

# SEIZING THE OPPORTUNITIES FOR CHANGE

*We must use time creatively, and forever realize that the time is always ripe to do right.*

—Nelson Mandela, *Higher Than Hope: The Authorized Biography of Nelson Mandela*

**T**his book has revisited the development experiences of recent decades, with a focus on the 1990s. The final decade of the 20th century saw striking progress in parts of the world, but also stagnation and reversals, even in countries that had previously enjoyed rapid growth. As prosperity spread and the quality of life improved for many in society, poverty is estimated to have persisted stubbornly or worsened for others. Greater population pressures, little access to education, and degraded natural resources made the poor increasingly vulnerable to the volatility of growth.

Between 2000 and 2010, the population of developing (including transition) economies is projected to grow from 5 billion people to 6 billion. If countries follow a business-as-usual scenario, the number of people in the developing world (excluding China) living below the poverty line could swell by some 130 million. This book addresses ways to improve future outcomes.

## **The Framework and Themes**

Human, natural, and physical capital assets are a country's main resources for growth and welfare improvements. Their distribution, growth, and productivity largely determine people's income and welfare. The poor rely on

human and natural capital in addition to physical capital, so the accumulation and productivity of these assets have a strong impact on poverty. Surveys show that “the poor rarely speak of income, but focus instead on managing assets—physical, human, social, and environmental—as a way to cope with their vulnerability” (Narayan and others 2000).

Growth based on relatively undistorted (or balanced) accumulation is likely to be less volatile and to be sustained over the long term. This theme is supported by the country evidence in chapter 2. First, a comparison of reformers and nonreformers showed that reforms helped to accelerate growth in the 1990s; however, this growth (in many instances) was based on a sharp rise in physical capital accumulation, while investments in human and natural capital lagged behind. Second, an econometric analysis of 20 mostly middle-income countries showed that the *rate* of economic growth declines as the stock of physical capital increases for given levels of human and natural capital, but the accumulation of human capital assets, by increasing access to education and health care, can arrest this decline. Third, an econometric analysis of 70 developing countries confirmed the previous findings about capital accumulation and showed that when natural capital is also considered as a factor of production, human capital can substitute for natural capital to some extent and reduce dependence on it as a source of growth.

### *Improving the Distribution of Opportunities*

For growth to reduce poverty effectively, the assets of the poor need to be augmented. Their main asset is their human capital. Yet, inequality in education is staggering. If capabilities are normally distributed across the population—regardless of whether people are rich or poor—the inequality in accessing basic education and jobs would represent one of the greatest welfare losses to society. When the quality of schooling is low and the inequality in schooling is high, the poor are hurt most by inadequate education. The underinvestment in the human capital of the poor is attributable to wealth gaps, gender gaps, market failures, and policy distortions.

In addition, many countries have not adequately focused public investment in basic education. A reallocation toward basic education is needed to improve the efficacy of public spending. Education at all levels, including higher education, needs to benefit from private investments and public-private partnerships. Decentralized decisionmaking and community-managed schools hold great promise for improving education outcomes. However, to make education more productive for the poor, they need to be empowered with land, equity capital, training, and job opportunities in open and competitive markets (chapter 3).

### *Sustaining Natural Capital*

Several indicators of the quality of natural capital, with the notable exception of access to clean water and sanitation, have tended to deteriorate in both slow- and fast-growth economies. For the developing world as a whole, depletion of natural capital (forest, energy, and minerals) and damage from carbon dioxide emissions is estimated at 5.8 percent of GDP. This deterioration of natural capital imposes significant current costs and diminishes prospects for future growth. Faster growth has the potential to make more resources available to invest in natural capital accumulation, but actions are needed to ensure the quality of the growth process. Thus, the grow-now-clean-up-later approach needs to give way to an environmental policy that is integrated with growth policies.

The book documents successful initiatives that simultaneously incorporated actions to stimulate growth and protect natural capital. These measures often involve selective state interventions and focus on collaborative approaches with local communities and the private sector. Global and national problems can be simultaneously addressed through international cooperation, including transfer mechanisms for payments to compensate for global externalities. As a consequence, the pursuit of high-quality growth is possible, and desirable, without extensive degradation of the atmosphere, forests, and rivers, or any other aspects of natural capital (chapter 4).

### *Dealing with Global Financial Risks*

Integration with the global financial system has undeniable technological and economic benefits for countries, but it also exposes them to shocks and to great volatility in currency values, interest rates, and capital flows. The shocks can bring about important output and job losses, corporate and banking distress, and increased poverty. Thus, countries need suitable mechanisms to balance the benefits of globalization with its risks. They must reduce the risks of panic and crises, while maintaining their commitment to market openness.

A sound macroeconomic policy environment is essential to sustained growth, but recent experience shows that macroeconomic stability cannot do it alone. It must be complemented by actions to remove the explicit or implicit government guarantees that provide incentives for short-term capital inflows, to strengthen domestic regulation and supervision of banks and other intermediaries, to rebuild the information infrastructure of financial markets, and to improve corporate governance and transparency. Countries must also maintain public support for open capital markets. In democratic countries this entails providing insurance to citizens—either through the

marketplace or through redistributive public expenditures on education, health, and transfer payments (chapter 5).

### *Improving Governance and Fighting Corruption*

Government has a key role in delivering the public goods essential for achieving balanced and sustained growth and for reducing poverty. It also needs to have effective and streamlined regulatory regimes to address externalities and market failure. Misgovernance and corruption distort policy-making and the allocation of key production factors, consequences that slow income and welfare growth and increase poverty. Many development projects and investments have failed because too little attention was paid to fostering good governance and civil liberties, controlling corruption, improving the bureaucracy, and building institutional capacity.

Participation by beneficiaries, attention to the voices of people and competitive enterprises, and accountability and transparency in governments are vital to controlling corruption and improving governance. New approaches to coalition building and the integration of the latest methods of governance and corruption surveys with new technologies for timely analysis and dissemination are producing encouraging results in some countries. Collective action from such a participatory consensus-building process, coupled with the power of information, disclosure, transparency, and knowledge and capacity building, can nurture the political will and technical ability to address misgovernance and sustain institution building (chapter 6).

### **Actions to Ensure Quality**

The emerging themes help clarify four dimensions that shape the quality of the growth process: distribution of opportunities, sustainability of the environment, management of global risks, and governance (box 7.1). These elements directly contribute to development. They have a two-way relationship with growth, they add to the impact of growth on welfare, they help make growth more sustained, and they address the conflicts that growth might pose to sustainability.

The book provides evidence from a range of areas and sources showing that a focus on quantity will not in itself ensure quality. So public spending levels alone cannot give an adequate indication of impact. In a WHO study that ranks 191 countries on the quality (including fairness and broad coverage) of their health systems, the United States is 1st in health expenditure per capita but 37th in overall health system performance. France—4th in

**Box 7.1. Actions for Quality**

What might be the policy implications for ensuring quality growth? The book has presented several, which can be organized under three principles.

**Policies for Undistorted Growth of Physical, Human, and Natural Capital**

- Avoid direct or indirect subsidies to capital, such as tax breaks, allocation of monopoly powers and subsidies, special privileges that feed corruption, and implicit guarantees on rates of return.
- Invest efficiently in human capital and ensure access for the poor through incentives and allocation of public investments in education.
- Sustain natural capital by clarifying property rights, avoiding unrealistically low levels of royalties for natural resources, and enforcing environmental taxes.

**Attend to the Stability and Distributive Aspects of Growth**

- Ensure that the poor can access education, technology, and health services, as well as

land, credit, skills training, and job opportunities in open markets.

- Ensure effective regulatory frameworks and anticorruption measures to accompany financial openness and privatization.
- Align reforms and restructuring to mechanisms for mitigating the costs of crises, which will likely be borne disproportionately by the poor.

**Build the Governance Framework for Development**

- Involve all stakeholders—the private sector, including transnational firms and the domestic private sector, NGOs, civil society, and the government—in implementing a commonly shared development agenda.
- Empower people through voice, participation, and greater civil and political liberties.
- Support economic liberalization by promoting institutional development and better governance.

per capita expenditure—is 1st in performance, Colombia is 22nd, Chile 33rd, Costa Rica 36th, and Cuba 39th (WHO 2000).

The book also shows the effects of market failures. On the ability of the poor to build human capital. On the undervaluation and subsequent overexploitation of natural capital. And on undue instability in financial markets. A focus on quality highlights the role of regulatory policies and public expenditures in dealing with these market failures.

The answer is not necessarily to increase the regulatory burden of the economy or to increase public expenditures. Instead, it is to reallocate public expenditure following new priorities and to change the nature of regulation—eliminating regulations that are counterproductive and improving those that address market failures. What should be the new public expenditure priorities? Do more to promote the buildup of human capital, especially among the poor. Invest more to prevent further degradation of

natural capital and reduce regressive subsidies benefiting physical capital. Target regulations at failures in financial markets and in markets that affect the use of environmental resources.

### **Where Have the Policies for Quality Worked—or Not?**

There is no single setting in which the attributes of quality have been emphasized with uniform success. However, the following four country experiences illustrate the pursuit of quality aspects of growth, with varying degrees of effectiveness.

#### *Investing Efficiently in Basic Education: The Republic of Korea*

Starting with a war-torn economy and a poor natural resource base, Korea had an average annual GDP per capita of just over US\$500, based on 1980 PPP dollars, in the late 1950s. GDP per capita then doubled in each of the next three decades, driven by relatively broadly based, export-oriented growth. The growth was accompanied by rapid poverty reduction and relatively equitable income distribution (Leipziger 1997).

Korea spent an average of 3.4 percent of GNP on public education in the 1980s, which was in line with the regional average. However, unlike other developing countries, Korea spent two-thirds of its education budget on compulsory basic education in the 1960s and early 1970s. In the 1990s, public subsidies to primary school students were two to three times those to college students. Tertiary education was financed mainly by private spending. Korea was able to expand basic education rapidly and reduce educational inequality, as measured by a drop in the education Gini coefficient from 0.55 in 1960 to 0.22 in 1990.

The Korean government supported favored industries through directed lending, subsidies, and guarantees. In liberalized but inadequately regulated environments, these measures led to excessive foreign borrowing and wasteful investment by the corporate sector and intensified financial fragility. Both positive and cautionary lessons can be drawn from the Korean experience.

#### *Broad-Based Growth within an Incomplete Agenda:*

##### *Kerala, India*

On such dimensions of social development as education, health, the gender gap, civil and political liberties, poverty reduction, and inequality, the development performance of Kerala, India, is comparable to that of much

richer economies. A baby born in Kerala can expect to live longer than one born in Washington, D.C. However, Kerala's measured economic growth has, until recently, been lower than average among Indian states.

Kerala attended to the qualitative aspects of development while neglecting first-generation, growth-oriented policies. For balanced asset growth, market-friendly economic policies need to complement social initiatives. The lack of progress in implementing an open and competitive environment for economic activities has hindered economic growth in Kerala. Once these first-generation policy reforms are implemented, the high level of social development should provide a basis for sustained high-quality growth.

Ravallion and Datt (1999) found that the poverty-reducing impact of growth varies with initial literacy, farm productivity, and standard of living in rural areas relative to that in urban areas. In states with high literacy rates and equitably distributed basic education every additional percentage point of growth has a stronger impact on poverty reduction than is the case in other states. The elasticity of poverty reduction to nonfarm growth in Kerala was the highest of all states in India. If all Indian states had Kerala's elasticity of poverty reduction, the share of their people in poverty would have fallen nearly three times as fast—at 3.5 percent a year, not 1.3 percent.

### *Balancing Economic Growth and Sustainable Natural Capital: Costa Rica*

Costa Rica has a high literacy rate, economic and political stability, and no military budget. Income distribution and social indicators are among the best in Latin America. Yet the country needed to address several environmental problems, from urban pollution, excessive agrochemical use, and overexploitation of fisheries to biodiversity loss and a deforestation rate in the 1980s estimated at 3 percent a year.

Costa Rica responded with an innovative and comprehensive system of forest protection. A system of compensation through markets for carbon sequestration, watershed conservation, and biodiversity protection has helped protect forests. The system generates its own resources through a dedicated fuel tax on domestic consumers, contracts with hydropower utilities, and payments by international parties for carbon emissions offsets.

The Ministry of Environment and Energy has supported research-based policy reforms for environmental protection and environmental education programs for schoolchildren. Environmental impact assessments are mandatory for most projects, including commercial and residential construction and mining. The law sets strict guidelines on protection of water resources,

wetlands, natural monuments, protected natural areas, and marine and coastal resources. It also sets strict guidelines on all types of pollution and on abuse of land and improper waste disposal. The plan now is to increase the effectiveness of the laws, to strengthen the capacity of institutions responsible for enforcement, and to enter into partnerships with the private sector and civil society (Thomas 1998).

***Balancing Openness, Risk Management, and Social Protection:  
Chile***

After a decade of rapid opening of markets and volatile growth in the 1980s, Chile took measures for risk management in the 1990s. First, Chile implemented a highly targeted system of social assistance through health, education, and housing programs and income transfers. The government's social investments increased by 75 percent between 1987 and 1994, which, complementing robust economic growth, made solid contributions to poverty reduction. Second, as capital flows became more volatile, the independent central bank implemented selective capital controls on short-term capital inflows between 1991 and 1998. Arguably, they have helped to increase the wedge between domestic and foreign interest rates and change the composition of capital inflows toward longer maturities (Gallego, Hernandez, and Schmidt-Hebbel 1999).

These and other policies have contributed to rapid economic growth with a significant decline in poverty. The incidence of poverty fell from 41 percent of the population in 1987 to 23 percent in 1994, while the incidence of severe poverty (based on a lower poverty/indigence line) fell from 13 to 5 percent. Income inequality seems to have stabilized since 1987, after rising during most of the 1960–85 period (Ferreira and Litchfield 1999). However, natural resources have been underprotected and overexploited. In addition, the distribution of education has become less equitable, as reflected by a widening gap in years of schooling between the rich and poor (World Bank 1997b).

**Political Economy of Quantity versus Quality**

The varied experiences of economies suggest that an emphasis on quality is essential on three counts. First, quality directly promotes well-being by influencing a more even distribution of education and health care and an improved environment. Growth and quality aspects—linked to each other in a two-way relationship—need joint attention.



Second, the pace of growth is less volatile and more sustainable when quality aspects are considered. Where growth rates are highly variable over time, the negative impacts are especially pronounced for the poor.

Third, economies that focus on quality can deal better with difficult tradeoffs. One tradeoff mentioned in this book is the temptation to subsidize physical capital or overexploit natural capital in an effort to promote growth. In this and similar cases, a focus on the qualitative aspects of growth helps to manage the tradeoffs.

Most countries—and much policy advice—have stressed macroeconomic stabilization and liberalization first. Meanwhile, actions on the qualitative aspects, such as the distribution of education and the sustainable use of natural capital, are postponed. The evidence presented here shows the fundamental limitations of this approach and the benefits of joint action.

Reformers have sometimes found it necessary to take advantage of windows of opportunity for liberalization, when vested interests and opposition to liberalization have been muted. Whether the qualitative dimensions also receive priority may depend on other conditions, including the spread of democratic institutions. In an increasingly mature and participatory setting, a country would not want to postpone the important qualitative aspects of growth to a time when the costs of addressing them will have multiplied.

Sometimes, political difficulties can impede progress, even when the importance of the qualitative aspects is clear. Interest groups may drive a wedge between policy design and implementation. Collusion between politicians and the elite may distort the allocation of public resources to reward the owners of physical capital. For example, tax holidays, implicit guarantees on infrastructure, monopoly powers, and easy access to natural resources often benefit the rich, but hurt the poor.

The political economy of reforms, less explored than other aspects of growth, is an area difficult to evaluate. Yet some initiatives seem unambiguously to be worthwhile. Fostering beneficiary participation, encouraging country ownership of reform programs, and promoting political representation of the poor are a good beginning.

## **Going Forward**

How can countries accord greater priority to the quality dimensions of growth? And how can they finance and support such objectives in practice? Several observations drawn from the discussion in this book can guide efforts in that direction:

- Explicit attention to ensuring transparency and reducing corruption and rent-seeking will not only raise national saving and investment and promote sustained growth, but will also help to distribute its fruits more equitably.
- Some quality dimensions lend themselves to full-cost pricing or taxation, both of which generate public resources.
- Other measures to ensure quality require a reallocation of public expenditures—reducing subsidies and distortions in some areas and increasing public investment in others.
- Attending to quality does not have to mean more government intervention, but rather may mean more involvement of the private sector, nongovernmental organizations, and civil society in implementing shared goals.
- Broader civil outreach can nurture civil liberties and participatory processes that can help to sustain policy changes.
- All this in turn would call for a much greater focus on skills, technological development, and capacity building and the effectiveness with which this is done.

The evidence in this book provides strong motivation for focusing on the quality aspects marking the ability of people to shape their lives—for example, the equality of opportunities for human development, sustainability of the environment, management of global risk, and the manner of governing—along with the traditional facets of growth. Governments do not have to assume the entire burden of giving greater priority to the quality dimensions—nor should they.

Rather than calling for more government intervention, the evidence in this book calls for greater voice and participation by the private sector, NGOs, and civil society. A broader involvement by all can move the emphasis of development beyond measured GDP growth to include social and environmental progress, greater empowerment and voice, and better governance. This reallocation of priorities will refine the contribution of the qualitative aspects of the growth process and focus the spotlight on what development truly means.