

Dynamic Development: Innovation & Inclusion

Lecture 3: Toward a Dynamic Public Economics

Munich Lectures in Economics

Center for Economic Studies

Ludwig Maximilian University, Munich

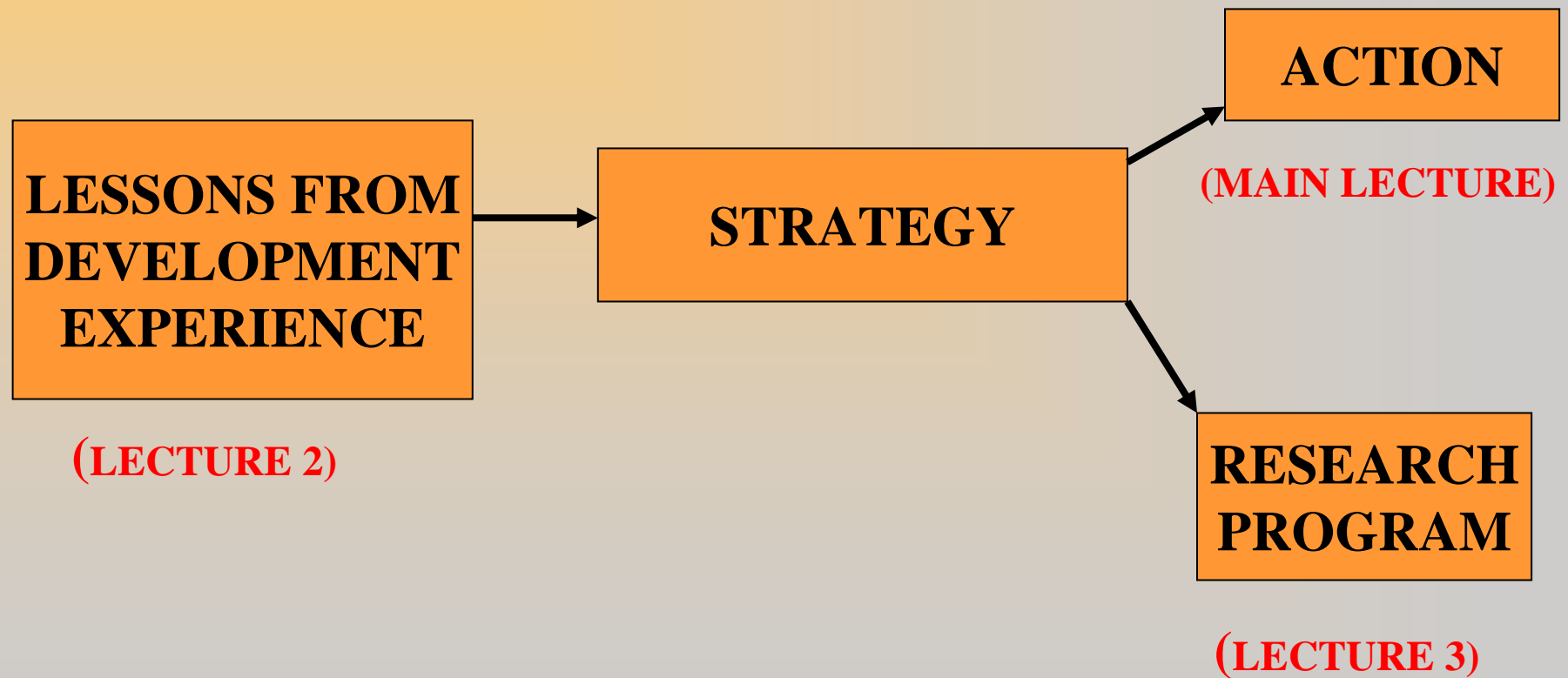
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STRUCTURE OF THE MUNICH LECTURES



Six Lessons from Development Experience

1. State necessary complement to markets

Growth

2. Growth as an engine of poverty reduction

3. Role of the private sector (incl. SMEs)

4. Key role of international trade

Development Effectiveness

5. Importance of empowerment and participation

6. Importance of ownership of reform process

Two Pillars: Strategy for Public Action

- ★ Improve investment climate to create conditions for entrepreneurship and productivity--particularly for SMEs;
- ★ Empowering people through education, health, social protection, and effective participation--to make and participate in the decisions that shape their lives.

Foundations

- ★ Growth theory: more about accumulation than acceleration,
- ★ From earlier theory, Smith, Marshall, Allyn Young, Kaldor, Jane Jacobs & others emphasize increasing returns dynamics of growth:
 - Smith's returns to deepening division of labor,
 - Marshall's external economies and agglomeration (e.g., industrial districts)
 - Young: more efficient special machinery w/scale
 - Kaldor: incr. returns in industry, e.g., surface/vol.
 - Jacobs/Lucas: external effects/interactions of human capital.

From Growth to Development

- ★ From government “big push” of planning (e.g., Rosenstein-Rodan and Mahalanobis)
- ★ To entrepreneurs moving “forward on a broad front” (Nurkse) in self-reinforcing investment climate dynamics (Schumpeter and Hirschman).

Public Economics

- ★ Market & government failures
- ★ Not either/or: complementarity of government & market
- ★ Size & distribution of cake issues
- ★ Focus on information and shape of incentives
- ★ Austrian view of markets as a competitive process of discovery & innovation: Mises, Schumpeter, von Hayek, Kirzner

The Research Agenda

- ★ From Theory to Data Sets
- ★ From Strategy to Research
 - Empirical Research
 - Dynamics of Investment Climate
 - Dynamics of Preferences
 - Dynamics of Political Reform
- ★ From Research to Action
 - SMEs, Growth and Poverty
 - Design of Public Actions
 - Strategies for Institutional Development

From Theory to Data Sets

- ★ Theories should suggest which data would capture drivers of development (Koopmans / Kant)
- ★ Growth models with aggregate data sets--which led to more 'regression' than progression.
- ★ Standard public economics used HH data on impact + aggregate demand & supply functions
- ★ Public economics of development should be based on: IC, Basic Services & other HH surveys.

From Strategy to Research: Empirical Research I

★ Investment climate surveys:

- By next year, IC surveys in 30 countries
- Guangzhou vs. Chengdu: bribes = 1% vs. 4% of sales
- China vs. Pakistan: customs clearance 9 days vs. 18 days; or telephone connection in 17 days vs. 72 days.
- Maharashtra vs. Uttar Pradesh: Twice as many "visits" by officials in UP and 44% vs. 98% firms with own generators.

Empirical Research II

- ★ Basic service delivery surveys:
 - Public Expenditure Tracking Surveys (PETS) in Uganda, Tanzania, Ghana, and Honduras
 - Citizens' Score Cards on Public Services:
 - Bangalore
 - Ukraine People's Voice
 - Report Card on Pro-Poor Services in Philippines ...
 - Women *pradhans* in Indian village councils
- ★ Next WDR: *Making Services Work for Poor People*

Dynamics of Investment Climate

- ★ Modeling changes in IC--Keynes' "state of confidence...congenial to average business man"--with positive feedback effects.
- ★ Modeling dynamics:
 - 1) Models with self-reinforcing IC changes.
 - 2) Models with low & high equilibria: big push in IC to move from low to high equilibrium.
 - 3) Models where good IC helps: (a) creating ideas and (b) diffusing ideas (learning by watching).
 - 4) Political economy "turning point" models with IC-related interventions that "tip" and sustain positive changes.

Dynamics of Preferences

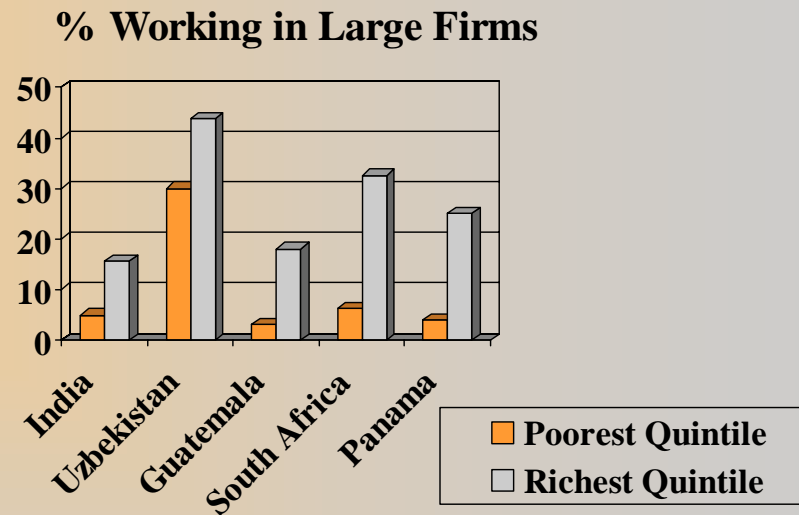
- ★ Choice going beyond model w/ “given” preferences:
 - Education/health experiences that change world-views(*Weltanschauung*)--e.g., girls' education: merit goods + info + preference change.
 - Addictive behavior
 - Learning ways of living (HIV/AIDS and family planning)
 - Leadership (Mrs. Gandhi);
 - Extreme situations
 - China: from “profit is wrong” (old & new mandarins) to “Getting rich is glorious” (Deng Xiaoping).
- ★ Social consensus created by endogenous modification of preferences through "government by discussion" (J.S. Mill).

Dynamics of Political Reform

- ★ Building constituency for reform since reform often yields some benefits for almost all but may hurt a few a lot (Machiavelli)--so aiming at one or a few reforms at a time avoids mobilizing all opponents at once.
- ★ Past US and Latin America and Russia today: Elites & oligarchs lock-in structures benefiting only today's winners.
- ★ Mao built constituency by giving land to peasants but extracted tax while Chiang's troops acted as roving bandits.
- ★ India 1800s: effects of two kinds of stationary bandit taxation:
 - Peasant land + taxation by authorities evolved toward farmers' ability to learn & better productivity a century later.
 - Taxation by landlord-zamindars who exerted control so farmers took little responsibility & didn't learn to learn. (Banerjee)

From Research to Action: SMEs, Growth and Poverty

- ★ Most working poor people find work in SMEs (including farms), not large firms



- ★ SMEs suffer most from bad investment climate & respond most strongly with improvements
- ★ SMEs bring flexibility, observability, and “disruptive innovations”; large firms often seek to improve only yesterday’s products.

Promoting SMEs

- ★ From Micro to Small and Medium-sized:
 - Breaking out of “informality trap”: role of second-order orgs to support SMEs (e.g., 3rd Italy) + de Soto
 - Industrial parks of new start-ups (e.g., post-liquidation)
 - Financing SMEs: e.g., EBRD’s “Small Business Credit Bank” in Russia
- ★ From Large to Medium-sized
 - Restructuring dinosaurs: spin-offs of viable parts.
- ★ Example of Slovenia: Over the decade, many more small firms created and large firms trimmed down to move closer to EU average of size distribution.

Design of Public Actions

- ★ Recall total aid < 1% of total LDCs' GDP.
- ★ Hence importance of changes to policies, governance & institutions.
- ★ Demonstration projects: innovation + evaluation
- ★ General principle of IFI public action:
 - Should *ex ante* empower people to change, e.g., finance part of costs of change;
 - Should not *ex post* 'reward' failure to change, e.g., should not pay costs of not changing.

Types of Reform: Institutional Implications

- ★ Top-down reform can work for certain highly specific reforms where new law is mostly self-executing, e.g., tariff cuts or tax reforms;
- ★ Reforms that need not only new laws but broad changes in behavior require time and bottom-up support, e.g., corporate governance, or, in general, rule of law.

Strategies for Institutional Development: I

- ★ Innovation & learning triggered by:
 - Transparency, e.g., PETS in Uganda or publishing pollution indices in Mexico City,
 - Analytical evidence, e.g., spurring trade, education, health reforms in many countries &
 - Visible examples, e.g., spread of HR system in rural China or spread of Green Revolution.
- ★ Avoid policies to 'institutionalize' opportunities for corruption (e.g., quotas and licenses).

Strategies for Institutional Development: II

- ★ Public action by policy/social entrepreneurs:
 - Muhammad Yunis of Grameen Bank
 - Hernando de Soto: informal to formal property rights
 - Ela Bhatt of Self-Employed Women's Assn (SEWA) India.
 - Ali Amahan of Assn. Ait Iktal du Développement in Maroc.
- ★ Press and media: govt by discussion in civil society.
 - Independent & multiple owners in media
 - Striking down licensing and insult laws used for govt control
 - Role of democracy and public media w/famines (Sen)
 - Broadcast of corruption video brought down Internal Security Minister and then the President in Peru.

Strategies for Institutional Development: III

- ★ Creation of constituencies for reform and change (SMEs and middle class)
- ★ Without conviction, conditionalities unlikely to deliver institutional change and ownership,
- ★ “But, though a nation may borrow its tools from abroad, for the energy to handle them it must look within. ‘Erquickung hast du nicht gewonnen, Wenn sie dir nicht aus eigener Seele quillt.’ ”
[R.H. Tawney (quote from *Faust*, 1st Part), 1932]

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Conclusions

- ★ Never before a better opportunity to take informed action in development &
- ★ Make a difference by scaling up efforts.
- ★ Throughout, “ideas...are more powerful than is commonly understood. Indeed, the world is ruled by little else.” (Keynes)
- ★ Hence importance of academic community to use its natural leverage of ideas to help meet the challenges of development.