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A Strategy for Development

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§1 Introduction

It is really a great pleasure for me to be back in China. I have happy memories of living in Beijing for six months in 1988 and teaching at People's University. I have been able to return from time to time and witness the remarkable changes that have occurred in China. The theme of my talk today is a strategy for development. And I think that you will see that my thinking reflects important development lessons that we have learned from China. I also hope that this strategy has something to offer to China as it confronts further challenges of development.

In my view, there are two pillars that form the basis of a sound strategy of development. They are the pillars of: (1) creating a good climate for investment and productivity growth, and (2) empowering people – including the poor -- to participate in that growth. It is a strategy for pro-poor growth, or growth in which poor people can participate strongly. In my talk I will examine the key links between investment climate and empowerment as the strategic pillars, and poverty-reducing development as the goal. The strategy for development will sound, I hope, very plausible, indeed almost obvious. But this description is fairly new and is not universally accepted.

The word "investment" in the phrase "investment climate" will evoke memories—in some—of the development philosophies of the 1950s and 1960s, when the emphasis was on growth through capital accumulation. There was mistrust of the private sector and little mention of entrepreneurship or social inclusion. Thus the challenge of development was seen primarily as creating a surplus – or savings – to finance accumulation of capital. Since those early days of development economics, we have learned through painful experience that simply accumulating capital does not ensure improvements in material living standards and welfare more broadly.

My emphasis here will be very different from those earlier models and will be, first, on innovation and productivity growth driven by private initiative, and, second, on how to empower poor people so that they can participate strongly in the process of growth. Both elements are crucial for fighting poverty. First, consider the role of private initiative. Not only is the private sector the main engine of aggregate growth, it is also the main provider of employment for poor people. Of the world's 1.2 billion people who live on less than $1 a day, only a minute fraction work in the public sector. Thus the growth of the private sector is vital to the reduction of poverty. But that growth will not take place as a simple translation of investment into output increases. What the notion of "investment climate" captures instead is a Schumpeterian view of investment and growth—a view that what matters is not just how much investment takes place, but what drives it, what effects it has, in particular its dynamic effects on productivity and further opportunities, and what happens to the other factors of production and their productivity. In other words, it tries to capture the whole process of investment and growth, and not just a simple snapshot at the point of investment.

Just as the concept of "investment climate" broadens our view of production processes in a useful way, so too have we enlarged our notion of what poverty is and moved to an *ex ante*, rather than an *ex post* notion. Rather than simply asking whether a person's current income level classifies him or her as poor, we ask whether, or to what extent, he or she has the capabilities and environment for action and success—opportunity, empowerment, and security, to use the trilogy from the *World Development Report 2000/1*. An attack on poverty is in large measure about empowering poor people to shape their own lives, through opportunities for education, health care, risk reduction and mitigation, and participation in the key decisions that affect them and their families.

§2 Investment Climate

What Does It Mean?

What do we mean by "investment climate"? Specifically, by "investment climate," I mean the policy, institutional, and behavioral environment, both present and expected, that affects the returns and risks associated with investment. The notion of investment climate focuses on questions of institutions, governance, policies, stability and infrastructure that affect not just the level of capital investments but also the productivity of existing investments—indeed of all factors of production—and the willingness to make productive investments for the longer term.

Seen in this broad way, the investment climate clearly depends on many different aspects of public and private action. It is useful to group these factors under three broad headings:

First, we have *macroeconomic stability and openness*. These embody the usual sound and sensible, if standard, economic prescriptions for macro and trade policy.

Second, we have a set of issues that we can group under *good governance and strong institutions*. These issues will be my main focus here; they include:

- government institutions and behavior, including: (limitations on) bureaucratic harassment, especially in the administration of regulations and taxes; the strength of financial institutions; the rule of law (including law enforcement), and (the control of) corruption and crime;
- the effectiveness of the government in providing sound regulatory structures for the promotion of a competitive private sector;
- the effective provision of public services or the framework for such services; and the quality of the labor force.

The third broad area is the *quality of infrastructure*, including power, water, transport and telecommunications.

That is a long list, and it looks fairly all-encompassing. Let us try to get more concrete by exploring what it means for economic activity at the micro-level.

Why Is It So Important?

The key to improving the investment climate can be simply stated: improving the connection between sowing and reaping. This is not just a point about multinationals and foreign direct investors. It is, even more importantly, also a story of the local level, of the micro-entrepreneur, small business person, or farmer (hence the metaphor). Every day as they work, these people have to make decisions about the investment of their effort and resources. A key to these investment decisions is the investors' sense of efficacy—their ability to get on with the job and see the rewards. Can investors carry out their efforts and reap the benefits, or will this investment be frustrated by uncertainty, instability, and predation? They will reasonably ask: "Why should I sow, if I will not be able to reap a harvest?"

Government cannot guarantee the harvest against all the natural uncertainties of investment (although the social organization of insurance can mitigate the risks of natural adverse events). But it is a fundamental obligation of government to see that those who sow will not be arbitrarily disrupted in their daily activities or robbed of their harvest by opportunistic human intervention. This is even more important than the protection of existing property, because it is only by protecting the connection between investment and return that new property will be created.

Too often, we see societies that have stagnated in low-level equilibria because of a dearth of opportunities or incentives for investment. The government may protect the static accumulated wealth of the past (large landed property, for example), and in some countries it has acted as the "employer of last resort." But unless it takes steps to encourage entrepreneurial investment in the private sector, or at a minimum to avoid stifling such investment, strong growth and poverty reduction are unlikely to ensue.

Consider the example of the Middle East and North Africa, a region that suffered the paradox of high investment in human and physical capital juxtaposed with stagnation in the 1980s and 1990s. 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 both human and physical capital in the area have been impressively high. One of the primary reasons that such high rates of investment generated so little additional output is that the institutional structure of the labor market has systematically misallocated labor. High government wages attracted the most qualified personnel to the public sector. And measures designed to protect existing employment have made it difficult for entrepreneurs to start and sustain dynamic businesses.

In many countries of the world that have exhibited slow growth, those who might make entrepreneurial investments of energy and resources are left to be the prey of "bandits," both real and metaphorical. A never-ending stream of arbitrarily imposed rents, taxes, fees, and outright bribes and confiscations will drown even the most dedicated entrepreneurs, washing away all the energy and dynamism that power economic growth and lift people out of poverty. Creating a climate, then, in which entrepreneurs and firms can do good business is crucial to encouraging the types of investment and economic activity that lead to long-term, sustainable economic growth.

This is especially true for small and medium-sized enterprises (the SME sector). Anyone who emphasizes the investment climate always risks being labeled as a narrow-minded advocate for big business. But it is SMEs—and I include microenterprises under this rubric—that account for the majority of firms and a large share of employment in most developing countries. Furthermore, it is in SMEs, including farms, where most of the world's poor people are working. By enabling a dynamic SME sector in both rural and urban areas, governments can strengthen income-generating opportunities for poor people while reducing their vulnerability to economic risks.

There are several reasons for this emphasis on SMEs. First, in rural areas, off-farm SME employment can play a vital role in income growth and stability. In India, for example, our survey research shows that about a third of rural households' income comes from non-farm sources, much of it from micro, small, or medium-sized firms. These incomes come from a variety of sectors, including commerce, manufacturing and services, and they stem from regular and part-time wage employment, as well as self-employment. Village studies reveal that rural households value such non-farm incomes highly, not only because they contribute significantly to overall income levels, but also because they can reduce the exposure of households to potentially devastating income fluctuations associated with bad harvests. A strong investment climate, then, is central to the off-farm SME employment that can lead to higher incomes for the poor as well as diversification of economic risks.

Second, small-scale agricultural activities are themselves very vulnerable to an adverse investment climate. They can suffer as much as, or more than, others do from weak governance, malfunctioning infrastructure, and instability.

Third, we are likely to see an increase in urban populations in developing countries of some 2 billion over the next quarter-century. It will be the SMEs in urban areas that will need to continue to provide employment opportunities for these rapidly growing urban communities.

Fourth, the experience of the East Asian countries, China, has shown us the great importance of SMEs (both urban and rural) in overall economic development. In most success stories of economic development, the growth of SMEs has been central, particularly in providing employment for poor people. In the case of China, the Township and Village Enterprises (TVEs) have played this role. In response to an initial set of reforms that created a better investment in climate in the early 1980s, these enterprises sprung up quickly and generated a large amount of employment an income. Their success has contributed much to China's growth and poverty reduction. Recently, I came upon an interesting quote from Deng Xiao-ping, in 1987, about the TVEs:

> "Generally speaking, out rural reforms have proceeded very fast, and farmers have been enthusiastic. What took us completely by surprise was the development of township and rural industries. All sorts of small enterprises boomed in the countryside, as if a strange army had suddenly appeared from nowhere. This is not the achievement of our central government. Every year, township and village enterprises achieve 20% growth. This was not something I had thought about. Nor had the other comrades. It surprised us." {*People's Daily,* June 13, 1987, Quoted in Becker, Jasper 2000. *The Chinese*. New York: Free Press. p. 68)

This quote nicely illustrates both the importance of SME initiative, and how the successes of such enterprises are usually unplanned and surprising. If you can create a good investment climate, then dynamic things will happen at the level of enterprises and households.

THE DYNAMICS OF INVESTMENT CLIMATE

We can now see one of the key ways in which the new focus on "investment climate" differs from an emphasis on the ordinary notion of "investment." In conventional theory, "investment" is expected to lead to diminishing returns. As more investments are made in one place, marginal returns decline and new investment will seek other outlets. Diminishing returns thus implies that "investment" is self-limiting in each use, as opposed to self-reinforcing, as long as other key inputs, including technology, remain unchanged.

The investment climate, in contrast, can be positively or negatively self-reinforcing, and thus can generate either prosperity or stagnation. Unlike the older stories of capital accumulation, the notion of investment climate tries to capture some of the external spillover effects, the complementarities, and the non-rivalrous public nature of improvements in governance and institutions. As the investment climate improves, the frontier of opportunity expands: existing investment becomes more productive, the rewards to productive behavior rise, the 'animal spirits' (to use a term of which Keynes was fond) of entrepreneurs are encouraged, and thus the economy tends to attract more investment rather than less. These examples of the success of entrepreneurship and investment show other investors what is possible. But they also foster a greater understanding of and commitment to a sound investment climate, thus strengthening the political and economic forces working in the direction of improving the investment climate. There will always be vested interests benefiting from the status quo; therefore strengthening of the forces for change is a key part of the process.

We have argued that a sound investment climate leads to the kind of sustained productivity improvements and vibrant entrepreneurship that induces a virtuous spiral of investment, growth, and poverty reduction. In contrast, where the climate for productive investment deteriorates, these processes work in reverse, and both replacement and new investments can suffer in a pernicious downward spiral. The kind of dynamic reinforcement or increasing returns we are describing may not apply as strongly in richer countries, where a greater part of the framework of a well-functioning market economy is in place, but they are unlikely to be entirely absent.

From this perspective, we may ask whether the reforms implemented by the transition economies of the former Soviet Union increased or decreased people's sense of being able to determine their own lives? In too many cases, governments used the rhetoric of reform to justify all sorts of half-measures and misguided policies that only deepened people's cynicism that the more things change, the more they remain the same or deteriorate. The chipping away at public trust has made later efforts to adopt real reforms—which rely so critically on credibility and consensus—that much more difficult. Much of the challenge for those whose job it is to promote development is to understand how to break free of a downward spiral.

Let me also note that our perception of the role of the World Bank has changed in line with our thinking about development. Traditionally, we emphasized the transfer of capital to the developing countries. Now, we realize that the volume of investment from the World Bank and other IFIs will typically be a small part of the total, and not likely to have much effect purely as capital. Viewed from the investment climate perspectives, however, the purpose of IFI investment projects is not simply to transfer capital but also to create both powerful demonstration effects (promoting "learning-by-watching" as well as "learning-by-doing") and to enhance the forces for changes in governance. These effects thus work on both productivity and the climate of expectations to help crowd in other investments.

Beyond projects, we also focus on improving governance directly. Thus we work through our research and advice to promote the institutional adjustments, anti-corruption measures, and policy changes that will alter the rules and their enforcement, together with the way in which individuals and organizations behave and function to directly improve the investment climate. As investors come forward, whether they are domestic or foreign, they tend to demand more effective institutions, greater security and constant improvements in the provision of public goods—thus further enhancing the quality of the investment climate. Without such a change in governance and institutions, economic decisions may continue to be dominated or blocked by those who are benefiting from (and who helped to create) the status quo.

Moving Forward

It is reported that Mark Twain said: "Everyone talks about the weather but no one does anything about it." Today Twain might well have asked: "Everyone is talking about the investment climate, but who is doing anything about it?"

The first step is to analyze the investment climate, notably through surveys of firms. Strong analysis and identification of problems are not only a guide to reform, but also a powerful spur to action. Striking figures can be cited to build public support for reform and help motivate a hesitant government—for instance, research carried out by the World Bank and the Confederation of Indian Industry shows a 30 percent additional "tax" burden effect in the Indian states with a poor investment climate in comparison with the good-climate states. There will be more to say about this survey research when we turn to our research agenda. It is crucial to the ranking of the key problems and to the identification of their nature, both of which will vary greatly from one location to another. Such information is crucial, as governments will not be able to tackle everything at once.

So good data and analysis can help to pressure, motivate and inform governments. The question then is, what exactly do we want governments to be motivated to do? This is not a question to which we will have simple answers, as the response will vary dramatically by country. But one constant is that reforming the investment climate will require leadership and powerful advocacy, primarily from governments. Leaders promoting reforms always face a fundamental problem, one that was given its classical expression by Machiavelli.

> It must be considered that there is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new order… . Thus it arises that on every opportunity for attacking the reformer, his opponents do so with the zeal of partisans, the others only defend him half-heartedly, so that between them he runs great danger [*The Prince*, 1513, Chapter VI].

The reformer's leadership lies in selecting and strengthening the best initiatives for reform (drawing on the type of analysis discussed above) and in taking positive action to weaken the obstacles erected by vested interests. It is interesting that Chandrababu Naidu, the Chief Minister of Andhra Pradesh, is fond of quoting this observation of Machiavelli. As a committed and successful reformer he has a deep understanding of how tough it can be.

But there will also be those who are not specially privileged who may be amongst those disrupted by the reallocations that are an integral part of reform. Here social protection can play a strong role. At the end of the day, however, the best social protection for the great mass of society is a growing economy. Further, changing the investment climate takes time; it is not a stroke-of-the-pen reform like eliminating a tax or fee. Thus reformers not only have to argue their case strongly; they also have to prepare their constituents for the long haul.

§3 Investment Climate ➔ Growth ➔ Poverty Reduction

The next point that I would like to elaborate on, is the strong links from investment climate to growth and poverty reduction—not because the links are so surprising, but because they are sometimes questioned and because the accumulated evidence is compelling.

It is widely agreed that the World Bank should help clients both with a "structural" agenda and with a "social" agenda. There is a temptation for some to think that the structural agenda is for (hard-headed) growth and the social agenda is for (soft-hearted) poverty reduction, but this is the wrong way to think about these issues. The social agenda of delivering public services, providing effective social protection, and empowering the poor to participate can contribute strongly to growth. And the structural agenda—though aimed directly at improving the investment climate—is vital for poverty reduction. We are not interested in investment or business development solely for its own sake. Rather, there is powerful evidence that the investment climate is a crucial ingredient for *both* growth *and* poverty reduction.

What is the evidence? First, consider the connection between the investment climate and growth. It is clear that developing countries that are improving their investment climates are benefiting strongly from globalization. The top tier (about one-third) of developing countries in terms of moves towards liberalizing and expanding investment and foreign trade (a group that includes India, China, and Mexico) did well in the 1990s, while the rest of the developing world as a whole did poorly**.** The experience of these countries shows that increased market orientation and greater trade openness leads to faster growth. Of this group of reformers, China had the best economic performance. The expanded investment and trade was partly the result of liberalization, but also depended on infrastructure investment and streamlining of government regulations. The factors contributing to success varied in the different countries in this group, and indeed the style of reform was very country-specific, but all the countries showed real movement on some dimensions. In contrast, a number of studies have shown that Africa's low involvement in international trade has been influenced strongly by the lack of progress on the investment climate—most notably, by poor and deteriorating infrastructure and governance, and by conflict. And amongst other large countries that have performed less well—including, for example, Russia and Pakistan—severe problems with property rights, the rule of law, and governance have been prominent. We are preparing a policy research report on globalization that will be published in the fall, and one of our key points will be that developing countries that are moving to improve the investment climate are the countries that are benefiting the most from globalization.

Second, we have the link between growth and poverty reduction. On average, there is a close relationship between growth of per capita income and growth of income of the poor. While China has grown strongly in the 1980s and 1990s, the number of rural poor declined from

250 million in 1978 to 34 million in 1999. China's progress with reducing poverty rapidly is one of the most successful examples in history.

How does this link between growth and poverty reduction operate? In some cases, members of poor households get employment in the formal-sector firms that expand in a good investment environment. But benefits for the poor go well beyond this. A good investment climate is also beneficial for the informal sector, where usually far more people are employed. And formal sector investment and employment generation also creates new demand for informal sector expansion, and for more farm output at better prices. In countries that have been successful, increases in agricultural productivity and farm income have gone hand-in-hand with the generation of off-farm employment opportunities. China is a strong example here: movements from communes to household operations led to dramatic increases in agricultural productivity in the early 1980s, with immediate consequences for poverty reduction. Very soon afterward, off-farm employment grew strongly (driven by the township and village enterprises), with growth of this employment averaging more than 12 percent annually over the past 15 years. Like China, India has become more open and has seen an acceleration of its growth rate. But India has not been nearly as successful as China in generating rural off-farm employment. In India this employment has grown at 2%, and that is a key reason why India has not grown as fast as China and not had such dramatic poverty reduction.

I have given prominence in my arguments here to small and medium enterprises, but it is important to emphasize that in fast-growing economies large and small firms tend to prosper and cluster together. Hence, the issue is to create a good investment climate for both small and large firms. We are steadily learning more about all these links, not only by making comparisons across countries and time periods but also through comparisons of regions within countries. Much of what goes into the investment climate concerns local institutions and policies, and in large countries these can vary substantially across regions. I briefly mentioned the research on different states in India. Because the investment climate varies greatly across states, the impact of macro reform on poverty similarly varies across states. A recent survey of manufacturing firms in ten states ranked them in terms of their overall investment climate, and then found that the ranking according to poverty reduction was quite similar.

As I have argued, the empirical basis of the link between investment climate and poverty reduction is now very strong.

§4 Empowerment ➔ Poverty Reduction

At the outset, I outlined a strategy for development and poverty reduction that is based on two pillars: investment climate and empowerment. A favorable investment climate can generate strong growth. And where there is growth, poverty reduction is likely. But it should not be taken for granted, because not all growth is equally pro-poor. The second pillar of empowerment and investing in people focuses on the questions such as how education and health services and social inclusion can enable poor people to take part in the process of growth and to shape their own lives.

At this point we should emphasize that poverty reduction is more than increasing income. Empowerment is *both* an inherent part of *and* a means to poverty reduction. Empowerment can indeed be the instrument to increase income, and to increase the assets, human and physical, of poor people. But it is a broader notion and refers to the ability of people to shape their own lives. As such it is an integral component of the standard of living, a message that we heard very clearly through our study *Voices of the Poor*, which drew on surveys of more than 60,000 poor people in more than 60 countries.

Let me focus on three types of investments that are of particular importance in empowering poor people: investments in education, in social protection, and in participatory processes and social and economic inclusion.

First, consider education. Basic education is critical to participation and productivity in economic life. A healthy, literate labor force will both increase the amount of growth you get from establishing a sound investment climate and strongly increase the poverty reduction benefit from that growth. The example of education makes it very clear that the two pillars of investment climate and empowerment are strongly mutually supportive. Or, at the risk of abusing the metaphor, these pillars are closely intertwined.

We know, of course, that the promotion of education usually goes far beyond supplying resources. Just as important is the organization of the delivery of education and other public services. This is an area where communities around the world are innovating, and there are many examples of exciting new initiatives. Often, these are more decentralized than past approaches, with local control and parental involvement emerging as prominent themes; in these cases, the means of supplying education itself demonstrates the role of empowerment.

In El Salvador, for example, the Community-Managed Schools Program has been expanding education in rural areas by enlisting and financing community management teams to operate schools. These teams are made up of parents, elected by the community, with responsibility and power for hiring and firing teachers and equipping and maintaining schools. Their experience demonstrates that community-based incentives can encourage teachers to perform better. In particular, these program schools have lower teacher and student absenteeism than do traditional schools. Similar effects have been observed in India's District Primary Education Programme (also supported by the World Bank, but conceived within India), which features very strong community involvement and incentives for girls' enrollment.

The role of education in increasing both empowerment and economic growth is most striking when we look at the evidence on the education of women and girls. Raising women's schooling levels empowers women, allowing them to participate more broadly and more effectively both in the economy and also in policymaking, administration, and government. The effects are deep and range very widely. First and foremost, there are the direct implications for the standard of living of women themselves. But the further effects are also profound, and they influence the functioning of the whole economy and society.

The evidence on these effects is extensive and powerful (see the examples and literature cited in the World Bank's recent publication *Engendering Development*). The evidence shows that governments—as well as businesses—are cleaner when women are more active in politics or business. Recent research reveals that countries with more women in parliament typically have significantly lower levels of corruption, even after we control for national income and other relevant factors, such as the extent of civil liberties and degree of trade openness. These findings suggest that women are an effective force both for good government and business trust. But if women's participation in political decision-making is to increase, there must be an expansion in the education and literacy of women, with the implication that more girls need to go to school and stay in school longer.

Greater women’s empowerment and education yields significant benefits virtually everywhere. There is a powerful relationship between female education and general health: for example, mothers’ education increases children’s nutritional status, life expectancy, and general welfare. Increasingly, with more longitudinal studies, we see that many of these effects last into later life, in that the education of the mother is an important factor in the age-specific mortality rates of her children well into their adulthood.

Increased investments in women's education, then, yield a healthier, more literate, more productive, and better-governed society in the long run. However one looks at the issue of development and poverty reduction, and certainly from the perspective of the investment climate and empowerment, the education of women and girls is an investment with outstanding returns.

Second, social protection can be seen as a dimension of empowerment—of enabling people to make adjustments and bounce back from economic shocks. During the adjustment after an opening to foreign trade, some formerly protected activities will cease to be viable, and some workers and firm owners will lose their employment and their income, even as new productive activities open up. Social protection measures can smooth this adjustment. Such measures have to be tailored to country circumstances. While unemployment insurance can be important for formal-sector workers, other approaches—such as public work schemes of the Cash- or Food-for-Work variety—are much more likely to reach the very poor. But we should see social protection as something much more than a short-run palliative. It is an essential underpinning of a market economy, one that helps it to function well and to involve poor people in the opportunities it creates. Without good social protection, poor people may be unable to take some of the risks that are part of participation in a market economy, even when they stand to gain strongly and build their assets in the medium term. From this perspective, social protection is indeed a crucial element of empowerment.

The third dimension of empowerment I want to discuss here refers to participation and inclusion in social organizations—from self-help credit groups, to water-user associations, to health services and to the governance of schools that we have already described. Examples of the benefits of participation stretch across sectors and countries, with increasing recognition of the powerful effect of community participation on public service delivery. I have already given examples from education, but the effect is everywhere. For example, in some of the countries where enforcement of environmental pollution regulation is weak, governments have provided local communities with reliable pollution data (see World Bank Policy Research Report *Greening Industry*). Poor people living in the vicinity of industrial polluters have then negotiated better arrangements for compensation and clean-up.

We can now see the deeper connection between the two pillars of investment climate and empowerment. To use yet another metaphor, investment climate as a lens brings into focus those reforms that increase people's sense of opportunity— if they sow, then they will be able to cultivate and reap. But, in a basic sense, these reforms also empower the farmers, workers, and local entrepreneurs and managers to be able to build assets and to shape their own lives. Further, empowerment should be a self-reinforcing process—like changes in the investment climate. But I think we now recognize that in some countries, many actions seen as reforms have had an adverse effect. In a number of cases, they took away the old way of doing things without any replacement, leaving people disempowered and demoralized. Instead of people participating in reforms, the reform process was captured by elites, and the majority were left to glean what they could from the leftovers. And in those countries, the investment climate has tended to spiral downward.

§5 A Research Program in Support of the Strategy

The pillars of investment climate and empowerment together provide the basis of a strategy for pro-poor growth. I hope that as a perspective and as a strategy they are very plausible, indeed convincing. But they are not yet standard, and they constitute a fairly new way of looking at the challenge of development. Thus at the same time they provide a research program; there is much that we have to do to better understand each of the elements and how they combine. I would like to turn now to what might go into this research agenda.

Analyzing and Measuring the Investment Climate

The hard-headed economists among you will be saying: “All these notions of investment climate and empowerment are splendid, but where are the analytics and data?”

Can we be analytical in assessing or measuring the investment climate? We can, and researchers have already gone a long way toward doing so. We are helping our clients develop the skills to evaluate the quality of the investment climate in their own countries through systematic surveys of private and public firms, with a particular focus on small and medium enterprises. This research has already demonstrated quite dramatically that a hostile investment climate hits SMEs the hardest. A central output of such research is the identification of the key problems in the investment climate. In the opening sentence of *Anna Karenina*, Tolstoy argues that happy families are all happy in the same way, but that unhappy ones are unhappy each in a unique way. We could apply this notion as well to the investment climate. Good locations have sound rule of law, efficient regulation, low corruption, excellent infrastructure – Singapore, the Netherlands, Ireland – would be some good examples. Locations that have problems with the investment climate typically have different problems that are of first-order importance. In some cases it will be a specific infrastructure deficiency (lack of power, or an inefficient seaport), in other cases honest but overbearing regulation – I can think of some locations in India like this – and in other cases corruption or violent crime.

In general, the ranking and nature of investment climate problems will vary considerably from country to country --- and even from location to location within countries. It is unlikely to be possible to attack all the problems at once and solutions will be different in different environments. Thus this kind of information is crucial to the formulation of sound policy.

An important example of this work is the joint EBRD-World-Bank *Business Environment and Enterprise Performance Survey.* This survey polled nearly 4000 firms in 22 transition countries, and it broke new ground in quantifying the negative impact of different forms of corruption on the performance of firms. It also demonstrated in a systematic way, beyond the flashy media headlines, the pernicious influence of powerful vested interests—including the so-called oligarchs—in distorting the investment climate in Eastern European transition economies and undermining growth. Such surveys are a valuable tool not to lecture other countries about the virtues of our own systems (which have their own problems), but to give voice to domestic firms to speak to their governments about the day-to-day obstacles they face in running a business.

Let me also share with you the results of a (previously mentioned) survey of 1,000 manufacturing and software firms that we carried out with an Indian partner, through our FACS (Firms Analysis and Competitiveness Surveys) program, to investigate differences in the investment climate in ten Indian states. We found that the costs to businesses of a poor investment climate—for example, a less reliable power supply, more onerous regulations, and more intrusive and disruptive visits from government officials—are high. In fact, those costs are analogous to an additional tax burden (conservatively estimated) of up to 30 percent for firms in poor-climate states such as Uttar Pradesh (which has a population of 166 million, or larger than that of Russia, Pakistan, Bangladesh or Nigeria) relative to those in Maharashtra (a state of nearly 100 million). China, like India, is a big country and has learned much from inter-regional comparisons of experience.

Upon examination, it is not difficult to see how one could arrive at such a large cost estimate for the cost of a poor investment climate. A functioning power grid is a key requirement for a vibrant SME sector. India is fairly remarkable in that because of the poor quality of grid-based electricity, most small and medium enterprises that we surveyed have their own power generator. In Uttar Pradesh (U.P.), 98 percent of firms surveyed had their own generator (they had little alternative), whereas in Maharashtra the figure was considerably better, at 44 percent. It is striking to the economic theorist that, U.P., one of the poorest states in India with very low wage rates, showed in the sample higher capital-output ratios than some of the richest states. The intrusiveness of government regulation also varied sharply across states: for example, firms were visited twice as often by government officials in the poor-climate states as in the good-climate states. Thus the variation in investment climate from states like Maharashtra and Karnataka on the high end to U.P. and West Bengal at the low end is real and measurable. Not surprisingly, the states with weak investment climates enjoy less growth and have seen less poverty reduction, making the investment climate a key reason why some states remain poor and struggling whilst others are beginning to win the fight against poverty.

This type of firm survey has the advantage of being systematic, covering a broad section of the economy, being amenable to fairly structured analysis, and capable of generating reasonably robust general conclusions. I am happy to report that the World Bank is working with the National Statistical Office on a similar firm survey in five Chinese cities -- Beijing, Tianjin, Shanghai, Guangzhou, and Chengdu -- and I would very much like to expand this kind of collaborative study of the investment climate in different locations within China. It should be quite interesting for Chinese cities to see how investment climate issues compare to other parts of the country, and to major emerging market economies such as India, Brazil, and Thailand.

One major item on the research agenda, then, must be to expand this effort to understand and, to the extent possible, quantify the different elements of the investment climate. Surveys of firms should stand next to household surveys as a centerpiece of microeconomic research and statistics in developing countries.

AREAS OF RESEARCH ON EMPOWERMENT

The concept of empowerment also carries with it a rich research agenda. We have seen an extraordinary amount of experimentation with programs to empower poor people in different countries and at different levels. Think of the overwhelming variety of approaches to the organization and practice of educating children and adults, to reducing and mitigating risk, and to building social cohesion and inclusion. Our goal as researchers should be to understand how people have succeeded in empowering themselves; it is not for us to instruct people on their own empowerment. Rigorous evaluation has a large role to play here, because it can help us cut through the thicket of promising approaches and disparate examples to discover which work best and under what circumstances. In an important sense, this research parallels the work on investment climate. In both cases, our goal is to understand first how governments can facilitate the individual—or family, or firm—to acquire the tools needed for success, but then also how they can reduce the impediments to the fulfillment of the individual's (or family's, or firm's) potential.

More specifically, the research agenda for this second pillar can be derived from three important factors affecting empowerment: (1) education and the delivery of other public services, (2) social protection, and (3) social inclusion and participation.

It should be no surprise that education has been a strong area of research in DEC, the Human Development Network, the World Bank Institute, and other parts of the Bank. For example, we have taken the lead in evaluating the effects of some recent innovations in education, including the programs that I mentioned to earlier that have increased community involvement in school management in Central America and elsewhere. But there is a great deal that remains to be done to understand the effectiveness of different approaches to schooling, not to mention adult education beyond formal schooling. And the problem is not limited to the education sector: many of the difficulties with education in developing countries are similar to those that impede the delivery of other public services such as health care. Indeed, the provision of basic services has such an important impact on poor people that it is the likely topic of a future WDR that will try to structure, summarize, and disseminate the research findings. Where we find successful practices, we will analyze and publicize them so that developing countries can learn from each others' experiences.

A crucial and central topic in current educational research is girls' and women's education. As I noted previously, improvements in the education of girls and women have effects far beyond the expected improvements in labor-force productivity: for example, they raise the health outcomes of families, and they attack directly the illiteracy and ignorance that constitute a key dimension of poverty. Some of the evidence has been gathered together in the Bank’s recent publication, *Engendering Development*. This demonstrates the crucial role of women and girls’ education right across the economy. But much of this evidence, although wide ranging, is patchy, new and tentative. Thus it is as much a research agenda as a research report.

The second factor is social protection. This is sometimes seen, mistakenly, as a charity program to alleviate the symptoms of poverty. We need a more active perspective on social protection. It is a springboard to help poor people bounce back from economic shocks. The dynamism of a market economy is based on risk-taking. Social protection is not only a safety net for those who drop out of the market, it should function as a part of a broader market economy that allows the market participants who are less well-off to take more entrepreneurial risks and to make the adjustments necessary for advancement. This perspective on social protection is a topic of active research in the Bank. But societies develop their own approaches to social protection and here, as in any question of institutional change, we should be careful not to urge people to abandon the 'old ways' when the path to the 'new ways' is closed or obscured.

Finally, participation and social inclusion constitute a third dimension of empowerment. The principles of the Comprehensive Development Framework (CDF) have lead the Bank in a major reappraisal and recasting of its relationship with client countries. The basic theme of “country in the driver's seat” entails participation not simply by the government but by the social organizations that reach down to the roots of society. Without that participation and inclusion, the new policies that might emerge from the CDF would lack the broader ownership necessary for implementation. At the same time, country ownership does not imply automatic support for whatever is proposed. If we are serious about poverty reduction, we must concentrate investment on the countries and programs that are generating the change that can overcome poverty.

The IFIs As Agents of Change

Let me reflect a little more on how IFIs such as the World Bank can better go about their work of supporting change. And let us remind ourselves that we are there to help meet the costs of changes that benefit poor people and not to meet the costs of not changing. So, how can the IFIs work as agents or catalysts of change to help countries implement the two-pillar strategy we have described? Our answer to this question is different from the one that would have been given fifty, or perhaps even ten, years ago. Much has changed since the Bretton Woods Conference of 1944. The world economy has moved decisively toward greater integration. The IFIs’ understanding of development has also broadened and deepened. We not only look beyond aggregate income to its distribution, but also recognize that standards of living and thus development have key dimensions beyond income. With these broader goals, the IFIs have developed an appreciation of the crucial role of reforming policies and institutions.

Those of us who work in the IFIs are keenly aware of the changes and pressures that the acceleration of globalization brings for the role of the IFIs. How does the strategy of development outlined here give a new purchase on this question of the IFIs' role?

I will argue that the IFIs do continue to have a role, but that it is a changed role. The IFIs now start unavoidably from the premise that the private sector is the engine or locomotive of growth and development; surely the failures of developmental *dirigisme* and the collapse of command economies have taught us that lesson. It is central to the role of the IFIs, therefore, to promote and foster private sector-driven growth—and to do so in ways that are pro-poor.

The IFIs, as the agents of change, should work to *create new opportunities*—that is, to help developing countries push out the frontier of what is possible. This should be the constant test that they apply to their activities, and it has at least three implications. First, it means that development assistance should have the effect of crowding in private investment—for example, through building a sound regulatory environment or upgrading the skills of the labor force—rather than substituting for such investment. Second, development assistance must be designed in such a way that it helps build and raise the productivity of public resources rather than merely replacing such resources. Third, IFIs should support projects with powerful demonstration effects. This can be private sector projects (funded, for example, by the IFC or EBRD) which are at the cutting edge of what the private sector can or is willing to do, thus demonstrating new opportunities. Or they can be public sector projects which can be followed by other institutions, for example by different states or provinces or countries. The World Bank does indeed work both to find such projects and encourage the learning process. There is a fundamental principle which should run through everything we do. *The IFIs should help finance the costs of change—and should not cover the costs of not changing.*

If the private sector is the locomotive of development, the IFIs' role is to help countries lay track and exploit the railway network externalities. Moreover, IFIs need to do so in a way that encourages the country to invest in improving systems and to build sound additional rail lines on its own, rather than simply relying on engineering and financing provided by the IFIs.

To achieve these goals, the IFIs should orient their work to helping countries improve their investment climate, while at the same time supporting country ownership of and commitment to reform initiatives. How do we do it? Serious research on this topic begins by recognizing that there *is* a contradiction in the whole idea of being an agent for change, or "helping people help themselves"—to quote the phrase from the World Bank's Mission Statement. It is a contradiction that runs through all forms of assistance. Being an agent of change, an external catalyst of empowerment, and a helper who is actually helpful, is a subtle matter. If the helping hand is too heavy, the agent for change can spoil, distort or suppress initiatives for and commitment to change.

In offering development advice to a country, one should not use, implicitly or explicitly, a monolithic model of the country and its polity. There are always contending groups with differing views, agendas, and interests. An international development agency should, as much as possible, resist the temptation to take sides in domestic politics. It should offer a range of ideas and good examples, to lay out, as scientifically as possible, the evidence, and to outline the rationale and the costs for the various options. The intellectually self-confident decision-makers might ask for our opinion—and we have an obligation to deliver it, professionally and clearly. A country can be "in the driver's seat" and still look for advice from those who are experienced, impartial, and committed to poverty reduction. Local politics may prevent them from acknowledging the help, but it is nevertheless generally welcome.

As the private capital flows have increased and economies have grown, resources from IFIs have become still more concentrated on activities which push out frontiers both in the investment climate and governance dimensions and through projects with powerful demonstration effects. In each case, precisely because the orientation to expanding the frontier is of the essence, careful analysis and preparation are vital. Hence the ever increasing importance of the Bank's analytical work, both in support of broad diagnostic analysis of countries and sectors and in the preparation of individual projects. The growing importance of the 'frontier' dimension of our work implies ever stronger emphasis on the Bank as an ideas or knowledge institution, and thus on research.

The political economy of assistance to reform is a complex art. The agent for change gains skill by learning from others through case studies, "war stories," and apprenticeship as well as reflection. Instead of trying to find or impose a fixed sequence or time-path, the agent for change must be open to supporting travel on a number of possible roads. Research on this topic should not search for a blueprint but should seek a "description" of the local landscape so that dead-end paths and pitfalls can be avoided and that we can give encouragement in the general direction of the more promising paths to reform.

There will be moments when, in pursuit of the goal of poverty reduction, the IFI has to take a chance and support a reform program which is serious but which may be under threat. Indeed that is where conditionality can be effective. A reformer who is trying to build coalitions for reform may seek conditionality as a way of tying a country more closely into the reforms. Such support has to be supplied judiciously and we have to be aware that it can backfire. And it may be ineffective where divisions are too deep. Conditionality is no substitute for real commitment to reform. My own sense is that the World Bank has overworked conditionality – a large number of detailed conditions is not an effective way to promote change and not a responsible way to treat partners. I have no doubt, and we often hear it from reforming ministers who quietly ask for conditionality on key issues, that conditionality can be a substantial help at crucial times in taking reforms forward, but conditionality needs to be used judiciously. At the same time, we are entrusted with resources by the international community and are responsible for their use. Conditionality is in essence a contract about how resources will be used. So, the key issue for the IFIs is to strike the right balance. The recent adjustment program for Indonesia had more than 100 conditions; that cannot possible be right. On the other hand, giving out money without any agreement on what it will be used for would be irresponsible and not supportive of change.

Modest and well-designed conditionality from the IFIs can help to strengthen and broaden reform coalitions. Reform A might be modified to yield a reform A' that would be more complementary and conducive to reform B, and thus the beneficiaries of reform B might be willing to join the coalition. Here conditionalities backed by resources can play a similar role in helping to build a reform coalition. If reform A unlocks resources that would enable reform B (or take away the threat to an existing program B), then the reform coalition would be broadened for that reason. The IFI-supplied resources might also cover the costs of adjustments required by the reform thus bringing on board some who might otherwise be in opposition. Eventually the reform coalition might be broad enough to reach the tipping point so that even indifferent bystanders will want to join the winning team. By anticipating problems, by being creative in the suggestion of possible solutions, and by adding its integrity in support, the IFI can help foster a “deal for reform” which might not otherwise materialize. If its integrity is to be maintained and to have a real effect over time, the support of the IFI should be focused on programs that have a real chance of success and are likely to benefit poor people.

Essentially we can see the IFIs, and particularly the World Bank, as having a power of “convening” that arises from its special ownership structure and goals. The World Bank is itself a big coalition of countries and it is devoted to the overarching goal of poverty reduction. The convening power is unique and a crucial aspect of its ability to act as an agent of change.

The effectiveness of the IFI as an advisor and agent of change is based on an open, respectful, and long-term relationship with both low-income and middle-income countries. If the IFI is asking a country to be open to new learning and experimentation, then it should ask the same of itself. There is no expert quick-fix for the problems of social change; there is no royal road to learning what works in a country; and there is no instantaneous solution or cheap short-cut to institutional development. To be an effective agent of change, the IFI must have a relationship with the country that is a genuine partnership and that is based on an understanding of local conditions. Such research should eventually be generated as much as possible by the knowledge institutions of the country itself. And understanding of local conditions requires local presence.

This concept of partnership applies to middle-income countries as well as to low-income countries. If we take seriously the common humanity that binds us all, we must recognize that the existence of significant absolute poverty in a middle-income country such as Brazil should not be seen solely as Brazil's problem. However, as a country grows into the ranks of the middle-income countries, our partnership should mature and change. The access to capital markets which come with rising income opens new opportunities. But while middle-income countries and other emerging markets do gain access to international private capital flows, that access is intermittent, often arm's length, and sometimes very costly; the IFIs, by contrast, can provide a steady responsive partnership and a flow of capital in support of needed reforms which are steady and flexible. The fight for poverty reduction is a long haul and the partnership is of special importance when the situation is at its most difficult.

§6 Conclusion

I have laid out today a strategy for development, one based on the twin pillars of investment climate and empowerment. What are the prospects that developing countries will implement this strategy, and that the developed world will provide real support for it? My answer is more positive than it might have been even just a few years ago. One cause for hope is the significant improvement in the quality of macroeconomic and trade policies in many developing countries. I mentioned the examples of some high-profile reformers earlier, but the phenomenon is more general. For the developing world as a whole, many of the policies that make a difference in growth and poverty alleviation—such as controlling inflation and lowering trade barriers—are better than ever before. For this reason, notwithstanding the recent slowdown in the US and the continued economic troubles in Japan, we believe the medium-term outlook for the developing countries is stronger than it has been in many years.

Reforms in the developing world thus create opportunities; but are the rich countries ready to do their part to help countries seize those opportunities? Again, recent trends have strengthened the grounds for optimism. First, consider trade policy. The returns to improving the investment climate depend in significant part on whether reforming countries have access to foreign markets for their goods. Rich-country barriers in key industries and sectors, such as agriculture and textiles, thus discourage investment climate reforms. And yet recent movements to increase developing country access are cause for hope that the rich countries have recognized their responsibility. I think it is a very positive development that China is about to join the WTO, and I hope that China plays a leading role in formulating a new round of trade liberalization that includes improving access of developing countries to OECD markets. More generally, I think that China's emergence on the world stage is a very important and welcome development. Within the OECD, the support for all types of international organizations has weakened. China can play an important role in strengthening international organizations and making them better focused on the paramount issues for the developing world.

Second, the rich countries have increasingly shown that they recognize the need to reduce the administrative burden (including by improving coordination) of development assistance on developing countries. In the World Bank we have tried to streamline procedures and reduce conditionality so that we can work more in partnership with developing countries. And finally, both developed and developing countries have declared their commitment to the International Development Goals for progress against poverty over the next decade and a half. Together, these recent trends signal some significant movement toward support for more rapid poverty reduction.

Thus those making political decisions and formulating economic policies have generated real opportunities for the IFIs to help accelerate development and poverty reduction. Research has a vital role to play in helping to take those opportunities. We have learned much about what works or does not work in economic development. And we have learned much too in recent years about how to catalyze and support reforms most effectively. We have already begun to build this knowledge into our work. We now understand that the IFIs, at their best, serve as agents of change, helping to push out frontiers and increase the possibilities for the economy as a whole. There remains, however, so much that we still have to learn about both the investment climate and empowerment, and how to foster the change. What I have described, in many ways, is only a structuring of the agenda. Our work should build on the understanding of the two-pillar approach that itself came out of the research of the past few years. Of course, we have to act on policy in real time. We cannot afford Hamlet’s agonised approach to decision-making. But today’s research underpins tomorrow’s crucial decisions. The research agenda I have tried to describe is not only of deep intellectual challenge and fascination. It can also yield powerful returns in our common fight against poverty.

Thank you.