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Investment and poverty: The role of the International Financial Institutions

The Jacques de Larosière Lecture[1]

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The European Bank for Reconstruction and Development (EBRD) is a unique institution with an inspiring and challenging mandate. I look back on the six years I spent with you as a most productive and cheerful period of my working life. And it is a great honour to give a lecture bearing the name of Jacques de Larosière. Like many of you, I learned enormously from him and owe him an immense debt. And even as bankers, we must recognize that there are some debts that it is a privilege to bear. Jacques is a very special figure in the international community. He is someone who, through his outstanding abilities, personality, dedication and charm, has changed the shape of development and progress in the global economy of the last fifty years. Giving this lecture in his name means a great deal to me, and I would like to thank Jean Lemierre and the Executive Committee of the EBRD for the invitation.

1. Introduction and the issues

My subject is investment and poverty and, in particular, the role of the international financial institutions (IFIs) in promoting the one and overcoming the other. The World Bank's *objective* is to fight to overcome poverty in client countries. An increasing proportion of the World Bank's total lending is in the form of programmatic loans to governments, designed to support change in the

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economy as a whole or in a major sector. The EBRD's *objective* is to promote transition to a market economy. It invests mostly in the private sector, largely through the financing of projects. The World Bank's development *strategy* stands on two broad pillars: (1) building an investment climate for investment and growth, and (2) the empowerment of poor people to participate in growth. The EBRD's *strategy* focuses on the transition impact of its individual projects and its overall portfolio. Both must operate according to sound banking principles (although we might have slightly different perceptions of what constitutes sound banking), and both should extend the boundaries of what the private sector can or is willing to do. Of course, pushing out frontiers often involves what economists call externalities (benefits to others for which you are not rewarded). It also often involves taking risks beyond those that private-sector market participants will accept. For these reasons, this role of pushing out frontiers requires a public institution.

This lecture will examine the key links between the investment climate and poverty reduction. In doing so, I will argue that a combination of the philosophies and approaches to development embodied in these two international banks, the EBRD and the World Bank, can provide a powerful boost to pro-poor growth. I will make the case that an activist approach by public institutions can help promote a dynamic form of a capitalist system that yields strong benefits for poor people. Indeed, these benefits may go far beyond those likely to be achieved by a public policy that attempts to be purely permissive or passive towards private sector development. We have to see our two international financial institutions as agents of change.

The word 'investment' in our title 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 development assistance was seen primarily as the transfer of capital to the countries recently emerging from colonialism and aspiring to join the ranks of industrialized countries. Since those early days of development economics, I hope that we have learned much.

My emphasis here will be very different from those earlier models and will be, first, on growth driven by the private sector 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. Not only is the private sector the main engine of aggregate growth, it is also the main provider of economic activity 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 growth of the private sector is vital to the reduction of poverty. But poor people often face enormous obstacles in realizing economic opportunities. And there are many more dimensions of poverty beyond the lack of income associated with the lack of economic opportunity. For both these reasons, an attack on poverty is vastly more successful if it also focuses on empowering poor people to shape their own lives,

through opportunities for education, health care, and participating in the key decisions that affect them and their families.

The strategy for development I have just described sounds, I hope, very plausible, indeed almost obvious. But this description is fairly new and is not universally accepted. At the same time, it builds on the intellectual capital bequeathed by development pioneers – those pioneers who, to paraphrase Dante's description of Virgil in his *Purgatory* (Canto XXII), 'walked at night, carrying the lantern behind, of no help to themselves but illuminating those who follow behind.' Indeed, many of the arguments that I will advance here will build on those that Jacques de Larosière developed and championed in his own way during his time at the French Treasury, the IMF, the Banque de France and the EBRD. He has always pretended that he is neither an economist nor a philosopher, but those of us who love those subjects and see them as fundamental agents of change have always known that he is both.

2. Investment climate

2.1 What does it mean?

What do we mean by 'investment climate'? By 'investment climate', I mean the policy, institutional, and behavioural 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, and policies 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 good sense of sound, if standard, economic prescriptions in 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 behaviour, including: bureaucratic harassment, especially in the administration of regulations and taxes; the strength of financial institutions; the rule of law (including law enforcement), 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 and prevailing work culture of the labour force.
- The third broad area is the *quality of infrastructure*, including power 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.

2.2 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 (and hence the metaphor), also a story of the local level, of the micro-entrepreneur, small business person, or farmer. 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 cannot reap my 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.

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, including (although to a lesser extent on average) the transition economies. Furthermore, it is in SMEs, and I include agriculture here, that 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. A similar fraction applies to incomes in the village of Palanpur, which my research collaborators and I have been following closely since 1974, and where our data go back to 1957. 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 suffer as much, or more, than others do from macro-instability, weak governance and malfunctioning infrastructure.

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 this rapidly growing urban population.

Fourth, the experience of the East Asian countries, notably Japan and China, and of the successful Polish and Hungarian transitions have shown us the great importance of SMEs (both urban and rural) in overall economic development and in providing employment for poor people.

We must also recognize that the benefits of growth for SMEs go way beyond the provision of economic opportunities. Small firms give a breadth and depth to public voice, which is so important for the development of democratic processes in the long term. They provide a big fraction of the population with a stake in society and thus can generate real forces in favour of sound economic and political governance.

2.3 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. As the investment climate improves, the frontier of opportunity expands: existing investment becomes more productive, the rewards to productive behaviour rise, and thus the economy tends to attract more investment rather than less. 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 is lacking, both replacement and new net investments will suffer in a pernicious downward spiral.

For example, did the reforms implemented by transition economies increase or decrease 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, a topic that I will take up later in this lecture.

Qualitative Aspects of Transition Impact of Projects: A Checklist (Summary)

Contributions to the structure and extent of markets:

- Greater competition in the project sector,
- Expansion of competitive/market interactions in other sectors.

Contributions to the institutions and policies that support markets:

- More widespread private ownership,
- Institutions, laws and policies that promote market functioning and efficiency.

Contributions to market-based conduct, skills and innovation:

- Transfer and dispersion of skills,
- Demonstration of new replicable behaviour and activities,
- Setting standards for corporate governance and business conduct.

(Adapted from Stern and Lankes, 1998)

From the investment climate perspective, the function of IFI investment projects is not simply to transfer capital but to seek powerful demonstration

effects. These demonstration effects work on the climate of expectations to help crowd-in other investments. This emphasis on transition impact (see following box) and the demonstration effect has particularly characterized the approach of the EBRD, which has indeed played a pioneering role both in the analysis of these ideas and in putting them into practice.

The other broad approach – particularly appropriate for the World Bank – is to focus on governance, on the institutional adjustments, anti-corruption measures, and policy changes that will change 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.

I think the arguments I have already given show how the two strands of projects with strong transition impact as championed by the EBRD and what I might call the governance approach of the World Bank are strongly intertwined and mutually supportive.

But I know the hard-headed economists among you will be saying: 'All this is splendid, but where are the analytics and data?'

2.4 Analyzing and measuring the investment climate

Can we be analytical in assessing or measuring the investment climate? We can, and researchers both at the EBRD and the World Bank 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 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.

An important example of this work, and of collaboration between the EBRD and the World Bank, is the *Business Environment and Enterprise Performance Survey*. This survey, which was led by the EBRD, polled nearly 4,000 firms in 22 transition countries. The survey 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 – the so-called oligarchs – in distorting the investment climate in transition economies and undermining growth. Such surveys are a powerful 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 own governments about the day-to-day obstacles they face in running a business.

Let me also share with you the results of a recent survey of 1,000 manufacturing and software firms that we carried out with an Indian partner 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 quite high in quantitative terms. In fact, those costs are analogous to an additional tax burden of up to 30 per cent for firms in poor-climate states such as Uttar Pradesh (which has a population of 166 million, or larger than that of Russia) relative to those in Maharashtra (a state of nearly 100 million).

Upon examination, it is not difficult to see how one could arrive at such a large cost estimate. To have a vibrant SME sector, you have to have a functioning power grid. 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, 98 per cent of firms surveyed had their own generator (they had little alternative), whereas in Maharashtra the figure is considerably better, at 44 per cent. 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 Uttar Pradesh 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 and amenable to fairly structured analysis and reasonably robust general conclusions. But also invaluable are the accumulated experiences of the clients of the EBRD and IFC. For me one of the key advantages of having a public institution working as a private-oriented investment bank is that those actually involved in financing and making investments are also thinking about how to improve the environment in which the institution is functioning. And this hands-on analysis is from the perspective of public policy, and not the narrow self-interest of business. This action basis for economic policy is invaluable. One channel for gathering and transmitting the experience is organizations such as the Foreign Investment Advisory Councils,[2] in which the EBRD has played a strong role (as well as the World Bank Group's similar activities in many countries). The EBRD has long recognized that it can affect the transition process not only through the transition impact of its projects, but also through working with governments to understand, and thereby influence, the investment climate.

These different types of information complement each other and will enable the IFIs to support clients (both inside and outside the government) to analyze the impediments to investment and the costs of those impediments. We are likely to discover that in one country petty corruption is a key problem; in another, unreliable power; in a third, transport infrastructure, and in a fourth, it is

[2] Organizations to monitor investment climate set up by governments (e.g., Russia in 1994 and Ukraine in 1997) and representatives of major investors.

promoting a free press and civil society to expose grand corruption. In this way, a good diagnostic survey can be a filter through which we look at different possible interventions, establish priorities, and relate our activity to what other IFIs are doing.[3]

2.5 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 such as those that I have just described. And I have already emphasized the Foreign Investment Advisory Councils in which the EBRD is involved. Strong analysis and identification of problems are not only a guide to reform, but also a powerful spur to action. Striking figures such as those cited here – remember the 30 per cent additional 'tax' burden in the poor-climate Indian states – can build public support for reform and help motivate a hesitant government.

The question 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.

But there will also be those who are not specially privileged who may be disrupted by the reallocations that are an integral part of reform. Here social protection can play a strong role, of which more later; still, at the end of the day, the best social protection for the great mass of society is a growing economy.

[3] See Stern (2001) for more on the research program associated with this development strategy.

Further, changing the investment climate takes time; it is not a stroke-of-the-pen reform like striking down a tariff. Thus reformers not only have to argue their case strongly, they have to prepare their constituents for the long haul.

Later in this lecture, I will discuss in greater detail the role of the IFIs in supporting improvements in the investment climate. Here, let me note briefly that the World Bank's structural agenda has begun to address the factors that together describe the investment climate, particularly as the World Bank moves more towards long-term programmatic lending (as opposed to discrete projects or short-term adjustment loans). Programs addressing macro-stability and openness are levers to change the investment climate. Governance and institutional development programs are, or should be, in large measure about the investment climate. They can influence how difficult or easy it is to register and start firms, to move goods in and out of the country through customs, and to pay taxes in a fair, predictable and transparent way. The quality of different types of infrastructure – power, ports, telecommunications, roads, and rail, all of which require far-sighted and market-oriented action – is also a crucial part of the story. Programs to improve training and education systems improve the quality of the labour force, in addition to being valuable in their own right. So, in short, and founded on serious analysis, I think there is a great deal that governments and IFIs can do about the investment climate.

3. Investment climate ➔ growth ➔ poverty reduction

In this section, I would like to comment on 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 evidence is now 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 different aspects of the development agenda. 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 growth *and* poverty reduction.

What is the evidence? First, we have the connection between investment climate and growth. It is clear that developing countries that are improving their investment climates as a part of globalization are doing well. 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 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 by conflict. And amongst the other large countries that have performed less well, including Russia, Nigeria and Pakistan, severe problems with property rights, the rule of law, and governance have been prominent. (see Dollar and Kraay, 2001)

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. Among low-income countries, Vietnam is a good example of this. It made a lot of progress with the investment climate between 1992 and 1997, a period during which growth accelerated and survey evidence shows that poverty dropped sharply: of the poorest 5 per cent of households in 1992, 98 per cent were better off five years later. (see Dollar and Ljunggren, 1997)

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 beneficial for the informal as well as the formal sector. 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 averaging more than 12 per cent annually over the past 15 years. 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 quite substantially across regions. I previously mentioned the study of different states in India. Because the investment climate varies dramatically 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 noted that the World Bank is pursuing a strategy for poverty reduction that is based on two pillars: investment climate and empowerment. A favourable 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. This perspective has also moved to centre stage in the literature on the meaning of development, most notably in the work of Amartya Sen. (Indeed, it is embodied in the title of his recent book *Development as Freedom*.) This broader notion of development and the role of empowerment were taken up in our World Development Report 2000/1, *Attacking Poverty*.

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 inclusion in development.

First, consider education. Basic education is critical to participation and productivity in economic life. A healthy, literate labour 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 approaches. 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 (Jimenez *et al.*, 1996, 1999). 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' enrolment.

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 policy-making, administration, and government. The effects are profound and economy-wide. 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 overall, 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. This is an example of a key theme to which I will shortly return: the role of the IFIs is to help finance the costs of change, rather than to cover the costs of not changing. 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. Poor people living in the vicinity of industrial polluters have then negotiated better arrangements for compensation and clean-up.

It is these equipping, protecting, and including dimensions of empowerment that boost the connection between growth and poverty reduction – that turn growth into pro-poor growth.

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 people were left to glean what they could from the leftovers. And in those countries, the investment climate has tended to spiral downward.

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.

5. The new role of the IFIs in the age of globalization

What can the IFIs do to help countries implement this two-pillar strategy? Our answer to this question is different from the one that would have been given fifty, or perhaps even ten, years ago. First, much has changed in the functioning of the international economy and the environment for development assistance since the Bretton Woods Conference of 1944. In particular, the world economy has moved decisively toward greater integration. Second, our understanding of development has broadened and deepened. We not only look beyond aggregate income to its distribution, but also recognize standards of living and thus development as having key dimensions beyond income. Third, we now see strategies for development in a much more subtle way: rather than focusing simply on boosting investment, we take a more comprehensive approach and recognize the need for a greater role for the private sector, based on a deeper understanding of how it functions. And fourth, we have reoriented our perception of how international financial institutions should work with their partners and clients. Country commitment, ownership, partnership, and a more comprehensive approach are now much more prominent parts of the strategy.

The new international financial architecture marks one of the most radical changes. It has brought massive increases in private capital flows and trade along with exchange rate volatility and greater pressure for sound economic policies. To use language that has become current, indeed often emotionally charged, there has been a remarkable acceleration in the pace of globalization. Different people mean different things by this. What I mean by globalization is the growing integration of economies and societies through the cross-country flows of information, ideas, activities, technologies, goods, services, capital and people. Globalization is not a new phenomenon, of course: the movement toward greater integration can be traced back to the earliest historical times. And it is also true that globalization has ebbed and flowed in different periods – reaching a peak in the early part of the twentieth century, for example, before war and depression

caused many countries to retreat from world markets. Nevertheless, the last decade has seen extraordinary changes, particularly in communications technologies, of which the advent of the Internet is the most visible.

The improved flow of information alone would have had a powerful effect on economies and societies. But the communications revolution has also been accompanied by declines in transport costs, and by more open policies towards international trade and capital flows. The result is a much more integrated world economy than we had just ten years ago. The last decade has seen dramatic increases in capital flows, and growth in trade has been much faster than growth in incomes. The recent increase in trade provides a striking example: the World Bank estimates that world trade volumes increased by 13 per cent last year, the most rapid rate of increase since the first oil shock of the early 1970s.

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. Jacques de Larosière has, in fact, already addressed the topic of the role of IFIs in a world of private capital flows in his Per Jacobsson Lecture five years ago at the 1996 Bank/Fund Annual Meetings, and I can only add a few thoughts to his main points.

I will argue together with Jacques de Larosière 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.

It is worth spending a moment to elaborate on this point. The IFIs, as promoters of development, 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 two 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 labour 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. To achieve these goals, the IFIs must succeed in helping countries improve the investment climate, on the one hand, and must support country ownership and commitment for reform initiatives, on the other. To push another metaphor, if the private sector is the locomotive of development, the IFIs' role is to help countries lay track and create railway networks. 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. If we want to strain the metaphor still further, there may also be moments when the IFIs can help to push-start a locomotive suffering from inertia.

What are the instruments best suited to this approach? On the lending side, we are moving toward a *programmatic approach* – that is, toward programs that cover a substantial part of the economy, involve basic policy reforms, and embody multi-year financing. These may be investments that involve substantial support for a sector or area of activity, or they may be programs for economy-wide adjustment. Within this approach, we will use two major lending instruments:

- *Programmatic adjustment lending:* The key role of this type of lending is to support reforms that are oriented to growth and poverty reduction by helping to meet the up-front costs of adjustment. Thus, as I have already remarked, it aims to meet the costs of reforming rather than carrying the costs of not reforming. In such cases, where country circumstances permit, the World Bank will increasingly provide aid in the form of what we call 'programmatic adjustment lending'. These are policy- and performance-based budget support loans, without the strong process-based conditionality and negative connotations (i.e., 'adjustment' as a response to past failures) of traditional adjustment lending. Such lending is a powerful vehicle for backing serious reforms in countries with, or establishing, good track records. Twenty years of experience with adjustment and other programmatic lending suggests that this type of support is most effective when it is: (a) grounded in strong borrower commitment to reform; and (b) disbursed on the basis of actions on the ground, rather than promises. In these circumstances, budget support can be a particularly effective vehicle for supporting reform.

  As a means of doing so, programmatic lending has an advantage over project-based lending: it promotes *greater ownership* of development strategies by the borrowing country**.** Borrower commitment to reform is likely to depend on the degree of autonomy that the country has in setting out its own development strategy, consistent with its knowledge and understanding of the local situation. Because countries are able to reflect their priorities better within the program than within a project, the programmatic approach can increase country ownership. Of course an IFI with a mandate to fight poverty cannot support a program merely on the grounds that it is 'country-owned'. It has also to be convinced that it will be effective in reducing poverty.
- *Programmatic investment lending:* The programmatic approach is not limited to budgetary support for economy- or sector-wide adjustment and development. It applies also to projects that are of a scope and influence such that they take on many of the characteristics of sector-wide adjustment programs. Let me mention just two leading examples from our portfolio that I have had the privilege of witnessing first-hand in recent months. One is the District Primary Education Programme in India, which encompasses over 50 million students and is thus large relative to an educational 'project' in the traditional sense; the second is the Kecamatan Development Program in Indonesia, which in many regions

provides block grants to support village-level projects throughout the country. The first of these has dramatically changed the way in which communities are involved in education and in which girls benefit from education, while the second involves a powerful example of communities being empowered to allocate public resources. Thus each of these projects clearly fits the criteria for the programmatic approach that I laid out earlier.

Complementing these programmatic instruments will be a greater emphasis by the World Bank on *demonstration projects*. Even with the shift to greater use of budget-support and sector-wide program lending, project lending will remain a powerful tool for Bank assistance to borrower countries. The difference is that projects will now be used where they are most effective – in demonstrating the value of new approaches and building capacity. The stakes in development are too high, and the resources too limited, to allow us to carry out what might be called 'enclave projects'. These are projects that may have a positive effect within the confines of the project, but that lead to neither significant knowledge spillovers, nor the building of any capacity for the future. Indeed, if not carefully designed with fungibility concerns in mind, IFI efforts may simply displace the country's own earlier initiatives, so that in the end the IFI projects may have minimal net developmental effect.

By contrast, 'demonstration projects' not only have a significant direct effect but also spark similar reforms throughout an economy. The EBRD has been in the lead in developing the theory and practice of demonstration projects as a participant investor. In their language, they speak of 'transition impact'. They have shown that one can provide serious analysis and measurement that can guide project selection and strategic decisions. In the language of the IFC, the analogous term is 'development impact'. Both the EBRD and the IFC have done much to prove the value of the demonstration project: they have pioneered new approaches and explored new markets, highlighting the way for further private-sector initiative. It is not for me to pick the outstanding EBRD examples but I do remember the municipal utility projects in Central Europe, the equity in private banks in Bosnia just one year after the Dayton Peace Accord, and the trade facilitation program first developed in Russia in 1995. Obviously, if the IFIs are taking the risks that they should, then not every project will be a success, let alone have spillover effects. Nevertheless, every proposed project should be judged against a criterion of potential for spillovers.

These demonstration effects can apply across countries, as well as across states within a country. Indeed, one advantage of the IFIs is their ability to help propagate such spillovers. One recent example is the market-based land reforms in northeast Brazil, which have been implemented successfully in several states with World Bank support and are now being replicated throughout Brazil's poorer states. Indeed, this is a good example of *international* demonstration effects, since the original example came from South Africa, and the Brazilian example is now being emulated by other countries, including the Philippines and Guatemala.

Similarly, with World Bank support the Indian state of Karnataka is about to launch a state-level VAT, which will both establish a buoyant revenue base and, over time, reduce administrative harassment; Karnataka's example is likely to be followed by other states in India.

These instruments – programmatic adjustment and investment lending, and demonstration projects – are most effective when combined with other assets and instruments at the disposal of the IFIs. These include:

- extensive knowledge about what development approaches are effective in what circumstances, bred of cross-country experience and serious research;
- a concern for capacity-building, together with instruments to promote it;
- an ability to use well-designed conditionality to help countries commit to reforms; and
- a financial structure that is well suited to development assistance.

These additional tools provide part of the answer to the obvious questions about the IFIs and the private sector. How can the IFIs partner with the private sector, so that the latter can do what it could not otherwise do? Why cannot capital markets do the job of institutional reform and economic development?

Some pioneering development projects would be within the ambit of private investment, were it not for the great commercial, social and political risks which often accompany innovation in developing countries. The IFIs have capital structures that allow them to absorb part of these risks in partnership with private investment. Moreover, the relationship IFIs have with governments enables them to reduce political risks in ways that a private investor could not. First-time foreign investors might make an investment that they would otherwise avoid if they can rely on the prior knowledge, experience, relationships, and standing of an IFI in the country. Moreover, the IFIs can bring local project development experience to new private investors to help projects get off the ground.

How do we ensure that this support does not become a crutch? How can the assistance of the IFIs enable new private sector activity without creating an enfeebling dependency on international subsidies? This question goes to the heart of the current debate about the IFIs. Critics might argue that investors love to fill the holes in their otherwise unfundable projects with public monies, but that this distorts rather than strengthens market discipline. Similarly, investors would welcome the IFIs running their interference for them with the political authorities. But that would postpone the day when the rights of private entrepreneurship and investment will be respected. These are serious arguments that the IFIs must take to heart.

The answer lies in the developmental learning and demonstration effect. The involvement of the IFI is premised on the learning and capacity-building that it brings about – so that its involvement will subsequently not be needed. In this sense, the job of the IFIs is to continually work themselves out of a job, assisting countries in increasing their capacity to carry out development reforms, and gradually replacing IFIs' technical expertise with their own in the process. In

doing so, an IFI has to embody the impartiality that its public and international status can bring. That is, it has to work to improve the investment climate for all investors, small or big, domestic or foreign, and not just for those who are its current clients.

This answer speaks to the whole issue of the role of the IFIs in a world of globalized private capital flows. The capacity-building business of a public development institution is fundamentally different from that of a private business. Imagine a country that needs to build ten power plants at reasonable prices. For a commercial institution, repeat business *is* their business: the incentive is to build the first power plant in such a way that the country's government then commits to purchase the other nine plants from the same supplier. By contrast, our role as IFIs is to ensure that the country is able to build and operate its own power plants. Our involvement should therefore be geared toward building one power plant as a demonstration project, while also helping the country develop the institutional structure that will promote the construction and management of the other nine power plants.

We should yield to no one in recognizing the promise of the international private capital flows for growth and development. But we should with equal force assert the distinctive role of the IFIs: to assist client countries in fostering the institutional learning and the building of the investment climate that are necessary to design their own development successes, and to help ensure that the poor within those countries share in that great promise.

6. Conclusion

In conclusion, I would like not only to assert but also to celebrate the distinctive role of the IFIs. Too often, development institutions are seen or portrayed as agencies that think they are solving grand collective action problems but that are actually pursuing rather mundane and parochial ends. Yet such a picture does not tell the real story.

From the ancient Stoics onward, there has been the vision that we are all not merely citizens of our own *polis* but are also citizens of the world. There is a lower self that is indelibly marked by the accidents of birth and upbringing. But there is also a higher self that can overlook these particulars to recognize a common humanity. Countries, like individuals, are prone to see issues narrowly in terms of self-interest, and thus the IFIs are sometimes seen as simply devices to pursue the ends of the rich countries that are their dominant shareholders. We all – shareholders, management and employees – would be selling our mission short if we saw it this way.

The development agencies should be seen as, and act as, institutional mechanisms for countries to contractually bind themselves to pursue higher ends. In the IFIs, each member country is like an Odysseus binding itself to the

collective mast of international development and governance – and thus the country commits itself to resist the siren-songs of parochial interests in order to pursue that common good. For all its riches and promise, the world community is threatened by poverty and disease. The international financial institutions must now, more than ever, call upon their member nations to go beyond narrow interests and to replenish their common commitment to the overall development of humankind.

Our responsibility is all the more serious, given that we now know more than ever about what strategy is most effective in promoting development, as well as what role the IFIs can most usefully play as agents of change. Strategically, we know that we need to focus on improvement of the investment climate and empowerment of poor people. Operationally, we know that the most effective tools for achieving these reforms are projects with powerful demonstration effects and programmatic lending, always bound together with the knowledge, capacity-building, and mutual commitment that the IFIs can offer. This knowledge about what works is born from the experience of the EBRD and the World Bank, which have led the way in accumulating the experience and analysis on which this vision is based. The developing world has itself been drawing its lessons, and economic policies have improved markedly over the past ten years. The result is that, for the first time in decades, per capita income in developing countries is growing more rapidly than in advanced countries. This surge is far from uniform, but on average it is happening. Thus there are more favourable circumstances in the developing world; we have a deeper understanding of development; and we know more about how the IFIs can work most effectively. Our opportunity to make real progress in the fight against poverty has never been greater. To paraphrase Churchill, 'We have the tools; let's get on with the job.'

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