OVERVIEW

The last decade of the 20th century saw great progress in parts of the world. But it also saw stagnation and setbacks, even in countries that had previously achieved the fastest rates of economic growth. These gaping differences and sharp reversals teach us much about what contributes to development. At the center is economic growth, not just its pace but—as important—also its quality. Both the sources and the patterns of growth shape development outcomes.

Have those patterns been adequate for rapidly reducing poverty or improving the quality of people's lives? Why have so few countries sustained robust growth rates for prolonged periods? Why have some crucial dimensions—income equality, environmental protection—deteriorated in so many economies, both fast- and slow-growing? How does governance underpin the growth process? As answers, we offer three principles of development and a set of actions for enhancing the quality of growth processes.

Development Outcomes and Growth Processes

Development is about improving the quality of people's lives, expanding their ability to shape their own futures. This generally calls for higher per capita income, but it involves much more. It involves more equitable education and job opportunities. Greater gender equality. Better health and nutrition. A cleaner, more sustainable natural environment. A more impartial judicial and legal system. Broader civil and political freedoms. A richer cultural life. As per capita incomes rise, several of these aspects improve in varying degrees—but others do not. How can growth processes be influenced so that the qualitative dimensions of development outcomes also improve? This book explores these issues of faster and better growth.

A recent study, *Voices of the Poor: Can Anyone Hear Us?* (Narayan and others 2000), indicates that raising incomes is one part of poverty reduction. Greater security in life and a more sustainable environment are others. The experience of the past decades and the voices of the poor offer compelling reasons to emphasize these qualitative factors.

Indeed, from Bolivia, Egypt, and Uganda to Romania, Sri Lanka, and Thailand, the development community is broadening the traditional definition of poverty and welfare. Beyond an individual's or household's measured income, welfare includes opportunity, as assessed by the functioning of markets and investments and improvements in health and education. It includes security, as reflected by reduced vulnerability to economic and physical shocks. It includes empowerment, as evaluated by social inclusion and the voice of individuals. And it includes sustainability, as represented by the protection of the environment, natural resources, and biodiversity.

Economic growth has been associated positively with poverty reduction. Early assessments projected a growth rate for the developing world for the 1990s of a little over 5 percent, or about 3.2 percent per capita. They projected a reduction in the number of poor people of some 300 million, or an annual rate of decline of nearly 4 percent. But actual growth during 1991–98 was about half that, at 1.6 percent per capita. If the countries of Eastern Europe and Central Asia are excluded from these estimates (as in the above-mentioned projections), actual per capita growth is closer to projected growth, at 3.5 percent—with the number of poor people unchanged and the incidence of poverty down 2 percent a year (World Bank 2000a).

The poverty reduction associated with growth has varied widely, as have social progress and welfare improvements, whether in education, health, voice, or participation (chapter 1). Where growth has stagnated or declined, social and welfare dimensions have deteriorated. The widely differing measure in which growth contributes to welfare improvements means that there must be a direct concern for sustainable advances in welfare. It also means that the way growth is generated is very important. The quality of the growth process, not just its pace, affects development outcomes—much as the quality of people's diets, not just the quantity of food, influences their health and life expectancy. That is why it is essential to explore the complex interactions of the factors shaping growth.

The pace of growth has been more sustainable in developing and industrial countries that pay attention to the qualitative attributes of the growth process. Indeed, there is a two-way relationship between economic growth and improvements in social and environmental dimensions. Attention to the sustainability of the environment, for example, helps to deliver more sustained growth, especially where growth rates are highly variable and the negative impacts are particularly pronounced for the poor. This suggests a premium for steady growth rates over stop-and-go growth, even if the go includes short periods of fast growth. As countries exhaust the possibilities for increasing growth through market reforms, the qualitative factors supporting long-term growth become much more important.

These dimensions of the growth process often interact positively in a virtuous cycle. But there can also be some difficult tradeoffs between quantity and quality. Fast, temporary growth relying on such distorted policies as subsidies to capital, neglect of environmental externalities, and biased public expenditure allocations can actually diminish prospects for more sustained growth. Even more difficult to correct are situations in which growth conflicts with environmental and social sustainability, which both contribute directly to development. Managing these qualitative aspects becomes essential for achieving sustainable improvements in welfare.

What then is the quality of growth? Complementing the pace of growth, it refers to key aspects shaping the growth process. Country experiences bring out the importance of several such aspects: the distribution of opportunities, the sustainability of the environment, the management of global risks, and governance. These aspects not only contribute directly to development outcomes. They also add to the impact that growth has on these outcomes, and they address the conflicts that growth might pose to environmental or social sustainability. It is the mix of these policies and institutions shaping the growth process that is the main focus of this study.

Principles of Development

Viewing the quantitative and qualitative sides of the growth process together puts the spotlight on three key principles for developing and industrial countries:

- Focus on all assets: physical, human, and natural capital
- Attend to the distributive aspects over time
- Emphasize the institutional framework for good governance.

The Major Assets

Broadly speaking, the assets that matter for development are physical capital, human capital, and natural capital. Technological progress affecting the use of these assets matters as well. For accelerating growth rates, much attention has traditionally gone to the accumulation of physical capital. But other key assets also deserve attention—human (and social) capital as well as natural (and environmental) capital (box 1). These assets are also crucial for the poor, and their accumulation, technological progress, and productivity, along with that of physical capital, determine the long-term impact on poverty.

By focusing predominantly on physical capital, industrial and developing countries can be tempted to implement policies that subsidize it at a cost (chapter 2). This can create a situation that benefits vested interests and is hard to reverse. Meanwhile, from the social viewpoint there is

Box 1. Asset Accumulation, Growth, and Welfare

Figure 1 lays out a simple schema of how human (H), natural (R), and physical (K) capital contribute to economic growth and welfare. Physical capital contributes to welfare through economic growth. Human (and social) capital and natural (and environmental) capital also do that; they are also direct components of welfare.

Human and natural capital also contribute to the accumulation of physical capital by increasing its returns. Physical capital increases the returns to human capital and natural capital and, if markets reflect this, their accumulation. Adding to all this, investments in physical, human, and natural capital, together with many policy reforms, contribute to technological progress and the growth of total factor productivity, thereby boosting growth (chapter 2).

But policy distortions, corruption, misgovernance, market failures, and externalities can put countries on a path of distorted or unbalanced asset accumulation. This situation can hold income growth and welfare improvements below their potential. More specifically, it can lead to lower total factor productivity and underinvestments in

- Productive physical capital, by reducing the profitability of investment through bribes and red tape or by distorting the allocation of physical investments—say, toward certain lucrative contracts
- Human capital, by promoting such favored areas as the military and large infrastructure and by regressively reallocating public expenditures
- Natural capital, by undermining taxes, royalties, and regulations that could sustain natural resources.

Distortions, market failures, implicit government guarantees, and inadequate regulation can cause

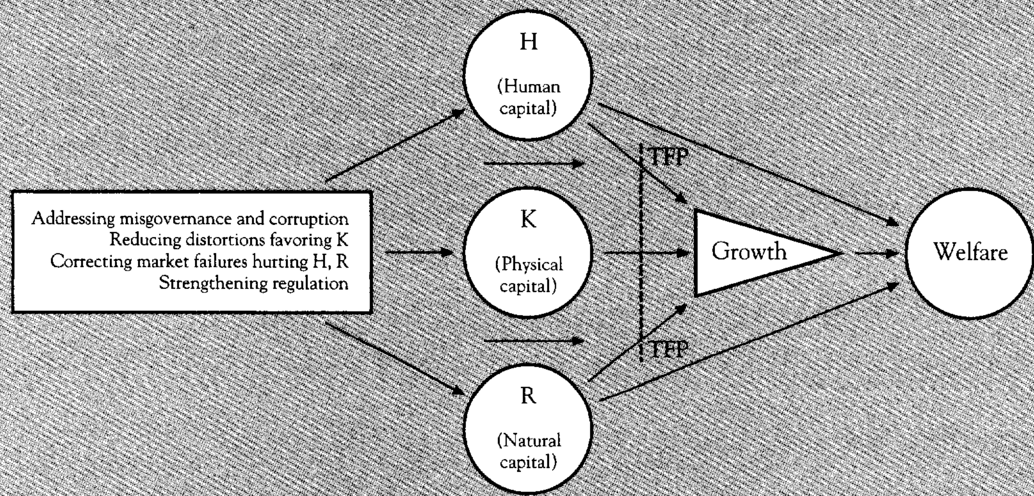
- Overinvestment or wasteful investment in physical capital by increasing the profitability of certain physical assets through guarantees—which influence risk-taking behavior by banks, corporations, and investors—and by lowering the value of certain natural resources
- Underinvestment in human and natural resources by underpricing these assets and by reducing resources devoted to them.

The effects of these policy distortions on the accumulation of human and natural capital relative to physical capital can reduce growth and welfare. Conversely, if corruption is controlled and governance is adequate, undistorted policies could boost asset accumulation, contributing to faster growth (chapter 6). So, by removing policy distortions, fostering good governance, and addressing market failures and externalities, countries can achieve less distorted, more balanced asset investments. And that can lead to more stable and sustained growth and to broadly based increases in welfare.

(box continues on following page)

Box 1 continued

Figure 1. A Framework



TFP Total factor productivity.
Source: Authors.

underinvestment in education and health (chapter 3) and overexploitation of natural capital, often because of its underpricing or weak property rights (chapter 4). At an aggregate level, (gross) subsidies to agriculture, energy, road transport, and water amounted to an estimated US$700 billion to US$900 billion in the early 1990s, about two-thirds of it in the industrial countries and one-third in the developing ones (de Moor and Calamai 1997).

Sustaining a relative dependence on physical capital accumulation could require continuing distortions. For example, as physical capital deepens, sustaining its rate of return could require larger public subsidies, for example, to attract foreign capital. Furthermore, accelerating growth through policies that lead to the overexploitation of forests and other natural assets runs down natural capital and hurts environmental sustainability. In 1997, gross domestic savings were about 25 percent of gross domestic product (GDP) in the developing world. Corrected for the depletion of environmental capital, however, genuine domestic savings were only an estimated 14 percent of GDP. This includes the case of Nigeria, with gross domestic savings of 22 percent but genuine savings of negative 12 percent, and the Russian Federation, with rates of 25 percent and negative 1.6 percent (World Bank 1999d).

A less distorted (more neutral or balanced) approach to the accumulation of the three types of assets is preferable. Policies can contribute to the accumulation of these assets. Investments in education at all levels, while helping to generate growth, also contribute to the accumulation of human capital and welfare. Investing in natural capital is essential to human health and, for the many poor people who depend on natural resources for their livelihoods, to economic security (chapter 4). As important as the accumulation of these assets is their efficient use. For that—and for greater total factor productivity of these assets—good governance, mitigating the undue influence of elite interests, and anticorruption actions are vital.

Distributional Aspects

This focus on quality brings to light the importance of distributional aspects to the growth process. A more equitable distribution of human capital, land, and other productive assets implies a more equitable distribution of earning opportunities, enhancing people's capacity to take advantage of technologies and to generate incomes. That is why a given growth rate is likely to be associated with better poverty outcomes in settings where educational opportunities are distributed more equitably (chapter 3).

Stability in growth outcomes over time is also likely to be important. The incomes of the poor can be very sensitive to cycles and crises, especially because the poor lack assets—land, skills, and financial savings—to smooth their consumption in bad times. Living barely above the poverty line, millions of near-poor have been thrown back into poverty by external shocks. So for growth to reduce poverty, it usually needs to be relatively stable, and its benefits need to be widely spread.

What, then, of the income gains expected from globalization in the 1990s? These have begun to materialize, but not everywhere. One reason is the inadequacy of regulatory and supervisory frameworks both at the global and country levels, and the overall lack of preparedness for participating in the global economy. Another is the volatility sometimes related to moral hazard and the responses of external players. A third is that, by some estimates, incomes in the last decade or so have become more unequal. Aims of development policy thus include reducing not only the inequality of opportunities, but also the inequality and volatility of growth outcomes. In this it is important to enhance financial risk management and reduce the sensitivity of poor people to changing economic fortunes (chapter 5).

The Governance Framework

The institutional structures of good governance underpin everything done to boost growth. The effective functioning of bureaucracies, regulatory frameworks, civil liberties, and transparent and accountable institutions for ensuring the rule of law and participation matters for growth and development. The effects of poor governance, bureaucratic harassment, and corruption are regressive and harmful to sustained growth. The capture of state policies, laws, and resources by elite interests often biases incentives and public expenditure toward less socially productive assets and, by eroding the benefits that would go to society, reduces the impact on welfare. Estimates of the "development dividend" in the form of higher incomes or better social outcomes are dramatic, in going from low levels of rule of law or high levels of corruption to even middling levels. (A difference in corruption levels of even one standard deviation can be associated with enormous differences in the development impact.) Thus investing in the capacity for better governance is a top priority for better economic performance (chapter 6).

A vibrant civil society—empowered by Internet computing tools, diagnostic survey techniques, and the latest information on governance—is indispensable in the fight against corruption and other forms of misgovernance. Civil liberties are not only linked positively to improved governance, reduced corruption, and increased productivity of public investments, but they also contribute to welfare directly. Indeed, attention ought to go beyond getting the government side of the equation right. It also needs to go to enhancing civil rights and giving greater voice to diverse groups, promoting competitive enterprises, and complementing top-down government policy reforms with bottom-up formulation and implementation of development strategies.

Neglected Actions in the Growth Process

While we now see the development process more broadly, there is often inadequate attention, especially in a crisis, to two of the three assets that the poor rely on: human and natural capital. This neglect in turn seems to have led to the neglect of some key actions:

- Improving the distribution of opportunities
- Sustaining natural capital
- Dealing with global financial risks
- Improving governance and controlling corruption.

Addressing them contributes not only to asset accumulation, but also to technological progress and greater total factor productivity.

Improving the Distribution of Opportunities

The main asset of poor people is their human capital. Of 85 economies examined, Poland and the United States (estimated to have the highest average years of schooling) have the most equitable distribution of educational attainment among people in the labor force. And the Republic of Korea recorded one of the largest improvements in educational equality over the past three decades. But inequality in education remains staggering, as in Algeria, India, Mali, Pakistan, and Tunisia.

The relation of any given growth rate to poverty reduction depends on the investments in people. The more equitable the investments, the greater the impact of growth in lowering the incidence of poverty, as seen in a comparison of the effects of growth on poverty across Indian states (Ravallion and Datt 1999). If people's abilities are normally distributed across the population, the skewed distribution of education and health outcomes would seem to represent especially large welfare losses to society as a significant proportion of people are deprived of opportunities to use new technologies and to lift themselves out of poverty.

A review of education spending for 35 countries finds it to be weakly related to educational attainment after controlling for incomes. In health, the United States, with the highest per capita health expenditure, ranks 37th among 191 countries in a measure of overall health system performance. France, with less than 60 percent of the U.S. per capita health expenditure, ranks first. Colombia, which is much further down in per capita health expenditure, ranks first in the category of fairness of financial contribution (WHO 2000). So spending on education and health services is not enough. Also demanding attention are the breadth and depth of human capital—its quality and equity, as measured by girls' education, access for the poor, and school attainment.

Governments need to reallocate public expenditure for basic education to ensure its quality and equitable distribution. Private-public partnerships need to be encouraged through market-based policies to increase efforts in education at all levels, including higher education. Also needed are supportive labor market policies and social protection policies. In addition, the human capital of the poor can be better applied by addressing the distribution of land and pursuing labor-intensive strategies in an open global environment (chapter 3).

Sustaining Natural Capital

Environmental degradation has worsened sharply. Contributing factors include population growth; domestic and global pressures on scarce resources; economic policies, for example, subsidies that ignore environmental consequences; and the neglect of local and global commons. The costs of environmental pollution and resource overexploitation are enormous; the losses in many cases are irreversible. Indonesia's forest fires—the result of human, policy, and natural factors—produced some US$4 billion in direct losses in 1997 and again in 1998, with extensive damage in neighboring nations. And it is poor people, because of their reliance on such natural capital as land, forests, minerals, and biodiversity, who suffer disproportionately from environmental degradation.

Few countries have adequately confronted the underlying causes of environmental and resource degradation—the policy distortions, market failures, and lack of knowledge about the full benefits of environmental protection and resource conservation. Growth and higher incomes can create conditions for environmental improvement by increasing demand for better environmental quality and by making resources available to meet that demand. However, only a strong combination of domestic and global market-based incentives, investments, and institutions can make environmentally sustainable growth a reality—as in examples from China, Costa Rica, Indonesia and many European countries (chapter 4).

Dealing with Global Financial Risks

Global financial integration has large benefits, but it also makes countries more vulnerable to hidden risks and sudden swings in investor sentiment. Volatile private capital flows seem to be associated with volatile growth rates, which hurt especially the poor, who lack the assets to weather an economic storm. To deal better with such risks, countries need to maintain sound macroeconomic policies. They also need to deepen domestic financial markets, strengthen domestic regulation and financial supervision, introduce corporate governance mechanisms, and provide social safety nets.

For all this they need sound institutions and strong capabilities, which take time to cultivate. Developing them, while opening a country's capital markets, can help deal with the risks for the financial system and the economy. In the meantime, as governments open their capital accounts, they can consider a spectrum of actions as in Argentina, Chile, Mexico, and elsewhere. One is to shun special incentives for short-term flows. Another is to set up reserve requirements and taxes for risky short-term flows. Yet another is to strengthen prudential regulation and supervision. International policy coordination and lender-of-last-resort activity can provide liquidity and emergency financial assistance (chapter 5).

Improving Governance and Controlling Corruption

Governance needs to move to center stage in institution-building strategies. That requires better analysis and measurement of the dimensions of governance and a clearer understanding of the vested interests of powerful groups. Where the legal and judicial frameworks are weak and vested interests have taken over the state policymaking and resource allocation apparatus, the social cost can be enormous. In that case the institution building needed for effective development interventions may be extensive, warranting an active approach.

Participation and voice would be vital for increasing transparency, providing the necessary checks and balances, and countering state capture by the elite. The engagement of civil society in participatory and transparent processes with reformists in the executive, legislative, judiciary, and private sectors can make the difference between a well-governed and a misgoverned state, between a stagnant and a thriving society. A rigorous understanding of governance would need to be supported by new technologies (as in Albania, Bolivia, Georgia, Latvia, and several African countries).

Creating a climate for successful development thus requires an integrated approach linking economic, institutional, legal, and participatory elements: building transparent and effective institutions for budgeting and public investment programs (as in Australia, New Zealand, and the United Kingdom), as complements to macroeconomic policies; establishing merit-based public administration (as in Malaysia, Singapore, and Thailand) and efficient and honest customs and procurement agencies; and promoting civil liberties and popular participation (chapter 6).

Shifting Priorities

Why focus on quality when the pace of growth is slow in many parts of the world? Growth has been modest in many countries—about 1.6 percent per capita for low- and middle-income countries since the 1980s and lower still when China and India are excluded. Some countries are also facing or coming out of financial crises. In these circumstances, the issue is not one of quality *or* quantity. Both are essential, and both are involved in a two-way relationship.

A relative shift in priorities could boost the pace of long-term growth. Investments in human capital—education, health care, and population policies—can directly improve the quality of life. They can also improve investment incentives through the effect of a healthier, more educated work force on the productivity of capital. So shifting the emphasis more toward human capital could promote faster growth in the long run. The key point? A focus on the quality of outcomes could help to sustain more rapid growth.

Addressing the quality dimensions that contribute to the pace of growth can in turn enhance welfare directly. For example, less air and water pollution or less degradation of natural resources, in addition to contributing to growth, enhances welfare directly by improving health or providing greater opportunities for income and consumption.

This book shows that some processes and policies in developing or industrial countries generate economic growth with greater equality of human development, sustainability of the environment, and transparency of governance structures. Others do not. Furthermore, sequencing actions is unlikely to be effective—whether liberalizing first and regulating later, privatizing first and ensuring competition later, growing first and cleaning up later, or growing first and providing civil liberties later. To do the most for long-term growth, liberalization, for example, needs to go together with regulatory actions, environmental management, and anticorruption measures.

Defining the Shift

The actions focusing on the quality of growth need to be a core part of the policy package, not add-ons to an already crowded agenda. That means that stakeholders will have to augment actions by governments, shifting the emphasis to

- *Asset accumulation and use*, by reducing policy distortions, for example, those favoring or subsidizing physical capital, while complementing markets in valuing natural resources and investing adequately in human resources. The implication is to ensure broadly based, sustainable growth, not to slow growth.
- *Regulatory frameworks*, by building regulatory frameworks for competition and efficiency to accompany liberalization and privatization and giving legal and judicial reforms greater attention, while ensuring macroeconomic stability. The implication is to take supportive regulatory actions along with liberalization, not to slow liberalization.
- *Good governance*, by nurturing civil liberties, participatory processes, and accountability in public institutions; promoting anticorruption efforts; and actively involving the private sector to reduce the influence

of vested interests, while building capacity for policy changes. The implication is to increase the attention to coalition building in civil society, not to detract from government policy and capacity building.

Making the Shift—Now

How can more and better investment in people and natural capital be financed? In several ways. First, improving governance, reducing rent-seeking and corruption, and encouraging greater corporate responsibility can increase national savings. Second, increasing the charges for the use of natural resources and taxing such externalities as pollution can make more resources available for development. Third, reducing distortions that favor physical capital can be beneficial—as with much of the experiences in removing such distortations. It can allow a reallocation of national savings in favor of human development. And fourth, reducing subsidies within sectors for services that are regressive or damaging to the environment can reallocate public resources to benefit the poor or to promote sustainable development.

In sum, this book supports broadening the focus of actions to encompass a comprehensive development framework, a qualitative and fuller agenda involving structural, human, social, and environmental aspects of the growth process. This broader focus complements liberalization with a build-up in the assets and capabilities of the poor. It shifts attention from an exclusive reliance on government as the agent of change to the engagement of all parts of society. And it requires much more effective capacity building across the board.

With all development partners complementing one another, a more integrated framework can be implemented more effectively. First, the large inequalities in opportunities—especially in education—if addressed now, present the greatest promise for welfare gains to society. Second, the environmental damage and biodiversity losses from current growth patterns are frightening, but if they are addressed now, growth can achieve a better natural environment and reduce the number of poor. Third, globalization presents risks to the poor, but if those risks are addressed now, globalization could make possible the technological wherewithal for reducing poverty. Fourth, corruption, misgovernance, and a lack of civil liberties and voice threaten the gains from any action, but if those threats are addressed now, better governance presents great promise of improved welfare.

The opportunities afforded by increased openness, knowledge, and technologies have never been more plentiful. Equally, the challenges of poverty, population growth, environmental degradation, financial distress, and misgovernance have never been greater. Needed is more growth with a focus on quality. This is not a luxury. It is crucial for countries to seize the opportunities for a better life for their present and future generations.