulting public furor led to the fall of President Fujimori’s government. Last year’s World Development Report, on *Building Institutions for Markets*, includes a host of other examples of the developmental role of media.

Fifth, the momentum for change can be built through the creation of constituencies for reform, and promoting effective partnerships to sustain

reform. Partnership across constituencies is often difficult since different interest groups may not recognize that they can gain by working together. But there are strong examples of success in promoting partnerships. Kenya's successful bed-net program against malaria was based on partnership between government, employers and employees via payroll purchasing programs, and HIV prevention efforts in Senegal have been based on successful partnership with mosques with strong community foundations. In other cases the prospects for change may be strengthened by enhancing the voice and representation of particular constituencies. For example, the growth of the SME sector increases the number of firms and households with a clear interest in the investment climate and thereby can strengthen the forces for improving it.

4.2 Aid: Effectiveness and the Scale of the Challenge

Let us turn now to what rich countries can do, beginning with aid. Increasing the volume of aid is central to the Monterrey compact. But it is just as important to make more effective use of aid, both to improve outcomes and to strengthen the rationale for increased aid flows. The evidence suggests that aid effectiveness has increased substantially during the 1990s. Based on a multi-country panel data analysis of the impact of aid on growth and poverty, World Bank estimates suggest that an additional \$10 billion in aid would have lifted 1

million people out of poverty in 1990, but that \$10 billion would have enabled nearly 3 million to permanently escape poverty by 1998.² Of course, the benefits of aid go well beyond the narrow effect on crossing the \$1 per day line embodied in these numbers.

Several factors underpin this increase in effectiveness. First is the improvement in aid allocation following the end of the Cold War, and the consequent decline in aid for political or military purposes. Aid is increasingly allocated on the basis of two key criteria: where poor people are and where it can be used effectively. This re-allocation was built on research findings that showed that aid was more productive in contributing to growth and productivity in a stronger policy and institutional environment. This motive led the Dutch government, for example, to reduce the number of countries receiving its aid from 70 to 17. These criteria also guide the allocation of IDA, the World Bank's instrument for concessional lending.

Second is the improvement in policies of developing countries themselves. Better macroeconomic policies and greater openness have made the domestic economic environment more conducive to growth. Inflation, which typically does the greatest harm to poor people, fell significantly during the

² Nicholas Stern and others, *A Case for Aid*, The World Bank, 2002, pp. 42 and 99.

1990s, macroeconomic management improved, exchange rates were more stable, and barriers to trade were reduced.

Third, evidence that project-specific aid was fungible across sectors led donors to place greater emphasis on the quality of a country's overall public-expenditure programs and less weight on the individual project rates of return. Help in the shaping of policy and the improvement of administration in a sector as a whole has increasingly become the focus of projects and programs.

A fourth factor has been that traditional aid conditionality, whereby aid is 'conditional' on promises of policy reform, has been recognized to be of limited effectiveness. Empirical work showed that the number and detail of conditions had little to do with whether policies were actually reformed or not. This has resulted in simplification of conditionality, greater emphasis on local ownership, and jointly monitorable results.

Fifth, although this is an effort which should go much further, agencies and donors are working to harmonize their efforts. All too often the different methods and procedures of different agencies have placed great burdens on scarce administrative resources of developing countries. For example, at one point Tanzania was required to produce 2,500 reports per quarter to different aid agencies.

One crucial lesson from the experience of development assistance is clear: resources should be used to help finance the costs of change and not to finance the costs of *not* changing. Too often aid programs have only mitigated the problems of poverty, without helping to find long-term solutions. In the Cold War era we saw even worse, the sustaining of regimes, such as Mobutu's Zaire, which were deeply damaging to their country and people.

4.3 Trade: Breaking Barriers

Rich countries have a contribution they can make to development which is still more important than more and better aid and that is breaking down their trade barriers. For the first time, initiated in Doha a year ago, we have a round of trade negotiations in which development is at the top of the agenda.

Both developing and high-income countries face the challenge of making the Doha Round a success. Notwithstanding measures to open their economies, many developing countries have made little progress in integrating into the world economy and have failed to realize the potential gains from trade. Poor countries suffer from many internal impediments to trade, including bureaucratic red tape and harassment, weak infrastructure, malfunctioning credit markets, and legal and institutional inadequacies. Addressing these behind-the-border constraints to trade is both a key element of development strategy and a priority

for development assistance. And many developing countries have protective barriers which are still very high.

But many of the barriers to expanding the trade of developing countries are not within their control. OECD countries continue to maintain major obstacles to imports from developing countries, notwithstanding pledges to remove or reduce them. I have already pointed to the magnitude of agricultural subsidies in high-income countries—more than \$300 billion annually, or roughly six times the total amount of aid to developing countries. For example, the average European cow receives \$2.50 per day in government subsidies and the average Japanese cow receives \$7.50 in subsidies, while 75 percent of people in Africa live on less than \$2 per day. US subsidies to cotton growers alone will total \$3.9 billion this year. Not only is this amount three times the USA aid budget to Africa, but it also undercuts incomes of poor farmers in North and West Africa, for whom cotton is the main cash crop, and effectively transfers resources out. As we are in Europe, let us be clear that European subsidies and barriers are, in general, absolutely and proportionally much higher than those in the United States. Some of the results are bizarre. We see sugar beet grown in Finland whilst poor sugar cane producers and cutters in the tropics struggle to make a living.

According to IMF research, tariffs and quotas for textile exports to developed countries cost developing countries an estimated 27 million jobs. Every textile job in an industrialized country saved by these barriers costs about 35 jobs in these industries in low-income countries. Escalating tariffs—duties that are lowest on unprocessed raw materials and rise sharply with each step of processing and value added—undermine manufacturing and employment in industries where developing countries would otherwise be competitive. A Chilean tomato exporter faces a U.S. tariff of 2.2% on fresh tomato exports to the US, 8.7% if the tomatoes are pre-packaged, and nearly 12% if they are processed into sauce.³ Escalating tariffs help confine Ghana and Cote D’Ivoire to the export of unprocessed cocoa beans; Uganda and Kenya to the export of raw coffee beans; and Mali and Burkina Faso to the export of raw cotton. These are taxes on development.

If rich countries are serious about their commitment to the MDGs, then, they will need to demonstrate this commitment through trade policies that are more conducive to development. It makes no sense, indeed it is hypocritical, to preach the advantages of trade and markets and then erect obstacles in precisely those markets in which developing countries have a comparative advantage. That hypocrisy does not go unnoticed in developing countries and they will

³ The World Bank, *Global Economic Prospects*, 2003, p.19.

draw their own conclusions. The recent Farm Bill in the United States and the recent agreement in Europe to delay the reform of the Common Agricultural Policy are deeply damaging. They are egregious examples, on the home turf of rich countries, of financing the costs of not changing, rather than supporting growth and facilitating development.

We should note also, and this is of importance to potential arguments within rich countries, that rich-country trade barriers have highly regressive effects domestically, in that they are usually found on goods which are important in the budgets of their poor people, such as food and clothing. These barriers not only waste financial resources and hit poor people in rich countries but they also lead to environmental degradation and damaging distortions to diets of both livestock and people. All this is on top of the severe harm they do to people in developing countries. It is time that the citizens of rich countries demanded their removal.

4.4 Capital Flows: FDI, Portfolio Investment and Debt

The opportunities for rich countries to support development go beyond trade and aid. Capital flows can play an important and constructive role, although they have their costs and risks. In thinking about the role they should play in financing development, it is helpful to understand some of the key

features of flows in recent years. First, cross-border capital flows have increasingly come to be dominated by flows between private sector parties. Second, the flow of private-sector debt to developing countries has slowed in recent years. Indeed, non-FDI flows are currently negative on a net basis. Third, foreign direct investment flows, even as debt financing has been weakening, have been remarkably resilient.

These developments point to the need for reconsidering the role of private external debt flows in financing development. Risk-sharing principles would suggest that in many circumstances the risks inherent in development finance may not be appropriately financed with fixed contractual debt obligations, particularly shorter-term debt. This is the same reason why private start-up companies often rely on venture capital financing rather than debt. Market-driven debt flows are prone to swings in investor expectations, amplifying the business cycle and hitting poor countries the hardest. Equity-related finance, on the other hand, brings with it the natural benefits of risk-sharing, and as a longer-term commitment appears to be less subject to the sudden stops and reversals that characterize debt flows. Further, foreign direct investment carries many indirect benefits much more strongly than debt finance: through innovative ideas, new technologies, and improvements in human capital.

The policy priority here, therefore, is not to try to encourage still further private debt finance but to encourage improved conditions for FDI. Our research shows that a key variable for attracting FDI is the investment climate in developing countries.⁴ And improving the investment climate fosters the level and productivity of domestic investment, which is 90% of the total in developing countries. That is exactly the focus of the strategy we have been proposing.

4.5 Global public goods

We have been looking at policies and actions of both developing and developed countries but we must also think of action at the global level. I have already touched on the importance of working to reduce instability in international capital flows, and to reduce the barriers to trade. But I would like to add a special note on the importance of protecting the global environment. Our water, our land, our forests and our biodiversity are vital assets, with potentially catastrophic losses if international protective action is inadequate. Tropical countries in particular are vulnerable to projected climate change and environmental degradation, including loss in food production arising from global warming, and an expanding range of tropical diseases. Global action

⁴ see The World Bank, Global Economic Prospects, 2002 and 2003 editions.

must be complemented by national and local level environment policies—rich countries, in particular, have a special contribution to make here as they dominate energy use.

5 Rising to the Challenge

What are our prospects for success? They will depend on two things. The first is an acceleration of learning and the second is leadership for and commitment to action. We cannot, however, wait for more learning before we move into action. We know enough to act effectively now. And learning and acting at the same time are the essence of development.

The second factor determining success or failure of our actions is political leadership and commitment. The leaders of rich countries must make development a central domestic issue. I believe that if this were taken seriously, it could elicit a strong response. Success requires the people of rich countries to see themselves as citizens of one world and to recognize that poverty anywhere is a responsibility everywhere. To some extent this recognition lies behind the motivations of those who protest against globalization. Unfortunately, all too often the admirable concern to fight poverty is blended with a confused understanding of the powerful role that trade has played—and can play—in driving growth and poverty reduction. For others, protest against globalization

is sometimes associated not with altruism but with the protection of narrow self-interest—for example, in the protectionist measures sought by special-interest groups to block imports from developing countries. However, I believe that the peoples of rich countries are responsible and decent and are, on balance, ready to insist that we do more to help.

Ladies and gentlemen, we are at an important juncture in human history, one replete with risks and opportunity. The world's nations have pledged again at Monterrey to reduce world poverty to half of its 1990 level by 2015 and have set targets for improving education, health, gender and environment. By supporting the climate for investment and productive employment, and by empowering people to learn and to take advantage of productive opportunities, I believe we can reduce poverty, in all its dimensions, dramatically and sustainably.

The strategy I have outlined here is both intellectually coherent and is supported by a research program that gives it analytical substance. It asks how the basic elements of productive activity and entrepreneurship really work. It forces us to focus on what really determines the ability of an individual to shape her or his own life. It leads us to an approach which guides action, and it helps us understand how development effectiveness can be raised. Therefore it can

guide us towards a program that could scale up our activities to meet the ambitious targets embodied in the Millennium Development Goals.

I believe we have the understanding and the resources to win the fight against poverty. We now have to go beyond commitment to delivery. This will not happen without both leadership and the engagement of people across the world. These, in turn, will require evidence: serious evidence of what works and what does not. Whichever way we look at it, if we as a generation are to take this special historical opportunity to fight poverty, no one has a greater responsibility than those of us who study economic development.