Equity, institutions, and the development process

chapter 6

Product, land, labor, and capital markets are crucial for the allocation of resources and development. Market institutions, however, exist and function in the context of a whole set of nonmarket and political institutions. The nature of these other institutions—and the way they function—are influenced by inequalities in the political and social realm.

The most obvious of these other institutions are those that define and enforce property rights and contracts. People will not invest if property rights are not well defined and enforced, or if they believe that the contracts they write will not be honored or that courts of law will not be fair. The state must also provide a whole set of other inputs apart from social order and fair contract enforcement. These include various types of public services and regulations. Lying behind well-functioning markets are legal systems, judges, policemen, and, ultimately, social groups and politicians.

This chapter considers the circumstances and processes for creating institutions that promote prosperity. These circumstances are closely related to the concerns of this report. In essence, societies that create institutions to generate sustained prosperity are equitable in important ways. Because talent and ideas are widely distributed in the population, it is crucial that the property of all people is secure and that there is equality before the law for all, not just for some. Predetermined circumstances should not constrain anyone's innovation or investment opportunities. This implies that a good institutional environment will not block entry into new lines of business and that the political system will provide access to services and public goods for all. Institutions must be equitable.

To take an extreme example, institutions were severely inequitable in slave societies, such as Haiti or Barbados in the eighteenth century. Even though property rights in land and people were well defined and even well enforced (although subject to potential slave rebellions), most people had no property rights and were thus subject to expropriation by others, particularly their masters. For 95 percent of society, there were no incentives to engage in socially desirable activities. A similar, although somewhat less extreme, example of inequitable institutions is South Africa under apartheid. Institutions there were good for the whites but left 80 percent of the population without incentives or opportunities to engage in economically productive activities.

The distribution of power and institutional quality: circles vicious and virtuous

How do societies develop equitable nonmarket institutions? First, there must be sufficient political equality—equality in access to the political system and in the distribution of political power, political rights, and influence.

Poor institutions will emerge and persist in societies when power is concentrated in the hands of a narrow group or an elite. Such an elite may grant property rights to itself, but the property rights of most citizens will be unstable. There may be equality before the law for a particular elite group, but not for the majority of people. Government policies may favor such an elite, granting them rents and monopolies, but most people will be excluded from entering profitable lines of business. The education system may invest heavily in the children of such elites, but most will be excluded.

Many things determine the distribution of political power in society—the constitution,

the nature of checks and balances, and the ability of different groups to solve collective action problems. But economic inequality often underpins political inequality. In a society with large inequalities of assets and incomes, the rich will tend to have more influence and an advantage in adapting and distorting institutions to their benefit.

Because the distribution of power, through its impact on institutions, helps to determine the distribution of income, the possibility of vicious and virtuous circles is clear. A society with greater equality of control over assets and incomes will tend to have a more equal distribution of political power. It will therefore tend to have institutions that generate equality of opportunity for the broad mass of citizens. This will tend to spread rewards and incomes widely, thereby reinforcing the initial distribution of incomes. In contrast, a society with greater inequality of assets and incomes will tend to have a less egalitarian distribution of power and worse institutions, which tend to reproduce the initial conditions.

The evidence in this chapter suggests that the first type of society will tend to be more prosperous. We argue that societies prosperous today are so because they have developed more egalitarian distributions of political power, while poor societies often suffer from unbalanced distributions. We also consider how some societies made the transition from one equilibrium to the other.

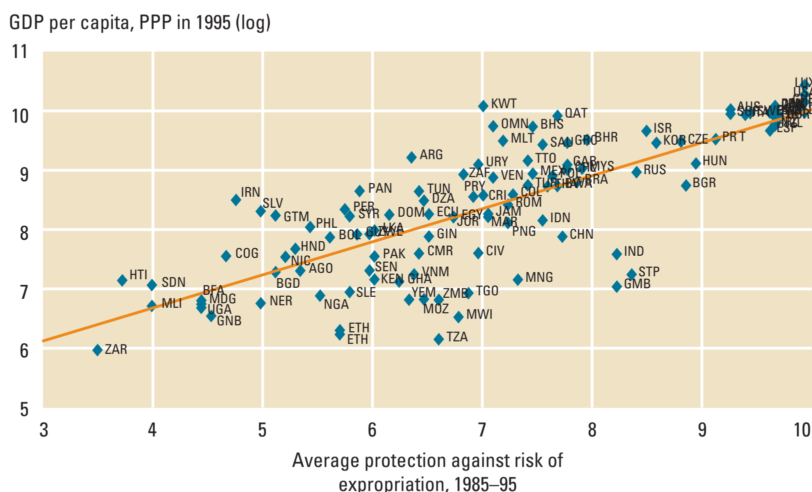
Because institutions have distributional effects, conflict arises naturally. One set of institutions will benefit some people, while another will benefit different people. Thus, there will be incentives for people to control power to create or keep the institutions that benefit them and to avoid or weaken the institutions that disadvantage them. If the groups in conflict are defined along ascriptive lines, such as ethnicity, then this may induce a more severe form of conflict than when groups are defined along other lines, or when there are cross-cutting cleavages. More polarized conflict seems to be an independent force leading to bad institutions that can help to explain the relatively weak performance in some societies (discussed below in a comparison between Guyana and Mauritius).

Political equality also matters for the quality of public policy. The basic role of the state is to provide public services. But politicians have the correct incentives to provide public services only when they have to appeal to the broad mass of citizens to attain power. If they can win power with a small number of key supporters, or with few votes, they will tend to be clientelistic and more inclined to buy votes or make individual exchanges of patronage for support without providing the goods and services critical to raising the mass of people out of poverty.

Some simple patterns in the cross-country data show that more egalitarian distributions of political power and income are associated with sustained and enduring prosperity. Figure 6.1 indicated that more secure property rights are associated with higher incomes. Crucially, however, better institutions and secure property rights are associated with greater political equality.

Although there is no perfect way of measuring political equality, protection against expropriation risk is highly correlated with measures of democracy and measures of "constraints on the executive" from the Polity IV database. This second variable is designed to capture the extent to

Figure 6.1 Countries with more secure property rights have higher average incomes



Sources: Political Risk Services, International Country Risk Guide (ICRG) and World Bank database.
Note: The figure shows the relationship between GDP per capita in 1995 and a measure of the security of property rights, "protection against expropriation risk," averaged over the period 1985 to 1995. The data on institutions come from Political Risk Services, a private company that assesses the risk that investments will be expropriated in different countries. These data, first used by Knack and Keefer (1995) and subsequently by Hall and Jones (1999) and Acemoglu, Johnson, and Robinson (2001, 2002a, 2004), are imperfect as a measure of the relevant institutions because they pertain to investments by foreigners only. Even so, they seem in practice to capture how stable property rights are in general. The findings are robust to using other available measures of related institutions.

which those who control political power are constrained or checked by others. The types of checks and balances and separation of powers written into the U.S. Constitution are classic examples of such constraints. There is a negative correlation between constraints on the executive and the Gini coefficient of income distribution.

The simple correlations suggest complementarities between a relatively egalitarian distribution of political power, good institutions, and prosperity, and a relatively egalitarian distribution of economic resources. The correlations are consistent with many different causal stories, but recent research suggests that one can tell a causal story about this data along exactly the lines we are suggesting, which the rest of this chapter discusses. The different evolutions of banking systems in Mexico and the United States in the nineteenth century provide a good example of the sort of historic argument we rely on (box 6.1).

BOX 6.1 *Banking in the nineteenth century, Mexico and the United States*

Much recent work on growth and development has focused on financial and capital markets. A central issue is to understand why financial systems differ. For example, studies of the development of banking in the United States in the nineteenth century demonstrate a rapid expansion of financial intermediation, which most scholars see as a crucial facilitator of the economy's rapid growth and industrialization. Haber (2001) investigated the development of banks in the nineteenth century in Mexico and the United States. He shows that "Mexico had a series of segmented monopolies that were awarded to a group of insiders" (24). In 1910 "the United States had roughly 25,000 banks and a highly competitive market structure; Mexico had 42 banks, two of which controlled 60 percent of total banking assets, and virtually none of which actually competed with another bank."

Why this huge difference? The relevant technology was certainly widely available, and it is difficult to see why the various types of moral hazard or adverse selection connected with financial intermediation should have limited the expansion of banks in Mexico but not the United States. Indeed, Haber shows when the U.S. Constitution was put into effect in 1789, the structure of U.S. banking looked remarkably like that arising later in Mexico. State governments, stripped of revenues by the Constitution, started banks as a way to generate tax revenues and restricted entry to generate rents. Yet this system did not last because states began competing among themselves for investment and migrants. As Haber (2001) puts it,

> The pressure to hold population and business in the state was reinforced by a second, related, factor: the broadening of the suffrage. By the 1840s, most states had dropped all property and literacy requirements, and by 1850 virtually all states … had done so. The broadening of the suffrage, however, served to undermine the political coalitions that supported restrictions on the number of bank charters. That is, it created a second source of political competition—competition within states over who would hold office and the policies they would enact (10).

The situation was very different in Mexico. After 50 years of endemic political instability, the country became unified under the highly centralized 40-year dictatorship of Porfirio Díaz until the revolution in 1910.

In Haber's argument, political institutions in the United States allocated political power to people who wanted access to credit and loans. As a result, they forced state governments to allow free competitive entry into banking. In Mexico, political institutions were very different. There were no competing federal states, and suffrage was highly restrictive. As a result, the central government granted monopoly rights to banks, which restricted credit to maximize profits. The granting of monopolies turned out to be a rational way for the government to raise revenue and redistribute rents to political supporters (North 1981).

Haber (2001) documents that market regulation was not aimed at solving market failures, and it is precisely during this period that the huge economic gap between the United States and Mexico opened (on which see Coatsworth 1993, Engerman and Sokoloff 1997). Haber and Maurer 2004 examined in detail how the structure of banking influenced the Mexican textile industry between 1880 and 1913. They show that only firms with personal contacts with banks were able to get loans and that such firms were less efficient. Even though economic efficiency was hurt by regulations, those with political power were able to sustain them.

Institutions and political inequality matter for development: historical evidence

Figure 6.1 showed the relationship between security of property and prosperity for the whole world, but to interpret this causally we need to find a source of variation in institutions. Doing this is not easy, but Acemoglu, Johnson, and Robinson (2001) provide a partial answer. They show that the same basic pattern holds for a smaller sample of countries—those colonized by Europeans after 1492. Indeed, colonization of much of the world by Europeans provides something of a large natural experiment.

Beginning in the early fifteenth century and massively intensifying after 1492, Europeans conquered many other nations. Colonization transformed the institutions in many diverse lands conquered or controlled by Europeans. Most important, Europeans created very different sets of institutions in different parts of their global empire, as exemplified most sharply by the contrast between the institutions in the northeast of America and those in the plantation societies of the Caribbean. This experience persuasively establishes the central role of institutions in development. It also provides fairly clear-cut evidence to support our conjectures about the joint evolution of prosperity and political and economic equality.

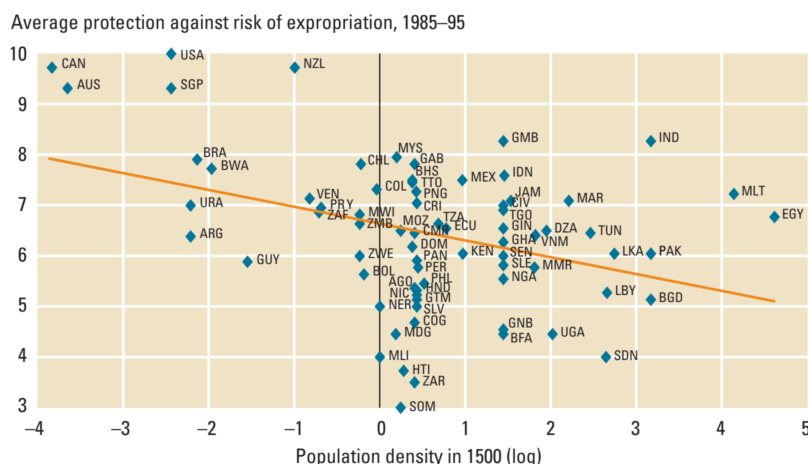
Colonial origins of contemporary institutions

Acemoglu, Johnson, and Robinson, building on the research of Engerman and Sokoloff (1997), explain that Europeans created good institutions in some colonies, particularly the United States, Canada, and Australasia (what

Crosby (1986) calls the neo-Europes), and bad ones in others (particularly in Latin America and Sub-Saharan Africa). These institutions had a strong tendency to persist and thus, today, generate the results seen in figure 6.1.

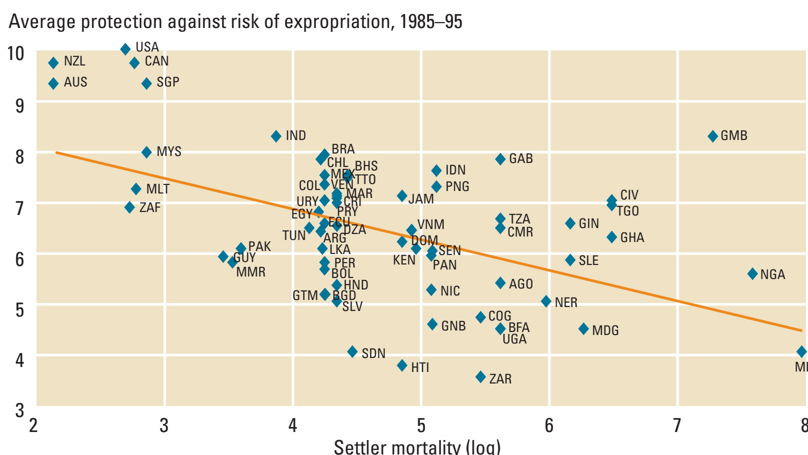
Why did different institutions develop in different European colonies? The simplest answer is that Europeans shaped the institutions in various colonies to benefit themselves. And because conditions and endowments differed among colonies, Europeans consciously created different institutions. There are several important empirical regularities connecting initial conditions to current outcomes. Of particular importance are initial population density, the disease environment, and the factor endowments that influenced economic organization.[1] There is a strong inverse relationship between population density in 1500 and current protection against expropriation risk for former European colonies (figure 6.2). And colonies with disease environments that were worse for European settlers also have worse institutions today (figure 6.3).

Figure 6.2 Low population density in 1500 is associated with a lower risk of expropriation today



Source: Political Risk Services, International Country Risk Guide (ICRG) and Acemoglu, Johnson, and Robinson (2002).

Figure 6.3 Worse environments for European settlers are associated with worse institutions today



Source: Political Risk Services, International Country Risk Guide (ICRG) and Acemoglu, Johnson, and Robinson (2002).

Other aspects of factor endowments are more difficult to measure directly, but Engerman and Sokoloff (1997) point out that where the climate and soils were suitable for crops such as sugarcane—which could be grown on large plantations with slave labor, such as northeastern Brazil—much worse institutions and more skewed distributions of political power evolved than in climates where wheat or other nonplantation crops could be grown.

Why did Europeans introduce better institutions in previously relatively unsettled and healthy areas than in previously densely settled and unhealthy areas? How did factor endowments influence institutions? Europeans were more likely to introduce or maintain bad institutions where there were a lot of resources and rents to extract—gold, silver, and, most important, people to provide the labor. In places with a large indigenous population, Europeans could exploit the population through taxes, tributes, or employment as forced labor in mines or plantations. And where plantation crops could be profitably grown, slave-based societies emerged. These types of colonization were incompatible with institutions providing economic or civil rights or equality of opportunity to the majority of the population. So, a more developed civilization with a denser population structure, and particular climatic and agricultural conditions, made it more profitable for the Europeans to introduce bad institutions.

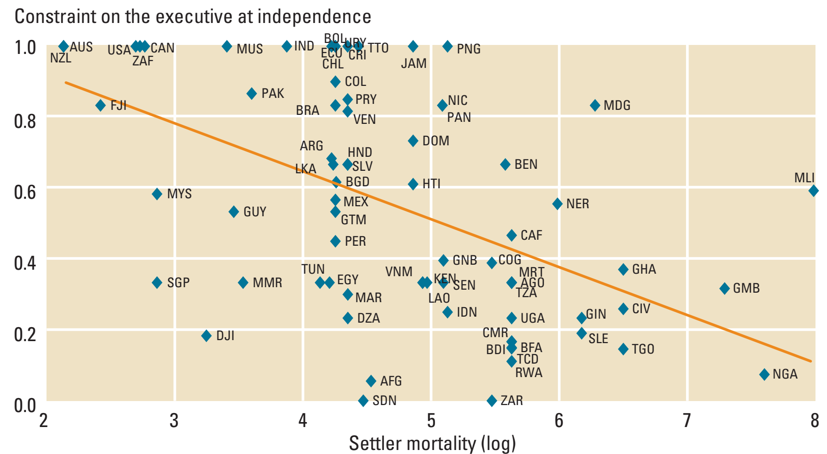
In contrast, in places with little to extract, where plantation agriculture was not profitable, and in sparsely settled places where the Europeans became the majority of the population, it was in their interests to introduce much better institutions. In addition, the disease environments differed markedly among the colonies, with obvious consequences for the attractiveness of European

settlement. When Europeans settled, they established institutions under which they themselves had to live.

This research suggests that most of the gap in per capita income between rich and poor countries today is due to differences in institutions. More precisely, if one takes two typical countries—in the sense that they both lie on the regression line—with high and low expropriation risk, such as Nigeria and Chile, almost the entire difference in income per capita between them can be explained by the differences in the historically shaped measure of the security of property rights.[2] The research also presented regression evidence showing that once the effect of institutions on GDP per capita is properly controlled for, geographic variables—such as latitude, whether or not a country is landlocked, the current disease environment—have no explanatory power for current prosperity.

Different types of societies thus developed in different colonies with radically different implications for subsequent development. Crucially, the societies that emerged in the neo-Europes had distributions of economic resources and political power that were much broader. And they placed constraints on the exercise of political power and the ability of elites to adopt policies favorable to themselves but deleterious for society (figure 6.4).

Figure 6.4 A worse environment for settlers is associated with fewer constraints on the executive at independence



Source: Acemoglu, Johnson, and Robinson (2002a). The analysis indicates that that the same factors that gave rise to good institutions gave rise to a more egalitarian distribution of power. Without some measure of voice, it is impossible for a person's property rights to be guaranteed or for them to have real access to the legal system to make sure that contracts are honored. A more egalitarian distribution of political power is also associated with a more egalitarian distribution of economic resources. To get a better understanding of the mechanisms, we need to look further into historical analysis.

Development and inequality in the Americas: A case study in colonial origins

The colonization of Latin America began with the discovery of the "Indies" by Columbus in 1492, the assault on Mexico by Cortés after 1519, and the conquest of Peru by Pizzaro after 1532. From the beginning, the Spanish were interested in the extraction of gold and silver, and later in taking tribute and raising taxes. The colonial societies that emerged were authoritarian, based on the political power of a small Spanish elite who created a set of institutions to extract wealth from the indigenous population.

After Pizzaro conquered Peru, he imposed institutions to extract rents from the newly conquered Indians. The main such institutions were the *encomienda* (which gave Spanish conquistadors the right to Amerindian labor),[3] the *mita* (a system of forced labor used in the mines), and the *repartimiento* (the forced sale of goods to Indians, typically at highly inflated prices). Pizzaro created 480 *encomenderos,* under whose care the entire Indian population was placed. In other colonies the situation was similar. For instance, in the territory of modern Colombia, there were about 900 *encomenderos.*[4]

The *encomienda* did not last for long in all parts of the empire because the Spanish Crown attempted to curtail it by the end of the sixteenth century. But the *mita* (from the Quechua word *mit'a,* meaning "turn") became a central institution until independence, and forced labor lasted far beyond this in most of Latin America (until 1945 in Guatemala). The effects of the *encomienda* also persisted because the concentration of political power that it was associated with led to the emergence of large landed estates.[5] The feasibility and attraction of this type of economic system was determined by the higher population densities of indigenous people in many parts of the Spanish empire and the extent to which such societies had already developed into "complex societies."[6]

Other institutions were designed to reinforce this system. For instance, indigenous

people were not allowed to give testimony in some cases, and in others the testimony of 10 indigenous people was equal to that of 1 Spaniard.[7] Although indigenous people did use the legal system to challenge aspects of colonial rule, they could not alter the main parameters of the system. In addition, the Spanish Crown created a complex web of mercantilistic policies and monopolies from salt to gunpowder, from tobacco to alcohol and playing cards, to raise revenues for the state.

Spanish colonies that had small populations of Amerindians, such as Costa Rica, Argentina, or Uruguay, seem to have followed different paths of institutional development. The sharp contrasts along many institutional dimensions between Costa Rica and Guatemala (where population density was greater) have been much studied. Although the formal political institutions of the Spanish empire were the same everywhere, the way they functioned depended on the local conditions.[8]

The institutions that emerged in the main Spanish colonies greatly benefited the Spanish crown and the Spanish settler elite, but they did not promote prosperity in Latin America. Most of the population had no property rights, nor incentives to enter socially desirable occupations or to invest. Europeans developed coercive regimes monopolizing military and political power and respecting few constraints on their power (unless imposed by the mother country in Europe).[9]

In North America, the initial attempts at colonization were also based on economic motives. British colonies were founded by such entities as the Virginia Company and the Providence Island Company with the aim of profits. The model was not so different from that of the Spanish or Portuguese (a system that other British colonizing entities, such as the East India Company, used to great effect). Yet these companies made no money. Indeed, both the Virginia Company and the Providence Island Company went bankrupt. Because of the absence of a large indigenous population and complex societies, a colonial model involving the exploitation of indigenous labor and tribute systems was simply not feasible in these places.

Historical accounts show that initial conditions had a large impact on the institutions that the settlers built. Because there was low population density and no way to extract resources from indigenous peoples, early commercial developments had to import British labor. And, relative to much of the colonial world, the disease environment was benign, stimulating settlement. Indeed, the Pilgrim fathers decided to migrate to the United States rather than Guyana because of the high mortality rates in Guyana.[10] But these same conditions made it impossible to profitably exploit labor, whose bargaining power forced elites to extend political rights and create equal access to land and the law. These forces were reinforced by the fact that plantation agriculture and slavery were not profitable, at least in the northern United States and Canada.

These colonies ultimately provided access to land to a broad cross-section of society and the legal system became fairly impartial, ensuring secure property rights for smallholders and potential investors. The new institutions made investment possible through financial development and secure contracting and business relationships. Underpinning these institutions were fairly representative political institutions and a fairly egalitarian distribution of resources. As in Latin America, there was a synergy between economic and political institutions, but this time it was virtuous, not vicious. Institutions giving and protecting property rights for the mass of people and institutions of democratic politics complemented each other, ensuring an environment conducive to investment and economic progress.

Representative political institutions in Virginia were a direct result of the authorities realizing that, because of the different conditions, the colonization strategy that worked in Peru would not work in the United States. Virginia had many competing and fragmented tribes, not a large central tribal empire. It had no gold or silver, and the Indians, not used to paying tribute or engaging in forced labor, would not work. So, the settlers of Jamestown starved.[11] In response to these early failures, the Virginia Company tried various incentive schemes,

BOX 6.2 *Growth with poor institutions does not last*

The elite had good investment opportunities in Argentina in the golden age from the 1870s to the 1920s, in Czarist Russia in the decades leading up to World War I, in Colombia in the half century after 1900, and in the Côte d'Ivoire for the first two decades after independence (Widner 1993). Such situations are rarely sustainable, for three reasons. First, the possibilities for sustained growth are, by definition, limited because institutions exclude the majority of the population from effectively investing. Second, in the rare situations in which elites manage to create arrangements so that they can benefit directly from growth without the need to create good institutions more generally, such arrangements tend to be fragile, vulnerable to shocks or crises. Third, bad institutions create power struggles that undermine growth, because they generate large rents for those who control power.

Consider the growth of Argentina in the half century before 1930. After its independence from Spain in 1816, Argentina plunged into 50 years of civil wars and conflicts over control of the country, mainly clashes between those in control of Buenos Aires and the littoral and those in the interior. These conflicts abated after the 1853 constitution and the presidency of Bartolomé Mitre with a compromise between the Pampas and the interior. Pampean mercantile and agrarian interests would be allowed to create institutions to take advantage of the huge economic opportunities emerging on world markets, but the structure of the political rules, such as their overrepresentation in national political institutions, guaranteed the interior provinces a large slice of the benefits (Samuels and Snyder 2001).

Although the majority was excluded from the political system, the economy boomed with the property rights of the Pampean elite guaranteed. But the huge rents created by this system began to cause conflict. In the 1890s, the Radical Party emerged under Hipólito Yrigoyen, and after a series of revolts it was incorporated into the political system by the democratizing impact of the Sáenz Peña Law in 1912.

Although Yrigoyen was elected president in 1916, the traditional interests were confident that they could keep control of the polity and the economy. They were mistaken. Significant changes in the social structure had occurred, with rapid immigration from Europe, induced by economic success, and the associated urbanization. The vote share of the Conservatives declined rapidly and the prospect of a Radical Party majority was a key factor behind the coup of 1930. Smith (1978) notes "this situation contrasts sharply with that in Sweden and Great Britain . . . where traditional elites continued to dominate systems after the extension of suffrage" (21). From this point onward political conflicts intensified, with a stream of coups and redemocratizations that lasted until 1983. Though among the richest countries in the world in the 1920s, Argentina gradually slid back to being a developing country.

Argentina shows that, even with poor institutions for political inclusion and conflict management, growth is possible if elites have good investment opportunities and can manage to forge compromises. But the booms eventually unravel. Even when elites, such as the agriculturalists of the Argentine Pampas, face very good investment opportunities, growth cannot be sustained forever by agricultural export booms. Moreover, the rents created by bad institutions create conflict without fundamental balances of power in society. This meant that democracy in Argentina after 1912 was unstable. The unchecked power of President Yrigoyen in the 1920s induced a coup in 1930, as did that of Perón in the 1940s and in 1955 and again in 1976 after his return from exile. Although temporary political solutions can sometimes ease conflict for a while, as they did in Argentina after 1853, in the absence of broader institutional inclusion, conflict ultimately reemerges, undermining the incentives to investment.

including a highly punitive, almost penal, effort to make money. Such efforts quickly collapsed, however, and by 1619 the Company had created an unusually representative set of institutions for that era: a general assembly with adult male suffrage.

The early history of the United States shows a possible path to good institutions. Early attempts to create an oligarchic society with close control of labor quickly collapsed. What emerged instead was a relatively egalitarian society, with representative institutions giving even the poorest colonists access to the law and some political representation. This laid the basis for economic and social institutions that underpinned the takeoff of the United States in the nineteenth century and its divergence from the fortunes of much of Latin America. Some countries with weak and unequal institutions have experienced periods of rapid growth, but these have proved to be unsustainable over the long term (box 6.2).

Institutions and political inequality matter for development: contemporary evidence

Our review of comparative history supports two conclusions. First, institutions, especially those that underpin property rights for all and broad-based investment, have a causative influence on long-run development processes. And second, greater political equality can lay the basis for better economic institutions. By greater political equality, we mean, in particular, checks on the predatory behavior of political and economic elites, and the political need for the state to be responsive to middle and poorer population groups. The basis for greater political equalities is often associated with underlying economic structures, although causation can run both ways.

How does this perspective relate to the variety of contemporary development experiences? It is consistent with the perspective

that institutions and governance are central to a wide variety of development performance, from growth to service delivery.[12] While debate continues, an important thrust of this research has been to support the view that causation runs, at least in part, from better institutions to higher incomes, rather than the other way.[13] What is additional to this (ongoing) debate is the second part of the argument—that the nature and management of inequalities in power shapes the formation of institutions. Some cross-country analysis is suggestive: Rodrik (1999a) argues that the capacity of societies to manage adverse shocks—itself a crucial determinant of growth—depends on the depth of latent social conflict and the strength of conflict management mechanisms.

To illustrate the argument, we continue to draw on comparative development experiences. We first look at East Asia, and then look at agricultural pricing polices in Africa. We then examine in greater depth the comparative experience of Mauritius and Guyana, countries that started with similar initial conditions, but then followed radically different development paths. This is also related to different experiences in managing polarization, which can be contributory factors for violent social conflict.

Shared growth in East Asia: the Republic of Korea, Taiwan (China), and Indonesia

Elites may be forced by threats of social disorder to promote the prosperity of most citizens. Indeed, societies that have a political necessity to appeal to or appease middle and lower groups (initially the peasantry) can grow substantially in the short run. Long-run prosperity, however, requires institutionalized, rather than contingent checks and balances on elite power and capacities to adjust to changing circumstances. The response of elites to social disturbances sometimes leads to solutions that permanently change the political equilibrium in a beneficial way, as may have happened with the agrarian reforms in the Republic of Korea and Taiwan, China, in the late 1940s and early 1950s. More often, however, the transitory ability of citizens to act collectively dissipates without elites having to propose anything more than a transitory solution, as may have been the case in Indonesia under the New Order.

The rapid economic development of the Republic of Korea after the mid-1960s was not due to a set of institutions put in place through a domestic balance of political power. Instead, as in Indonesia under the New Order regime, a precarious geopolitical situation, particularly after the rundown of U.S. aid in the early 1960s, induced the Park regime to create a pro-growth environment.[14] This at least led to a contingent commitment to good institutions, as it did under an authoritarian regime in Taiwan, China, where a fairly egalitarian distribution of assets and incomes, perhaps eased the transition in the 1990s toward democracy, a greater equality of political influence, and good institutions. As in much of East Asia, there was a political necessity to deliver income growth and services to the peasantry.

In Indonesia, Suharto's New Order government also recognized that economic growth was necessary to keep the regime in power and that, to achieve this, good economic policies had to be in place. This induced Suharto to delegate macroeconomic policy to technocrats and to respond to the oil booms wisely. It also led him to intervene to attempt to control corruption and excesses that would put in jeopardy the underpinnings of the regime.[15]

Yet this constraint, real though it was, at least in the 1960s and 1970s, is only part of the story about Indonesian growth. Suharto managed to create a system that, while not introducing good institutions, induced investments and growth from which the regime could benefit. One of the secrets behind this appears to have been the role of Sino-Indonesian businessmen, the *cukong* entrepreneurs. Many firms and businesses were controlled by Indonesians of Chinese origin who were very marginal politically. Suharto granted such businessmen monopoly rights and placed members of the military and his supporters on their boards of directors.[16] Rock (2003) argues, "There is little doubt that the . . . distortions in New Order microeconomic policies thwarted competition, rewarded cronies, and encouraged substantial investment in uneco-

nomic projects" (10). Yet they also generated wealth, economic growth, and rents for the regime. It was precisely the political marginality of the *cukong* entrepreneurs that made them an attractive business partner for the regime.

The economic success of Indonesia after 1966 elevated it into the class of an Asian "miracle economy."[17] The East Asia financial crisis in 1997, however, exposed and exacerbated Indonesia's institutional weaknesses, plummeting the country into an economic and political crisis from which it is only now beginning to recover, doing so on the basis of a new foundation of decentralization and democracy, which have progressively institutionalized greater relationships of accountability between citizens and state. (See focus 4 on Indonesia for a further discussion of the relationship between social and political context and policy choices.)

Agricultural pricing policies in Africa

Another important example illustrating the connections between institutions, the distribution of political power and growth comes from the seminal studies of price regulation prices in agricultural markets in Africa by Robert Bates.[18] Bates (1981) demonstrated that poor agricultural performance in Ghana, Nigeria, and Zambia was due to government-controlled marketing boards systematically paying farmers prices much below world levels. The marketing board surpluses were given to the government as a form of taxation. As a result of this pernicious taxation, reaching up to 70 percent of the value of the crop in Ghana in the 1970s, investment in agriculture collapsed, as did the output of cocoa and other crops. In poor countries with a comparative advantage in agriculture, this meant negative rates of economic growth.

Why were resources extracted in this way? Although part of the motivation was to promote industrialization, the main one was to generate resources that could be either expropriated or redistributed to maintain power. As Bates (1981) put it,

> governments face a dilemma: urban unrest, which they cannot successfully eradicate through co-optation or repression, poses a serious challenge to their interests . . . Their response has been to try to appease urban interests not by offering higher money wages but by advocating policies aimed at reducing the cost of living, and in particular the cost of food. Agricultural policy thus becomes a by-product of political relations between governments and urban constituents (33).

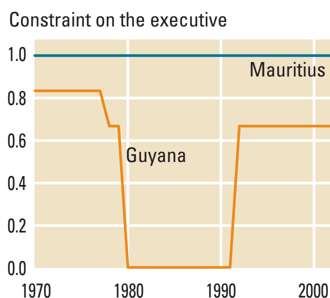
In contrast to the situation in Ghana, Nigeria, and Zambia, Bates (1981), Bates (1989) showed that agricultural policy in Kenya over this period was much more pro-farmer. The difference was due to who controlled the marketing board. In Kenya, farmers were not smallholders, as they were in Ghana, Nigeria, and Zambia, and concentrated landownership made it much easier to act collectively. Moreover, farming was important in the Kikuyu areas, an ethnic group closely related to the ruling political party, the Kenya African National Union (KANU), under Jomo Kenyatta.[19] Farmers in Kenya therefore formed a powerful lobby and were able to guarantee themselves high prices. Even though the government of Kenya engaged in land reform after independence, Bates (1981) argued that—

> 80 percent of the former white highlands were left intact and . . . the government took elaborate measures to preserve the integrity of the large-scale farms . . . [which] readily combine in defense of their interests. One of the most important collective efforts is the Kenya National Farmer's Union (KNFU) . . . The organization . . . is dominated by the large-scale farmers . . . [but] it can be argued that the KNFU helps to create a framework of public policies that provides an economic environment favorable to all farmers (93–4).

Bates concluded that in Kenya "large farmers . . . have secured public policies that are highly favorable by comparison to those in other nations" (95).

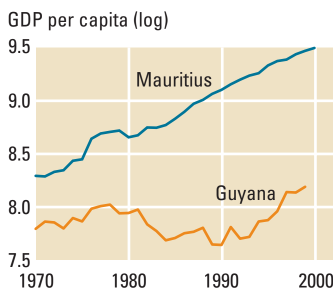
Bates demonstrated why economic policies were better in Kenya than Ghana in the 1960s and 1970s, but this advantage did not survive the coming to power of Daniel arap Moi in Kenya.[20] The change in the ethnic basis of the regime, from Kikuyu to Kalenjin, undermined the coalition that had supported good agricultural policies, because the export farmers were not only large, but

Figure 6.5 Constraints on the executive are greater in Mauritius than in Guyana



Source: Polity IV data set, downloaded from Inter-University Consortium for Political and Social Research. Variable described in Gurr (1997).

Figure 6.6 GDP per capita is rising in Mauritius, not in Guyana



Source: World Bank (2005g).

also predominantly Kikuyu. As a result, economic performance declined precipitously in the 1980s and 1990s. The balance of power that sustained good policies in the 1970s did not endure.

The contrasting experience of Mauritius and Guyana

Mauritius and Guyana, in the 1960s, were both poor societies dominated by the production and export of sugarcane. They had similar histories, factor endowments, social and political cleavages, and institutions. If anything, Guyana, although slightly poorer, had better prospects, because of its proximity to the large U.S. market. Yet Mauritius has become one of the most dynamic and successful (and equal) developing countries, industrializing and maintaining competitive democratic politics. Guyana slumped into dictatorship and poverty.

The divergence between Mauritius and Guyana since independence is a fascinating example of economic and political divergence in apparently similar societies (figures 6.5 and 6.6).

What can explain this? Both countries have similar histories. Mauritius was taken from the French and Guyana from the Dutch during the Napoleonic wars.[21] In the nineteenth century both developed sugarcane economies and, after the abolition of slavery in the British Empire in 1834, imported large numbers of indentured laborers from India. Both have a similar population structure, with Indo-Guyanese and Indo-Mauritians forming the majority of the population with significant minorities of people of African, European, and Chinese descent.

After World War II, both colonies were moved by the British toward independence with early elections for democratic legislative assemblies dominated by pro-independence political parties led by Seewoosagur Ramgoolam in Mauritius and Cheddi Jagan in Guyana. Both groups used extensive socialist rhetoric and proposed land reforms and fairly radical policies. Many of the political struggles with British administrators over postindependence institutions, such as the form of the electoral system, were fought over similar issues. As independence arrived however, political forces re-formed into a situation in which parties led by Indo-Mauritians and Indo-Guyanese faced a coalition of parties supported by the non-Indian population, led by Gaetan Duval in Mauritius and Forbes Burnham in Guyana. Yet, at independence, politics and economics diverged.

The Mauritian Labour Party won power initially and quickly abandoned its radical policies—by the early 1970s, investment in the export processing zone had begun. The political hegemony of the Labour Party was quickly contested by a strong socialist party, the MMM (Mouvement Militant Mauricien) led by Paul Berenger and Dev Virahsawmy. In response, the Labour Party entered a coalition with Duval and his PMSD (Parti Mauricien Social Democrate) and the previous opposition groups. The Labour Party drew back from repressing the new political forces, allowed the MMM to contest the 1976 election, and instead adopted social policies, such as the provision of universal secondary education, to improve its popularity. It also quickly dropped populist macroeconomic policies and, in the late 1970s, implemented a serious stabilization program under the IMF. The final test of Mauritian institutions was the election of an MMM government for the first time in 1982. Once in power, the MMM abandoned its more radical policies, and when the broad political consensus for good institutions became clear, the export processing zone boomed.

The contrast with Guyana is stark. The first election on the eve of independence was won by Burnham and his People's National Party in a coalition against Jagan's People's Progressive Party. Burnham maintained power by increasingly fraudulent means, finally changing the constitution in 1980 to make himself executive president. He assassinated opponents, most famously the radical economist and political activist Walter Rodney in 1980. The economic policies of Burnham's regime were a disaster. He expropriated the sugar plantations, creating highly inefficient state industries, and he aggressively promoted his party members through patronage, particularly in the civil service. The implied or actual threat to property and person led to a huge diaspora of Indo-Guyanese from the country, including most of the professional and middle-class people. Only in the

1990s did a democratized Guyana begin to slowly recover from this legacy. But the ethnic divide endures, and the country continues to suffer from weak governance, a lack of political transparency, and ethnic tensions that hamper economic and social development.

What can explain such divergent outcomes in such apparently similar circumstances? In Guyana, there were fewer constraints on the use of power, and political conflict was more polarized, defined solely along ethnic lines. And although both countries started independence as democracies, what the majority could do (or wanted to do) to the minority was limited in Mauritius, but not in Guyana.

In Mauritius, the British colonial state faced a powerful and homogeneous French planter class that did not leave the island after Mauritius was annexed to Britain in 1812. In the 1870s, when Britain was reducing the autonomy of colonial administrations, it was forced to create a legislative assembly. Although this was initially dominated by the planters, by the turn of the twentieth century the first Indo-Mauritians were elected. This was a clear sign that the greater political autonomy of the island was allowing for a more open society with greater upward mobility of former indentured laborers. The power of the colonial state was checked, evident in the fact that Mauritian independence leaders were able in the 1960s to negotiate postindependence institutions closer to the ones they wanted.

This juxtaposition of different local interests and the weakening of the legacy of the colonial state gave rise to a more balanced distribution of political power in Mauritius. And from this situation more fluid interests emerged. Though ethnic identities were certainly important in politics, so were different cleavages, as is clear from the development of the MMM into a powerful political force and the coalition of Ramgoolam and Duval in the 1970s. Politics became much less polarized than they might have been.

In Guyana, there was no indigenous planter class to check the power of the colonial state. After the departure of the Dutch, the plantations came to be owned by absentee British companies. The authoritarian tendencies of the colonial state were reinforced by British military intervention, promoted in 1953 by the United States, to remove Jagan from power because of his socialist tendencies. Guyanese politicians, unlike those in Mauritius, had far less ability to get what they wanted from the colonial state. This meant that there were fewer indigenous checks on the exercise of power, and unfettered use of political power was the norm. The best example here is the electoral system. Britain imposed a proportional representation system on Guyana because it was afraid that the overrepresentation of large parties inherent in majoritarian systems would allow Jagan to win an absolute majority in the 1964 election (the People's Progressive Party won 42.6 percent of the vote in the 1961 election). This system facilitated Burnham's rise to power.

Although the British tried to do the same thing in Mauritius, political elites there held out and forced a compromise: a system with relatively large electoral districts with the three politicians who got the most votes being elected and with the eight best "losers" from the entire country being elected to parliament. This system maintained elements of the majoritarian institutions that Mauritian leaders believed were essential to maintaining the country's governability. Politics in Guyana became completely defined along ethnic lines. This occurred because the previous evolution of the economy, and the dominant power of colonial interests, left little room for the varied interests that emerged in Mauritius. While Guyana has not suffered outright social conflict, high levels of polarization and weak conflict management institutions can be contributory factors to civil wars (box 6.3).

Implications

In Mauritius, property rights are secure and the country has experienced open democratic politics. There has been intensive investment in education and free access into profitable investment opportunities, illustrated most clearly by the export processing zone. In Guyana, the opposite was true in the 1970s and 1980s. The puzzle is why institutions have been so good in one case and so

BOX 6.3 *Polarization, conflict, and growth*

Researchers have long recognized that deep social divisions make it harder to implement policies that benefit all. Getting a more precise measure of the nature and extent of such divisions, however, has proved problematic. For much of the 1990s, scholars used a measure known as "ethno-linguistic fractionalization"—first compiled by Russian social scientists in the 1960s—to show that economic growth was slower, controlling for other factors, in societies where there was a low probability that two citizens drawn randomly from a population group were of the same ethnic group. Africa's "growth tragedy" was, in part, blamed on its high level of "fractionalization" (Easterly and Levine 1997).

More recent work has sought to refine measures of social diversity by focusing instead on polarization, or the extent to which a small number of influential groups dominate a society, thereby providing a more theoretically informed basis for explaining the relationship between diversity and conflict, and through this channel, economic growth (Esteban and Ray 1994). By this measure, a country with three groups that comprise, respectively, 49 percent, 49 percent and 2 percent of the population will be more polarized than a counterpart country where those same groups comprise 33 percent, 33 percent, and 34 percent of the population. The polarization measure is a far more robust predictor of civil conflict than either measures of the inequality of individual incomes or fragmentation. This statistical association is illustrated by the fact that, by this measure, 9 of the 10 most polarized societies in the world have experienced major civil conflict in the past few decades, including Eritrea, Guatemala, Nigeria, Sierra Leone, and Bosnia and Herzegovina (García-Montalvo and Reynal-Querol forthcoming). This is only one influence on conflict, of course, and other work has emphasized the role of resource dependence and state capacities (see World Bank 2003h).

bad in the other, given such apparently similar histories and circumstances.

But the two cases make sense in more detail. The colonial history of Mauritius diverged from Guyana's in significant ways that allowed the development of a stronger domestic political society. Mauritius resisted the colonial state more effectively and, ultimately, generated a more egalitarian distribution of political power and a less polarized structure of political conflict. In Guyana, however, there was no powerful domestic interest group that had a vested interest in opposing the colonial state or that was able to block the state from expropriating land and other assets after independence. The use of power was unconstrained, and politics were highly polarized along ethnic lines.

Indonesia shows that growth is possible even with underlying bad institutions when elites can credibly make a contingent commitment to improve institutions and when they manage to forge mechanisms that indirectly benefit from encouraging the investment opportunities of others. The acceleration of growth after 1966, and particularly the pro-poor aspect of growth, was clearly driven by the threat of communism and rural social disorder. The spillover from the conflicts of 1965 and 1966 was a redistribution of power toward the rural sector, with sustained, inclusive growth necessary for the political survival of the regime.

Yet the redistribution of power in Indonesia was not institutionalized, unlike what occurred in the Republic of Korea, for example. Moreover, it did not force the New Order Regime to improve institutions outside the rural and education sectors, although the connection between promoting economic development and social order may well have helped the government to sustain its relationship with the *cukong* entrepreneurs. As the constraints on economic policies of the New Order Regime relaxed in the 1990s, it appears to have been more difficult to avoid a massive and debilitating upsurge in corruption and rent-seeking. Moreover, the collusive agreement that the state forged with the Sino-Indonesian entrepreneurs appears to have been very fragile. It rested on shared expectations about the longevity of the relationship, expectations that clearly deteriorated with Suharto's failing health and could not survive the financial crisis in 1997.[22]

Transitions to more equitable institutions

So far we have examined cases illustrating the mechanisms that create good institutions and sustain prosperity. They involve institutions that allow for greater equality of opportunity, and behind such a set of institutions lies a relative balance of economic resources and political power. Such institutions have emerged in some societies but not others. Although systems of institutions often tend to reinforce one another and persist for long periods, they also change. Countries with unequal distributions of resources and political power become more egalitarian and democratic, and previously powerless people gain power and influence. Although institutions are sometimes created by colonialism or military conquest, they can often evolve through good decisions, virtuous paths, and the intrinsic dynamics of the development process, as in Mauritius. It is also possible that even transitory condi-

tional solutions lead to permanent change, because growth unleashes transformations that induce beneficial changes in institutions. This message from modernization theory[23] is precisely what may have happened in the Republic of Korea.

The biggest challenge is to understand processes of change and to distill from them lessons about how poorer societies can undergo beneficial institutional transitions. This does not appear to have happened in Argentina (box 6.2) or Guyana, but it did happen in Britain in the seventeenth, eighteenth, and nineteenth centuries and in Finland, Sweden, Spain, and the Republic of Korea in the twentieth century. It also happened in Mauritius. Here we briefly review three such transitions: early modern Britain, Finland and Sweden in the early twentieth century, and China in the last 20 years. The transitions and policy choices in Spain are discussed in focus 3 on Spain.

Early modern Britain

Around 1500 most European countries were highly hierarchical feudal societies ruled by absolute monarchs whose powers were endowed by God. The most prosperous places, such as the Italian city states of Venice, Genoa and Florence, had escaped feudalism and were ruled by republican governments strongly representing mercantile interests. The Netherlands also escaped intense feudalism and was relatively prosperous, but it was part of the autocratic Habsburg Empire. Nevertheless, the differences in income between the most and the least prosperous places were relatively small. After 1500, this picture began to change rapidly. First the Netherlands and then Britain became much more prosperous than the rest of Europe, and the Mediterranean world went into decline.

As North and Thomas (1973) argued, the most plausible explanation for these changes is the emergence of constitutional government in the Netherlands and Britain: diverging prosperity within the early modern period was tied to the evolution of political institutions.[24] Institutions improved because of a change in the distribution of resources and political power. Indeed, there was a virtuous circle of changes in institutions, the broader distribution of resources and power, and subsequent changes in institutions. These changes included the collapse of feudalism and serfdom and the move to a free labor market, the changes in land distribution, the commercialization of agriculture and the development of interoceanic commerce.[25]

Yet, even after 1688, the political system was at root oligarchic. Further changes were needed in the distribution of power toward greater political equality to sustain Britain's development path and eventually deliver a more egalitarian society. Even though Britain was a constitutional regime, it was a very limited democracy in 1800. Before the first reform act of 1832 set in motion political liberalizations that culminated in full democracy in 1918, fewer than 10 percent of adult males could vote. The reason for these changes seems to have been the effect of early industrialization and urbanization on the ability of the disenfranchised to contest the power of political elites.[26] British democratization in the nineteenth century was the outcome of a series of strategic concessions by political elites to avoid social disorder.[27]

While the political system of the eighteenth century was consistent with individual initiative, invention, and the start of the industrial revolution in Britain, sustained long-run growth called for broad investment, particularly in human capital. Such institutions had to wait for mass democracy to begin to arrive after 1867.[28] However, the longer history of the Poor Laws provide an example of how provisioning for adverse risks was also supportive of greater dynamism (box 6.4)—a theme we return to in chapter 7.

The types of political reforms in nineteenth-century Britain led to economic institutions that clearly influenced the distribution of income, most obviously the promotion of education after 1867. But the same period also saw extensive labor market reforms that strengthened the bargaining power of labor and led to the rise of the Labor Party. After 1906, the Liberal government of Herbert Asquith also began to introduce the basics of a welfare state, further extended by the Labor government after 1945. As Britain began to adopt institutions that promoted prosperity,

BOX 6.4 *Aiding equitable growth in early modern Britain: the role of the Poor Laws*

Far from being a consequence of successful economic growth, recent historical research on seventeenth- and eighteenth-century Britain has found that widespread but unique institutions of social security were in existence for several centuries before the industrial revolution. Indeed, scholars increasingly argue that a previously underestimated influence on Britain's industrial revolution, in fact, lies in its prior agricultural revolution. The principal comparator here is with the immensely advanced Dutch rural and trading economy of the sixteenth and seventeenth centuries. Many of the most important technical innovations in British agriculture during this period, such as land drainage engineering, new crop types, and rotations, were directly borrowed from the Dutch. Yet it was the British agricultural and service economy that was increasingly outpacing the Dutch as the seventeenth and eighteenth centuries progressed. Why?

Attention has recently been given to one major institutional difference between the two countries—the nationwide system of social security created in England by the Poor Laws, which gradually evolved during the course of the sixteenth century, culminating in the famous Elizabethan statutes of 1598 and 1601. This was a Christian humanist response, imbued with a new optimism about what government could and should be able to achieve in the face of perceptions of increased poverty amid plenty in a time of population growth. The Poor Law was mandated by the central state but—most important for its practical effectiveness—its implementation was entirely locally devolved: it was funded by a local tax on property in every parish, administered by local officials but also rigorously enforced by local magistrates. It went side by side with a relatively efficient nationwide population registration system, the Church of England's parish registers, which was instituted in 1538. This placed the English population on an entirely different basis, in terms of social security, from that of the rest of Europe.

The comprehensive social security system provided by the Poor Laws had a number of highly significant economic consequences. In combination with laws (dating from the thirteenth century) granting complete alienability of land, it encouraged labor mobility and reduced the attachment to land holding as the only form of security for peasants. Individuals had a relative certainty of being provided for, wherever they moved to work in the economy, no matter what their property-ownership status. Landlords and farmers could reap the economic gains to be had from increased farm sizes, from enclosure, and from laying off workers or changing their labor contracts to more efficient weekly or day labor, without provoking the same degree of peasant protest as occurred on the continent. But equally, employers in England had a strong incentive only to do this if it made economic sense because, through the Poor Law, they would also have to reckon with their liability to pay for the families of the laid-off workers.

What the Poor Law created in England was a public system of acknowledgment of collective responsibility for the basic subsistence of all, including for a strikingly nonmoralistic approach to the support of single mothers and their illegitimate children. The comparative evidence suggests a relative lack of correspondence in England—alone in all of Europe—between fluctuations in the price of food and the death rate, and England—but not Ireland—was the first nation in the world to cease to experience famine-related mortality.

Sources: Szreter (2005) drawing on Slack (1990), Wrigley (1998), Solar (1997), Solar (1995), King (1997), King (2000), Lees (1998).

it was still a highly unequal society, and inequality almost certainly increased until the early or mid-nineteenth century (figure 6.7). Although precise measures of inequality differ depending on the sources, inequality appears to have risen until the early and perhaps mid-nineteenth century.[29] After about 1870, there is wide consensus that inequality fell substantially for the next century.

The fall in inequality after 1870 is closely correlated with the Second Reform Act of 1867, which was the first reform that really expanded voting rights to working people. When democracy enfranchises the relatively poor, they usually can use democracy to tilt economic institutions and the distribution of income in society in their favor.[30]

Twentieth-century Finland and Sweden[31]

Finland and Sweden are popularly identified as prosperous countries with generous welfare states that, in some measure, are products of a small and ethnically homogenous population. But, a closer reading of their economic histories shows that their contemporary "virtuous circles"—with growth and equity mutually reinforcing—are the outcome of a long and difficult political struggle to establish institutions and enact policies that provide broad economic opportunities and respond to the inherently wrenching social transitions of positive (economic growth, structural change) and negative shocks (macroeconomic crises, civil war).

Finland was part of Sweden in the Middle Ages, but following a war between Russia and Sweden in 1808–09, it became part of the Russian empire. It experienced one of the last European famines in 1867–68, an event that ushered in major demographic and economic changes as entire regions were devastated. The Russian revolution of 1917 led to a collapse of imperial authority in Finland, and the country soon declared its independence. But this immediately gave birth to a bloody civil war between "white guards" (bourgeois nationalists) and "red guards" (socialists loyal to Russia). More than 30,000 troops alone lost their lives.

In the aftermath, however, many progressive reforms laid the foundation for the modern Finnish economy and society. Land reform—a major cause of the civil war—was enacted almost immediately. A law passed in 1918 allowed sharecroppers to buy their land, and amendments in 1922 facilitated the subsidized expansion of small farms. Progressive income and wealth taxation were in place by 1920, soon followed by expansions of women's rights (although universal suffrage in parliamentary elections had been in place since 1906) and commitments by the central

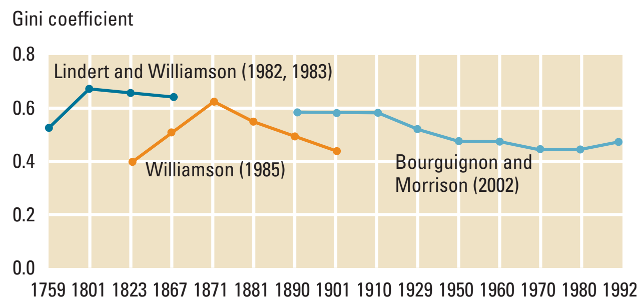
government (not just local municipalities) to primary education.

From the late 1940s until the early 1990s the economy expanded steadily, with per capita incomes catching up with Great Britain in the 1980s and Sweden in the 1990s (from roughly half a century earlier). This success was a product of Asian-style "governed markets": collaboration between the state and private sector was harnessed to rapidly industrialize an economy that, as late as the 1950s, generated 40 percent of its output from agriculture.[32] A crucial counterpart to Finland's activist industrial policy (based on high rates of capital accumulation and public saving, low interest rates on credit, and major investments in manufacturing infrastructure), however, was the construction of a welfare state to cushion citizens of all ages against the unsettling social changes wrought by such a rapid economic transformation.

Strong and credible political leadership was central to making this possible. In the aftermath of World War II, President Urho Kekkoken famously asked his nation, "Do we have the patience to prosper?" Thereafter, he set about negotiating the arrangements ("social corporatism") among industrialists, trade unions, and citizen groups that would enable all to act as complements. The Finnish model has its problems (high unemployment), but it shows how state, market, and society can jointly generate the institutions, policies, and spaces needed to generate equitable development outcomes.

Sweden is perhaps most closely associated with the welfare state today. Less well known is the timing and sequencing of events putting it in place. Importantly, the Swedish welfare state was the product of, not a precursor to, the country's transition to modern economic growth. Indeed, it was designed in response to the very problems (old-age security, unemployment) generated by such growth. But to make such growth possible, and to have in place sociopolitical conditions that would enable the articulation of and sustained support for something like the welfare state (when such a system existed only in rather embryonic forms elsewhere in the capitalist world), it was vital that a prior set of equitable institutional arrangements be in place.

Figure 6.7 Inequality in Britain began to fall around 1870



Sources: Lindert and Williamson (1982), Lindert and Williamson (1983), Williamson (1985), and Bourguignon and Morrisson (2002).

In Sweden, these prior arrangements were unusually favorable to upward mobility by subordinate groups: a long history of peasant autonomy, a correspondingly weak aristocracy, and an emerging nation-state able to secure support from farmers while also repudiating aristocratic claims on its powers. Sweden was also the first country to have a central bank (in 1668) and among the first to grant basic property rights. As such, "inclusion of the peasantry in the transformation of the agrarian economy and institutional arrangements that sustained egalitarianism were to become fundamental elements in the rise of the Swedish industrial market economy."[33] This was an economy increasingly grounded in broad political rights and social opportunities.

But history is not destiny. Equitable development is as much a function of key choices and decisions at pivotal historic junctures. The Middle Ages, the industrial revolution, and the tumultuous twentieth century unleashed sweeping forces on Swedish society. Some were leveling (rising agricultural productivity), others wrenching (mass unemployment). Each attempt to respond to these forces established the political contours for subsequent attempts. Drawing on and extending the equitable institutional foundations during these pivotal historic junctures have been the unifying elements of Sweden's development strategy. Its achievements to date have been remarkable, even as twenty-first-century realities present distinctive challenges to its welfare state.

The main implications of the Finnish and Swedish cases for today's developing countries are that economic growth and sociopolitical equity can be powerfully reinforcing, and can be underpinned by institutional transitions. These cases should not be seen as blueprints for others to follow. Instead, they should be read as examples of how commitments to equity in a given context help lay the foundations for short- and long-term prosperity by consolidating virtuous circles linking institutions and incentives.

China in the late twentieth century

Economic development in China since 1978 has been nothing short of spectacular. With the quadrupling of GDP per capita over the last 25 years, China has transformed itself from a poor centrally planned economy to a lower-middle-income emerging market economy. As a result, the number of people living in poverty (under $1 per day) fell from 634 million in 1981 to 212 million in 2001.[34]

From the perspective of this chapter, what is interesting is that the world's largest country has undergone profound economic transformation without substantially changing the political institutional structure, that remains dominated by the Chinese Communist Party. Yet institutional improvement did take place in China along with economic reform. And the large increase in nonstate investment and free entry into profitable economic opportunities suggest that property rights are secure, despite the absence of a Western-style judicial system.

While the particular institutional form is different from other cases reviewed here, the experience in China is broadly consistent with the thesis of this chapter. The earlier discussion of equitable transitions in Britain and Scandinavian countries illustrated the argument that a successful economic system depends on the political system to assign and enforce property rights and contracts, and to protect the market from political encroachment. China's recent history suggests that the starting point for reforms does not necessarily have to be in political institutions. Changes in economic institutions and in economic relations among levels of government can also establish credible commitment to a reform path and act as a check on the discretionary use of power by the central government. China's experience also demonstrates that what is important for equitable development are credible checks on the arbitrary use of power, assurance of property rights and fair treatment for a broad segment of society. The particular form that institutions take to deliver these functions can vary, especially during periods of transition.

The key to China's equitable development was the combination of initial conditions and the economic reforms launched in 1978 that unleashed entrepreneurial initiative and legitimized the profit motive. China's economic policies following the 1949 revolution proved seriously flawed: they stifled incentives for investment and innovation. But the social policies of the Mao Tse-Tung period leveled the distribution of assets in important and durable ways. As a result, both land and human capital were equitably distributed on the eve of reforms. With the adoption of the rural household responsibility system, peasants became the immediate beneficiaries of reform. This helped to reinforce equity, while unleashing entrepreneurial initiative and boosting productivity.

The economic reforms launched in 1978 aimed at decentralizing economic decisions—to individual farm households, enterprise managers, local governments—so as to generate incentives for investment and innovation. Importantly, the form these policies took and the transitional institutions that were created were designed to preserve the political support for reforms, by compensating potential losers.

The aftermath of the cultural revolution, and the recognition that China's economy had fallen behind—not least in relation to the East Asian Tigers—led to a growing consensus on the need for and urgency of change, and paved the way for the economic reforms initiated under Deng Xiaoping's leadership. These reforms were inspired by the widespread recognition of the failure of central planning as an instrument for economic organization, and reflected the need to deliver on economic growth for the legitimacy of the new leadership. The political need for growth implied a new focus on liberating markets

and incentives. The sequencing of reforms and the transitional institutional arrangements that accompanied the economic decentralization, on the other hand, reflected the premium the leadership placed on social and political stability.

The impetus for economic decentralization on the one hand, and the need for an integrated national market on the other, helped to shape a dynamic relationship between the central government and local governments that held them mutually accountable and limited discretion on both sides. Over time, the result of these policies was to create a stake in new economic institutions for all the main actors, including the local governments which served as a credible check on the powers of the central government in the economic domain. The reforms also fueled the emergence of strong economic centers, such as Guangdong province and the Shanghai municipality. These centers now wield considerable influence and bargaining power relative to the central government and can serve as important countervailing forces.

How did economic decentralization reinforce private incentives? According to Walder and Oi (1999), "For almost 20 years, reform in China has proceeded through the gradual reassignment of specific property rights from higher government agencies to lower government agencies, or from government agencies to enterprises, managers, families, or individuals" (7). All of these reforms enhanced the power of economic agents to make decisions over economic activities in their respective domains, and boosted productivity through better incentives. Farmers retained their earnings and therefore worked harder and invested more. Township and village governments had rights to the profits made by township and village enterprises (TVEs) and therefore adopted policies that promoted business. But because they had no revenue authority, they did not have the ability to bail out poorly performing TVEs, which made for hard budget constraints and higher efficiency.

Higher levels of local governments (country and province) acquired control over local enterprises and therefore also had a stake in their performance. They were allowed to retain more local revenues through fiscal contracting and to have extrabudgetary funds, which generated incentives that focused on collection to provide local public goods that attracted local investments. These changes provided for significant autonomy from the central government and considerable independent authority over their economies.

> The modern Chinese system includes a division of authority between the central and local governments. The latter have primary control over economic matters within their jurisdictions. Critically, there is an important degree of political durability built into the system.[35]

China's reforms are also replete with innovative mechanisms for protecting potential losers during transitional periods. This often involved designing reforms that sustained sources of income for incumbents, by keeping important elements of pre-existing pricing and payment mechanisms, while providing incentives at the margin. "The transitional institutions [were] not created solely for increasing the size of [the] pie, [but also] to reflect the distributional concerns of how the enlarged pie is divided and the political concerns of how the interests of those in power are served."[36]

Dual pricing at the start of reforms is a prime example. The system obliged farmers and enterprises to sell specified quantities to the state at "plan" prices, while allowing them to obtain market prices for any above-quota production. This maintained the planning system for those who benefited from it, while creating incentives for efficient production. Equally important, it allowed time for market institutions to emerge, avoiding the institutional vacuum that plagued many transition economies when state institutions were dismantled. Fiscal contracting guaranteed the central government a certain level of revenues,[37] but it generated incentives for local governments to collect more because the marginal retention rate was much higher. Similarly, labor contracting allowed state workers to retain the guarantee of lifetime employment while introducing greater flexibility in labor policies for new contractual workers. These arrangements made reforms a win-win game, ensuring social stability and the support of those in power.

But there is a danger in such a strategy of incrementalism: getting stuck in incomplete

reforms if local governments and incumbents acquire too much power and are able to block further progress. The prevalence of interprovincial barriers to trade in the 1990s, with each province vying to boost profits for the enterprises it owned, is an example. But there are some checks and balances in the system that help maintain the direction and momentum of reforms. These include competition among local governments, hard budget constraints for local governments, the central government's insistence on enforcing a unitary market, and a growing economy that reduces the economic influence of incumbents.

The struggle for the right balance between economic centralization and decentralization is constantly evident in many of China's domains of intergovernmental relations. The 1994 tax reforms recentralized fiscal revenues, in part to ensure greater regional equity in spending, and the central government continues to apply strict controls on deficit financing by local governments. Constraints on labor mobility have eased considerably over time, helping to create a more unified labor market, despite concerns by some provincial governments that this might aggravate problems of unemployment for established urban residents.

There are also some more recent and more permanent institutional changes that reconfirm the government's commitment to market-oriented reform. These include mechanisms that strengthen accountability at the local level and empower local populations. Local elections are the most important of these mechanisms but others include, for example, recent regulations to eliminate nuisance taxes on the rural population. China has also successfully used the external commitment device of WTO accession to signal its resolve to move ahead with market reforms and impose discipline on incumbents. For example, it is no longer possible for every province to have its own inefficient automobile factory erected behind trade barriers designed to provide local employment and local taxes. More broadly, China's desire to carve for itself an important place in the global order and to be recognized as a responsible global power places constraints on the shape of its future policies.

Qian (2003) notes the following:

> There is apparently a larger room than we thought for institutional innovation to simultaneously address both the economic and political concerns, that is, to make a reform efficiency improving and interest compatible for those in power (305).

But there are many challenges ahead, some of which will not be amenable to win-win solutions and therefore are likely to be politically and socially more costly. Continued reforms in the state enterprise and financial sectors, managing rural-urban migration, and addressing increasing regional disparities (see focus 6 on regional inequality) are some of these challenges. Macroeconomic policy and structural reforms will need to be underpinned by further institutional improvement to ensure broader participation and accountability so that the interests and desire of the people are better reflected in decision making, and to further strengthen the government's capacity to lead market-oriented reform while maintaining economic and social equity.

Conclusion

A few simple principles go a long way toward unifying different development experiences in the historic and the contemporary worlds. There is little disagreement among scholars that basic institutions, such as security of property rights and equality before the law, are keys to prosperity. These institutions lie behind the capital, financial, land, and labor markets that we saw in action in chapter 5. Because talent and ideas are widely distributed in the population, a prosperous modern society requires the mass of people to have incentives—and a state that can and will provide key complementary inputs and public goods. It therefore requires an underlying set of institutions that generate the equality of opportunity for individuals and assure the accountability of politicians to all.

Why do some societies have such institutions and not others? A relatively egalitarian distribution of political power underpins the institutions that promote prosperity. Institutions clearly have distributional effects, and bad institutions often

arise because they benefit some group or elite. Good institutions arise when checks are placed on the power of elites and when the balance of political power becomes more equal in society. Often, equality of political power is supported by economic equality, and this connection gives rise to the possibility of both virtuous and vicious circles.

Growth certainly can occur in societies in which these conditions do not apply. But the preponderance of evidence suggests that such growth is unsustainable. This perspective is consistent with historical narratives, basic patterns in cross-country data, and more careful causal empirical work on the sources of prosperity.

The crucial question for the promotion of development is this: how can poor societies improve their institutions and move onto a dynamic path toward a virtuous circle of equity and prosperity? The organization of society is highly persistent, but we have seen many cases of transitions to better institutions. Sometimes, as in early modern Britain, economic changes lead to changes in the distribution of power, which promotes a more equitable society and better institutions. Contemporary China follows a similar pattern albeit with a different configuration of institutions. In other times, as in the Republic of Korea and Indonesia, regimes are forced, by external or internal threats, to change the trajectory of their society in ways that become institutionalized. In still other times, such as Mauritius and Botswana, leaders make good decisions that lead to reinforcing paths of better institutions and development.

focus 4 on Indonesia

Growth, equity, and poverty reduction in an East Asian giant

Indonesia presents an illuminating example of the long-term interactions of the three basic themes of this report on equity and development:

- The importance of market-driven processes in determining the distribution of opportunities and incomes.
- The role of political processes, and the engagement of the poor in these processes, in determining the policy framework for market and asset accumulation.
- The overriding dominance of institutions in determining the long-run conditions of governance for markets and politics to operate.

These complex interactions require long periods of developmental evolution to observe and identify.

Indonesia has substantial variance across all three of these themes. There is enough independence in the variance for each factor to sort out, if only roughly, what is driving what. In chapter 6, the political dimension of the economic performance of the Suharto regime was discussed. Here, we discuss the connections with policy choices.

Because Indonesia has been so important to the development profession, it has been studied for a long time. The Dutch exploited the Netherlands East Indies from the seventeenth century to early in the twentieth century. Then, under political pressure at home, the Dutch experimented with an "Ethical Policy" for the colony, and the poor benefited significantly. During the Great Depression, World War II, and the fight for Independence, the Indonesian economy deteriorated rapidly, and the poor suffered disproportionately. Java was the original home of the "dual economy" analyzed by Boeke (1946) and formalized by Lewis (1954). After declaring independence in 1945, President Sukarno eventually put "politics in command" in 1959 and produced a ruinous inflation that brought much of the population to near starvation in the mid-1960s. It was with just cause that Gunnar Myrdal pronounced in *Asian Drama,* 1967, that "no economist holds out any hope for Indonesia."

Indonesia's rapid, pro-poor growth for the 30 years after the fall of Sukarno astonished the development profession and, along with other countries in East and Southeast Asia, Indonesia became the object of intense analysis.[1] In Indonesia, the weak starting conditions significantly influenced how the economic planners approached the task of linking growth to the poor. They designed a three-tiered strategy for pro-poor growth, which connected sound macroeconomic policy to market activities that were facilitated by progressively lower transaction costs. Those policies were linked to household decisions about labor supply, agricultural production, and investment in the nontradable economy.

The extent to which the poor benefited from growth depended on the array of assets they controlled: their labor, human capital, social capital, and other forms of capital, including access to credit.[2] Appropriate government policies also influence those dimensions, especially in health and education. The "road to pro-poor growth" started from desperately poor economic conditions, weak institutions, and a decade of political instability. It seemed that everything needed to be done at once. The key was to focus on restarting and then sustaining rapid economic growth, empowering poor households to enter the market economy, and reducing the costs and risks of doing so by investments to lower transaction costs.

The strategy worked for three decades: between 1967 and 1996, income per capita increased by 5 percent a year. The incomes of the bottom quintile of the income distribution, all individuals below the national poverty line until the 1990s and all still subsisting on less than $2 a day, grew at the same rate (or possibly slightly faster). The distribution of household expenditures had been remarkably stable, with the overall Gini coefficient staying within a narrow range between 0.31 and 0.36.[3] Rural inequality had actually declined significantly since the 1970s, when access to land allowed substantial benefits to be reaped from the green revolution. By the mid-1980s, the labor market had become the primary determinant of income in rural areas.

But when the Asian financial crisis hit in 1997 and President Suharto was forced to resign in the face of widespread rioting in 1998, the country was entirely unprepared in political or institutional terms to cope with the rapid changes needed in corporate and public governance. The crisis sharply lowered inequality, as urban real estate and financial markets collapsed. But the dramatic reduction in GDP—over 13 percent in 1998 alone—caused poverty rates to triple. Only after 2002 did poverty rates return to the previous lows observed in 1996. By 2004 they still had not returned to the trend rate of decline disrupted in 1998.

Explaining these trends in per capita incomes and their distribution requires an understanding of how markets, politics, and institutions jointly shaped the rapid, pro-poor growth strategy, its subsequent collapse, and current efforts to revive it. Any such explanation is bound to be controversial, and there is no formal model behind the story about to be told.[4] But the story is plausible and anchored in the historical record.

The story begins with two concerns of the emerging Suharto government in the late 1960s. The first was the misery and discontent of the rural masses, who had supported Sukarno's communist leanings and populist rhetoric. After a decade of active discrimination against their livelihoods,

rural households were near starvation and thus an obvious source of opposition unless the new government could incorporate them in its development plans. Second, the hyperinflation of the mid-1960s, the total disintegration of the market economy, and the political chaos meant the entire population was ready for a more stable life. A strategy that promised stability and rural recovery would win wide support (as it would throughout densely settled East and Southeast Asia).

This is the message that Suharto delivered to his technocrats. This economic team had engaged Suharto and other senior military officials in economic training exercises at the Military College. The technocrats were handed the macroeconomic portfolio and told to deliver on what became known in Indonesia as the development trilogy—growth, equity, and stability. To many in the political and military arena, stability meant repressive measures to stifle dissent, but to the technocrats it meant restraining inflation (which they did in spectacular fashion in just three years) and stabilizing the rice economy, which was still a quarter of GDP and providing half the average Indonesian's daily calories. The institutions built to provide this stability, in both macro terms and in the food economy, became essential to the Suharto regime's success.[5]

Thirty years of rapid economic growth, with equally rapid rates of poverty reduction, was politically popular (the elasticity of reduction of the headcount poverty index with respect to growth in per capita incomes was about 1.3 during the Suharto era). Every five years, the polling results for parliament were gleaned for signs of disappointment with the development program. Despite the heavy hand of Golkar, the president's party, real information was flowing from villages up to the center through these elections.

Almost despite the intentions of the Suharto regime, political institutions were taking root (people expected to vote) and these institutions provided feedback to the policy approach of the government. There were other feedback mechanisms as well, and the ones that threatened stability were taken very seriously. After the 1974 riots in Jakarta in reaction to the visibly widening income distribution, especially in urban areas, the government responded brutally by putting down the riots and imprisoning the student leaders. Then it mounted a serious effort to make the economy more equitable. The result, also stimulated by the world food crisis in 1973–4, was a major shift in priorities toward rural development and a specific push toward increasing domestic rice production. Behind this push were the objectives of stabilization and equity. To lose control of the rice economy was to lose control of what mattered to Indonesian society.

The restructuring of Indonesia's development approach after 1974, especially the preemptive devaluation of the rupiah in 1978, signaled the government's determination to include the poor in the development process. The stability of the Gini coefficient seen from the late 1960s to 2004 should not be taken as the result of market-driven forces in the face of given technology, but as a conscious government effort, led from the macroeconomic arena by the technocrats, to stimulate pro-poor growth.[6] This effort succeeded in spectacular fashion until the mid-1990s, when cronyism and the growing influence of Suharto's children on economic decision making caused the approach to unravel.

Part of the problem of post-Suharto governments has been their need to distance themselves from this record of repression and cronyism, despite three decades of pro-poor growth. This tension brought the failure of political and institutional development during the Suharto era to the fore. Questions about causality remain, particularly whether rapid, pro-poor growth can be implemented by authoritarian regimes. Indonesia's record, along with that of most of East and Southeast Asia, indicates that they can. But is such growth sustainable? And which is more important for managing long-run, pro-poor growth: good economics or good institutions?

In Indonesia, there was no "chicken or egg" problem. Something had to be done at once in view of widespread destitution and political chaos, and the sequencing was clear. Rapid, pro-poor economic growth was imposed by an authoritarian regime concerned about its survival. But this same regime also imposed on itself commitment mechanisms to make the growth process market friendly to rural households and to Chinese capitalists—that is, both ends of the economic system. Inflation was brought under control by a law requiring the national budget be balanced quarter by quarter—a law Suharto basically imposed on himself, but then touted to all constituents as a rule the government had to live under. To build confidence among the Chinese business community, the government opened the capital account in 1970 when it unified the exchange rate. The flow of foreign exchange to and from Singapore and Hong Kong was a sensitive barometer of the investment climate.

Thus the two constraints on the presidency, which Suharto felt personally and used as motivation for his bureaucracy and government (not the same thing in Indonesia), were the need for rural areas to participate in growth, and the need to keep the investment climate highly favorable for Suharto's business partners. The response to both constraints was an economic package—low inflation, food price stability, an open economy, and massive investments in rural infrastructure—that generated rapid pro-poor growth. But another part of the investment climate, a part only for those favored business partners, involved special licenses, trade protection, and lucrative access to domestic markets. This part unraveled the "open economy" part of the growth package.

The Suharto legacy, despite the deep commitment to pro-poor growth, did not build the groundwork for a political and institutional framework that would ultimately support it. A deep tension developed between the institutional framework to keep the open economy functioning efficiently and the political controls to keep the cronies' businesses profitable. Without political feedback about these very same political controls, the regime was blindsided by the ferocity of the opposition to its management of the Asian financial crisis. The depth of the crisis, both economic and political, reflected the vacuum of institutions in place to cope with an alternative political system.

The climb out of the chaos of 1998 mirrors that from the 1965 era, but this time without order imposed from above. The eagerness and skill with which the Indonesian population has participated in the democratic process suggests that social and political order will now be far more sustainable. The challenge now is to translate the same democratic process into rapid and sustainable pro-poor economic growth.

Leveling the economic and political playing fields

PART III

WHAT CAN BE DONE TO INCREASE EQUITY IN THE WORLD? Can this be done in ways that also spur long-term prosperity? We read in part I that there are large inequalities of opportunity between people within countries and—even more—between people in different countries. These inequalities are perpetuated through interlocking economic, political, and sociocultural mechanisms, creating inequality traps. Individuals from different groups and countries face a highly uneven playing field, both in their capacities to acquire endowments and aspire to a better life, and in their opportunities to reap returns from those endowments through market and nonmarket processes. Because differences between countries often exceed within-country differences, it is of particular importance that national policies support, or are at least consistent with, the narrowing of international differences, notably through the growth process.

We argued in part II that many inequalities not only violate people's concern for fairness, but actually have costs for the development process. The effects on development depend on specific forms of inequality and their interactions with market imperfections and institutions. Unequal opportunities are associated with inefficiencies and wasted economic potential. Pronounced inequalities in the distribution of power are often associated with weak economic institutions, undermining the investment and innovation that is central to long-run growth. Greater equity is thus not only intrinsically desirable but also is complementary to long-run growth and prosperity. For poorer and excluded groups, a focus on equity can bring a double benefit—a bigger pie and a greater share.

But the scope for such a complementary relationship between equity and aggregate development is often not exploited. When examining this, we suggest there are two kinds of pathology in policy

design. First, there is the pathology associated with oligarchic dominance—institutions and policies that further the interest of elites but not those of the whole society. This may take the form of extreme predation and high-level corruption, as in Mobutu's Zaire or Haiti under the Duvaliers. Or it may take the form of enmeshed alliances between economic and political elites that favor rent-seeking, as in the Philippines under Marcos, in much of Latin America in past decades, and in more subtle forms in many countries of the world.

Second, there is a more complex pathology of policies pursued with the intent, or in the name, of equity that have high efficiency costs or perverse effects. Communist economic policy was disastrous for efficiency, even while many communist societies did much in social provisioning. Directed credit—in India, for example—was intended for the poor (and reached some of the poor), but proved a high-cost strategy. Populist macropolicy is always bad for growth, and almost always bad for equity sooner or later—witness Argentina during much of the second half of the twentieth century. Perverse or growth-sapping effects of policies under this pathology can be caused by adverse consequences for incentives, unaffordable fiscal burdens, or the capture of the benefits, often by middle groups, which "hoard opportunities" at a cost for other groups and the overall growth process.

What can be done? At a fundamental level, the analysis underscores the centrality of shifting to a state that is more accountable, has checks on predatory behavior of political and economic elites, is responsive to all citizens—especially from middle and poorer groups—and has effective conflict management mechanisms. In part II, we sketched cases of transitions in this direction from history and contemporary experiences, and at the local level. The emphasis in the development community on issues of governance and empowerment is entirely consistent with this perspective.

While such overall shifts are central to development, the World Bank has neither the mandate nor the comparative advantage to discuss specifics of the design of political institutions (even though action to support empowerment of the poor is now emphasized in the design of specific policies—see Narayan 2002). In part III, we focus on a set of areas that do lie squarely in the arena of development analysis and practice—in policies affecting the sectors, markets, and in the global arena. This recognizes the influence of the political and sociocultural context, but focuses rather on what an equity prism, based on the analysis of parts I and II, has to say about the policy design to break inequality traps and support aggregate growth The lesson from part II is that this implies paying attention to *specific* inequalities and their interactions with markets, social structure, and power. This involves both issues of technical design and mechanisms that provide the political underpinnings for change, notably through broader accountability, coalitions for change, or compensation of losers. And while an overarching message is of the potential complementarity between greater equity and long-run prosperity, there will often be tradeoffs in specific areas and context. One cross-cutting area concerns the need to raise taxes to finance desirable public spending. The design of tax instruments is of great importance to minimize adverse efficiency effects, while also promoting equity where feasible.

We organize the discussion of domestic action into three areas. First is building and protecting people's human capacities—from the start of people's lives and through adulthood and old age. Here we focus on equalizing from the bottom up—equalizing up the opportunities of the least advantaged in terms of skills, health, and risk management. There are certainly issues of equity among more advantaged groups, but we give priority to the disadvantaged (in part for reasons of space). As seen in part II, there are major market imperfections in human capital formation and insurance that affect poor or lower-status groups most, yet political action has also often been biased against these groups.

Second is ensuring equitable access to justice and complementary assets. A fair and accessible justice system is crucial for constraining the power of the political and eco-

nomic elite, avoiding discrimination, and protecting property rights and personal safety for all—with important implications for the willingness to invest and innovate. Inequitable access to land and infrastructure—by wealth, location, or social group—is typical of developing societies and often enmeshed with political structures. Policy design can help shifts to more equitable and often more efficient patterns (chapter 8).

Third is the domain of markets—financial, labor, and product—that have a powerful influence on the returns to people's endowments. As chapters 5 and 6 argued, markets are typically far from ideal, working in noncompetitive and discriminatory ways, whether because of intrinsic market imperfections, or because power structures have shaped them to serve the purposes of those in power. In these areas, and notably in the case of finance, a primary concern is equalizing down, by reducing protecting privileges of incumbents. Closely related is the conduct of macroeconomic policy (chapter 9).

In the global arena, concern remains with individuals—and the enormous, unjustified differences in opportunity that people face through the morally irrelevant fact of country of birth. The global playing field between nation-states is uneven—and has uneven effects on different groups within countries. There is substantial scope for making the playing field more even. But as in the domestic arena, policy design involves both technical questions (such as the details of migration arrangements and the application and design of patent legislation) and the political underpinnings of rules and institutions for global governance. We examine the potential for change both in the key global markets—for labor, products, ideas, and capital—and in the potential scope for designing aid in ways that support (rather than undercut) domestic development, and through more effective and equitable management of the global commons (chapter 10).

The epilogue links the report's perspective on equity to the thinking and agreements that have evolved in the development community in the past decade—captured, for example, in the Millennium Declaration (2000) and the Monterrey Consensus (2002)—as well as the World Bank's own strategic pillars of an enabling investment climate and promoting empowerment. We argue that an approach to development that is deeply informed by equity is fundamental to the full integration of these frameworks into an effective development strategy.