Reform, Investment Climate and Economic Growth

Address by Nicholas Stern
Senior Vice President and Chief Economist
The World Bank

Event hosted by the ICRIER, New Delhi, India
March 27, 2001

Introduction

It is always special for me to visit India, a country that I have been visiting for more than 25 years, of which I am very fond, and where I have so many friends. But this visit carries a sadness that I know we all share. On many of my visits, including the last one in November, I saw Pravin Visaria. I had always been happy to see him— to discuss anything and everything. This time I was looking forward to talking, as often before, about the poverty data. Pravin was an outstanding scholar of the first rank, and a wonderful man. India, the world, and all his friends have suffered a great loss. Above all, our thoughts and warmest wishes go to his family at this very difficult time. We will all be inspired by his memory, and he will stay with us in so many ways. I would like to dedicate this lecture to him. Let us discuss economics and policy as Pravin always would.

My topic today is "Reform, Investment Climate and Economic Growth." The last decade of the twentieth century saw a remarkable acceleration in the pace of globalization. By globalization, I mean the growing integration of economies and societies through the cross-country flows of information, ideas, activities, technologies, goods, services, capital, and people. The history of India, which has been home to diverse peoples and cultures for many centuries, teaches us clearly that globalization is not a new phenomenon. 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 percent last year, the most rapid rate of increase since the first oil shock of the early 1970s.

The main theme of my talk will be that this increased integration provides tremendous opportunities for developing countries — but it also carries with it serious risks. I will argue that with the right policies and institutions, the benefits from taking these opportunities vastly outweigh the potential risks and costs. But in establishing these policies and institutions, we must pay very close attention both to the analysis of risks and to the costs of adjustments.

The risks and costs are of different types. Without the right policies and institutions, there can be great volatility with large swings in income. This potential volatility clearly feeds the fears of many people around the world who are challenging globalization. Those fears go beyond concerns over income. Many of those opposed to this growing integration worry about its effects on culture, the environment, disease, movement of people, and crime and violence, as well as loss of control over their lives. Whilst many of these fears and anxieties are understandable, we must recognize that key aspects of globalization are essentially irreversible, particularly those associated with information, ideas, and communications. This irreversibility, together with the magnitude of the potential benefits, surely tell us that the central questions concern how to manage and gain from the process, and not how to reject it.

Today, I would like to take stock of what we know about the impact of globalization — its impact both on developing countries generally and on poverty in particular, since that is the focus of the World Bank's work. In forming the assessment, I will make four points:

- First, globalization is on the whole a positive force for development and poverty reduction, though there are specific measures that the rich countries could take to make globalization much more favorable to development.

- Second, to realize the great potential from globalization, countries need complementary institutions and policies. Among the most important of these policies are those concerning the investment climate, particularly, in the case of India, at the national and state level.

- Third, these institutions and policies can themselves be strengthened through involvement in international markets. This immediately raises issues of sequencing: which kinds of opening to undertake first if one wants to limit the risks associated with globalization.

- Finally, there are specific measures that countries can take to ensure that poor people participate in globalization and benefit from it. Again, in the case of India, state-level policies to improve the investment climate and to empower poor people are critical in determining the level of participation. Such policies can have strong effects on off-farm rural employment and the growth of agriculture as well as on urban opportunities.

1. Globalization, a positive force for development

In defining globalization, I pointed to integration in several dimensions. There are sharp differences between countries in many of these dimensions. For example, countries have embraced (or have been able to embrace) the Internet and open communications to very different degrees: while more than 30 percent of the population in the United States has access to the

Internet, we find that only 1 to 2 percent of the population in the Middle East, North Africa, Latin America, Eastern Europe, and Asia as a whole (as well as India specifically) enjoys the same service. Developing countries — many of which 20 years ago had quite restrictive policies toward foreign trade and investment — have opened up to the global market to quite different extents. These differences across countries provide evidence for the examination of the impact of globalization on development.

Country experiences: India, China, and others

The evidence from the two largest developing countries, India and China, is of particular importance. Both countries have chosen to become much more open to foreign trade and investment in the past two decades. There are other significant examples of countries moving strongly to open their economies that I would highlight: most of the Southeast Asian countries; Argentina and Mexico in South America; Hungary and Poland in Eastern Europe; and Ghana and Uganda in Africa.

Growth rates for these recent globalizers have generally accelerated as they have become more open. This trend is clearest for India and China. These are the two countries with which I have been most involved personally in my research and policy work as a development economist. As you know, taken together, their population comprises more than one-third of the world's total, and more than two-fifths of that of the developing countries.

The growth in China and India's aggregate per capita income has accelerated from roughly 2 percent in the 1970s to 3 percent in the 1980s and 5 percent in the 1990s. This acceleration is all the more remarkable because the growth rates of the rich countries slowed down over this period, from 3 percent to 2.5 percent to 2 percent. Many of the other globalizers have seen their growth rates accelerate as well: Mexico, Uganda, and Vietnam are all examples.

So in the 1990s, for the first time, we had the majority of the population of the developing world living in economies that were growing distinctly faster than the OECD economies — that is, catching up. One of the distinctive features of the developing economies that did well was their greater participation in trade and investment. Conversely, the large number of countries that had poor growth, or decline, in incomes in the 1990s — countries such as Pakistan, Nigeria, and some of the former Soviet Union republics — were not increasing their trade and investment.

The responsibilities of the rich countries and the international community

Clearly, as this evidence shows, integration with the international market can be an effective support to increasing incomes. However, the fact that some countries have had success with this path should not blind us to the possibilities for making the international trade and investment regime much more favorable to development. Let me focus on three ways in which the rich countries, and the international community more generally, could increase the development returns to trade liberalization.

First, you probably know that even after the Uruguay Round of trade liberalization, OECD countries still place significant barriers on trade from developing countries. Although average tariffs in the United States, Canada, European Union, and Japan — the so-called Quad countries — range from only 4.3 percent in Japan to 8.3 percent in Canada, their tariffs and trade barriers remain much higher on many products exported by developing countries. Products with high tariffs in Quad countries include: major agricultural staple food products, such as meat, sugar, and dairy products, where tariff rates frequently exceed 100 percent; fruits and vegetables, such as the bananas that are hit with a 180 percent tariff by the European Union once they exceed quotas; and textiles, clothing, and footwear, where tariff rates are in the 15 to 30 percent range for many products. All these are sectors in which developing countries have a comparative advantage.

For India, the issue of market access is an important one. Some of its most competitive industries, such as textiles and garments, not only face relatively high tariffs but have also been subject to Quantitative Restrictions (QRs). Even the decade-long dismantling of this quota regime (the Agreement on Textiles and Clothing) by 2005 has been back-loaded, so that much of the benefits will accrue to India in the years to come. In agriculture, too, many competitive products such as fish, fruits and vegetables, and milk and meat products face high non-tariff barriers. In more recent times, India has been concerned by the use of product standards such as sanitary and phytosanitary measures, packaging and labeling requirements and certification and testing requirements, which have affected several exports, especially in food-related areas. In the area of services, one of India's major concerns is the free movement of "natural persons," which is a natural counterpart to the free movement of capital. With its very dynamic and educated work force, India could earn even more than it currently does from labor remittances if labor were freer to move. India has also had to suffer anti-dumping investigations, which usually target its most competitive exports, such as textiles. A less frequently cited barrier is also the preferential arrangements that divert trade away from India to less competitive sources.

Our trade experts estimate that tariff and non-tariff barriers imposed by rich countries, together with the agricultural subsidies that they give their farmers, cost developing countries at least $100 billion. And I have to say that this is a very conservative estimate — the number could be much larger. But even taking these numbers we a have a figure which is much more than the $50 billion or so that they receive in foreign aid every year. We at the World Bank see this as one of the most important contributions that developed countries could make for development: to lift, once and for all, the trade barriers and subsidies that prevent developing country products from reaching their markets. It is surely hypocritical of rich countries to encourage poor countries to liberalize trade and to tackle the associated problems of adjustment, whilst at the same time succumbing to powerful groups in their own countries that seek to perpetuate protection of their narrow self-interest. Such protection damages not only the economies of the rich countries themselves, but also those of the poor countries whose development they profess to support. In this context, the "Everything But Arms" initiative approved last month by the European Union — which removes virtually all barriers to exports from the least developed countries — is a welcome first step. It is imperative that the other leading industrialized countries now follow the EU's lead, and that all OECD countries broaden the initiative by ensuring barrier-free access for many more developing countries.

A second area to which I would like to attract your attention is the efforts to introduce different types of standards in the WTO framework — most notably, environmental and labor standards. These standards have the danger of becoming new vehicles for developed-country protectionism. Take child labor. There can surely be no doubting of the importance of children attending school and receiving a good education. Indeed, education is both a central objective for development, an end in itself, and a potent force for raising incomes — which is why it is a key priority in the work of the World Bank. The best way to combat child labor is through investment in education. But if we try instead to tackle the problem through the WTO, there is a real danger that interest groups from wealthy countries will essentially tie up poor countries in court over this issue. The result would be less trade and less development — and, as a result, probably more child labor.

In contrast to the negative approach of trade sanctions, let us look to more positive programs. Parents send young children to work when they are poor and lack other options. Bangladesh has tried to attack the root causes of child labor and poverty traps through a Food-for-Education program, through which poor families that send their children to school are provided food subsidies. This program successfully cut child labor in half in communities where it has been implemented. The District Primary Education Programs recently implemented in India, with support from the development community, including the World Bank, now cover well over 50 million children. Under these programs, India has seen dramatic increases both in attendance of children in school, particularly girls, and in the quality of education. The point is that if we care about child labor, there are constructive programs that we can support. But they require resources. If rich countries are serious about the issue, they should support these programs. Sanctions levied through the WTO are not a productive substitute.

A third area where we can make the global trading regime more pro-development concerns intellectual property rights. At the moment, developing countries participating in the WTO are expected to adopt a standard set of laws on intellectual property protection. But this is an area where I really doubt that "one size fits all." The White Paper on globalization issued last year by the UK included as one of its key recommendations that a New Commission on Intellectual Property Rights should "examine how national intellectual property regimes should be best designed to benefit developing countries and how the international framework of rules might be improved and developed." This is a valuable initiative, and I hope that World Bank research can make a useful contribution to an understanding of these issues and to policy formation. Indeed, we recently hosted a workshop on intellectual property rights that explored how we can ensure that the intellectual property regime works for developing countries — for example, through improving the provisions covering pharmaceuticals and agriculture, as well as strengthening the realization of the return to cultural knowledge in developing countries.

To summarize my first point, then: integrating with the world economy is a powerful vehicle for growth and poverty reduction in developing countries, but it would be still more powerful if the rich countries further increased the openness of their own economies. It is in the interest of developing countries to work to enhance the openness of the trading regime and to participate in the WTO. Looking forward, we should support the active participation of developing countries in setting the agenda for the next round of trade liberalization talks. It must be a development round, with its central focus the market access of poor countries to those of the rich. It must examine all forms of barriers, including anti-dumping and standards. It should also take on intellectual property rights. The World Bank is eager to be a partner in this endeavor: we have oriented much of our trade research over the past several years toward providing developing countries with the data and ideas necessary for effective involvement in the negotiations.

Thus there is much that the world community can do to make the international trading environment more conducive to developing-country growth and poverty reduction. Yet no matter how much we achieve on that front, it will not be enough. We will need to complement those global reforms with measures that help developing countries take advantage of their new access — measures that improve their governance, increase their people's access to education and training, and build their physical and institutional infrastructure. It is this point to which I now turn.

2. <u>Complementary institutions and policies</u>

My second point is that developing countries themselves can take action to ensure that they benefit more strongly from globalization, in particular by building key institutions and policies that can support and complement the expansion of trade.

Opening markets

Before turning to these complementary measures, let me first stress that the developing country's own policies on trade and investment can be damaging to integration and development. It is sometimes tempting to push for market-opening in other countries while protecting domestic industry and services. Such a strategy is more likely to impede development than to spur it. Countries benefit from their own market-opening in many ways. One is technological and managerial: foreign direct investment brings with it innovations in product, process, and organizational technologies, while importation of goods brings embedded technologies and access to lower-cost production inputs and consumer goods. Another benefit is greater efficiency: competition from abroad spurs domestic industry to make productivity improvements, promoting growth and employment over the medium term. It would therefore be a mistake if hypocrisy in the trade policies of rich countries were used by developing countries as an excuse to delay market-opening. Liberalization — if accompanied by appropriate policy and institutional reforms — will help the liberalizing country, notwithstanding the fact that the gains would be still greater if the richer countries reduced their protection. Indeed, one need only look to India's recent history for convincing evidence of the benefits that come from unilateral reductions of high trade barriers.

Build a sound investment climate

Now let me turn to these complementary policies and institutions. Open trade and investment policies will generate little benefit if other institutions and policies are not in place. I like to sum up these other policies in the phrase, "the investment climate." The investment climate is affected by a number of factors: macroeconomic stability; bureaucratic harassment, especially in the administration of regulations and taxes; the strength of financial institutions; the rule of law (including law enforcement) and corruption and crime; the quality of infrastructure, including power and telecommunications; the effectiveness of the government in providing sound regulatory structures for the private sector (including the promotion of competition and regulation of private infrastructure); the effective provision of public services or the framework for such services; and the quality of the labor force. By this last point, I mean not only the level of skills but also the prevailing work culture and the quality of labor relations. If you have an unreliable power supply, no financial depth, lots of harassment from government officials, a high level of corruption, a monopolistic private sector, and a very low skill base, then more open trade and investment policies — beneficial though they are likely to be — are unlikely to generate large increases in productive investment and employment.

The issue of the investment climate is highly relevant for India. It is instructive to look at the World Competitiveness Yearbook to put India in an international context on these matters. This Yearbook ranks 47 countries — the members of the OECD plus 18 emerging market economies — on a range of factors, with rank 1 given to the top performer. Out of the 47 countries, India ranks 43rd overall, while China receives a ranking of 31. While India scores very well on such measures as supply of skilled workers (ranked 12th), those areas identified as particularly in need of reform are key elements of a good investment climate: curbing corruption (ranked 45th), improving the effective implementation of government policies (ranked 42nd) and infrastructure (ranked 47th). These figures are based on the opinions of 3000 executives around the world. These executives should not be taken as the only or even most relevant judges of a country's investment climate — domestic entrepreneurs are at least as important a group — but their views do provide some insight into why India has attracted so little foreign direct investment. In 1998, China received 5 percent of GDP in FDI, Brazil 4 percent, and Mexico 2.5 percent, but India got less than half of 1 percent. Thus, while China's GDP is twice that of India, it received 20 times as much FDI.

Investigating the key determinants of the investment climate, and how to improve it, is one of the important areas where I am trying to expand the research agenda at the World Bank. We have been trying to understand better the investment climate by helping clients systematically survey private firms, focusing especially on small and medium enterprises. It is usually small and medium enterprises that suffer most when the investment climate is hostile — even though it is foreign and large investors whose voices are sometimes heard the loudest. The development experience of some countries of East Asia, notably Japan and China, have shown us the great importance of SME growth in overall economic development; more recently, Poland's experience has reaffirmed the same lesson.

One of our important projects in the research department of the World Bank has been our work with the Confederation of Indian Industries on a survey of 1,000 manufacturing and software firms in ten Indian states. The survey covers ten states across India. One question we asked was for entrepreneurs to identify the best-climate states and to estimate the cost saving from operating in these locations relative to the worst-climate states. I recognize that this is subjective, but it is a starting point for looking at differences in the investment climate. First, we found fairly consistent views. Certain states (such as Maharashtra and AP) were identified as better places to produce, while others (such as UP and West Bengal) were identified as worse. The estimated cost difference between producing in the best and the worst was about 30 percent, which is a very large cost hurdle for the poor-policy states to overcome in trying to attract investment.

A second important finding was that the objective data on productivity match these subjective views quite well: entrepreneurs — even of small firms — are pretty well informed about variations in problems and bottlenecks. So, in the same sector and controlling for size, we find firms in the good-climate states to have about 30 percent more value added per worker than do firms in poor-climate states.

Firms in the good-climate states also have higher total factor productivity, which is basically a measure of how well capital and labor are being combined to produce value. More importantly, we can trace these productivity differences back to specific problems in the investment climate. Some of the poor-climate states have particularly acute problems with the public power grid: in those states, virtually all of the firms we surveyed had their own generators (compared with less than half in the best states). Those firms collectively got only 50 percent of their power from the public grid. Clearly, heavy reliance on generators is a sign of weakness in the investment climate: for small firms in particular, own-power-generation is extremely expensive and capital-intensive. Uncertainty of the power supply has created major costs for these firms.

Another important factor in the investment climate is the regulatory burden imposed by government. Obviously, all countries need to regulate firms in some ways, for example on fire, safety, pollution and monopolistic practices; this happens in every market economy. But the extent and nature of regulation, its efficiency and transparency, and the corruption associated with it all vary across countries. To take one example: we find in the World Business Environment Survey, which covered a large range of countries, that managers report spending about 5 percent of their time dealing with government officials in Latin American countries and about twice that amount in the transitional economies of Eastern Europe, many of which are well known for bureaucracy and corruption. In India, the average reported in the survey was much higher: 16 percent of management time. Within this high overall average, there is substantial variation across Indian states. Our survey reveals that government officials visit firms twice as often in the poor-climate states as in the good-climate states.

Naturally, these discrepancies translate into differences in the rates of investment and growth across states. For our sample of firms, the average real growth rate of sales for the past five years was 9 percent per annum in the good-climate states, compared with only 2 percent in the poor-climate ones. The aggregate growth figures for these states are quite consistent with this pattern. Moreover, the evidence currently available suggests that poverty reduction too has been more rapid in the good-climate states.

In short, then, the investment climate is a key determinant of whether an economy is able to respond dynamically to the opportunities offered by globalization. Within India, some states are responding much more effectively than others. I think that this is a key area for World Bank focus: helping countries analyze and improve their investment climates, so that they attract efficient investment — both domestic and foreign — that produces jobs, higher incomes, and poverty reduction.

Freedom and globalization

While I am on the subject of institutions that complement globalization, I would like to touch on the issue of freedom, both economic and political. There is no doubt that economic freedom is vital to development and poverty reduction. Over the long run, societies in which individuals, households, and firms have the freedom to make key economic decisions that affect their lives have consistently outperformed those in which the government has arrogated those decisions to itself. Economies cannot succeed without reasonably well-functioning governments, as I have already said — indeed, such government is vital to economic freedom. But neither can they succeed if those governments overreach in ways that undermine the incentives for and dynamism of the private sector.

Political freedoms, and democracy more generally, can promote development in several ways. First, they serve as a bulwark protecting economic freedoms: freedoms of speech and assembly make it possible to organize against government decisions that would benefit a minority at the cost of reducing the dynamism of the economy as a whole. Second, as Amartya Sen has emphasized, democracies do not suffer famines: democratic political systems have the information flows and responsiveness necessary to prevent the worst types of economic volatility from occurring. As he noted, it is no accident that India has been able to avoid famine since Independence and the advent of democracy. I do recognize that as we speak a number of states of India are suffering profoundly from natural calamity and drought. Third, there is some evidence that democracies respond and adapt more rapidly to external economic shocks, such as the one that hit East Asia in 1997, because they are able to share the costs of adjustment in a way that is perceived to be more fair. In the same way, democracies may be better able to mediate tradeoffs or conflicts that inevitably occur in development more generally.

This openness is also likely to have an effect on culture, but that effect has a number of dimensions. Some people in a society will value that outside influence on culture, others may not. No economist or technician can decide if the net benefit of openness on poverty reduction outweighs any effects on culture. Let me note here, however, that the vast majority in the UK, including myself, has benefited enormously from the rapid growth in the availability of Indian food over the last decades. Indeed I have it on the highest authority, Amartya Sen, that chicken tikka has replaced fish and chips as the nation's most popular dish. But whatever one's personal views, only democratic participation can make the choice effectively. So, in my view, democratic participation is important for the management of the social and political tensions that will inevitably come with globalization, or indeed with any other social process.

Finally, we should recognize that history tells us that political freedom is highly valued as an end itself, over and above any effect it might have on other dimensions of development. And it is also the message we heard through tens of thousands of interviews with poor people around the world in preparation for last year's World Development Report on Attacking Poverty.

India's long history of political participation, and its more recent emphasis on ensuring economic freedom, equip the country well for meeting the challenges of a globalizing age. Great strides have been made. But if India is to achieve the sustained rapid growth that will make real and lasting inroads into poverty, then, as I think we all recognize, the reforms will have to be deepened and extended.

Management of decentralization

In the context of governance and political freedom, let me say a few words about decentralization. Like many other countries, India is simultaneously decentralizing and globalizing. The two are not incompatible; indeed, in many ways they are complementary. We know from work in other countries that decentralization, and the greater local participation it can generate, can improve accountability and public service delivery: in Central America, increased participation of parents in school management has improved student outcomes. We can see the same forces at work in India in the District Primary Education Program. Decentralization can also allow policy and project experimentation, which can lead to innovations that are then imitated by other states. At the same time, there are risks to decentralization. For example, irresponsible budget decisions by states and localities can add up to macroeconomic instability. Further, tax competition among them can lead to a "race to the bottom" that benefits no one. And finally, decentralization, can exacerbate regional inequalities. Through its effects on the investment climate and poverty, management of decentralization thus influences heavily the degree to which India can benefit from globalization.

India is no stranger to the challenges of a decentralized system, of course. I had the pleasure of participating this past November in the India States Reform Forum, where the discussion and the breadth of the participation were very impressive. I took away from that discussion two major points: that the fiscal problems of the states require both fiscal and governance reforms, and that the center and states must work together to solve these problems. Addressing these points is crucial, because effective decentralized government can both improve the investment climate and empower poor people — the two elements necessary to make globalization more pro-poor.

On the fiscal side, it became clear at the States Forum that something of a pattern is emerging for any state that wants to bring its finances back on track. As a first step, the government should issue a credible report on the true state of the fiscal problem, as a means of rallying the public behind reform. The next step is to develop specific and realistic reform measures to increase revenue and cut expenditure, and to embed these in some sort of medium-term fiscal framework. By this, I mean a projection exercise for, say, a 5-year period that shows how the desired fiscal targets — such as elimination of the revenue deficit, stabilization of debt, and improved composition of expenditure — will be achieved if the right reforms are adopted. This medium-term fiscal framework then becomes the basis for assessing whether the proposed reforms are sufficient or whether more needs to be done, as well as a benchmark against which to assess the budget. Implementing the required fiscal reforms is not easy: the frameworks can be too ambitious and states can lose commitment; and individual reforms can also be very difficult, as in the case of the power sector. But at least for fiscal reforms there seems to be a shared conceptual approach, a clear road map.

One major fiscal area where work seems to be necessary is the institutionalization of these medium-term frameworks. Frameworks that are agreed between a state government and a funding agency can achieve only so much. Other measures are possible: the province of Salta in Argentina has passed its own fiscal discipline legislation, and it may be that the states of India could consider moving in this direction. Fiscal frameworks also need to become more than projections, and in fact be integrated with the budgetary process. If these two things happen – provision of legislative backing and budgetary institutionalization – ownership will increase, and the fiscal frameworks that many states are now developing will become much stronger and longer-lasting sources of fiscal discipline. Indeed, with broad backing and buy-in, they could continue across changes of government and senior administrative officers. The Central Government could usefully provide incentives for the development of a medium-term fiscal framework, for example in the context of Plan discussions.

On the governance side, we have a good idea of what the problems are, as well as a range of possible solutions, but less of a road map than we do for correcting the fiscal side. In the power sector, attempts to improve efficiency within the public sector have failed, and the emerging consensus favors privatization, at least of distribution. But government itself cannot be privatized. How can depleted and over-stretched state governments revitalize themselves? Some ideas are being implemented, but much more research, experimentation, and bold leadership will be required if we are to see what can work.

The importance of moving forward in governance reforms, of moving beyond good ideas towards a feasible sequence of actions, emerged from the States Forum as absolutely critical. The emphasis must be on finding delivery mechanisms, for education, health, rural infrastructure — indeed across the board — that really work for consumers, producers, and farmers. And if this is to happen, the involvement of these consumers, producers, and farmers is crucial. Participation will be a vital and central principle if governance and delivery are to be improved.

The strong development of local institutions is already providing a deepening of participation, even though the degree of decentralization has varied across states and powers. Decentralization of political power to the Panchayati Raj Institutions (PRIs) has been largely successful, at least as measured by participation in elections. But international experience suggests that decentralization is most effective when it is balanced across the political, fiscal, and administrative dimensions. In India, most states have yet to carry out a concomitant decentralization of fiscal or administrative powers. As a result, PRIs lack the capacity to implement the functions assigned to them, reducing their ability to improve service delivery and inspire deeper popular participation.

Finally, with respect to both fiscal and governance reforms, the center and states must work together. Without central government leadership, reform at the state level will not succeed.

We have seen from such cases as Australia and Argentina that some states may embrace reform more than others, but there have been very few examples of a reforming state succeeding when the federation as a whole is not in a reformist mode. I would just add that what is required is not, at least in my view, primarily a matter of fundamental reforms in fiscal federalism. India's system of fiscal federalism is quite healthy by international standards. Of course, existing federal arrangements could always be improved, and I was very interested in the ideas of performance-based center-state transfers raised at the Forum by some participants. But the key challenge lies in replacing populism by deep commitment to development and poverty reduction, and in implementing fiscal and governance reforms at both the state and central levels.

3. **Role of international markets and sequencing**

My third theme is that international markets can be used to strengthen institutions and policies.

The importance of building complementary institutions and policies to reap the benefits from global integration inevitably raises the question, should countries first make sure all their institutions are strong before opening up? The answer is clearly "no".

Developing countries that have done well have taken a step-by-step approach to liberalizing different types of exchange. Let me illustrate the importance of this with the experience of Indonesia, which until 1997 was among the countries that were most successful in reducing poverty over a long period. I think that there is broad agreement now that one factor behind Indonesia's financial crisis was the lethal combination of an open capital account, weak domestic financial institutions, and weak economic governance. We know now, and perhaps should have known before, that this combination can lead to serious problems of currency volatility and banking crises. Russia's experience is another important example of weak institutions combining with an open capital account to cause trouble.

We can think of this as a sequencing issue. Intelligently utilized, the international market for financial, legal, and accounting services can help develop a sound financial sector and better economic governance. Thus, the practical issue is which steps to take first, not integration versus isolation. Trade in financial services is not the same as, and indeed need not be tied to, trade in financial claims. In Indonesia's case, it had restrictive policies concerning the provision by foreign financial institutions of services to domestic firms and consumers. The evidence, however, is that participation of foreign financial institutions strengthens the financial system. On the other hand, in the 1990s Indonesia allowed its weak financial institutions to have easy access to international capital markets. This sequencing turned out to be disastrous.

The rapid growth of trade in services is one of the interesting developments of the past decade. These markets can be used to improve provision of power and telecommunications, accounting services — even customs and tax administration — as well as financial services. By increasing the efficiency and reducing the costs of core business services, openness in these areas feeds directly into improved productivity and competitiveness for other downstream manufactures and services.

What are the implications for India? On the financial-market side, further liberalization remains a priority, in our view. India took great strides taken in the 1990s with its first round of reform: the emergence of new sources of capital has spurred competition and reduced interest spreads, helping make non-financial firms more productive and competitive. Nevertheless, Indian producers continue to pay more for capital than they would if faced with a more competitive financial system. There are further steps that India could take to address this problem: creating better legal and judicial frameworks for loan recoveries, providing better incentives for lending quality, and improving regulation and supervision. Over the longer term, India will likely want to move in the direction of liberalization of the capital account, but it may be sensible to move gradually.

4. <u>A pro-poor globalization</u>

My title today is “Globalization, the investment climate, and poverty reduction,” and the question of poverty has run through, at least implicitly, much of what I have said. But let me turn to it more directly. Do poor people really benefit from this globalization?

Globalization, income inequality, and poverty reduction

One of the most common claims today is that globalization typically leads to growing income inequality within countries, so that its benefits go primarily to the rich. This claim is simply not true. In fact, it is one of the big myths of the anti-globalization movement. Certainly there are important examples, notably China, where opening has gone hand-in-hand with rising inequality, but that has not been a general pattern. In many developing countries, integrating with the international market has coincided with stable inequality or declines in inequality. Examples would be Ghana, Uganda, and Vietnam. Further, in China’s case the rise in inequality has more to do with the establishment of market-oriented incentives in a previously centrally planned economy than it does with China’s opening to international markets.

When trade liberalization is accompanied by stable or declining inequality, the benefits for the poor are powerful. In Vietnam, per capita income of the poor has been rising at about 5 percent per year since the country's opening up began in the early 1990s. The share of the population in poverty [living below a 2000-calorie-per-day poverty line] was cut in half in a decade, from 75 percent in 1988 to 37 percent in 1998. In the case of Vietnam, where we have a particularly good data set for analyzing the effect of reform, we found that of the poorest 5 percent of households in 1992 (at the start of reform), an incredible 98 percent were better off six years later. Here, the link from trade to poverty reduction was very clear. In Vietnam the export of rice has risen strongly, and many of the poor are rice farmers. Also, Vietnam has become a major exporter of garments and footwear, and the jobs created in these expanding sectors pay far more than the factory jobs available before the opening up. Ghana and Uganda are other instructive examples from the low-income world: in each case the incomes of the poor have been rising at 3 or 4 percent per year during their reform. The better prices that farmers get from exporting products such as cocoa and coffee are a key reason why openness has benefited many of the poor in these countries.

Even where inequality has increased, it is still the case that globalization has led to rapid poverty reduction. China is perhaps the best example of this. But the benefits of the globalization for the poor are particularly strong in the cases where inequality is stable or declining, and I will turn in a moment to this important question of how to make globalization and growth pro-poor.

Before I do so, let me say a word about the Indian case. As you know, the uncertainties about recent poverty data, highlighted by the marked divergence between growth rates from the household data and the national accounts data, make it difficult to draw any firm conclusions about what has happened to poverty and inequality here. We are still in the process of trying to understand better the results of the 55th survey round, but our best guess at this point is that poverty continued to decline India in the last five years, with the headcount poverty rate falling by at least 5 percentage points.

Making globalization more pro-poor

While it is important to realize that, even without special measures within countries, globalization as I have defined it above will generally benefit the poor, there is no reason why we should be satisfied with that result. Countries can take steps to make globalization and growth more "pro-poor."

The three most important ways to do this are through basic education, through social protection measures to deal with adjustments, and through ensuring that all regions of a country are connected to the global economy. This last concern is of particular relevance in a vast, diverse country such as India.

First, on education. Basic education is critical to ensuring that everyone can participate and benefit in growth and globalization. Many factors are important for development, but I like to emphasize the combination of a sound investment climate and good basic education, a key element in participation. And they are complementary. A healthy, literate labor force will increase the amount of growth you get from establishing a sound investment climate and will strongly increase the poverty reduction benefit from that growth. Further, we should remember that education is a goal in itself, a dimension of development, above and beyond its effect on raising incomes.

The World Bank has talked about education for a long time, but I would like to see a still stronger focus on this in our work. We know, of course, that problems with education usually go far beyond money, and concern how the delivery of education is organized. As I mentioned earlier, this is an area where communities around the world are innovating. There are many examples of exciting new approaches — often more decentralized with local control and parental involvement. By understanding and learning from these experiences the World Bank can help with the design of innovations, their funding, and — of great importance — evaluation and dissemination of lessons.

Second, in discussing the benefits of openness, I do not want to minimize the problems of adjustment. Much of the benefit of openness comes through more competitive markets. When countries open up particular markets, we often see a common pattern. The Indian machine tool industry is a concrete example. When its protection was reduced in the early 1990s, the first thing that happened was that Taiwanese firms came in and claimed about one-third of the Indian market. That was a boon to firms that needed high-quality machine tools, but obviously created a problem for the large domestic machine tool industry. After nearly a decade of more open policies, several Indian producers have adapted. They have dramatically increased productivity, introduced new products, reclaimed much of the market — and have started to export. The higher productivity and better quality of product is one of the sources of the gains from openness.

But during the adjustment some workers and firm owners lost their employment and their income. This highlights that during the liberalization process there are going to be winners and losers, among the poor and the non-poor alike. To help prevent people from falling into poverty and to smooth this adjustment, it is important to have social protection measures — measures that need to be tailored to country circumstances. The best protection of all is a vibrant and growing economy. Unemployment insurance can be of importance for formal sector workers but, other approaches, such as public work schemes of the Food- or Cash-for-Work variety, are much more likely to reach the truly poor. Good social protection is not just a short-run palliative, but an essential underpinning of a market economy to make it 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.

Governments should provide leadership in the move toward openness. They should encourage people to recognize the long-term benefits of openness rather than just the short-run adjustment costs, because there will always be myopic or vested interests that will oppose reform. But at the same time, governments need to promote and provide social protection to share and minimize these costs of adjustment. Opening up is a political as well as economic process. It can have great benefits but, like most reforms in a democratic system it must be justified by clear and sound arguments. There is no doubt that this requires leadership.

Third, on regional policies. As I noted earlier, a simple statement of how to realize strong benefits from globalization could be expressed as "Create a sound investment climate and education for all." But much of what goes into the investment climate is a local issue — such as local government regulation and the quality of local infrastructure. I used India already as an example of how those factors can vary dramatically across states. Thus, states or districts with weak investment climates tend to become concentrations of poverty, and a key measure, or set of measures, to ensure that poor people benefit from globalization is to strengthen the investment climate throughout the country, rather than just in the highest-capacity (often wealthier) states.

I would like to develop this third point — the importance of state policies on investment climate and empowerment — in some detail, because India provides some of the most convincing evidence in support of it. To anticipate the argument, what we learn is that a positive state-level investment climate has benefits for the informal sectors, which is where the poor often have the best chance of finding employment. Formal-sector employment creates new demand for informal-sector expansion, as well as for more farm output at better prices. Increases in agricultural productivity and farm income in turn generate further off-farm employment opportunities. Off-farm employment is crucial in combating rural poverty and States level policy is vital to its growth.

Research carried out in the World Bank's research department, in collaboration with India's National Council for Applied Economic Research (NCAER), shows that about a third of rural households' income came from non-farm source in 1994. 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 harvest variability.

The relationship between the non-farm rural sector and agriculture has long been studied in India. As far back as the early 1970s, John Mellor described the many forward and backward linkages between these two sectors, and argued that they could combine to create a "virtuous" circle of rural development and poverty reduction. On the one hand, agricultural intensification stimulates demand for non-farm production and distribution of agricultural inputs and services, while also increasing employment in agro-processing activities, and, of course, increasing demand for consumer goods and services that are often produced locally. Equally important are the reverse linkages, those that flow from the non-farm economy to agriculture. Rising non-farm incomes increase the demand for, and prices of, cash crops such as fruit and vegetables. In addition, to the extent that the non-farm sector can provide farm households with a stable source of income, farmers move closer to crop choices that maximize expected profit rather than minimize risk. Arriving at a quantitative assessment of these different linkages is not straightforward, but the evidence suggests they may be large. For example, one estimate made by the International Food Policy Research Institute (IFPRI) for North Arcot district in Tamil Nadu during the 1980s suggests that an increase in agriculture value added of Rs 100 results in nearly Rs 90 additional value added in non-farm goods and services.

But because of barriers facing the poor, the route from non-farm employment to poverty reduction is not always as direct as it could be. Although there is evidence that even the poor sometimes do find employment in the non-farm economy, they more typically lack the assets, particularly the education levels, necessary to gain access to such jobs. The World Bank/NCAER study indicates that the poor often face additional barriers, associated with low social status and low wealth. These findings resonate with our observations for Palanpur, where access to regular non-farm employment depends critically on a network of contacts who can provide information about vacancies and can furnish references. It is generally the higher-status households who have access to such networks. In addition, villagers in Palanpur are often required to pay bribes to gain access to the more attractive non-farm jobs. As a result the poor are generally confined to casual employment in unskilled non-farm activities, or engage in residual, last-resort, self-employment activities. This further emphasizes a theme that has run throughout the paper: improving the investment climate is crucial to poverty reduction, but it is far from the whole story. We also have to empower and invest in poor people if they are to play a full part in the growth process and overcome poverty.

An important lesson that emerges from these findings is that public investments and policies should be geared toward lowering, the barriers to entry of poor people into non-farm employment. Evidence from developing countries around the world suggests that reductions in rural income inequality are greatest when the poor have the capacity — as a result of adequate education, access to infrastructure services, freedom from discrimination, and so on — to participate fully in the opportunities that the non-farm sector offers.

It is of some comfort to note, however, that even when the poor do not yet enjoy strong access to non-farm employment opportunities, investment-climate improvements that expand the non-farm sector can still contribute to poverty reduction. As shown in the World Bank/NCAER study, growth in non-farm employment is often associated with rising agricultural wage rates. The study indicates that this effect is particularly strong in the construction sector, where increases in construction employment lead to a tightening of the agricultural labor market, resulting in higher agricultural wages. A well-known stylized fact about rural poverty in India is that agricultural laborers are highly represented among the rural poor in most parts of the country. With more than 250 million people still employed in agriculture, representing around two-thirds of India's entire labor force, it is clear that an expanding non-farm sector that exerts upward pressure on agricultural wages can play a crucial role in aggregate poverty reduction, even via this indirect route.

In India expansion of the non-farm sector has been steady, with rural non-farm employment shares rising from around 19 percent in the 1970s to around 24 percent in 1997. In Palanpur I have witnessed this process first-hand. While the village economy remains primarily oriented around agriculture, employment in regular and semi-regular non-farm jobs has increased dramatically both in numbers and in range of activities since the 1950s, resulting in a contribution to village income (depending on the quality of the harvest) of more than one third.

This expansion of non-farm employment in India is welcome, but is slower and more uneven than might be hoped. In China, non-farm enterprises have grown at a rapid rate after liberalization policies were introduced in the late 1970s and early 1980s, first in agriculture and then elsewhere. China's annual rate of growth of off-farm employment has been 12 percent, compared to the 2 percent observed in India. To a considerable extent, India's slower progress in this regard can be attributed to the development strategy it has pursued. A large share of total non-farm investment in India has been directed at public works projects, especially during the 1980s. These public works projects often combine the provision of infrastructure with a safety net for the poor in the form of employment provision. Their importance in mitigating poverty has been widely noted. However, sustaining these expenditures during the 1990s has been difficult, in the face of fiscal constraints, and this has resulted in a slowdown of public investment-induced poverty reduction in recent years. Public works projects have also played a role in China, and what has been particularly noteworthy is the extent to which such infrastructure provision has been accompanied by a pro-rural-industry investment climate which has made possible a major expansion of rural non-farm employment. Today, an estimated 31 percent of the rural labor force in China is employed in rural industry, compared to 18 percent in India. Rural enterprises in China have been both a major engine of economic growth and a potent force for rural poverty reduction during the past two decades.

Research undertaken in the World Bank by Martin Ravallion and Gaurav Datt illustrates how these mechanisms fit into an aggregate picture of economic performance across Indian states. They show that from 1960 to 1994, the pace of poverty reduction varied widely across Indian states. The contribution to poverty reduction of farm productivity and development spending did not typically vary much across states, but the impact of non-farm growth did vary markedly. Growth was clearly more pro-poor in states with initially higher farm productivity, a smaller gap between rural and urban living standards, and better education levels. Basic education — which I highlighted earlier — was especially important in explaining why non-farm growth had more impact on poverty in some states than in others. The sectoral composition of growth (notably how much comes from agriculture) is key, especially in states with low human resource development. Let me emphasize: the investment climate (stability and openness, governance, infrastructure) is as important to those investing in their farms and agricultural activities as it is to those investing elsewhere.

Both the contrast with China and the variation among states show that great potential exists in India for state-level improvements, both in the investment climate and in measures to empower the poor, that can translate into further progress in poverty reduction. If India can exploit this potential, there are grounds for expecting India's performance in poverty reduction to at least match that of China.

Conclusion

Globalization has been with us for centuries, and it is here to stay. The communications and information revolution and the capital market changes that made it possible are not going away; nor is the worldwide policy shift toward greater openness and integration likely to be reversed. India has the resources to use globalization as a force for development and poverty reduction, as indeed it has already begun to do. But taking full advantage will depend on improving all the complementary factors we have discussed today. The investment climate — urban and rural, at both the national and state level — is key to achieving sustained poverty reduction. Some states are now responding to the challenge and are beginning to provide an environment characterized by good governance, dependable infrastructure, skilled human resources, and sound financial institutions; in those states, not surprisingly, firms are taking advantage of economic opportunities both here and abroad. As the success of these reforming states becomes increasingly evident, other states are likely to follow their lead. At the same time, there is a challenge throughout India to ensure that poor people are able to participate in growth — that they receive an education, that they have some protection or help during transition, and that they have access to the rural infrastructure and anti-discrimination protection that will allow the growth of non-farm employment. These are tough challenges, but the great progress that I have seen in India over more than twenty-five years as a visitor and friend convinces me that it is well within reach. It is not unrealistic to suggest that India should work to halve poverty rates in the next fifteen years. I believe that this target is attainable if India continues to move forward and follows the policies we have been discussing today.