

KEYNES LECTURE IN ECONOMICS

Development as a Process of Change: Toward a Dynamic Public Economics

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MOST OF THE GREAT ECONOMISTS, especially John Maynard Keynes, wanted both to understand how economies and societies function and to change them for the better. Keynes knew that we have to think about building institutions as well as designing policies—indeed he was the creative force behind the institution for which I now work (Gardner 1975; Skidelsky 2000). Issues of governance were fundamental to his approach to policy. His design for a new world order after the Second World War was driven by a recognition that international problems require international responses. Institutions, governance, and internationalism are central to the challenges and responses I want to discuss today.

The greatest challenge facing us at the beginning of this millennium is the fight against world poverty. At the start of the new century we live in a profoundly unequal world: nearly half of the world's population lives on less than \$2 a day, and less than 20 per cent of the people control 80 per cent of the income. But I believe we now also have a special opportunity to fight poverty. As an international community, we have set internationally accepted goals for poverty reduction; we have achieved an unusual degree of agreement on broad lines of action; and many developing countries have made great strides in the past two decades in improving their policies and governance. If we do not take the opportunity to fight poverty that is before us now, I fear that the world may retreat into disillusion, narrow self-interest, and protectionism.

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A coherent plan of action to fight poverty requires a strategy for development. The first task in this lecture is to set out some key lessons of development experience and the strategy to which they lead. Whilst I will argue that we do have enough understanding to act now, we have a great deal of learning to do along the way. The bulk of what I have to say concerns how we can and should do further research—both on the processes of development behind the strategy, and on the type of public economics that should inform public action. This explains the title of this lecture: development is a process of change, and the challenge for research in the public economics of development is to discover how to change, for the better, a process of change.

1. Promoting development: from lessons to strategy

In drawing the lessons from experience and development thinking that underpin the strategy, let me look briefly at the objectives of development, the role of the state, the driving forces behind growth and development, and the role of aid. I will state the lessons in summary form here, in a way that points to the strategy.

1.1 Lessons on development: objectives and instruments

The *first* lesson concerns the *objectives* of development. For some time now, we have seen the objectives of development as going beyond household or individual income, to encompass education and health. Amartya Sen has argued persuasively that the appropriate way to look at development objectives is in terms of ‘the substantive freedoms—the capabilities—to choose a life one has reason to value’ (Sen 1981, 1999). Aristotle, Adam Smith, John Stuart Mill, and Keynes himself shared this view.¹ Of special importance here are the views of poor people themselves. In *Voices of the Poor*, a collection of surveys covering more than 60,000

¹ Keynes made clear his view of the constitutive role of personal choice in his discussion of the advantages of individualism within a well-regulated market economy. ‘But, above all, individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice. It is also the best safeguard of the variety of life, which emerges precisely from this extended field of personal choice, and the loss of which is the greatest of all the losses of the homogeneous or totalitarian state. For this variety . . . being the handmaid of experiment as well as of tradition and of fancy, it is the most powerful instrument to better the future’ (1936: 380). The passage surely embodies a view of personal choice as both end and means.

people from more than sixty countries, the message that poor people seek empowerment, or the ability to shape their own lives, came through very strongly (World Bank 2000; Narayan *et al.* 2000). Looking at objectives this way, we see that many goals or ends are also means of achieving development.

Second, moving forward depends on understanding *the role of the state* in development. This question is often posed as whether the economy should be dominated by the state or by the market. This formulation is a mistake. The state is not a substitute for the market. It is a critical complement: markets do not function well without effective government, and governments that do not work with markets are doomed to be ineffective.² As we have learned repeatedly—whether from the experience of East Asia, Russia, Latin America, Sub-Saharan Africa, or the OECD countries—the state should concentrate on providing the right environment for entrepreneurial activity to flourish throughout the economy. This means an environment where contracts are enforced and markets can function, where basic infrastructure is assured, and, of particular importance, where people (especially poor people) are enabled to participate.

A *third* set of lessons concerns the dynamics of *economic growth and development*. What have we learned? We know that in the past fifty years the world has seen remarkable economic growth, and that growth is the most powerful force for the reduction of income poverty. Further, trade has been central to growth. As an illustration of this point, consider the experience of the two dozen developing countries, led by India and China, that most rapidly integrated with the world economy between the 1970s and 1990s, while at the same time improving their private-sector environments. During the 1990s, the 3 billion people in those integrating developing countries saw their per-capita incomes rise at an annual rate of about 5 per cent—compared with just 2 per cent growth in the rich countries, and a fall in per-capita incomes in the remaining developing countries (World Bank 2002b). Growth has been accompanied by remarkable *structural changes* in the economy—from rural to urban areas, from agriculture to manufactures and services, from commodity to manufactured exports, and so on. It is hard to imagine that this kind of change can be well captured in a one-good growth model in steady state, of which the profession has been so enamoured.

² Indeed, some of us warned that in the rush to markets in the transition economies in the early 1990s, its architects neglected the importance of sound institutions and effective government, and that this neglect could well undermine the transition (Stern 1989, 1991, 1992).

We have learned that a *dynamic private sector* is key to sustained growth, and that within the private sector, *small and medium enterprises*³ (SMEs) should feature prominently in any strategy to promote shared growth. Across countries, the small and medium enterprise sector accounts for the vast majority of firms, and it provides employment and income for a very large share of the 1.2 billion people in the world who live on less than \$1 per day.

Fourth, there have been dramatic changes in *social indicators* in the developing world. At every level of income, infant mortality fell sharply during the twentieth century (World Bank 1998a). Life expectancy in developing countries increased by a remarkable twenty years between 1960 and 2000—whereas the previous twenty-year increase had probably taken millennia to achieve. And the adult illiteracy rate in the developing world has been cut nearly in half over the past thirty years. Such changes have occurred even in countries where growth has not been rapid, such as Bangladesh, which cut infant mortality by one-third in the 1990s alone (World Bank 2002a).

Fifth, we have learned a set of lessons about using *aid* effectively to promote development. Most important is the role of local ownership, local involvement, and local conditions for development. At the macro level, aid succeeds best where countries have shown their commitment to reform by adopting adequate policies, institutions, and governance—for their own reasons, rather than as a result of outside pressure (World Bank 1998b).⁴ And at the micro level, projects where people *participate effectively* yield better development results than those where they do not. We have seen this in examples across the developing world, from communities running schools in Madagascar, to self-employed women's associations in Gujarat, to village-level infrastructure investment in rural Indonesia. The involvement of women is particularly important for the functioning of virtually every sector of activity, from agricultural production, to education, to credit, to fighting corruption.⁵

1.2 The strategy: building the two pillars of development

Let us turn now to the strategy. The evidence from fifty years of development progress and development thinking provides the foundations. The

³ 'Small' and 'medium' are usually defined here in terms of employment, with 'small' generally below 50 and 'medium' between 50 and 250 employees.

⁴ See World Bank (1998a, 2002c).

⁵ See the *Engendering Development* report (World Bank 2001a) for evidence on women and development.

strategy itself can be described in terms of two basic pillars. First, create a good investment climate—one that encourages private firms, both small and large, to invest, create jobs, and increase productivity. Second, empower and invest in poor people—by enabling their access to health, education, and social protection, and by creating mechanisms for participating in the decisions that affect their livelihoods. The underlying processes are intertwined and mutually reinforcing. Growth generated by improvements in the investment climate is empowering; and if poor people are empowered, they contribute strongly to the process of growth. Although I do not much like the term, it is a story of ‘pro-poor growth’.

What are the most important elements of the investment climate? There are three broad areas in which government policy and behaviour are crucial. First, we have seen the importance of macroeconomic stability and openness to trade for sustained growth. But a good investment climate consists of much more. It also depends, second, on good governance and institutions, including control of bureaucratic harassment and crime, as well as effective financial and legal institutions. Third, investment and productivity depend on adequate transportation, power, and communications infrastructure. Let me emphasise—because there is a risk of being misunderstood—that in focusing on the investment climate, we think first of the climate for small and medium enterprises (or SMEs); and let us further recognise that the most important SME in developing countries is the farm. In many developing and transition countries, the SME sector has languished. A weak investment climate hits SMEs harder than other firms, reducing the dynamism of this sector and obscuring its potentially powerful role. An improvement in the climate for SMEs will usually bring an improvement in that for large and foreign firms, and they too have a major role to play in development.

Empowering poor people to shape their own lives, the second pillar, means ensuring that they have opportunities for education and for health care, avenues for risk reduction and mitigation, and mechanisms for participating in the key decisions that affect them and their families (World Bank 2000, Narayan 2002). The term ‘empowerment’ is sometimes regarded suspiciously by economists, but I can assure you that what lies behind it is hard-nosed development effectiveness. Empowerment is both an end in itself and an avenue to development—indeed it is key to scaling up for development results.

Empowerment is not synonymous with investment in social programmes, nor does it necessarily mean poor people wresting power from the elites. For example, an investment in basic rural water provision can free

the time of girls, by reducing the amount of time they spend carrying water for the household; this can empower them by giving them time to attend school, which in turn can contribute both to the empowerment of their families and to economy-wide growth. Viewed in this way, empowerment clearly does not have to be a zero-sum game.⁶

The strategy aims at building a market economy that grows strongly and that enables poor people to participate effectively. Such a strategy cannot emerge from standard growth models, whether traditional or endogenous, because it is a story about processes—a story that incorporates history, learning, changing behaviour, and changing economic and social structure. It is not about redistribution before growth, or even redistribution with growth, although it does recognise the complementarity between empowerment and growth opportunities.

The strategy takes us way beyond the ‘Washington Consensus’, which is a title given by John Williamson (1990) to the package of policies proposed by the international financial institutions in the 1980s. The Washington Consensus emphasised fiscal discipline, market-determined exchange and interest rates, property rights, liberalisation, privatisation, and openness to trade, as well as redirection of public expenditure toward education, health, and public infrastructure. Whilst one can raise questions about where the emphasis should lie, these are very reasonable broad principles for development. But there are profound questions about what is left out of the Washington Consensus. It says nothing about governance and institutions, the role of empowerment, the importance of country ownership, or the social costs and pace of adjustment and transformation. Many of the setbacks in the structural adjustment programmes of the 1980s resulted from inadequate attention to these issues. And it is these issues that lie at the heart of the strategy proposed here. Whilst it is not my task to examine the World Bank, I should also note that in recent years, action on governance, empowerment, and the costs of adjustment has been central to its work.

This two-pillar strategy carries us forward in two ways, in my view. First, as I can describe only briefly here, the strategy is a basis for action: it provides a productive and measured approach to the dynamic problem of how a developing country, supported by external partners, can spur

⁶ Of course, some aspects of empowerment of poor people can indeed involve diminishing the power of others. For example, every oligarchy must decide whether to risk educating the poor and getting the benefit of a more skilled labour force, given that this may lead to political empowerment of poor people and thereby lead in turn to a progressive redistribution of income or assets (Bourguignon and Verdier 2000).

growth and poverty reduction. Second—and this is my main topic—it suggests a programme for research that can take forward both the theoretical and the empirical investigation of public policy.

2. From strategy to action

The two-pillar strategy for development proposed here can, I believe, provide a basis for international action. The context for that action is the ambitious set of development goals to which the international community has committed itself. At the United Nations Millennium Summit in New York two years ago, international leaders adopted the Millennium Development Goals (or MDGs), which embody the multidimensionality of the development agenda. These goals include, among others: halving the proportion of people living on less than one dollar a day between 1990 and 2015, achieving universal primary education by 2015 (while eliminating gender disparities throughout the educational system), and reducing by two-thirds the under-five mortality rate in the same period. Broad outlines for action were agreed at the Monterrey meeting on finance for development in March of this year, and the commitment to the environment was deepened at the Johannesburg gathering on sustainable development in August, when explicit goals for expanding access to clean water were added.⁷

The need for action is urgent. We still face deprivation on a massive scale, despite the development progress of recent decades. I cited earlier the very large numbers of people who still live in income poverty. Some 3 million people die of AIDS each year, and a million die of malaria; the large majority of deaths from both diseases occur in Sub-Saharan Africa. The overall life expectancy for the developing world remains fourteen years below that of the rich countries, while the under-5 mortality rate is fourteen times as high. And in education, more than 100 million primary-school-age children do not attend school, while a third of adult women in the developing world are illiterate. Given the massive scale of the challenge, it is clear that aid alone will not be enough to meet our goals. Development aid from all sources adds up to less than 1 per cent of the GDP of the developing world. Even if we were to succeed in doubling aid flows, they would remain far too small to spur rapid growth and poverty

⁷ This year's World Development Report, *Sustainable Development in a Dynamic World* (World Bank 2002d), was published in August 2002 and helped lay the foundations for the Johannesburg agenda.

reduction on their own. This is why it is essential to scale up both our development efforts and their impact, through the concerted efforts of developed countries, developing countries, and the international financial institutions. Let me explain what I mean.

At the Monterrey conference, the international community showed that it recognised the urgency and scale of this challenge. The framework for action agreed there delineated clearly the responsibilities of both rich and poor countries. The rich countries committed to providing more aid and assisting with capacity-building. And they also reiterated their important commitments—made at the Doha WTO meeting a year ago—to open their markets, especially in areas such as agriculture and textiles that are of special importance to poor countries. The gains from trade action could be much larger than those from aid. Opening markets in rich countries could yield several hundred billion dollars per year in welfare gains for developing countries, dwarfing current aid flows of around 50 billion dollars per year (World Bank 2001b). That is why recent setbacks in agriculture, such as the US farm bill and the delay of reform of the Common Agricultural Policy in the European Union, are so worrying.

Developing countries had already made strong progress on their part of the Monterrey compact well before the Monterrey meeting—improving policies, governance, and institutions. For example, between the early 1980s and late 1990s, median inflation rates were halved (from 15 to 7 per cent), and average tariff rates also fell sharply, dropping by more than half in both South Asia and Latin America. In Sub-Saharan Africa, the home-grown New Partnership for Africa's Development (NEPAD) signals a recognition that improving governance, institutions, and policies is the responsibility of developing countries themselves. And such improvements have already brought strong growth and poverty reduction to parts of Africa, for example in Uganda and Mozambique.

The international financial institutions (or IFIs) also have a key role to play in scaling up by supporting change. Reforms necessary to improve policies and governance will always involve dislocation, since they require movement of resources and change. Outside assistance can support these reforms, by providing resources to help fund the costs of dislocation and investing in new systems. In this role, we must constantly remind ourselves that we should be in the business of financing the cost of changing, and not financing the costs of *not* changing. Beyond this financial role, the international financial institutions have done much to promote the generation of development knowledge, by drawing on their global experience and analytical strengths. Yet it is on

these knowledge dimensions in particular that they must raise their game still further.

In thinking about the agenda for action, it is hard to overstate the role of ideas. Keynes recognised this; in speaking of the importance of ideas, he went so far as to say that ‘the world is ruled by little else’ (1936: 383). What we are trying to do today is to explore how we can develop ideas that contribute powerfully to the reduction of poverty. While the sense of direction in Monterrey was sound and demonstrated a remarkably broad agreement, our analysis has to dig much deeper.

All this puts a real responsibility on those whose task it is to develop and demonstrate ideas. While good practical ideas require a sound conceptual foundation, we must go beyond the abstract and demonstrate convincingly what works and what does not. Let me now turn, therefore, to the topic that I want to highlight today: the research challenge.

3. A research agenda: constructing a dynamic public economics

3.1 Foundations and challenges

The rich traditions of development economics, growth theory, and public economics provide a valuable foundation for the analytical enquiry generated by the two-pillar strategy of investment climate and empowerment. But in many ways, the strategy raises theoretical and empirical challenges that go well beyond the existing literature. My task here is to begin to sketch out some of these challenges and what may be involved in responding to them. Let me start with a brief look at the analytical foundations provided by these areas of economics.

In *development economics*, the strategy has important antecedents in Rosenstein-Rodan’s (1943) ideas in the 1940s of a ‘big push’ to break out of a low-level equilibrium; in Schultz’s (1964) emphasis on traditional agriculture as poor but efficient and on the role of technology in generating change; and in Boserup’s (1965) seminal analysis of population pressures as the key determinant of agricultural change. While they varied in emphasis, each of these authors pointed to the need to understand and promote change, whether from agriculture to industry or within agriculture. From Schumpeter (1934 and 1962) and Hirschman (1958), we draw our emphasis on entrepreneurship as the driver of innovation. In stressing the investment climate, my focus is on the obstacles to

entrepreneurship, particularly those associated with governance and institutions.

In taking this view on the importance of entrepreneurship for growth, I have been influenced strongly by my work in developing and transition countries. Of particular importance in shaping my outlook has been close involvement over several decades with China and India—two countries where the release of constraints on entrepreneurship has produced a powerful response in terms of growth and poverty reduction. Since China launched its reforms a quarter-century ago, it has lived through the single most important episode of poverty reduction in history. My work in India, including the close study of one Indian village over several decades, with Christopher Bliss, Jean Dreze, Peter Lanjouw, and others, has made me well aware of India's long-standing barriers to entrepreneurship (Lanjouw and Stern 1998). And yet India's reforms, particularly since 1991, have begun to dismantle what has been called the Permit Raj, and have thereby engendered a strong growth response.

While at the European Bank for Reconstruction and Development here in London for six years in the 1990s, I saw entrepreneurship stir in the former Soviet Union after seven decades of suppression—and then saw failings in governance divert much of that entrepreneurial energy in destructive directions. And in my first applied project in Africa in the 1960s, which focused on tea farming, I witnessed the powerful entrepreneurship of smallholders (most of them women) in the highlands of Kenya, supported by public-sector investments in infrastructure and agricultural extension.

These experiences convinced me that entrepreneurship is, or can be, the central creative economic force in all countries. Sometimes that force is expressed positively, sometimes it is latent, and sometimes it is misdirected into rent-seeking and crime. Our goal should be to support policy change that creates conditions where entrepreneurship is constructive and dynamic.

Theories of *growth* have attempted to model processes of change in a formal way. As ever, when we turn to formal approaches we gain something and we lose something. Growth theory has helped us understand the differential role of accumulation and technical progress, for example, and to analyse the relationship between savings and growth. But in its emphasis on the steady state and on aggregation, with a few honourable exceptions,⁸ growth theory has also lost something absolutely central—

⁸ These exceptions include Aghion and Howitt (1998) and Grossman and Helpman (1991).

the growth engines of entrepreneurship and creative destruction, to use Schumpeter's term. Periods of strong growth in history bear little resemblance to steady state, notwithstanding Kaldor's misleading 'stylised facts', and the structural change that drives development is not well captured in an aggregate model.

Public economics since the 1970s has placed the serious analysis of incentives at the centre of its agenda. It has shown how we can integrate incentives and distribution—in crude terms, the size of the cake and the distribution of the cake—rigorously into a discussion of public policy, both theoretically and empirically. What we need today is research that would extend this analysis of size and distribution to the more dynamic questions of innovation and inclusion.

Let me now turn to further research. My objective here is not to outline a fixed programme, but to illustrate how this approach can help us identify research priorities in support of public action. I begin by describing the empirical investigation of the investment climate and empowerment. This work is beginning to gather momentum and, in some ways, has run ahead of the theory. I will then turn to three important, but I think fairly difficult, areas of theoretical and empirical research motivated by the two-pillar approach.

3.2 The empirical investigation of the two pillars

Our conceptual approach should guide the data that we construct and use.⁹ Public finance research on the impact and design of public policy has leaned heavily on household data sets. Motivated in part by optimal tax theories, this research also looked at aggregate revenue and incentive effects of policy change through supply and demand elasticities and production functions, sometimes in computable general equilibrium models. But the two-pillar strategy suggests different data priorities.

In particular, we will need to gather and analyse two new types of micro data: first, data from firms, to provide detail on the quality of the investment climate; and second, data on the functioning of various services that are key elements in empowerment, such as health, education, and social protection. For both data sets, it is fundamental that we go beyond inputs and outputs and ask how processes actually work and how people are involved. In the past few years, we have begun to accumulate data in both of these important areas. As before, we will still need our

⁹ See 'The Interaction of Tools and Problems in Economics' in Koopmans (1957).

third major type of micro dataset, information on households and individuals, if we want to assess outcomes. Taken together, these three data sets—on the investment climate, service delivery, and households—will provide very powerful research tools for analysing development processes. They are far richer and deeper than the cross-country macro data sets that, driven by the aggregate approach to growth, have formed the basis of so many cross-country regression analyses. Let me provide you with a few examples of what we are learning from the data we have collected.

Systematic investigation of the investment climate using firm-level surveys started at the World Bank and the EBRD during the 1990s. It has gathered pace in the last year or two. We now have comparable surveys completed, under way, or planned for the next year in thirty countries, and these surveys cover large random samples of firms (some 1,200 firms in India and 1,500 in China, to take two examples). These surveys collect the usual firm information on sales, outputs, inputs, and costs, but they also include specific quantitative questions about the investment climate. Examples include: ‘How often are you visited by the authorities, and how much management time is spent with them?’ and, in some cases, ‘What fraction of your turnover do you spend on bribes?’

The results can be very striking. For example, we find that it takes half as long to move goods through the port of Shanghai (nine days) than it does through Karachi (eighteen days). Within India, we can now compare the investment climates at the state level. Firms in Uttar Pradesh (or UP) report twice as many visits from officials as firms in Maharashtra, and twice as many (proportionally) have their own generators, reflecting the lower reliability of electrical power in UP. The result is that UP, the largest and one of the poorest states in India, has both a higher capital intensity and a lower growth rate than Maharashtra. These findings are strong and easily communicated, and they can make a powerful impact on policy makers.

The empirical information on the second pillar, empowerment, is no less rich, although so far it is somewhat less structured. Next year’s *World Development Report*, entitled ‘Making Services Work for Poor People’, will provide an analysis of much of the evidence, drawing on a large number of examples in areas ranging from basic services to economy-wide issues, such as:

- community involvement in school management in El Salvador and Nicaragua

- citizen report cards on services in Bangalore (India), Ukraine, and the Philippines
- legal and judicial reform and property rights in slum areas in Guatemala, Ecuador, Venezuela, and Peru, and
- corruption surveys in Albania, Georgia, and Latvia.

The challenge going forward is to generate more structured data on empowerment, so that we can carry out further systematic empirical investigation. One example is the Public Expenditure Tracking Survey, which was carried out first by Uganda in the mid-1990s. The Ugandan survey discovered that less than 13 per cent of non-wage school funds distributed by central government was reaching the schools—meaning that 87 per cent was disappearing along the way. The central government responded innovatively, by publishing the monthly transfers in the newspapers and broadcasting them on the radio, while requiring primary schools to post the information on the funds received. The information empowered local organisations to press for action and, presumably, embarrassed those diverting the resources. The result was that the share of funds received at the local level rose from 13 per cent in the early 1990s to about 90 per cent by the end of the decade. We are investing heavily now not only in similar expenditure tracking surveys, but also in other surveys of service delivery by schools, health services, and other facilities. But this research is still very new, and there remains a great deal to be learned from deepening this line of empirical inquiry.

3.3 The dynamics of the investment climate

Let me now turn to the next area for research, the dynamics of the investment climate. A central challenge for students of development is to help understand what kinds of change can generate strong and sustained increases in growth rates and large transformations in education, health, and other outcomes. I think that in many of the processes at work the investment climate plays a central role. Let me briefly sketch possible mechanisms, starting with the dynamics of the investment climate itself. This is a concept that Keynes would have recognised, with his emphasis on the ‘state of confidence’ (1936: 148) and the ‘animal spirits’ (p. 161) of entrepreneurs in the *General Theory*.

One dynamic story of accelerating and self-reinforcing change in the investment climate might go as follows. As the investment climate improves, the frontier of opportunity expands: existing investment

becomes more productive; the rewards to productive behaviour (as opposed to predatory or defensive behaviour) rise; the ‘animal spirits’ of entrepreneurs are invigorated; the case of those arguing for improvements in the investment climate is strengthened; the effects on investment climate and investment reinforce each other; and the economy generates more and more productive investment. Thus the ‘diminishing marginal efficiency of capital’, to use another Keynesian term, is kept at bay. These examples of the success of entrepreneurship and investment show other investors what is possible, broadening the constituency for further improvements in the investment climate.¹⁰

More broadly, several types of models in the literature generate the kind of dynamic growth we are seeking to understand. They may capture the notion that we can act in a way that tips a lever in the right direction, or that enables us to move to and up the steeply rising portion of a logistic curve. We focus here on those for which the investment climate is likely to be important for the functioning of the mechanisms at work:

- 1 We have models that involve the diffusion of ideas or knowledge. There is an inherent increasing-returns element in ideas, since a new idea or piece of knowledge can be used across the whole sector or economy (for example, the work of Griliches 1958 on hybrid corn). Thus a small change by an innovator can lead to a large effect through learning and diffusion. But if a small farmer is to apply what she has ‘learned by watching’, she must often make what are for her radical changes. She is much less likely to do this if the relation between sowing and reaping—that is, between the investment and its returns—is weak.
- 2 There are a number of models that can generate multiple equilibria (such as Murphy, Shleifer, and Vishny 1989). A disturbance of sufficient magnitude—such as a policy improvement or an institutional change that improves the investment climate, and thereby boosts investment or the productivity of capital—could initiate a movement from a lower-level to a higher-level equilibrium. Growth would then accelerate in the process of transition from one equilibrium to another.
- 3 There are political economy models that focus on crucial historical turning points. By this, I refer to times when political forces

¹⁰ There are analogies here with the work of Maurice Scott (1989) and of Atkinson and Stiglitz (1969).

are fairly evenly balanced and the right kind of external support can help to sustain or even start a process, in which the investment climate is central, that can gather momentum.¹¹

There could be real returns to deepening our insight into how small beginnings can lead to substantial accelerations of growth. As we have seen, these insights could come in part from looking at the role of the investment climate in enabling other mechanisms, and in part from looking directly at the investment climate itself.

3.4 The dynamics of preferences

Let us now turn to the next area for research inspired by the two-pillar model, and in particular by the empowerment pillar—the dynamics of preferences. Much of economics takes preferences as given and works with a simple model of an optimising individual who understands the relevant constraints on decision-making. This has been a fruitful approach, especially for public economics, which relates social welfare to individual welfare. Increases in the latter can then be associated with a bundle of commodities that is preferred by the individual.

However, a number of philosophers, such as John Stuart Mill and Keynes himself, who emphasised objectives in terms of individualism and expanded personal freedoms also recognised that preferences adapt through development and discussion.¹² And development is in large measure about fundamental changes in behaviour, driven by shifts in preferences, as the following example illustrates. Suppose the Pakistani government recognises the importance of raising the enrolment of girls in school. How should it go about convincing a girl's parents, particularly her father, to allow her to attend school? The standard economists' answer, which would mention merit goods and externalities, would be to subsidise attendance of girls, by eliminating school fees or even giving the family a small grant. This approach, which takes preferences and information sets as given, reduces the relative price of schooling in order to induce a different choice. And this is indeed likely to be one part of a

¹¹ See Schelling (1978) generally for these types of models.

¹² See also R. H. Tawney (1966: 17): 'The movement to industrialization is a growing force. Where it directly affects, for better or worse, the livelihood of one, it indirectly modifies the habits of ten. Its effect on the mind . . . is ultimately more important than its visible embodiment in mills and mines.'

policy package. But there are at least two other ways we might go about expanding attendance, each supported by a different model of the world.

The first of these would take preferences as given, but recognise that people making decisions do not always have all the relevant information. The policy response to this lack of information would be to provide the parents with good data about the advantages of schooling. These data could be used to point out, for example, that more educated girls are healthier as adults, and that their own children will be healthier and better educated, and will earn higher incomes as a result. If he is persuaded by this new information, the father may allow his daughter to attend school even without any change in his preferences. That is, while his objective was always to ensure a good life for her and for his grandchildren, he now understands more clearly that education will increase the chances that will happen.

But a further policy approach recognises that preferences are not immutable. What may distinguish Pakistan from, say, Sri Lanka in this respect is that in the latter, far more fathers regard education for their daughters as something inherently desirable. In other words, it is not simply that it is relatively cheaper for Sri Lankan parents to send their daughters to school, or that they have a deeper understanding of the theory and evidence on human capital, but that they place a higher value on education for their daughters. Part of the policy challenge is to persuade fathers to think differently about the kind of life they would like their daughters to lead. Note that this preference transformation can happen for reasons other than direct efforts to change preferences. It can also result from either of the two policy interventions described above: if a subsidy or better information gets the girl into school, then her father's preferences may subsequently change, once he sees how valuable education can be for the life of his daughter.

Of course, as with most real-world issues, the problem of girls' education in Pakistan has a number of other important dimensions. I am focusing on preferences to make an analytical point: preference change is a widespread issue in development, and one that bears much further study. Understanding changes in preferences will require new modelling approaches. Without going into detail, let me highlight three examples. These examples are intimately linked to empowerment—indeed the first is empowerment itself, particularly of women.

First, most aspects of *empowering people* involve changing attitudes and behaviours. Such changes are of special importance for the empowerment of women, which requires new attitudes, aspirations, and behav-

hours for both men and women. As social scientists, we should be trying to understand better just how these changes take place.

Second, *education* systems that are dogmatic and doctrinaire can have profoundly damaging effects on behaviour. Other systems can result in behaviour and codes that help build strong and creative societies. Education changes values and preferences in ways that are likely to be hard to predict, yet students and parents make decisions over education in the knowledge—or indeed the hope—that preferences are likely to be changed.

Third, values can change in response to examples set by *leaders*. Many would argue that individual behaviour in Russia deteriorated in the 1990s in part because of the example of large-scale looting of the state by individuals and groups close to the sources of political power. Similarly, when Mrs Gandhi financed election campaigns in the 1970s with funds obtained through corruption, she contributed to the erosion of ethical standards in Indian public life. The influence of both these developments on the investment climate were profound in terms of an increase in the respectability of predatory behaviour.

There are many more examples where changing preferences is key, including control of sexually transmitted diseases such as HIV/AIDS,¹³ addiction, behaviour under extreme conditions, and so on. These examples are not marginal; they are central to the development process. Thus, a move toward more systematic analysis of changing preferences is hard to avoid. As we have noted, changing preferences immediately cause problems for standard public economics, as it is no longer possible to track social welfare through identifying bundles of commodities that are preferred with reference to fixed preferences of individuals. And yet this problem can be addressed; in fact, it goes away if we move to criteria for development that are based on the expansion of the ability to shape one's own life.

3.5 The dynamics of political reform

The final research area that I want to touch on focuses on the dynamics of political reform. The strategy that we have been discussing has political change at its centre, both for improving the investment climate and for empowering people. Indeed, generating the necessary political change is

¹³ See World Bank (1997) for examples of preference changes as a tool for fighting the HIV/AIDS epidemic.

often the greatest challenge in development. Change will invariably face opposition, and driving it through requires leadership, commitment, and skill. Machiavelli in *The Prince* expressed this point eloquently at the beginning of the sixteenth century:

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. (Machiavelli (1940 [1513]), ch. 6)

Machiavelli saw very clearly the relation between prospects for change and constituencies for change, a relation that must feature prominently in any attempt to understand improvements in the two pillars of the investment climate and empowerment. Obstacles to such improvements are often, or even usually, political.

Let me give two sets of examples of the importance of constituencies for change as a focus of study. In the former Soviet Union, potentially beneficial reforms were derailed or hijacked in the first decade of transition by what quickly became powerful elites. Russia's loans-for-shares deal and other schemes allowed well-connected oligarchs to capture and entrench monopoly positions at very low cost and, in so doing, undermined attempts to move to a well-functioning and inclusive market economy. Equally important, these developments raised still further the barriers to reform. With greater economic power, the oligarchs now had greater political power to block reforms, so that the state was in effect captured and used for private interests. One could not expect those benefiting from the institutional defects of the existing system, at least in the short run, to campaign for institutional and governance improvements that would limit their activities.

Acemoglu and others (2001) highlight a second example of how contrasting patterns of endogenous institutional development can have long-term development consequences. These authors compare North and South America in the nineteenth century, noting that both areas had large tracts of land and raw materials and were conquered and settled by Europeans. They argue that the endogeneity of institutions is crucial to understanding the subsequent divergent development in the two regions. In North America, an improvement in investment climate led to more small and medium-sized firms, creating a constituency for further

improvements in the investment climate. In South America, by contrast, initial features of the political, economic, and physical landscape led to much greater inequality. As a result, powerful vested interests were able to capture the state and restrict competition and innovation, hampering development.¹⁴

Both of these examples illustrate that some basic modelling is likely to provide real guidance on the dynamics of political reform. In both stories, the investment climate and change in institutions and governance were central.

4. Driving institutional change

The purpose of this lecture has been to set out a strategy for development and to argue that it provides both a basis for action and an agenda for research. The strategy was based on our review of fifty years of development, which pointed to some key strategic lessons—about the multiple dimensions of development, the complementarity of states and markets, the nature and drivers of growth and poverty reduction, and the role of aid. We distilled these lessons into a strategy, one that places the investment climate and empowerment at centre stage. Both of these elements involve processes of change. The public economics that the strategy helps us identify then becomes the study of how to shape and guide processes of change—an analytical agenda that is both challenging and essential.

Research and action must reinforce each other: we cannot delay action without the risk of squandering the unique opportunity before us. We have by now understood, I trust, that changing institutions and governance is at the heart of the agenda for action. But we are only beginning to understand *how* they can be changed. Let me close, therefore, with a few words about how to translate knowledge into action to promote this kind of change. It is important to note that the impetus for change can either be top-down or bottom-up. On the former, we have strong examples of entrepreneurship in government. Mexico's Progresá programme has improved health and education outcomes of poor children by providing grants to families that keep their children in school (Gertler and Boyce 2001). The law requiring representation of women in local government in India has led to shifts in public investments, toward rural infrastructure and other public goods valued by women (Chattopadhyay and

¹⁴ See also Engerman and Sokoloff (2002) for a similar argument.

Duflo 2001). In other environments, particularly where government has been unable to perform basic functions or is uninterested in trying out new approaches, the innovations have come from the grass roots. This is the case with the NGO sector in Bangladesh, which was the driving force behind that country's dramatic achievements in infant health, girls' education, and family planning. Similarly, the household responsibility system originated in China at the local level in Anhui province at the beginning of the reform era; as its efficacy and popularity were demonstrated, this innovation was rolled out nationally by the government, and it led directly to an economy-wide revolution in agricultural productivity.

How can we guide governments and international institutions in triggering or supporting innovations in institutions, governance, and policies? First, as you will suspect by now, I believe strongly in the power of evidence, information, and analysis as a catalyst for change. One way in which this can happen is through embarrassment, where things are going badly; the Ugandan survey showing leakage of school funds is an excellent example. Equally important, but less dramatic, can be rigorous analysis of programmes and approaches that could work well in a given situation. Good evidence bolsters and arms the constituencies for change.

Second, we can help establish institutions and build capacity for taking knowledge forward. For example, a World Bank project to build a ring road in Shanghai also helped create local institutes that were then able to apply the techniques for construction, tendering, and finance across the country. Similarly, capacity for analysis, learning, and administration is a fundamental part of development assistance.

Third, political action by policy entrepreneurs can promote change. Like markets for private goods, markets for policy and institutional innovation are not characterised by spontaneous combination of inputs. It takes an entrepreneur to recognise an opportunity and exploit it—someone like Muhammad Yunis of the Grameen Bank for micro credit in Bangladesh, or like Hernando de Soto, who showed in Peru how practical action at the local level can improve property rights and investment opportunities for slum dwellers.

Fourth, the press and media can goad policymakers to change. Last year's World Development Report, on *Building Institutions for Markets* (World Bank 2001c), and a recent volume on the role of the media (World Bank 2002c) include a host of examples of the media's developmental role in catalysing change, not only of policies but also of institutions.

There are of course many more examples of how one can trigger institutional change. We are beginning to go beyond an understanding of the

importance of institutions to an analysis of how to change them. But we have a long way to go.

The story that I have tried to tell in this lecture is one of a world where poor people—indeed, all people—are enabled and equipped to shape their own lives, where people have a chance to experiment and to learn. It is a story of a vibrant and innovative market economy complemented by an active state. It provides an agenda for action, and as I have emphasised here, for research. If we are to move forward on a sound basis, then we must have rigorous evidence and well-founded ideas. It is our responsibility as academics to provide them. I hope, and I believe, that the agenda sketched here—an agenda of development and internationalism, of governance and markets, of idealism and down-to-earth experience—stands firmly in the tradition of John Maynard Keynes. No challenge is more worthy of his extraordinary legacy than the global fight against poverty.

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